



Investing In Real Estate -- Down Under

I just returned from Sydney, Australia and had a wonderful trip; I participated as a speaker in a wealth conference. Even though it was the height of winter, the weather was incredible. The last few days we stayed in an apartment owned by a great friend. He also shared his car, which I proceeded to drive on the wrong side of the road with several cars and trucks heading straight at us at 70 plus kilometers per hour! I had to jump over the (fortunately) soft “kerb” center median, and thereafter my mate and I took a deep sigh of relief. Before proceeding in the correct direction, I looked back at the center median to make sure I did not leave the car’s transmission there.

But I am a real estate bloke and I am always considering real estate investing wherever I go. Which brings me to my friend’s investment in his downtown Sydney apartment. His apartment is well located in the heart of Sydney, is a great one bedroom with “lifts,” and nearby we found a perfect little Italian coffee restaurant on Kent (*Caffe Amici*). He did not also purchase a parking space with this unit; but the building does have a parking garage. I asked him about buying apartment units in downtown Sydney and he related information to me on the current market. He said that an apartment like his would require an investment today of about \$500,000AU, and that typically Australians do not make such purchases with a loan. He told me that his and similar units would rent for about \$500AU per week, furnished, possibly with utilities included. That would be \$26,000AU total annual gross income, not including reimbursement of utility costs, if an investor can get the tenant to pay them, and assuming one would not have any vacancies, which would be rare because I assume vacancies do exist. This rent would be for a furnished apartment, which would also require an initial investment in the furnishings and appliances including a washer and dryer and there would be an expense to maintain, repair and replace these items from time to time. There are also costs like wear and tear of the carpet and the insides. My friend also informed me that most buildings like his would require monthly building costs, probably at least \$300 plus per month. He did not believe he would have to pay taxes for his unit, which was amazing to me, but one should have to pay insurance costs and taxes on their net income, if any.

One benefit I learned about is that tenants of downtown Sydney apartments pay rent on a weekly, not monthly, basis, and almost everyone pays by direct payment from their bank account to the landlord’s account (that’s sweet!). He reported to me that management fees are commonplace and they would usually range between 8 and 10%. I found that Australians do not use credit cards like Americans do; they typically use debit cards or cash for everything. Almost all retailers charge a one to two percent fee on top of the purchase if you use a credit card.

Let's go through the monthly numbers, all estimated by me:

Income	\$2,166
Less vacancy	\$217 (I assumed only 10%; probably not conservative enough)
Less utilities	\$200
Less building costs	\$300+
Less insurance	\$25
Less furnishing	\$25
Less wear and tear	\$25
Less management fees	\$175 (I am using an 8% figure, which may be on the low end)
Net income before tax	$\$1,199 \times 12 = \$14,388$ Annual Net Income Before Taxes
Depreciation Allowance	<u>\$16,363</u>
Reportable Annual Income	-\$1,975

To determine the depreciation, I used 90% of the purchase price, which ratio I believe could be allocated to the building depreciation since the building goes from sidewalk to sidewalk, and I divided it by 27.5 years, the number of years we can use in the United States to depreciate a building. Australia also allows a landlord to take a depreciation allowance, between 2.5% and 4% per year, depending on certain factors. Assuming the 2.5% rate, an investor could use a depreciation number of as much \$12,500 per year under a \$500,000 investment if an investor could use her entire purchase price for the depreciation calculation; hence, she would report some taxable income under that scenario. An investor could also depreciate the furniture, appliances and fixtures over shorter life terms but I have not done this. Remember that each year that an investor takes a depreciation deduction it lowers her basis in the property: therefore, her basis after the first year would be \$483,637 (\$500,000 - \$16,363). If she sells her unit after five years, she has to lower her basis in the property by \$81,815 (5 yrs x \$16,363/year). Therefore, if she sells it for a net (after selling costs, including commissions) sales price of \$525,000, she would report a gain of \$106,815, not just \$25,000.

Calculating an investor's annual return on that investment, and assuming he takes a depreciation allowance and wipes out most of his taxable income, he is making a return of about 2.9% per year, not counting any gain or loss resulting from an eventual sale. Because of the depreciation allowance, much of that income may be sheltered from annual taxes. If inflation is considered, which it should be, the Australian newspaper that I picked up the first day showed that the inflation rate in Australia is about 3.6% per year at this time and is increasing. I also looked up the historical annual inflation rates for Australia and simply eyeballing it starting in 1974 reveals that it has averaged over 2.5% per year; therefore, after taxes and inflation, an investor under the above scenario is at best getting no annual return. This means that he has to rely entirely on the appreciation in value of his investment, which my crystal ball cannot predict. I heard current Australian real estate prices are high and if buying today an investor would be buying in this high priced market. Therefore, in this scenario an investor may have to hold onto the apartment for a long time to recover his investment and to make an adequate return on his investment. On the other hand, if the apartment's rents and value increase at the inflation rate, and assuming an investor can keep the apartment rented, then he should do okay.

I started thinking about our purchases of apartment buildings in the Midwest United States and whether or not we are doing better than an investor purchasing a unit in downtown Sydney. For example, we bought an 86 unit complex for about \$16,000 per unit, which amount includes all the initial negative cash flow during the first approximately nine months after we purchased the property, financing costs, guaranteed preferred return to our investors (we are paying the investors interest on their investment until their investment is returned), substantial renovation costs, and other hard and soft costs over the first 18 months, the period of time it took us to stabilize the property and get it to a nearly constant 100% leased state. Our rents for a typical unit average \$500 per month. Therefore, on a \$16,000 all cash investment per unit we are getting \$500 per month; however, we leveraged (used debt) part of our costs and we are returning all investments by refinancing the property within two years of our acquisition, which we are able to do because of the value we added to the property. Our operating costs, including taxes and insurance now that the property is stabilized, are about 40%, or \$200 per month per unit, so our net operating income is about \$300 per month per unit. I would also assume a vacancy factor of 5% because I know lenders will do that even though we currently have a waiting list of tenants; however, when tenants vacate a unit, it usually takes us several days to clean up a unit. And we are doing more at this time; we are actually remodeling the units to a new standard. Therefore, it takes us about two weeks to turn a unit around.

We actually financed part of our renovation costs, so we leveraged our investment, increasing our return on investment. But let's continue by comparing kangaroos to kangaroos (I'd say kiwis to kiwis, but I think that they are New Zealand fruits and I don't know of a fruit unique to Australia). Here's a table:

ANNUAL NUMBERS

Income or Expense Item	Single Sydney Apartment	Midwest Apartment/Unit
Gross Income	\$26,000	\$6,000
Less: Vacancy	2,600	300
Utilities	2,400	1,200
Building Costs	3,600	1,200
Insurance	300	350
Taxes	-0-	450
Furnishings	300	-0-
Wear and Tear	300	300
Management	2,100	360
Net Annual Income Before Taxes	\$14,400	1,840
Purchase Price/Unit (Investment)	\$500,000	\$16,000
Annual ROI	2.9%	11.5%
Leverage or Debt	-0-	\$7,500
Net Investment/Unit	\$500,000	\$8,500
Debt Annual Costs	-0-	\$340
Net Annual Income After Debt	-0-	\$1,500
Leveraged Annual ROI	2.9%	17.6%

The leveraged return on investment in the Midwest US apartment building assumes the investment has not been returned; in reality, we are in the process of refinancing the complex and through the process we anticipate returning 100% of the investors' funds. Therefore, within two years after our purchase we will have a deal that is 100% leveraged, making our return on investment thereafter INFINITY.

I discovered that it is difficult to find and purchase an apartment complex in Sydney; rather, you buy units within a building. Most apartment buildings there have divided ownership, that is "stratas" as they call it there, which would be like converting an apartment building into condos in the United States. That could explain why investors do not pay real estate taxes; it's possible the strata process is more like our process in the United States of [stock] cooperatives ("co-ops"), which exist usually only in older cities like Los Angeles and New York. Usually with co-ops, the building pays the real property taxes and the individual unit owners are assessed the taxes along with the other building costs.

None of this necessarily implies that every time one buys an apartment in Australia versus buying an apartment complex in the United States that one is automatically getting a better investment in the United States or in purchasing a complex over an individual unit. I believe that my analysis does imply that purchasing multiple units in the form of a complex results in better economies of scale and that the use of leverage increases one's return on investment. While time will tell, possibly the best test for both investments is the ultimate selling price and the timing of selling. I remain believing that one makes his or her money on the purchase.

G'Day Mates!

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