

# Investing by the numbers



How to take the **emotion out** of buying your next investment property and give yourself the greatest opportunity of **maximising** your **long-term profit!**

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# Why invest by the numbers?

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It's easy to get wrapped up in the emotion of buying a property. Often, logic simply flies out the window. People fall for the pleasant views from the kitchen, the charming back patio, the colour of the walls or the polished-wood flooring.

They never fall for the generous tax deductions and low finance costs, the high potential for growth or the low after-tax holding cost.

## Poor investment research can cost you dearly

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For any property that is destined to be an investment, this spells trouble.

Capital growth fails to materialise. Rents are low or the property is vacant for long periods and interest charges begin to bite.

Worse still, sustained losses impair on your ability to buy more property. Without capital growth and the cashflow to go with it, your ability to access further finance is extremely limited.

A poor investment decision can be very costly indeed.

## Do you know how much you can afford?

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The reality is that to give your property investment the best chance of being successful, you must invest by the numbers. You have to do your research and ensure the numbers stack up before you buy the property.

How much can you really afford to outlay per week? What sort of interest rate can you expect to pay, and what would be the effect if it were lower? What sort of growth has the property and the area displayed over the past 20 years and what sort of rental returns might you expect to see? Are recent nearby sale prices a guide to true value?

Having concrete answers to these questions provides a strong guide to whether a particular property will make you money over the long term.

*This process also allows you to analyse the major costs of owning any property, revealing which costs you can most easily minimise to boost your profit.*

## Your step-by-step guide to investing by numbers

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This guide provides a scientific process that will help you determine whether one property will make you more money than another property — or whether you'd simply be better off putting your hard-earned dollars into the bank.

This process also allows you to analyse the major costs of owning any property, revealing which costs you can most easily minimise to boost your profit.

You'll discover that the long-term financial benefits of even miniscule improvements can be dramatic, allowing you to hold more property for a much lower cost (and far better return) than would have been otherwise possible.

Moreover, you'll discover which factors only add a few hundred dollars profit over the long term, and which ones will transform an average-performing property into a spectacular one that delivers tens-of-thousands of dollars more profit than you thought possible.



# Why you need a baseline measure

**Y**ou could just as easily take the money you're thinking about ploughing into a new investment property and invest it in something else. You could invest in shares, superannuation or even a fixed deposit.

As an investor, you need a way to gauge which option is going to be most profitable.

The long-term returns on investing in superannuation offer the best baseline comparison. It's an investment we all have to make for our future, and the level of risk is very similar.

Therefore, if a few hundred dollars a month put toward your superannuation is going to give you a better return than investing the same amount in a property, it's obvious where you should be directing that money.

The good news is that as long as you know the long-term return that superannuation is paying, and the amount you'd be shelling out each month on your property, a simple equation (explained in the box opposite) will reveal your long-term baseline return.

Monthly investment	10-year baseline return
For S = \$600	\$102,265.80
For S = \$800	\$136,354.40
For S = \$1,200	\$204,531.20

Now you have a series of benchmarks to evaluate any property against. This means it's just a matter of analysing the long-term profit from your investment property to obtain a figure that you can compare against the baseline return from investing in superannuation.

<sup>1</sup> For the purposes of simplicity, we've chosen to use the monthly after-tax holding cost (averaged over 10 years) as the best representative of your ongoing investment. This includes the effects of rental income as well as the taxation benefits.

<sup>2</sup> A working paper released in February 2004 by the Australian Prudential Regulation Authority (APRA) reviewing the superannuation investment performance from June 1995 to June 2002 revealed that investment returns net of expenses for all funds averaged 6.68 per cent per annum. Source: <http://www.cfoweb.com.au/stories/20030601/19036.asp>

## How to calculate your baseline return

Financiers and economists have developed a formula for working out the future value (or return) of a regularly paid investment that pays a fixed interest rate. This formula is:

$$R = S [(1 + i)^n - 1] / i$$

Where:

**R = Total return**

**S = Sum invested each month**

**i = interest rate per month**

**n = number of compounding periods**

Your monthly investment is simple: it's the after-tax monthly holding cost of your property.<sup>1</sup>

If you have a property picked already, there are programs that will calculate this figure for the property that you have in mind. Even if you don't, you should have a good idea of what after-tax outgoings you can sustain while holding your investment.

It's then a matter of plugging in the average rate of return you could expect from investing that money in superannuation.

Recent research by the Australian Prudential Regulation Authority reveals that the long-term return on superannuation in the seven years to June 2002 was 6.68% per annum for all funds.<sup>2</sup>

Assuming monthly compounding of interest, and a return of 6.68% per annum (or 0.0056% per month), it's a matter of plugging in the figures to calculate the future return on investment of this nature over a 10-year period (or 120 monthly compounding periods):

$$R = S \times [(1 + 0.0056)^{120} - 1] / 0.0056$$

$$R = S \times 170.443$$

From this it's very simple to calculate the baseline return for differing investment amounts.

# Determining your long-term return on property

It's possible to estimate the net profit across the same 10-year period on any property using the following basic formula:

**Net investment profit =**

- Resale value**
- loan payout**
- (capital gains tax+ solicitor fees+ sales commission)**
- 10 year total after-tax holding cost**

Naturally, your eventual return depends on factors such as: capital growth, inflation, the starting property value, loan size, rental yield and interest rate.

## The need for expert research

But using the expertise of property market researchers, you should be able to find reliable information on capital gain, likely rent and vacancy rates for property in any area that you're interested in.

With this information, it's then a matter of performing an investment analysis on the potential profitability of your property.

As long as the net return from a property is higher than the return from your baseline investment, the initial numbers stack up on the investment.



*... you can boil everything down to a single figure — expected net profit.*

## A basis for comparing different properties

Of course, that's not where you want to stop. The objective is to maximise your investment return.

That's why this method also provides a way to objectively compare the performance of different properties against each other in a way that doesn't resort to trying to pin a dollar value on non-quantifiable features such as room sizes, views or even the location. Instead you can boil everything down to a single figure — expected net profit.

**Table 1: Analysis Starting Values**

	Property One	Property Two
Value	\$350,000	\$350,000
Loan Amount	\$364,510	\$364,510
Interest Rate	7.35%	7.35%
Capital Growth	5%	7%
Rental Income	\$300	\$250
Vacancy rate	3%	2%
Inflation	3%	3%
Depreciation <sup>3</sup>	2.5%	2.5%
Annual Income	\$70,000	\$70,000

<sup>3</sup> Depreciation allowances vary depending on the age and type of your property. For the purposes of this example, we have assumed that both properties are new, and that the depreciation allowances will therefore be the same.



Table 2: Investment Analysis Summary		
	Property One	Property Two
<b>Resale value</b>	<b>\$570,113</b>	<b>\$688,503</b>
<b>LESS</b>		
Loan Amount	\$364,510	\$364,510
Capital gains tax	\$60,656	\$88,433
Solicitor fees	\$2,851	\$3,443
Sales commission	\$16,173	\$19,429
10 year total after-tax holding cost	\$41,801	\$56,620
Av. monthly cost	\$348	\$471
<b>Subtotal costs</b>	<b>\$485,991</b>	<b>\$532,435</b>
<b>Forecast net profit</b>	<b>\$84,122</b>	<b>\$156,068</b>
<b>Baseline comparison</b>	<b>\$59,314</b>	<b>\$80,278</b>

Let's take the example in Table 1. As an investor, you've narrowed your options down to two properties in different suburbs. Your research has revealed that Property Two is likely to have better capital growth, but Property One is likely to yield a better rental return.

But which is the better investment? Will the capital gains tax impact on your profit from Property Two be minimal, or will the increased rental yield on Property One decrease your holding cost enough to make it a better investment?

As Table 2 reveals, the analysis proves that both of these properties surpass the return on superannuation. However, despite the higher holding cost, Property Two significantly out-returns property one on the basis of the investment analysis.

Therefore, assuming your research was good and assuming you can afford the higher holding cost, your investment decision would most likely be to choose Property Two.

# Maximising your returns on your chosen investment

**Y**et, irrespective of the property you choose, your aim is always to maximise your investment return.

Research that gives you the best chance of strong capital growth is only one side of the equation.

The other side is cost driven. All too often, though, investors neglect to consider how they can slash their ongoing investment cost.

This is shortsighted. The reality is that after-tax holding cost (or serviceability) is the largest constraint on the amount and quality of investment property that you can hold.

## Minimising costs boosts net profit

And the more quality property you can hold over the long-term, the larger the net profit you'll walk away with in the long run — just the same as the more money you invest in superannuation, the larger absolute return you'll enjoy.

In fact, reducing your holding cost increases your profit comparative to the baseline, because a minimised holding cost means a proportionately smaller opportunity cost. As a result, your profit from the property increases because your total overall holding cost is much smaller.

For all these reasons, it makes sense to keep your holding cost as low as possible.

*... investors neglect to consider how they can slash their ongoing investment cost.*

## Major influences on your holding cost

Many factors affect your holding cost, but some have a greater impact than others. Some of these factors are totally beyond your control while others you can influence through the right finance structure or careful property selection.

## Finance costs

Finance costs are possibly the biggest influence on holding cost.

- 1. Interest rate:** Interest payments constitute a huge part of your outgoings when you buy an investment property. In fact, without the necessity of paying interest, most properties would be cash-flow positive.

As the Table 3 reveals, with our example property a half-a-percent increase in interest rate can slash your profit over a 10-year period by more than \$10,000. What's more, another half percent hike slashes yet another \$10,000 from your net profit!

**Table 3: Profit impact of interest rates changes**

	7% interest	7.5% interest	8.0% interest
<b>Resale value</b>	<b>\$668,053</b>	<b>\$668,053</b>	<b>\$668,053</b>
<b>LESS</b>			
Total sale costs	\$475,815	\$475,815	\$475,815
10 year total after-tax holding cost	\$48,798	\$59,983	\$71,284
Av. monthly cost	\$406	\$499	\$594
<b>Subtotal costs</b>	<b>\$524,613</b>	<b>\$535,798</b>	<b>\$547,099</b>
<b>Forecast net profit</b>	<b>\$163,890</b>	<b>\$152,705</b>	<b>\$141,404</b>
<b>Baseline comparison</b>	<b>\$69,199</b>	<b>\$85,051</b>	<b>\$101,243</b>

*In this example, it rapidly becomes obvious that decreasing interest rates (obtained through better finance arrangements) can very quickly turn an underperforming investment into an extremely profitable investment choice.*

## 2. Principal and interest versus the interest-only loan:

The repayments on a principal and interest loan are generally much higher than those on an interest-only loan, even though P&I loans tend to have a more generous interest rate. Although you make a greater equity gain, as you can see, this is usually outweighed by the vastly increased holding cost.

**Table 4: Profit impact of a principal and interest loan versus interest only**

	P&I loan	I-O loan
<b>Resale value</b>	<b>\$688,503</b>	<b>\$688,503</b>
<b>LESS</b>		
Total sales costs	\$400,711	\$475,815
10 year total after-tax holding cost	\$118,123	\$56,593
Av. monthly cost	\$984	\$471
<b>Subtotal costs</b>	<b>\$518,834</b>	<b>\$532,408</b>
<b>Forecast net profit</b>	<b>\$169,668</b>	<b>\$156,095</b>
<b>Baseline comparison</b>	<b>\$167,715</b>	<b>\$80,278</b>

*In this example, the large monthly outlays associated with a P&I loan mean that you're almost better off investing in superannuation. On the example property, you'd be much better off with an interest-only loan.*

**3. Fixed or variable:** Choosing between a fixed or a variable interest rate is invariably a trade off. Home buyers usually have to ask themselves whether they prefer the predictable monthly payments of a fixed-rate mortgage, or are they more comfortable accepting lower initial payments in exchange for facing the risk of a future rate hike that may bump up repayments significantly over time and add to your holding costs.

If you have a very tight cash flow, you may not want to bank on the unpredictability of variable rates.

**... maximising your rental yield is an important way to decrease your overall holding cost and increase your long-term profit.**

**4. Duration:** A shorter loan duration — say, 20 years instead of 30 — will incur a higher weekly payment. This again impacts on your holding cost, and can make cashflow issues prominent and reduce the value of the property you can safely hold.

**5. Bank charges:** Loan establishment fees and ongoing account charges, as well as early exit charges, can impact on your overall holding cost. It's important to take these into account because their presence can at times tip the scales in favour of another loan package with a higher rate that doesn't have them.

## Rental yield

A strong rental yield offsets the costs of holding your property. As a result, maximising your yield — either through minimising the vacancy rate or maximising your weekly rental income — is an important way to decrease your overall holding cost and increase your long-term profit.

**1. Vacancy rate:** The longer your apartment stands empty each year, the more money you lose. Doing research to ensure you choose a high-quality property in an area with employment opportunities, infrastructure and population growth means you'll rarely have a shortage of tenants.

Even then, keeping a property well maintained and securing tenants on long-term leases can reduce your vacancy rate even more. Yet, the analysis in Table 5 reveals that the effect of an increasing vacancy rate is quite minor in its impact on your net profit.

**Table 5: Profit impact of a changing vacancy rate**

	2% vacancy rate	3% vacancy rate	5% vacancy rate
<b>Resale value</b>	<b>\$688,503</b>	<b>\$688,503</b>	<b>\$688,503</b>
<b>LESS</b>			
Total sale costs	\$475,815	\$475,815	\$475,815
10 year total after-tax holding cost	\$56,620	\$57,435	\$59,113
Av. monthly cost	\$471	\$478	\$492
<b>Subtotal costs</b>	<b>\$532,435</b>	<b>\$533,250</b>	<b>\$534,928</b>
<b>Forecast net profit</b>	<b>\$156,068</b>	<b>\$155,253</b>	<b>\$153,575</b>
<b>Baseline comparison</b>	<b>\$80,278</b>	<b>\$81,471</b>	<b>\$83,857</b>

Compared to the effect of a changing interest rate, the effect of an increased vacancy rate on your investment property is very small. A 3% increase in vacancy rate only skims \$2,493 off your forecast net profit over a 10-year period.

- Rental income:** The weekly rent you can charge your tenants is also vital to maximising your long-term net profit. Again, choosing a property in an area with employment opportunities, infrastructure and population growth means there will be plenty of demand for housing. And if your property is well maintained and has a high quality of fixtures, you'll be able to charge more.

And, as the figures in Table 6 illustrate, having to accept a lower rent on your property has a significant impact on net profit over a 10-year period.



**Table 6: Profit impact of varying rents**

	\$250 per week rent	\$300 per week rent	\$350 per week rent
<b>Resale value</b>	<b>\$688,503</b>	<b>\$688,503</b>	<b>\$688,503</b>
<b>LESS</b>			
Total sale costs	\$475,815	\$475,815	\$475,815
10 year total after-tax holding cost	\$50,301	\$40,819	\$25,388
Av. monthly cost	\$419	\$340	\$211
<b>Subtotal costs</b>	<b>\$526,116</b>	<b>\$516,634</b>	<b>\$501,203</b>
<b>Forecast net profit</b>	<b>\$162,387</b>	<b>\$171,869</b>	<b>\$187,300</b>
<b>Baseline comparison</b>	<b>\$71,415</b>	<b>\$57,950</b>	<b>\$65,963</b>

*Like interest rates charges, the rent you can charge has a significant effect on the amount of profit you can generate over and above your baseline comparison.*

**Any shortfall between rental income and loan payments, rates, insurance, maintenance and letting fees are 100% tax deductible in that financial year.**

## Tax deductions

Any shortfall between rental income and loan payments, rates, insurance, maintenance and letting fees are 100% tax deductible in that financial year.

For high-income earners in particular, tax deductions can make a very large difference to the after-tax holding cost of your property investment. In effect, you use a tax loss on your property to get the taxman to subsidise part of your investment.

- Single income versus joint income:** If you're a high-income earner, you'll probably choose single income rather than joint income, simply because at the highest tax brackets, you get a more tax back (48.5 cents in every dollar invested). If you have a smaller annual taxable income, it may make more sense to split it across yourself and your partner's income to maximise your tax benefits.

- Varying depreciation allowances:** Taxation laws allow you to claim a depreciation deduction as a percentage of the amount paid for the physical building on the property as well as fixtures, fittings and furniture. Naturally, the newer the property, the more it's worth, so the more depreciation you can claim. As the property ages, your depreciation claim tails off. Older properties, therefore, have negligible depreciation deductions.

If you have a high income, depreciation deductions will help you reduce your ongoing holding cost. However, you should be aware that when an asset is sold and produces a capital gain, the depreciation you've claimed is re-included for capital gains tax purposes. Therefore, for the purposes of property investment, depreciation is only a deferment of tax.

# John and Mary run the numbers

John and Mary wanted to purchase an investment property. After some research, they narrow their options down to two different properties in two different locations — a brand-new \$500,000 two-bedroom apartment in the Brisbane CBD or a 25-year-old recently renovated \$750,000 three-bedroom house with river views in the Brisbane suburb of Bulimba. They can afford an after-tax holding cost of anything up to \$1,500 per month.

Their research into each area (as shown in Table 7) indicated that the Bulimba house would give them a better long-term capital gain, but they knew the rental yield would be smaller. Moreover, because of the age of the house, John and Mary felt they would get a smaller depreciation tax deduction, as compared to the brand-new apartment.

**Table 7: John and Mary's property options**

	Property One	Property Two
Value	\$500,000	\$750,000
Loan Amount	\$520,834	\$780,800
Interest Rate	7.35%	7.35%
Capital Growth	5.1%	10.0%
Rental Income	\$380	\$380
Vacancy rate	3%	2%
Inflation	3%	3%
Depreciation	2.5%	2.5%
Annual Income	\$80,000	\$80,000

**Table 8: John and Mary's Investment Analysis Summary**

	Property One	Property Two
<b>Resale value</b>	<b>\$822,237</b>	<b>\$1,945,000</b>
<b>LESS</b>		
Loan payout	\$520,384	\$780,800
Capital gains tax	\$90,866	\$293,416
Solicitor fees	\$4,111	\$9,727
Sales commission	\$23,107	\$53,911
10 year total after-tax holding cost	\$62,734	\$179,700
Av. monthly cost	\$522	\$1,497
<b>Subtotal costs</b>	<b>\$701,202</b>	<b>\$1,317,544</b>
<b>Forecast net profit</b>	<b>\$121,035</b>	<b>\$627,446</b>
<b>Baseline comparison</b>	<b>\$88,971</b>	<b>\$255,153</b>

To work out whether the properties would be a viable investment — and which property would provide the best return — John and Mary decided to run the numbers.

As Table 8 reveals, although both properties compare favourably against the superannuation baseline, John and Mary are far better off investing in the three-bedroom house in Bulimba. Despite the higher holding cost, the forecast net profit is significantly larger — more than five times larger, in fact.

# The Next Step

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**E**ven this brief analysis reveals finance and investment structures that minimise your after-tax holding cost are a huge part of successful property investment.

Finance costs in particular are a major factor in your overall holding cost. A small improvement in the interest rate you're paying has a significant impact on the affordability and profitability of your property.

This is where Access One can help.

## Run the numbers on your next investment property!

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Our free Investment Forecast Report uses a three-pronged approach to put your property under the investment microscope and help you determine the potential costs — and returns — of any property.

- **First, a FREE Property Report** into nearby housing sales that reveals what similar properties in the area are worth and whether you're likely to get the capital growth you were expecting. It also reveals previous rental yields, using this data to make short and long-term growth predictions.
- **Then a FREE Mortgage Comparison Report** analyses more than 30 different lenders. If you already have a loan, it reveals whether you're paying too much in interest, and recommends a specific loan package that will give you the lowest total cost (and maximum profit) over the life of your mortgage.
- **And a FREE Property Investment Analysis** delves into the likely performance of a property or properties, revealing your indicative weekly holding cost, rental yield and possible tax savings, as well comparing the likely net profit you could expect to see in the long term.

If you already own an investment property, we can reveal thousands of dollars in potential finance savings that could transform your property from a good performer into a real star!

Or, if you've just begun to consider investing in property, we can help you pin down exactly how much you can afford to pay — and the performance characteristics you need from a property to stay within those parameters.

## Ensure you're not buying a lemon

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Either way, this free report can reveal hidden flaws that could turn your investment into a financial nightmare over the medium and long term.

If you attempted to source this information yourself, you'd pay hundreds of dollars. A Property Location Report itself is worth \$65! But because of our size, we're able to offer you this all for free!

Ultimately, we'd like to source your mortgage. But there's absolutely no obligation, and unlike the rubbery statistics real estate agents and property marketers use to flog you property, an Access One Investment Forecast Report is totally impartial.

Because the lender pays us, our only interest is ensuring that your property is financially viable and provides you the best return possible. It also means our service to you is totally free of charge!

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