



“No money down” strategies - *what the banks really think!*

Property investment “experts” emphasise building a property portfolio quickly using ‘no money down’ strategies. These strategies often involve purchasing property below fair market value and/or undertaking minor or cosmetic improvements to create instant equity and then using that equity to purchase the next property or pay for 100% of the current property. A couple of examples of these strategies include:

- Buy below market value and commission a valuation (using one of the bank’s valuers) and the bank will lend against this valuation and not sales price.
- Purchase a property, negotiate a long settlement and by the time settlement comes around the property’s value would have increased and the bank will lend on the increased value.

Many people walk away from these seminars thinking that it all sounds good on paper but do banks really do that? If so, which ones?

These property investment strategies throw up a number of lending issues. Sometimes these seminars can create more questions than answers. I discuss some of these issues below after canvassing the opinions of a substantial number of lenders and using my own experience as a mortgage broker.

Purchasing Under Fair Market Value

Many ‘no money down’ strategies include buying property below fair

market value and then lending against the fair market value (and not the sales price) of the property.

Consider this example:

Purchase price:	\$80,000
Fair Market Value:	\$100,000

If you borrow 80% of fair market value you can pay for 100% of the property using debt (ignoring costs such as stamp duty). Sounds good on paper, right?

Fair Market Value

Does contract price equal fair market value? The banks generally regard the purchase price as the most compelling evidence as to the fair market value of the property. At the end of the day, a purchase price is generally determined after a sales process involving a knowledgeable, willing buyer and a seller at arms length under no compulsion to buy or sell - being the definition of fair market value.

So what circumstances would give rise to price not equalling fair market value? Price will not equal market value where the purchaser has either paid too much or the vendor has sold for too little. A purchaser may pay more than fair market value where they perceive a special value to exist. That is, in their eyes the property is worth more than market value (e.g. perhaps the purchaser has an emotional attachment to the property). A vendor may sell for less than fair market value where they are under a compulsion to

sell and/or they do not appreciate the fair market value of the property (i.e. an un-knowledgeable seller). That’s why most property investment experts tell how to buy property under market value by finding out more about why the vendor is selling. Is the vendor an elderly person that has not read the property section of the newspaper for 30 years and has no idea what their property is worth? Or does the vendor need to sell quickly because they are leaving the country?

There are two steps in demonstrating to the banks that the price paid for a property is less than fair market value:

1. Demonstrate why the property was sold at a discount (i.e. why you think the price paid for the property does not represent fair market value); and
2. Provide evidence of fair market value (e.g. through analysis of recent comparable sales). It is extremely important to investigate comparable sales to ensure the purchaser and vendor were willing, knowledgeable and under no compulsion to buy or sell.

But what do the banks think?

Most banks will only lend against the contract price or valuation whichever is the lower. In fact, very few of the 15 lenders that I spoke with will consider lending against the valuation of a property where the value is greater than the sales price. I note a couple of points to consider:

- Some lenders will lend on valuation (and not contract price) where an

extraordinary long settlement period (e.g. in excess of 12 months) exists. A good example is where an investor has purchased off the plan today but does not have to settle until the property is built in 12 months time.

- Some lenders will lend against valuation where the sale of property may not be at arms length (e.g. sale of property from parents to children).

- It is unclear how the structure of the Contract of Sale may affect the lender's opinion. What if the contract of sale is structured in such a way that the sales price is \$100,000 but the purchaser only ever has to pay \$80,000. For example, the Contract of Sale states the sale price to be \$100,000 with \$80,000 payable on settlement (transfer of title occurs at this time) and the remaining \$20,000 payable only if and when the purchaser nominates. If the purchaser does not nominate to pay the additional \$20,000 in 6 months from the date of settlement then the debt expires and is no longer payable. Therefore in reality the only amount payable by the purchaser is \$80,000. This example is a bit convoluted but you get my drift.

- Generally, a lender will not solely rely on a valuation that has been commissioned by the borrower. The bank will prefer to instruct its own panel valuer. Therefore, obtaining your own valuation will not guarantee that the bank will lend against that value.

So some banks do lend against valuation

Whilst there are some banks that do lend against valuation it is very likely that the bank will commission its own valuation from its panel of valuers.

What can you do to increase the chances of getting a valuation in excess of the purchase price?

You may like to submit evidence and research with your loan application and request the bank pass it on to its valuers. Whether the bank provides this information to the valuers and whether the valuers use this information is totally up to them. There is no iron clad way of ensuring the bank lends against your value.

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The most persuasive evidence that you could submit is an independent

valuation. This valuation should address recent comparable sales, discuss the merits of this transaction (i.e. why the valuer does not consider it to represent fair market value), and any other relevant information. It is worth taking some time to interview valuers to obtain a full understanding of their experience in valuing similar properties and the likelihood of them considering information supplied by you.

"Generally, the evidence needs to be absolutely overwhelming for a valuer to conclude that the sales price of a property does not equal fair market value" says Peter Hutchins, Director of property consulting firm, Charter Keck Cramer. In my experience, only in rare circumstances does a purchaser truly purchase materially below fair market value Mr Hutchins said. Valuations are normally stated in a range due to the inherent uncertainties associated with all types of valuations.



Are there any alternatives?

If the bank will not lend against valuation at purchase the next best thing is to lend against valuation after settlement. Most banks do not impose any restrictions as to how long after settlement you can renegotiate your loan. Therefore one strategy is to instruct the bank to perform a valuation immediately after settlement. The bank will then lend against that valuation. However there are two main issues you need to consider:

1. You need to consider how the valuer will treat the most recent transaction, i.e. your purchase. As discussed above you need to ensure there is enough evidence for the valuer to conclude that your purchase is not a comparable transaction and therefore is not accurate indication of fair market value.

2. Consider the cost of renegotiating. Make sure your finance broker selects a

product that is going to minimise these costs. Undertaking such a renegotiation may give rise to application fees and possible break (or early repayment) fees. Some professional packages allow one free renegotiation per year.

What else you must know about building a property portfolio

Portfolio Property Mix Affects Borrowing Capacity

When planning and evaluating property purchases it is important to evaluate how they will affect your borrowing capacity. Most of us have finite incomes and therefore a maximum borrowing capacity. However you may be able to increase your borrowing capacity by structuring your property purchases in a certain way.

When assessing an investment property, the banks will compare the property's income (being rental income) with its expenses (being the interest expense). The banks are conservative and as such will reduce the income and increase expenses when undertaking its analysis. Most banks only take into account 80% of the expected gross rental. The 20% representing an allowance for the costs associated with managing and maintaining the property and to allow for any tenancy vacancy. In terms of expenses, the banks will assess the repayment amount at an interest rate equal to the standard variable interest rate plus 2% (e.g. if the standard variable interest rate is 6.57% then the bank will assume principal and interest repayments at an interest rate of 8.57%). The banks will generally use the standard variable rate regardless of the product you elect to use. Lenders normally assume principal and interest repayments in its lending analysis even if you have elected an interest only term. This is because at some stage during the term of the loan you will have to repay the loan (assuming you don't sell the property).

Consider an example* where two properties for \$100,000 each are purchased at two different yields. The purchasers borrow 80% of the property value.

	Scenario 1	Scenario 2
Rental Yield	5%	10%
Rental Income @ 80%	\$4,000	\$8,000
P&I Repayments @ 6.57% + 2%	\$7,430	\$7,430
Assessed surplus/ (deficit)	(\$3,430)	\$570

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Under Scenario 1 the applicant would need to satisfy that it had a regular income stream (such as a PAYG income) to finance the assessed deficit of \$3,430. Under Scenario 2 the borrower would not have to prove any other income to qualify for the loan. This analysis assumes that the borrowers have other incomes to adequately cover all personal expenses and other financial commitments.

Scenario 1 would 'eat into' or reduce ones borrowing capacity whereas Scenario 2 would actually have the effect of increasing ones borrowing capacity. The break even yield is 7.43%. That is, purchasing an investment property with a yield of 7.43% would not affect ones borrowing capacity (while standard variable interest rates remain at 6.57%). In theory a borrower could purchase an infinite number of properties as long as the yield is 7.43% or above. For every 1% increase in interest rates property yields have to increase by approximately 0.7% to maintain this equilibrium. Naturally, in practice, an investor may not be able to purchase an infinite number of properties due to limited funds available for deposits and inability to manage interest rate exposures.

Taking into account how the bank assesses lending may be a very important element when planning property portfolio purchases. For example, you may choose to purchase a combination of high and low yield properties to maximise your borrowing capacity.

How Quickly Can You Accumulate Properties?

Everyone wants to get rich quick! If you have 2 properties you want 4. When you have 4 you want 8. But are there any lending issues to consider when building a substantial property portfolio in a short timeframe?

First and foremost you need to consider the risks associated with having a substantial property portfolio, namely interest rate exposure and experience.

There are a number of ways to manage your interest rate exposure including:

- Fixing the interest rate on a portion of your debt.
- Making extra repayments while interest rates are low. This reduces your outstanding balance and allows you to redraw funds when cash flow is tight

(assuming a redraw facility is available).

- Do not over extend yourself. Ensure your rental income and other income will more than adequately cover your repayments even taking into account potential interest rate rises before taking out the loan. I always advise clients to consider what their repayments will be if interest rates increased by 1% or 2%.



Also, consider your property investment experience. As the old adage goes, "there is no substitute for experience". There are many ways to deal with this risk such as:

- Use the expertise of a property consultants/buyers advocates.
- Find a mentor that has travelled the road you are taking. Find someone that has built a substantial property portfolio quickly and learn what they did right and wrong.
- Go slow. There is nothing wrong with taking it slow and learning as you go. After all Rome was not built in one day!

There are a few issues the lenders consider with investors that build a substantial property portfolio in a short amount of time:

1. Reliance on rental income. Obviously if you diversify your income streams, you will reduce your overall risk. You need to consider the affect on your financial position if there is a downturn in the rental market and rental yield drop. Furthermore lenders like to see a strong history of income. This will provide comfort over the likelihood of the income continuing into the future. The issue with building a property portfolio quickly is that you will not have a long (e.g. 2 years) history of rental income. One way of solving this

issue may be to use a low documentation loan. Whilst the interest rates applicable to these loans may be 1% to 2% higher, they do not require substantiation of income (all that's required is for you to self certify your income level). The more reliant you are on one income the greater the "buffer" the lender may require. The bank may consider the lease terms of your properties (e.g. the lender may consider it favourable if the properties are on long term leases) and may like to review the lease documents.

2. Geographical spread of your property portfolio. Lenders do not look favourably on a concentration of property in one area or development. Geographical diversification reduces overall risk.

3. Experience. If you have a strong history of property investment, they will be more comfortable lending to you. However if you are just starting out they may be more concerned. Showing that you are a sophisticated investor by the way you go about your investing (e.g. use of advisors, the way you manage your risks, the level and type of analysis before a purchase, etc.) may help you secure finance.

4. Exposure to one client. For example, they may cap the amount they will lend you to \$2 million. Recognise that you may have to use a number of lending institutions.

Securing Your Loan Portfolio

An excellent strategy to building a property portfolio is to use the equity in an existing property as a deposit for your next property.

Consider the example where an investor owns one investment property and is considering purchasing another property for \$200,000 (plus costs of approximately \$10,000).

Existing Property Value: \$300,000
Outstanding Mortgage: \$100,000
Equity: \$200,000

There are two ways to structure this purchase.

1. Take out one loan for \$300,000 (plus purchase costs) secured by both properties; or

2. Refinance the existing loan and increase the loan value by \$50,000 (being a deposit of 20% plus costs). This loan is only secured by the existing property. Take out a separate loan for 80% of the new property's value (i.e. \$160,000). This loan is only secured by the new property.

The advantages of the second option are:

- Each property is only securing one loan. Therefore if you decide to refinance, restructure or sell one of the properties it will not affect the other loan of property.

- You are not tied to the one bank. For example, you can have loan 1 with bank A and loan 2 with bank B.

- If anything goes wrong with one of the properties the bank can only sell one property to recover one loan.

Overall the second option maximises your flexibility and reduces your risk.

Use A Tax Effective Structure

"When purchasing an investment property, the tax effectiveness of the investment and the tax payable on the sale of a property may vary significantly based on whether the property is purchased as an individual or partnership or through a company or trust structure" says Mr Keith Wells-Jansz, Manager from international accounting firm KPMG.

The income and growth potential of the property along with personal circumstances should be evaluated prior to purchasing an investment property. Mr Wells-Jansz suggests investors consider the following:

- Income from positively geared properties is ultimately taxed at marginal tax rates irrespective of whether the property is held individually or through partnership or as a company or trust. A company will pay tax on income at the rate of 30%, but may defer distribution of income and therefore the payment of personal 'catch-up' tax (if your marginal tax rate is greater than 30%) on this income. This deferral is not available when purchasing as an individual, partnership or trust.

- Tax losses from negatively geared properties derived through an individual or partnership holding may be utilised to offset other personal assessable income. However, tax losses generated from negatively geared properties held by a trust or company cannot be distributed and must be retained within the trust or company for offset against future profits. Therefore, individual and partnership structures benefit investors that have "other" assessable income (e.g. PAYG earners).

- Individuals, partnerships and trusts are entitled to the 50% capital gains tax discount, if the property is held for at least twelve months (and if the trust does not later distribute the gain to a company). However, this capital gains tax discount is

not available to a company.

- Establishing and maintaining a partnership, company or trust comes at an administrative cost.

Mr Wells-Jansz strongly advises investors to seek professional taxation advice prior to and during investment property purchases.

Keep Loan to Value Ratios Below 80%

Most, if not all, lenders require loans to be mortgage insured where the loan to value ratio is greater than 80%. Most banks use third party insurers and there are only three major mortgage insurers in Australia.

In order to insure a mortgage loan the mortgage insurers impose their own credit criteria which is generally more stringent than the banks criteria. As such the banks do not have as much "discretion" with applications that require mortgage insurance.

The reason for mortgage insurers being more stringent is that the more you borrow the less security the bank has to cover the loan and therefore giving rise to a higher risk.

The banks and mortgage insurers will normally seek to offset this higher risk with a lower risk in other facets of the application such as serviceability and credit history (e.g. they would like the applicants serviceability to be strong if they are going to lend 95% of a property's value). In this regard, all mortgage insurers will only lend against the contract price or valuation whichever is the lower.

Ensuring your loan value ratio is below 80% gives rise to two main benefits:

1. You avoid the cost of paying a mortgage insurance premium. Most lenders on charge the mortgage insurance premium if the loan to value ratio is greater than 80%. Mortgage insurance premiums can range from 0.5% to 2.5% of the loan value.

2. The bank will have more discretion with the assessment of your loan application. If the application has a lower security risk (due to lending 80% of the property's value) they may be willing to accept a higher credit risk (e.g. being less conservative when assessing serviceability).

Use Pre-Approvals to Trouble Shoot Any Problems Early

The best way to minimise the risk of purchases not being financed is to seek a pre-approval from a lending institution. I always advise clients to obtain a

pre-approval before committing to any purchase. This will allow you or your broker to deal with any issues prior to purchase.

I would still advise people to purchase 'subject to finance' (where appropriate) just to ensure that if they have any problems they should get their deposit back.

Mitigating Factors

All the opinions and views of lenders contained in this article are indicative views only. All finance applications are assessed in light of the individual strengths and weaknesses of the application. There may be mitigating factors in respect of your financial situation which may allow you to achieve certain things that fall outside lenders general lending policies. Most applications are assessed on a case by case basis.

Conclusion

No money down strategies are, in theory, a fantastic way of building an investment property portfolio. However, in practice, 'no money down strategies' are often very difficult to execute. We all like to think that we have purchased well. But in most cases it's a very difficult task for valuers to identify strong evidence that the fair market value of a property is in excess of the purchase price. I'm sure there are properties that sell for less than fair market value but you just have to recognise the limitations of borrowing against that value.

There are many other issues to consider when planning the acquisition of a property portfolio. I have touched on some of these issues above but it is important to consider the issues applicable to your individual situation.

That's why it's important to surround yourself with a knowledgeable team of solicitors, accountants, and mortgage brokers. Also, find a good mentor, someone who has successfully built a property portfolio and dealt with some of the issues described above.

* Assumptions: 1 - 30 year loan term. 2 - Lender includes at least 80% of gross rental in its serviceability calculations. 3 - Current standard variable rate is 6.57%. 4 - Lender loans assessment rates by 2%. 5 - Analysis ignores any personal expenses and other financial commitments. 6 - All rates and dollar values are expressed per annum.

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