PropertyInvesting.com 'Insider'

Discover proven tips, strategies and techniques to dramatically increase your property investing profits

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By Steve McKnight

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Hi and welcome to your October 2003 edition of *Insider* - the e-zine outlining how to successfully invest in real estate delivering a positive cashflow outcome.

If this is the first time you're receiving this newsletter then I warmly welcome you to the PropertyInvesting.com community. Don't forget to regularly check out our forum to leverage off what other people are saying, as well as have your questions answered.

There's a lot to discuss this month so let's get right into it... here's what's on offer:

- Auction shenanigans - when price does not equate to true market value.
- Forum discussion starter post of the month

Auction shenanigans – when price does not equate to true market value.

Last Saturday I attended an auction a few houses up the road from where I'm currently living. The dwelling was a three-bedroom clinker brick property in need of renovation. The agent had advertised the property at "$360,000+ buyers".

I wasn't interested in buying the house, just at gaining a sense of what was happening to demand in the marketplace.

There was a smallish crowd in attendance - perhaps thirty or so people. The auctioneer began his spiel, going on to say how property was the most secure asset, proven to go up in value and how prices may seem high today, but will be seen as cheap tomorrow.

He went on to outline the auction conditions and then asked for an opening bid. Not unusually, no one wanted to make the opening offer. So instead the auctioneer started by declaring a vendor bid of $325,000 and called for $25,000 rises.

It took a lot of coaxing, but eventually someone offered $350,000.

The next increase wasn't as forthcoming, despite a hard sell effort worthy of a Hollywood epic. So the agent walked inside to talk to the vendors, who in this case turned out to be the executors to a deceased estate.

Returning a short time later, the auctioneer advised that the property had not reached its reserve. In fact, it was a long, long, long way off it. He called for new bids, to which there were none, so he submitted a further vendor bid of $375,000 in an attempt to create value from thin air.

Well, if there were no bidders before, there certainly weren't any new bidders now!

Sensing that it was all turning pear-shaped, the agent started saying that if anyone wanted first right of negotiation then they had better put in an offer or risk missing out. No one took the bait, so instead the agent passed in the property, but not before he put in a further vendor bid of $25,000 raising the price to $400,000.

I was perplexed as to why anyone would do this, until it dawned on me that this was done to potentially misrepresent what really happened for advertising purposes.

This suspicion was later proven to be correct, with Monday's auction results for that property reporting that it was passed in for $400,000, with a reserve of $425,000.

Based on this case study, there are many valuable lessons for those interested in property, namely:

- Advertising saying "360,000+ buyers" looks a lot like false and misleading when the reserve is set at 18% higher. The defence that "Most agents do this, so it must be OK and accepted" is nonsense. It's an issue of integrity.
- There was one genuine offer of $350,000, yet the paper said the property was passed in for $400,000. As such, the price of houses passed in at auction can be manipulated by vendor bids. If you are interested in a house passed in at auction, make sure your due diligence tests to see whether the highest bid was genuine.
- The value of a property is what someone is willing to pay for it, not what someone is willing to sell it for. The focus is on the buyer, not the seller.

Epilogue: As the house was passed in, the auctioneer's last comment I heard was, "See, auctions aren't anywhere near as fun when you can't use dummy bids."

The October Forum Discussion Post.

Starting this month I'll be taking one post made on the PropertyInvesting.com forum boards and providing an answer that we can all learn from. Here is this month's post:

What's the percentage of cash on cash return if you are investing for +ve cashflow investment property in regional area? Say 400kms from the city? I am looking for 13% and above, but most of them are below that. Is that a good call? The area is not bad, last year's median price change +10%? Opinion?

Source: http://www.propertyinvesting.com/forum/topic.asp?TOPIC_ID=4969

First, a cash on cash return (CoCR) is my preferred way of evaluating investments. It is calculated as: ((annual net cashflow *divided by* net initial cashflow) *multiplied by* 100)

To use an example, $50 annual interest on a $1,000 term deposit is a CoCR of 5%. A property that returns a net cashflow of $20 per week, but requires cash of $15,000 (to pay for the deposit and closing costs) represents a CoCR of 6.93%.

I like the CoCR because it reflects:

- A cashflow focus; and
- It allows for leverage; and
- Because it is based on cash rather than profit, it can't be easily manipulated by

accountants.

So how much is a reasonable CoCR? The answer to this question depends on four things:

1. What is the risk associated with the investment?

   There's a premium that needs to be paid for riskier investments to compensate for the chance of losing money. This is why no-doc and low-doc loans are set at higher interest rates than standard home loans, which are generally on a 80% lend and are processed in the normal application channels.

   In this case of the forum post, we're dealing with a property that's probably in a rural area. As such, you'll want a much better return than the risk-free rate, which is the interest you'd earn if your money was left in the bank.

2. What is the payback period?

   One of the critical questions when I invest is "When do I get my money back?" You can easily determine the number of years it will take by solving: (1 *divided by* CoCR%).

   In terms of the forum post, a 13% CoCR would mean a payback period of 7.69 years. The only person who can tell if this is reasonable is the investor.

3. What are the likely capital growth prospects?

   While I invest principally for positive cashflow returns, I'm also interested in any capital appreciation. The post mentions that there was a +10% rise in value last year. This seems good, but just be mindful that percentage terms can be a little deceptive. If property is worth $40,000 and it goes up $4,000 then that doesn't seem as attractive as a $100,000 property increasing by $10,000.

4. What is the level of Liquidity?

   I'd also like to raise the point of liquidity. In a mad panic that has all the hallmarks of a mania, people seem to be flocking to positive cashflow property regardless of location (did someone put out a book???) and without proper due diligence process.

   I've heard of people investing in small towns, forgetting that property is not a liquid asset and that finding a buyer when it comes time to sell might be difficult. In these circumstances the return needs to be higher than normal to reflect the additional risks.

While all these points are valid, at the end of the day the CoCR that each investor individually finds acceptable is likely to differ because we all have varying degrees of risk tolerance.

For what it's worth, 13% seems like a pretty high value for a buy and hold strategy, but not high enough for a wrap.

My opinion... it seems promising at first glance... but remember that in order to actually achieve the expected return you'll need to find a quality tenant (or wrap purchaser). Don't just buy based on the expected yield, and be sure to complete a thorough due diligence on the user of the property to ensure you don't end up with a property lemon.

Summary

The key messages from this October newsletter are:

1. Auction results reporting the last offer on houses passed in are open to manipulation if there is vendor bidding present.

2. A cash on cash return is a useful way to evaluate investment return, but the acceptable rate for each investor will vary according to his/her risk profile. Apply the logic that the higher the risk, the higher the return must be. However, don't buy based on the numbers alone. Make sure that the person supplying your income is of sufficient quality to ensure your expected return is more than just an attractive financial projection.

That's it for this month! As always, I wish you the very best with all your investing activities. Until next time, remember that success comes from doing things differently.

Warm regards,

Steve McKnight

P.S. Just a quick update on the remaining seminar places. At the time of writing there are **two seats left for Melbourne** seminar (on 16/11/03), **eighteen for Sydney** (on 30/11/03), and **twenty-three** for Brisbane (on 23/11/03). If you want to find out the latest techniques and strategies to profit from property and protect your empire then secure your place while you can. Go to http://www.propertyinvesting.com/resources/15 to book or find out more about these upcoming events.

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