Home Buyers Information Guide

Understanding Cash Flows for Investment Properties

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Introduction

Buying an investment property is a big step in the overall wealth creation process. Like any other decision, a lot or research is required to ensure the investment fits in with your current financial plans.

Most people look at investment properties to achieve some of the following:-

1. Long Term Capital Growth
2. An Income Stream in Retirement
3. Tax planning
4. Negative gearing

To ensure that your long term plans are achieved, you need to look at the short term to **safeguard** future planning strategies.

In a nutshell, the most important consideration is understanding the **Cash Flows** generated from the Investment Property. If you cannot fund the expenses and meet the interest payments on any borrowings, it will not matter how good the potential long term growth is. You could have to sell in the short term.

To understand **Cash Flows**, we need to look at the issues that effect the **Cash Flows** of a property.

This book is designed to provide you with information so that you will have an understanding of what effects **Cash Flows,** and how best to plan.

Later we will look at how you can easily work out the expected Cash Flow from a property and whether it suits your financial situation.

Cash Flows can be influenced in many different ways. Listed below are the main areas that will have an impact :-

1. Acquisition or Purchase Costs
2. Rental Property Expenses
3. Depreciation of Building and Fixtures & Fitting
4. Interest rate on Borrowings
5. Occupancy Rates
6. Lenders Mortgage Insurance
7. Australian Tax Office – E Variations

Lets take an in depth look at each of these areas.

1. Acquisition or Purchase Costs

When buying an investment property, the costs incurred come from different areas. To assist you with your evaluation we have put together a list of the various costs that could be incurred during the purchase process.

Area	Cost Incurred
Real Estate	• Purchase Price
Conveyancing Costs 	• Standard Fee + GST • Mortgage Registration Fee • Transfer Fee for Property Registration • Title Searches and Property Enquires • Strata or Community Search Titles
Stamp Duty NSW Office of State Revenue	• Stamp Duty on Purchase Price • Stamp Duty on Mortgage
Lending Costs** 	• Loan Application Fee • Lenders Mortgage Insurance (If borrowings are more than 80% of the LVR) • Loan Maintenance Fee **These fees could vary from Institution to Institution
Whitegoods 	To make the property attractive to renters there maybe a need to update some items. This could include:- • Cook Top or Oven • Hot Water Services • Air Conditioner • Floor Coverings
Miscellaneous 	• Building Inspection Report • Pest Report • Property Valuation • Updates to new property incl. painting • Tax Depreciation Report • Buyers Agent's Fee

This list, although by no means exhaustive, should allow you to compile a close estimate of the total cost of your investment property.

Why is it important to have the estimated costings as accurate as possible?

1. This will allow you to arrange finance for the total project so that it is not left incomplete due to unforseen needs that were not allowed for in the original budget.
2. Any shortfalls will have to be funded by extra borrowings (if available) or using current "Cash Flow" which would interfere with existing plans.

2. Rental Property Expenses – What you can claim

You can claim expenses relating to your rental property but only for the period your property was rented or available for rent; for example, advertised for rent.

Expenses could include:

- advertising for tenants
- bank charges
- body corporate fees and charges
- borrowing expenses
- capital works
- cleaning
- council rates
- decline in value of depreciating assets
- gardening and lawn mowing
- insurance - fixtures and fittings, public liability & building and landlords insurance
- interest expenses
- land tax
- legal expenses
- pest control
- phone
- property agent fees and commissions
- repairs and maintenance
- stationery and postage
- travel undertaken to inspect or maintain the property or to collect the rent
- water charges - This would be the Fixed charges as the tenant should pay for the usage charges

This list of expenses was taken directly from the ATO web site.

The items underlined have a direct link to the ATO web site should you need further clarification on the expenses. Click on the link for details

Why keep a record of all expenses?

- Tax law requires you to keep a record of all expenses that are claimed in your tax return. You do not lodge these records with your tax returns but are required to produce them on request.
- Using the above list may jog your memory on some expenses that you may have missed or not been aware of.

3. Depreciation

As a building gets older and items within it wear out, so they depreciate in value. The ATO allows property investors to claim a deduction related to the building and the plant and equipment items within it.

Listen to Bradley Beer, Managing Director, BMT Tax Depreciation as he discusses:-

[What is Tax Depreciation]

As stated in the video, depreciation enables the owner to write off a percentage of the cost of plant and equipment used in creating income in the financial year.

Property depreciation is made up of two main elements: capital works deductions and depreciation of plant and equipment.

- Capital works deductions are available on the structure, including items that cannot easily be removed. Remember this is **not** the purchase price but the cost of the building.
- Depreciation of plant and equipment is available on mechanical and removable fixtures, including those deemed to have an effective life set by the Australian Taxation Office. (ATO)

The rates are set by the ATO and are different for Capital works and Plant & Equipment.

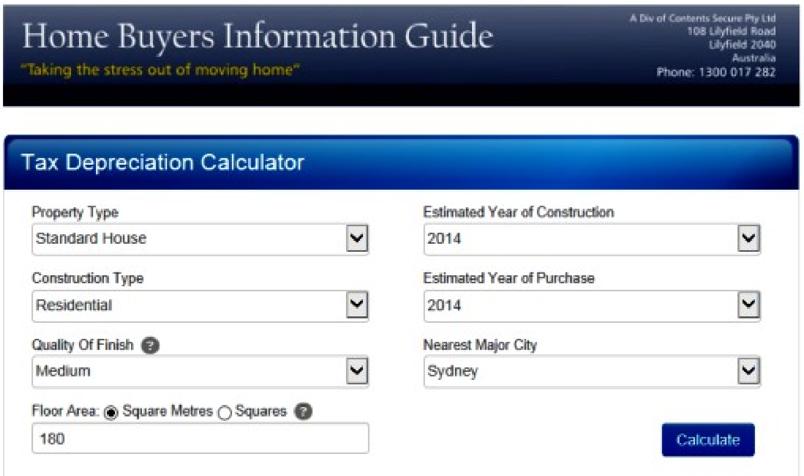
To claim depreciation against income, it is advisable to obtain a Tax Depreciation schedule from a licenced Quantity Surveyor. This can cost a few hundred dollars and is not recommended until a property is purchased.

How to calculate Depreciation Amounts for estimating purposes.

a. For estimating purposes you can use a Depreciation Calculator that is designed by BMT Tax Depreciation. This will give you an estimate of the total amount of depreciation that could be claimed. This figure can then be used in your "Cash Flow" analysis.

b. Three questions you will need to ask about the intended property to be purchased:-
   1. Floor area of the property.
   2. Estimated year of construction.
   3. Quality of Finish

   The input screen for the Depreciation Calculator will appear like this:-



Go to Depreciation Calculator

Once you have inputed the data in the calculator you will see the results like this.

For estimate purposes use the amount shown here.

This will give an approx. 5 year average for depreciation so that you do not get an inflated figure in your estimates

Estimate of Depreciation Claimable Standard House
Approx. Construction Cost as of 01 July 2013 $211,381

Maximum				Minimum			
Year	Plant & Equipment	Division 43	Total	Year	Plant & Equipment	Division 43	Total
1	$9,300	$6,300	$15,600	1	$7,000	$4,800	$11,800
2	$8,200	$6,300	$14,500	2	$6,200	$4,800	$11,000
3	$6,100	$6,300	$12,400	3	$4,600	$4,800	$9,400
4	$4,700	$6,300	$11,000	4	$3,500	$4,800	$8,300
5	$4,000	$6,300	$10,300	5	$3,000	$4,800	$7,800
Total	$32,300	$31,500	$63,800	Total	$24,300	$24,000	$48,300

For an accurate assessment of Depreciation available, you will need to arrange for a Tax Depreciation Report. This should only be obtained after a property is purchased.

This report can be obtained from BMT Tax Depreciation

Why is it important to understand Depreciation allowances?

- It is tax deductions you can claim without outlaying any money.
- A good Tax Depreciation report will save tax and increase the "Cash Flow" of the Investment
- To obtain the best results from depreciation allowances you need a Tax Depreciation report combined with an accountant that specialises in Investment properties.

Below is an extract from an article written by Mr Bradley Beer, Managing Director of BMT Tax Depreciation

"Properties which generate income for their owners are eligible for significant taxation benefits.

"Despite this fact, according to the Managing Director of BMT Tax Depreciation, Bradley Beer, 80 per cent of property investors are failing to take advantage of property depreciation and are therefore missing out on thousands of dollars in their pockets."

Table Showing Tax benefits when $10,000 is the depreciation amount claimed			
Taxable Income Range	$37K - $80K	$80K - $180K	$180K plus
Marginal Tax Rate	32.50%	37.00%	45.00%
Tax rebate received	$3,250	$3,750	$4,500

Note: This rebate is received without outlaying any funds except for the cost of the depreciation report.

4. *Interest Rate on Borrowings*

At present (July, 2014) interest rates are at a historical low. As investing in property is considered long term, it would be prudent to suggest that sometime in the future, interest rates will rise.

When and if this happens, who could predict? But, as an investor, you need to be prepared and understand the ramifications it will have on your “Cash Flow”.

Remember any increases in interest rates could mean your investment would require extra funding. If your property Cash Flow is negative, this funding would need to come from your personal income.

Are you prepared for Interest Rate increases.

Set out below is an example of how cash flows are effected when interest rates rise.
The data used is as follows.

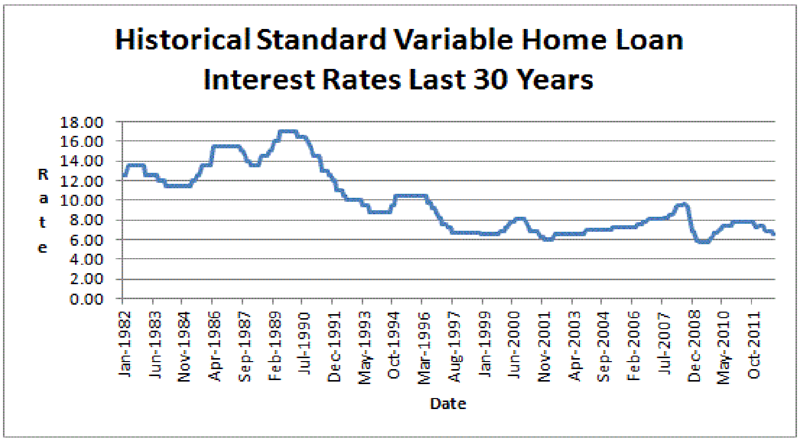
Purchase Price	500,000
Costs incurred in Buying incl. Stamp Duty	25,000
Total Purchase Cost	525,000
Deposit	125,000
Amount Borrowed	400,000
Rental / Wk based on 90% occupancy	500

The figures shown below are after tax figures after taking into account all running costs incl. Depreciation and a Marginal Tax rate of 31.5%

Interest Rate on borrowed Funds	6.00%	7.00%	8.00%	9.00%
Net weekly cash flow	-87	-153	-218	-284

This basically shows that on a borrowing of $400K and a rental income Of $500 a week, a rate rise of 1% will require an extra $66 a week in funding.

For an accurate assessment of your own situation, downland our “Software Package” for Investment Properties



As can be seen from the graph on the left we are currently experiencing the lowest interest rates in 30 years.

During that period there have been increases at various times along the way.

Could you fund a rate increase next year?

5. Occupancy Rates

For planning purposes, don't assume that the property will be occupied 52 weeks of every year. Check with Property Managers in the area to gauge what sort of occupancy rates can be expected.

6. Lenders Mortgage Insurance (LMI)

Lenders mortgage insurance protects a lender against financial loss if you default on your home loan and the property is subsequently repossessed and sold

LMI is required when the Loan to Valuation Ratio exceeds 80%.

Property Valuation	$800,000.00	$800,000.00
Loan Value	$700,000.00	$550,000.00
LVR	87.50%	68.75%
Is LMI required?	Yes	No

To get a better understanding of Lenders Mortgage Insurance you can visit the 2 web sites listed below:-
ASIC Web Site
https://www.moneysmart.gov.au/borrowing-and-credit/home-loans/fees#insurance

Insurance Council of Australia
http://understandinsurance.com.au/types-of-insurance/lenders-mortgage-insurance#tab-1

What does LMI cost?

As the LVR increases so does the premium. The premium for LVR is a one off payment and is usually amortised into the loan. **As this could be a substancial amount don't forget to include it in your costing.**

To obtain an indication of the cost of LMI visit the web site.

http://www.genworth.com.au/borrower-centre/homebuyer-tools/lmi-premium-estimator

7. Australian Taxation Office – E Variation

An E Variation allows you to apply for variation to your PAYG withholding tax. In essence you can receive your tax refund each fortnight or month depending on your pay periods. If you are not eligble for E Variation you will need extra funds to meet outgoings until you receive your tax refunds. This is shown in the software package as follows:-

- **Net Weekly after tax Cash Flow** is after tax rebates are received or an E Variation is used.
- **Net weekly pre tax Cash** Flow is before any tax refunds or variations have been applied

Now that we have discussed the various issues that influence "Cash Flows" it is time to see how you can draw all this information together and see some meaningful results.

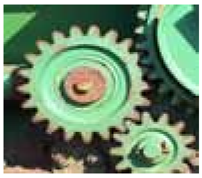
Cash Flow Projections

How are **Cash Flows** determined?

Income	minus	**Expenses**	Equals	**Cash Flow**
Rentals received Tax rebates		Interest payments* Property Management Fees Strata Fees* Council Rates* General Property Maintenance* Insurance* Depreciation		This can be positive or negative

* Remember these expenses have to be met regardless of whether you are receiving income or not.

How important is the cash flow from the proposed Investment Property?
Is it required for :-



- A positive cash flow to supplement income, or
- A negative cash flow (gearing) to create short term tax benefits, with potential for long term capital growth

Either way some calculations will need to be made to ensure that the investment is structured to meet your financial needs. These calculations can be quite complex.

To assist with these calculations we have designed a purpose built **"Cash Flow Software Package".** This allows for the information collected from areas 1-7 above to be inputed so that the "Cash Flow" projections can be seen.

By changing various inputs, different scenarios can be viewed. **Why is this important?**

- As discussed earlier, if interest rates change it would be a benefit to know the impact in advance.
- This can easily be achieved by changing the interest rate in the "Software Package"
- Any scenario can be checked simply by changing the input data.

The Cash Flow section of the "Software Package" contains 2 excel Spreadsheets:-

1. Cost Analysis for buying an Investment Property.
2. Cash Flow projections for Investment Properties.

Lets take a look at these on the next page

Cost Analysis Spreadsheet

This spreadsheet will enable you to calculate the total cost of your Investment Property. It can also act as a prompt when it comes to “Whitegoods” & “Miscellaneous” items needed to enhance and update your property.

Check here first for detail — *Costs Analysis for buying an Investment Property*

Disclaimer

Summary of costs		$	SAMPLE
Notes	Purchase Price	500,000	500,000
	Lending Institution Costs	3,060	3,060
	Conveyancing Costs & Stamp Duty	20,204	20,204
	Whitegoods	600	600
	Miscellaneous	1,200	1,200
	Grants & Rebates	0	0
	Total Price	525,064	525,064

Borrowing Expenses		$	
Notes	Loan Application Fee	600	600
	Lender's Mortgage Insurance (LMI)	2,460	2,460
	Misc		
	Totals	3,060	3,060

Miscellaneous		$	
Notes	Buyers Agent		
	Independent Building Inspection Report	500	500
	Independent Pest Report	300	300
	Independent Property Valuation		
	Painting of new Property		
	New Carpet before occupation		
	Other capital outlays at inception		
	Start a Strata or Community title Search		
	Outstanding rates on new property		
	Quantity Surveyor	400	400
	Totals	1,200	1,200

Conveyancing costs & Stamp Duty		$	SAMPLE
Notes	Standard Fee + GST	1,000	1,000
	Misc. like photocopying, filing etc		
	Stamp Duty on Property	17,990	17,990
	Mortgage Registration Fee	105	105
	Transfer Fee for property rego	209	209
	Stamp Duty on Mortgage	400	400
	Title Search and property Enquire	500	500
	Misc		
	Misc		
	Totals	20,204	20,204

Whitegoods required		$	
Notes	Cook Top	600	600
	Oven		
	Misc		
	Misc		
	Totals	600	600

Grants & Rebates		$	
Notes	Commonwealth Govt. Incentives		
	State Govt. incentives		
	Misc		
	Misc		
	Totals	0	0

The benefits of an accurate costing schedule are:-

- No need for top up finance later, if it is still available.
- Piece of mind that the project can be completed within planned budget

Cash Flow Spreadsheet

This spreadsheet is designed to take the data that has been discussed through this E-book, and calculate the resultant cash flow position.

There are provisions for 2 different scenarios to be used at the same time. This can prove beneficial in the following situations:-

- Making a comparison between 2 different properties
- Checking some "what if" scenarios for the same property. In the example below, the data is the same for each plan except the interest rate. This shows how the "Net weekly Cash Flow" is affected by interest rate rises.

Cash Flow projections for Investment Properties

Check here first **Disclaimer**

The red triangle in the top right hand corner of some cells indicates a "Comments Box"
Hold the cursor on the "cell" to see information about that cell.

	Plan A	Plan B
Total Cost of Property	525,064	525,064
less Deposit	90,000	90,000
Borrowed Funds	435,064	435,064
Interest Rate		
Interest Rate	5.00%	7.00%
Annual Interest on borrowed amount	21,753	30,454
Weekly Interest	418	586
Depreciation Costs		
Tax Depreciation Calculator		
Est. of Depreciation Claimable	10,000	10,000
Tax benefit from depreciation	3,700	3,700
Income		
Weekly Rent	500	500
No. of weeks occupied	48	48
Annual Gross Income	24,000	24,000
Borrowing Expenses		
Loan Application Fee	600	600
Lenders Mortgage Insurance	2,460	2,460
Other		
Totals	3,060	3,060
Property Management Fee	7.50%	7.50%
Marginal Tax Rate	37.00%	37.00%

	Plan A	Plan B
Expenses	Annual	
Rates - Council & water	2,000	2,000
Body Corporate - Regular outgoings	2,500	2,500
Body Corporate - Sinking Fund		
Insurance - Landlord	1,400	1,400
Smoke Alarm Monitoring Service	99	99
Repairs & Maintenance	600	600
Advertising for new tennants		
Accountants Fees		
Land Tax		
Borrowing Expenses	612	612
Interest on Loan	21,753	30,454
Depreciation Claimable	10,000	10,000
Property Management Fee	1,800	1,800
Annual Expenses	40,764	49,465
Nett Taxable Income	-16,764	-25,465
Cash Flow	Annual	
Net Income (loss)	-16,764	-25,465
Add back Depreciation	10,000	10,000
Tax Saving benefit	6,203	9,422
Net Annual Cash Flow	-561	-6,043
Net weekly after Tax Cash Flow	-11	-116

	Plan A	Plan B
During the first 12 months the investment will have a higher negative cash flow until Tax saving benefits are available		
Net weekly pre tax Cash Flow will be	-130	-297

In the above example "Plan A" and "Plan B" have the same data except for interest rates. Plan B is 2% higher.

As can be seen with this interest rate the difference in Cash Flow is **-$105** a week.

Before any tax benefits are received the difference is **-$167** a week.

Remember, this is money you will have to find from your normal income streams. This makes it critical to understand Cash Flow before a property is purchased.

Other stategies or “what if's” that can be checked out are:-

- Reduce purchase price to reduce borrowings
- Change of ownership could change the marginal tax rate
- The result of different occupancy rates (Can extended vacancy be afforded)
- Compare Property Management rates (although price should not be the sole consideration)
- Check if future interest rate increases can be absorbed

As you can see it is possible to run many “what if” situations until you reach a combination which best suits your needs.

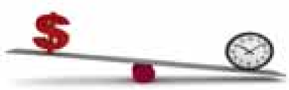
Understand how Cash Flows work and you should be well placed financially in the early years of your investment.

This will allow you to enjoy the potential long term growth that you have planned for.

In Summary

In todays world most people are time poor. But looking for investment properties can be very time consuming.

As stated earlier, “if you cannot fund the expenses and meet the interest payments on any borrowings, it will not matter how good the potential long term growth is. You could have to sell in the short term”.



Therefore it makes it compelling to understand the Cash Flow of the proposed investment very early in the process. This could save you a lot of time not having to research properties that don't meet your financial situation.

Our Software Package allows you to easily check the cash flow of an investment property. It also allows you to check various “what if” situations to give you piece of mind should certain factors change in the future.

Also provided is a Data Collection Sheet that guides you through the information gathering process. This also makes it easy to input data to the Software Program.

At only $10.95 this Software will save you lots of time during the research process and ensure that your investment is complimentary to your current financuial situation.

*The **Software Package** includes the following:-*
- PDF How to use the Software Package
- Cash Flow & Cost Analysis worksheets
- Budget worksheet
- PDF Data collection sheet for Cash Flow Information required

Purchase Now

My Notes

For further information visit out web site at:-

www.hobig.com.au