

31 May 2002

Hi and welcome to your May edition of Financial Independence.

May has certainly been a big month for me, both in a business and a personal sense. I turned 30, travelled whirlwind style across the world to England (York) to MC a friend's wedding, continued to project manage a \$0.5m renovation in Traralgon, purchased two more positive cashflow residential properties and also our first commercial property. Phew - what a month!

As I write this newsletter, David and I are re-evaluating our goals and monitoring our progress in terms of continuing to find new deals to create passive income. I thought this would be an excellent theme for Financial Independence and as such, the topics I will outline are:

- The Rise of Interest Rates -How to avoid being the classed as the greatest fool!
- Negotiate Success Using Leverage
- All the details of Our First Commercial Property Acquisition

Let's get started!

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### **Rising Interest Rates... What Does It All Mean?**

Garth Insing recently made a post on the Inner Circle forum board asking for my opinion about the current real estate boom that seems to be sweeping certain parts of Australia.

Specifically, Garth made mention of a real estate deal on the Gold Coast where someone purchased real estate for \$2m and then sold it a few years later for \$5m.

This kind of story reminds me of the story of 'The Greatest Fool', which I've adapted into the following story:

Four years ago, a certain person decides to buy a property for her home. She follows her Mum's advice to buy a property on a large block of land, as it is more likely to appreciate in value. She buys it at a private sale for \$160,000 during a period when the market is flat.

Three years later our homebuyer decides to upgrade to a larger property closer to her work. She approaches a real estate agent who convinces her that selling her property at auction would get the best price - especially if there was a bidding war on the day.

On the day of the auction, our vendor sets a reserve price at \$210,000.

It's a lovely day and as luck would have it, there are two builders who want the property due to the large block. Both plan to demolish the property and build two three-bedroom units. After strong bidding the property eventually sells for \$250,000. Our vendor is ecstatic and buys her Mum the biggest bunch of flowers she's ever seen.

The developer spends \$240,000 and seven months developing the block and building the two three-bedroom units, bringing the capitalised value of the project up to \$490,000.

By this time the property market has boomed, primarily due to low interest rates and a recently introduced government scheme where first homebuyers can access either \$7,000 or \$14,000. This has seen previously unheard of gains and many seemingly overnight property millionaires.

Building contractors are now seen driving flash new four-wheel drives and utilities around town.

The builder contacts a marketing promoter that he has a deal with to sell real estate to 'out of town' property investors looking to save tax in the short term and make huge profits through capital gains in the long run.

Most of the leads from the marketing company come from a series of free 'wealth creation' seminars done across town that advertise a proven way to build wealth by using the tenant and the taxman.

Simon, a highly paid computer technician who already owned his own home worth \$300,000, was first attracted to property as he saw it as a way of legally lowering his tax bill.

He attends the seminar and learns that the depreciation deductions (which are non-cash) can be used to offset his salary income to dramatically cut his annual tax bill.

All in all, if Simon follows the seminar system, he could buy a brand new three-bedroom unit in a prime capital growth location for just the cost of a dinner out each week! These are the very units that the developer is looking to sell.

Following on from the very good advice given by a wealth consultant from the seminar company, Simon agrees to buy both two three-bedroom units that luckily happen to be on the same site for no money down!

Again, the friendly staff at the seminar company put him in touch with a finance agency that lends him the 20% deposit (secured against the equity in his private home) as well as providing the remaining 80% finance on the investment property.

Although confused as to the reason why, Simon signs a contract to pay for the property before they are completed to save on stamp duty (in Victoria). The contract price for each unit is \$350,000, but since he is buying both the agent is able to negotiate a better price of \$640,000 total for the two on a contract that settles in four months when the properties are scheduled to be finished. The developer has offered a six month rental guarantee which makes Simon feel at ease knowing he has certain rent from day one.

However, the news isn't all good when wet weather and delays getting materials cause the construction to be delayed for three months. This wouldn't be a huge problem, except that Simon has refinanced to fund his deposit and is now paying interest at 7% on \$128,000. His accountant is happy though as the interest paid is a tax deduction, which assists to lower his tax bill.

Just before he's due to settle interest rates rise by a quarter of a percent. This rise in interest rates has some property investors a bit jittery, especially as rental vacancies are rising due to a glut of new accommodation coming onto the rental market.

The day Simon is due to settle interest rates rise by a further quarter of a percent, which means that his repayments rise an additional \$50 per week.

The same day Simon receives news that the company he works for has hit some uncertain times and there has been a 12-month wage freeze introduced immediately. Around the coffee machine there have also been whispers of possible retrenchment.

The units are finished but no tenants can be found. However the rental guarantee kicks in and provides rent of \$380 per week, less an 8% management fee that was written into the fine print of the contract.

A quick analysis of the numbers showed:

Amount borrowed: \$640,000  
Interest rate: 7.5%  
Weekly repayments: \$1,054.54  
Weekly rent: \$380 - two properties \$760  
Weekly Management fee (8%): \$60.80  
Annual cashflow: \$-18,477.68  
Tax saving (48.5%): \$8,961.67  
Annual depreciation benefits: \$9,600  
Tax saving (48.5%): \$4,656  
After tax saving annual cashflow: -\$4,860.01  
Cost per week: \$93.46

After two months Simon is able to rent out one of his units, but has to accept a discount on the weekly rent due to the glut of new properties on the market. He signs a twelve-month lease at \$320 per week to a young couple moving into the area.

The other unit remains vacant and after six months Simon decides to try and sell it. He approaches the agent he purchased it from who tells him that there hasn't been any capital appreciation as such, but he could still probably sell it for what he bought it for.

He decides to put the property on the market because he cannot afford the negative cashflow if the property remains vacant for much longer.

His property goes to auction on a bright Autumn afternoon and there is a mixed crowd attending - mostly friends and neighbours, although there is one strong bidder in the crowd who bids up to \$290,000 before the agent passes the property in.

Later Simon is pressured into selling to be rid of the problem. He'd rather take a hit now than have the risk that it stays vacant (the rental guarantee has expired) given the prospect of rising interest rates and the uncertainty that has crept into his job stability. The price negotiated is \$305,000.

After the agent takes his cut, the solicitor is paid and the mortgage is paid out (it turns out that the finance company charged a \$3,000 early payout fee as the loan didn't last three years!), Simon clears \$285,000 and suffers a loss of \$35,000.

He now has mixed feelings about property and wonders how it was that other people used as examples at the wealth creation seminar ever made millions in real estate when he seems to have failed.

Simon's story reflects the theory behind 'The Greatest Fool' example.

He was third in line to make profit on the property, behind the original owner and the developer. Finally when he bought and then tried to sell there were no 'greater fools' to buy from him and he lost money because he was motivated to sell since he couldn't afford the negative cashflow arising from one vacant property and a rise in interest rates.

It will be people like Simon who have purchased property based on greed and ignorance that will be the early casualties when the property market softens. The important word here is *when*, not *if*.

I remember only too well those share investors thought that they had built an impenetrable wall against natural market forces and created the term 'new economy' stocks, only to see billions wiped off the sharemarket value when the .com bubble burst in spectacular fashion. I'm not sure what it is that gives property investors the misguided view that real estate, which is currently enjoying a boom, will not react in a similar fashion.

The fact is property has *never* risen at rates we have seen across the country and as such no one can accurately predict just how big the eventual correction will be. However, there are steps that you can take right now to mitigate any potential risk you might have should interest rates continue to rise. They include:

- Monitoring your profit margin and converting it back to the maximum interest rate you can sustain before you lose money. This means that you need to calculate the impact of rising interest rates and find the annual percentage rate that causes your investment to be cashflow neutral.

Alternatively, if you already negatively gear property or shares, you need to calculate how much of a loss you can afford to fund from your employment income before you suffer a noticeable loss of lifestyle.

For example, let's say that you have the following property:

Purchase price: \$70,000

Deposit: \$14,000

Loan: \$56,000

Current interest rate: 6.5%

Loan repayments: \$87.08 per week

Rent per week: \$150 per week

Management fees: 6%

Annual expenses: \$1,400

Annual positive cashflow: \$1,403.84

At this profit level interest rates can rise to 9.67% per annum before the profit is nullified.

- Looking at potentially fixing some or all of your loans to remove exposure to interest rate movements for between one and ten years.

Interest rates are at thirty-year lows and expectations of them staying at such low levels for much longer are unrealistic. This being the case, the question is perhaps not *should* you fix, but *when* should you fix.

My view is that you don't want to necessarily fix at the lowest rate possible, since some of the drawbacks of fixed loans such as the inability to repay extra amounts and the higher interest rate than a variable loan mean that you should try to hold out until there are more regular increases.

I've heard talk that interest rates might be between 7.5 and 8% by the end of next year. This is pure speculation and it is important to maintain a clear distinction between fact and opinion in your mind.

This being the case I am holding out looking for three interest rate rises in 12 months before I will rush out and fix my interest rates. Even if this happens I will be tempted to do a split loan and leave a portion variable, as I believe that you should look to repay debt to reduce the overall impact of potential interest rate rises.

- Be pro-active... Look for the triggers and read the press.

Now is not the time to stick your head in the investing sands and cross your fingers and hope that everything will be OK. I suggest that you regularly read the financial commentary and gather different perspectives on what might happen. Keep strict control over your investing activities and try to report monthly on the financial outcomes.

Start networking with your financiers and also wrap clients (if you have them) and let them know what are the available options for fixing loans.

In the earlier example Simon was shown as someone who purchased poorly and sold out of necessity. As interest rates rise, many investors who purchased higher priced property will feel the wallet squeeze as already negative cashflow investments deteriorate further.

I expect there will be some panic and overselling at all levels in the market, which will be a real opportunity for the prudent investor who has not overcapitalised and has kept some cash up his/her sleeve to buy a bargain.

Avoid becoming the greatest fool when you buy on fact rather than greed and retain profit up your sleeve so that you are not forced to sell *when* interest rates rise and the property market softens.

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### **Negotiating Success Using Leverage**

My experience with property and businesses is that a lot of your profit is secured at the time you buy. That is, so long as you buy well to begin with, your investment will be well positioned to make money immediately.

You can vastly improve your chances of buying well when you can create *leverage* in the negotiating phase. I've found that negotiating without leverage results in many more rejections to my offers and sometimes even some hostility.

Leverage is finding a circumstance that allows you to argue for a change to the sale offer. I believe that making a whole lot of low-ball offers trying to find a 1 in 100 bargain deal is unrealistic. However, submitting a low or varied offer to what is wanted is acceptable when you have justification for doing so.

While every deal is unique, the methods I have used to create leverage include:

#### *1. Distressed Sale*

It's easy to negotiate when the vendor has an urgent need to sell. The only problem is - how do you know if the need is urgent when you first inquire?

The answer is quite straightforward. All you need to do is ask. Just say "Hi. I'm cashed up at the moment and am keen to do a deal. Do you have any vendors who are negotiable if they walk away with a quick and easy sale?"

By doing this you imply or blame the reason for the low offer on the owner's need to sell and not that you are looking for a bargain. In other words, you are trying to help the vendor out rather than penalise them for an urgent need to sell.

#### *2. Need Alternative Terms*

If you try the distressed sale approach and it doesn't work, you can move on and try this negotiation technique if you are still interested in the deal.

Since price is not negotiable, the only other variable in the deal is the terms of sale, that is, either:

Deposit: Instead of paying a 10% deposit you pay say \$1,000 and keep your working capital freed up for other deals.

Settlement: Seek to have a long settlement period - say six months or longer where you can tie the deal up, benefit from any capital gains from that date and also buy yourself more time to come up with the money.

Finance: You can also ask for the vendor to 'take-back' a loan and as such reduce the money gap between the sale price and the amount that the financier will provide.

By all means try to negotiate on price and terms, which is what we did our Traralgon 27-plex purchase. The sale price was \$610,000 - but by reducing our 'subject to' clauses to only a finance approval and also helping the owner to move some of the problem tenants on, we were able to buy at \$510,000.

After we agreed on price we then negotiated for:

- a 120 day settlement
- early access so we could begin to renovate the units immediately
- all broken glass to be replaced (about \$1,500 worth of work)
- the vendor to carry back a second mortgage of \$50,000 and reduce the amount of money we would need as the bank was only going to provide an 80% loan

It's amazing what you can get when you ask for it!

### *3. Building / Expert's Report*

It is essential that you seek an independent expert's opinion about your investment if you are committing tens or hundreds of thousands of dollars to a project to protect yourself from making an expensive mistake.

In relation to property, you should **always** engage a builder to write a report. For businesses you should seek the advice of an accountant who knows the industry you are buying into.

When you have a written expert's report then you can negotiate using the report findings. Sometimes it is possible to even renegotiate when new information comes to hand.

There are two examples I can use here.

The first is in relation to a single family home that I put under contract to buy for \$50,000 (this is the property that is featured in the <http://www.propertyinvesting.com/forum> forum). At the time of buying the owner would not budge on price but did accept a six-month settlement. I purchased this property with a 'subject to a builder's inspection to my satisfaction' clause as a special condition.

When the report came back there were several minor cosmetic problems with the property, but of most concern was an older part of the roof which would soon need replacing.

Armed with this information I went back to the real estate agent and said that if the vendor replaced / repaired that part of the roof (about \$2,000), or discounted the purchase price, then I'd be happy to purchase.

After two days the agent finally came back to me and said that the owner was not prepared to do any more work and wouldn't go lower on the price.

In other words, the owner was generally *not* motivated to sell. As I type this newsletter the agent is waiting for me to get back to him.

While this house might be a good positive cashflow 'starter house' for a new property investor (especially as a wrap), it does not fit in with my current investment strategy with the possibility of repairs needed in the next year or so.

At this stage I'm inclined to pass the deal over.

The second example is with the commercial property that I have just purchased and which is discussed in more detail below.

In this case I purchased the property for \$155,000 after it was originally listed at around \$250,000 before being reduced to \$160,000. The rent is \$425 per week.

The quick reduction in price was a clear sign that the owner was motivated to sell.

I recognised that the property was only built about six years ago and as such it would attract a significant income-producing building write-off of 2.5% of the construction value. However, to access this deduction I would need a quantity surveyor's report to assess the value of the site. I also organised a builder to go through the property and write up a report. The conclusion was that the building was in excellent condition and that the only issue was a faulty hot water service in the upstairs office area.

Armed with this new information I went back to the agent and negotiated a:

- 50:50 split on the cost of a building surveyor's report (my share worth about \$200)
- new hot water service in the office area (value \$600)

This may not appear to be a lot, but if you can negotiate an additional \$800 off each property you buy and you buy 100 properties... \$80,000 is a significant amount of money to save. Hopefully you can see the distinction between both these examples and note that when you have a motivated seller you have a much better chance of purchasing a deal on exceptional terms.

In summary, I recommend that you spend time finding motivated sellers and then look to gain leverage when negotiating the price and / or terms of your purchase. If you can 'buy well' in the first place then you set yourself up to immediately maximise your return.

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### **Our First Commercial Deal**

This month David and I signed the contract on our first commercial investment property. It is a warehouse / factory on two acres of land which we acquired for \$155,000.

The terms of our purchase were a deposit of \$2,000 and a 90-day settlement period. The 'get out' clauses we used were subject to finance and subject to a builder's report to our satisfaction.

I came across this deal as I was completing an audio recording with two fellow friends and property investors. It was a Friday afternoon when we walked around town 'window shopping' in real estate agents windows and a A3 sized flyer caught my attention.

It said:

Industrial property comprising 8,594 sq. metre land area with newer 600 sq. metre warehouse/workshop building, all fully leased:

- six year lease and a further 5 year option
- current rent \$20,800 rising to \$22,100 from 20 April 2002
- council rates and land tax paid by tenant

For sale at \$160,000

13.8% Return

WAREHOUSE INVESTMENT

We went in and I inquired about its location before we drove out to inspect it. It looked like a very new building and there is no way you could build something like that today for anywhere near \$155,000 given the two acres of land and the sizeable colorbond wall structure. The internal lighting alone must be worth about \$40,000.

The tenant is an engineering company and the property was first let on 3<sup>rd</sup> June 1998 which runs until 19<sup>th</sup> April 2004 at \$425 per week.

The lease also calls for the tenant to pay for all outgoings, which means the only expense we'll need to cover is the loan repayment. There are no agent's management costs as we'll do it ourselves.

In negotiating the finance for this property I have approval from the National Australia Bank for a 5 year fixed interest term at 8.07%. The bank will only do a ten-year loan term though. We'll look for more competitive finance terms, but analysing the deal based on these figures reveals:

Purchase price: \$155,000  
Closing costs: \$4,000  
Total purchase price: \$159,000

Loan @70% LVR: \$108,000  
Interest rate: 8.07% (Fixed for 5 years interest only)  
Weekly repayments: \$168.38

Total cash needed: \$50,500

Weekly rent: \$425  
Weekly repayment: (\$168.38)  
Weekly management fees: Nil (done internally)  
Weekly maintenance: (21.25 or 5% of rent)  
Weekly outgoings: Nil - the tenant pays these  
Weekly cash profit: \$235.37

Annual nett return: \$12,239.24

Cash on cash return: 24.24%

I think that a 24.24% return plus any capital gain stacks up as a healthy first deal for our venture into the commercial market. We are making money from day one and have the potential to secure capital appreciation due to the extensive land content of the property. The one contingency is that we need to complete some further due diligence on the existing tenant and also look at ways to provide an incentive to renew the lease in advance before it falls due.

I'd be interested in your thought on this deal and I invite you to post them, together with any questions you might have on the General Discussion forum.

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### **Summary**

Evidence seems to show that the interest rate cycle has turned from record lows - a circumstance that was sooner or later inevitable.

Now rates have moved, as investors and business owners we need to be on guard to protect our existing asset empire. It would be prudent to estimate and quantify your exposure to interest rate movements and certainly lock in your rate before your profit margin was consumed by a higher cost of money.

Yet rising interest rates is not all bad news. Investors who have purchased badly in the first instance and had their mistakes masked by record low interest rates will be forced to sell as rates rise higher and higher.

In this newsletter I've outlined how vendors motivated to sell provide the best opportunity for you to buy at a bargain price, which is the 'Greatest Fool Theory' operating in reverse.



When you purchase your investments remember that the best way to negotiate is to create a point of leverage. It might be your openness for a quick sale, or it might be a builder's report showing something needs attention. Having this point of leverage will assist you to substantiate the reason for making an offer that should be framed so as to provide a win-win outcome.

Finally, I outlined my first experience in the world of commercial real estate. I hope to forge a niche in this area in the upcoming months and Inner Circle members will be the first to benefit and profit from my experience.

I hope you have enjoyed this newsletter and I wish you the best of success for the upcoming month. Remember that success comes from doing things differently!

Regards,

Steve McKnight

P.S. Remember that the time to complete your Australian tax planning for the current financial year is before 30 June 2002. It would be wise to make an appointment with your accountant in the next two weeks and discuss what options are available.