

PROPERTY

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COORDINATOR'S MESSAGE

By Adrian Vorbach

There are two excellent articles in the March Property Bulletin which will reward careful reading and I would suggest printing and stowage for future reference.

Geoff Doidge, one of the Reno Kings, writes re "Property Risk Identification" from his vast experience. He lists eight areas of risk and for each risk the appropriate remedy and opportunity.

Carolyn Majda, General Manager, Insurance Services at Terri Scheer Insurance, stresses the importance of Landlord Insurance as a risk management tool for which her company is renowned. Standard house and contents policies are usually deficient.

Adrian Vorbach is a Councillor of the AIA.

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PROPERTY RISK IDENTIFICATION

By Geoff Doidge

All investments have risk, no matter how 'safe' they appear. Investment property is no different.

As a long-term investor I have been faced with many threats to my portfolio, starting with my very first tenants, 'the dreaded bikies'. The Harley had oil changes inside the house. They never mowed the lawn so they got a sheep to do it. Unfortunately the bikies ran out of meat at their backyard BBQ so they ate 'the lawnmower'!

I have had my misfortunes, including survey errors, structural problems, termites, soaring interest rates, inflation, recessions, oversupply, resumptions, flight paths and even floods. Sharing some of these experiences, and the ways I handled them, may be helpful to other investors.

In the interest of helping other people cope, I tried to identify every risk to property I could think of. I then thought about how that risk or threat could affect me or my property. I took it one step further and sought the remedy for the risk. Finally, because I believe that behind most problems there lies an opportunity to turn it around to your advantage, I have considered that opportunity.

So we have two parts under each risk:

- risk identification and effect of the risk
- the remedy for the risk, and the opportunity.

A word of encouragement: Although I have been confronted by many of these risks, I don't recall ever losing money on any rental property. Quite the reverse, in fact, as my portfolio now exceeds \$20 million and annual rental income exceeds \$800,000. I do confess, however, to losing a minor amount of money on vacant land. The lesson learnt was 'no tenant equals no income'.

I also confess to losing money in my youth on the share market, horseracing, gambling, unlisted property trusts, and of course cars.

The eight risk areas in property are:

1. Direct property characteristics
2. Effect of the market and the economy
3. The building
4. The land
5. Government
6. Management
7. Natural disasters
8. Other risks

Direct property characteristics

Risk: Property is long-term. The majority of property investors don't see that property as a long-term investment is a risk. It is possible to suffer short-term loss of equity or no capital gain for some periods. Some property investors would even see this as an advantage, but share investors generally see this as a disadvantage and a risk.

Remedy: Time in the market is the answer. Buy, rent and hold long-term. Property as compared to many other investments has a good chance of long-term capital gain because of the land value.

Risk: Property is capital-intensive. You will need substantial cash or equity to purchase property, and good cash reserves to manage it until it goes cash positive.

Remedy: Once you pay off or pay down your home you can use a line of credit secured by your home equity to buy an investment property. Mortgage insurance will reduce the deposit required. First home owners can get significant FHOG monies from the government and reduced stamp duties. An investment property bought well and used wisely can accelerate home loan reduction. I suggest you consult a property accountant.

Risk: Property may return low capital growth. Some properties in some areas have had slow equity growth and low rental growth over some periods. In recessions there has been negative growth of –20% in some suburbs over a number of years.

Remedy: Buy well below market value and then add value. Buying where the ‘haves’ live insures you in those tough times. Long-term capital growths of 7–12% pa have been achieved in the more affluent areas.

Risk: Property is reported to have low yield. The result is poor (negative) cash flow — money coming out of your pocket.

Remedy: When interest rates are low, positive gearing is possible on most property if you have bought well and added value. When interest rates are high it is much more difficult. One option is to fix the interest rate. If interest rates are say 7%, returns would be positive if you had the following returns: flats 10%, houses 8–9%, units 8–9% — that is, a margin of 1% to 2% above the interest rate.

You can get high yield, but that usually involves higher risk (e.g. commercial properties, rural or mining towns). When properties have a low yield they are likely to have lower risk, because they are usually in sought-after areas.

The Effect of the Market and the Economy

Risk: Rising interest rates. You may suffer cash flow problems if heavily borrowed.

Remedy: You can use a fixed interest rate or variable rate with a fixed option or a cocktail loan i.e. part fixed/part variable. Always keep a cash buffer maybe in your offset account. Normally interest rates rise when there is an increase in inflation. This usually slows the stock market and boosts property (to a point). A crash in the stock-market often leads to a rush to property.

Risk: Very low inflation or low growth. This lessens the advantage of borrowing as you can't depend on inflation or capital growth alone to increase your equity.

Remedy: You can focus on the intrinsic value of the property. You buy well in areas in demand. You add value to create equity. Low inflation equals low interest rates so you can borrow more than you can with high inflation/high interest rates. When inflation or capital growth is low, investors focus on the return from rents. Rental yields may increase in the low growth period.

Risk: Hard to sell. You are unable to achieve goals. You may be ‘asset rich and cash poor.’

Remedy: If you have bought well you should be able to find a buyer especially if you have added value and managed well. Keep a buffer so you are not forced to sell. It may be better to hold than to sell at a loss if you can find the cash from somewhere else to get by in the interim.

Risk: Hard to raise cash quickly. Property is illiquid for small amounts. It is possible you will have short term cash flow problems.

Remedy: The answer is to use equity to borrow - but have a buffer. Being hard to sell quickly stops you from cashing in your long term investment for a short term need.

Risk: Deflation. Falling asset values.

Remedy: Add value. Spend a \$1 to add \$5. You may even decide to pay down your loans. Make sure you have good quality, well located assets. They are more likely to hold their value. You may need to liquidate if you have negative cash flows, high loan interest and no cash or equity. Keep a cash buffer. Interest rates may be very low and yields very high. If you are cashed up or have high equity you could pick off the bargains.

The Building

Risk: Buildings are a depreciating asset. They will need regular and increasing maintenance. As the building ages these costs increase.

Remedy: Maintain the building to slow the deterioration. Add value to the building to increase rental returns. The depreciation and maintenance may be tax deductible.

Risk: Structural problems. This could mean possible major repair costs. At worst it could lead to condemning the building. You could suffer loss of rent during repairs or at worst demolition of the whole building and total loss of rent.

Remedy: Intensive building inspection before purchase. For lesser structural problems it might become a negotiating point. Maybe you can buy the property very cheaply.

Risk: Termites/pests. These can cause possible major damage and costs.

Remedy: Get termite and pest inspection before purchase - again, a negotiating point. Maybe you can buy very cheaply and repair the damage.

The Land

Risk: Survey error. If your property is over the boundary this could lead to a dispute regarding encroachment onto neighbours land. It may entail moving the building at great expense. It may require partial demolition. In almost all cases it could lead to substantial loss and expense.

Remedy: Purchaser organises land survey before purchase. Purchaser buys a section of land from the neighbour. This could become a negotiating point. Maybe you can buy the property very cheaply but would you want to if you can't solve the problem.

Risk: Incorrect title. This could lead to major dispute and potential loss and solicitor expenses. This would be a disaster. No advantage here.

Remedy: Title search and survey.

Risk: Contaminated site. This may mean you are not able to develop or occupy the site. The result is substantial holding costs and/or loss of rent. It could mean sickness, demolition, loss of capital or even being sued.

Remedy: Carry out a contaminated site register search. Ask neighbours, especially long term residents, of the past history of the land. This could be a negotiating point. Maybe you can buy very cheaply and clean it up cheaply.

Government

Risk: New road near your property. If close by it means noise, loss of rent, vacancies, loss of value, vibration and pollution.

Remedy: Some solutions may be a sound barrier, double glazing, maybe you protest to stop it, ask for compensation or at worst sell it before the development is widely known. Initially you can ask for compensation. Once built you may have better road access and shorter travel times.

Risk: New rail line near your property. If close by it means noise, loss of rent, vacancies, loss of value, vibration and pollution.

Remedy: Some solutions may be a sound barrier, double glazing, maybe you protest to stop it, ask for compensation or at worst sell it before the development is widely known. You might get compensation, better rail access, shorter travel times and walk to train.

Risk: Rezoning of your property. You may suffer a loss of land value if your land is rezoned to a lower use. If your area has been rezoned to units in a residential house zone it may affect your existing house value. Rezoning from residential to industrial for example will decrease your existing house value but if you have sufficient land it may increase the development potential.

Remedy: Check your zonings and object if the use is being changed. Make sure there are no plans to rezone, however if there are, you may wish to take advantage of this. Higher densities

may dramatically increase your potential land value (if you have a good sized block and/or the house can be removed).

Risk: Resumption of your property. You may suffer possible capital loss if compensation is inadequate. You may need to claim relocation costs. Could be very disruptive emotionally.

Remedy: You need to fight for highest compensation. Normally you would be eligible for legal fees to do so. This may be an opportunity to relocate away from the problem. Hopefully the compensation may be excessive and you make money from the problem.

Risk: New flight path over your property. You may suffer aircraft noise, loss of rent, vacancies, loss of value and vibration.

Remedy: Some solutions may be sound insulation in your roof, double glazing, protest, ask for compensation or at worst sell before widely known.

Management

Risk: Bad tenant-malicious damage. You may suffer capital losses, low cash flow and emotional stress.

Remedy: You need to evict the tenant. Subscribe to a 'bad tenant' database. Improve your tenant selection process. Seek a good property manager. Have malicious damage insurance. Manage the manager. Insurance should cover loss. Learn how to pick a good tenant so you can self manage if required.

Risk: Bad tenant - won't pay. You may suffer low cash flow and emotional stress.

Remedy: You need to evict the tenant. Subscribe to a 'bad' tenant database. Improve your tenant selection process. Seek a good property manager. Have malicious damage insurance. Manage the manager.

Risk: Management effort required in residential property. Your time and effort is required.

Remedy: You need to use a good Property Manager or get trained yourself if self managing. You will get to understand your investment and how to control it.

Risk: Long vacancies may occasionally occur. Low cash-flow and emotional stress.

Remedy: Change the Property Manager, renovate, add value, take control and advertise the property yourself.

Natural Disasters

Risk: Flood. You may suffer possible loss of capital and rent. Worst case is you may lose the whole house.

Remedy: Flood insurance and do a flood map search. Note: check before you buy that you can get flood insurance. You may be able to fill above flood level or raise the house. Check with your council.

Risk: Weather. Capital loss, maybe rental loss.

Remedy: Most insurance would cover damage from the weather. You might be able to insure for 'new' for 'old'.

Risk: Landslip. This can cause catastrophic loss of capital and the building.

Remedy: Check with neighbours or Council whether there are any known slip areas. Check carefully that you are covered by insurance.

Risk: Earthquake. This can cause catastrophic loss of capital and the building.

Remedy: Check carefully that you are covered by insurance if in a known earthquake area.

Other

Risk: Oversupply caused by new developments nearby. You may get an increase in rental vacancies.

Remedy: Buy in areas with high demand and/or low supply and good infrastructure. Find a niche market. Students? Affordable housing?

Risk: Property is overpriced i.e. you pay too much. As the property is repriced by the market you may suffer lower yield, lower capital gain.

Remedy: You can look at previous sales. You can get a valuation by a Registered Valuer. You can view the valuation.

Summary

Within the eight different risk areas I have identified 30 property risks. Much of this information has been learnt by me the 'hard way'. I don't want you to have to learn that way. I want you to learn from my mistakes, not make my mistakes. Please use this information to identify potential risks and deal with them effectively.

Property can be very rewarding if you do so.

Geoff Doidge, *The Reno Kings*. For a checklist of the "Forty-three Steps to Success in property" with all the tips and traps send a blank email to 43steps@renos.com.au.

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WHY LANDLORD INSURANCE IS A WORTHWHILE INVESTMENT

By Carolyn Majda

The shortage of rental properties in Australia has created a good opportunity for people who are thinking about purchasing an investment property. As property purchase is a significant financial commitment, there are a number of things for property owners to consider, particularly where tenants are concerned.

Landlord insurance is an important risk management tool and a worthwhile investment for any owner of residential rental property.

The specific risks associated with owning a rental property include malicious damage by a tenant, theft, accidental damage, legal liability and loss of rental income if a tenant absconds or if you are unable to rent the property while repairs to damages caused by tenants are undertaken.

Even the best tenant can unintentionally damage a property and despite the landlord's best intentions many may suffer either loss of rental income or damage by tenants.

Standard home and contents insurance policies may not cover landlords against the specific risks involved with owning a rental property. However, a tailored landlord insurance policy should offer this protection.

A landlord insurance policy should cover the following:

- **Loss of rental income**

In instances where malicious damage has been caused to a property, a loss of rental income may result during the time required for the property to be repaired. Loss of rental income can also result from absconding tenants, defaulting payments, death of a sole tenant, failure to give vacant possession or a court awarding a tenant a release from lease obligations due to hardship. Choosing a policy that covers these incidents will ensure the landlord continues to receive a steady flow of rental income.

- **Malicious damage by a tenant**

Malicious damage covers everything from holes punched in walls and doors that have been kicked in, through to intentional damage to carpets and floors.

- **Accidental damage**

This covers unintentional damage to a property. It might include the accidental breakage of a window or the spilling of red wine on a white carpet. Accidental damage *may* also cover damage caused by small children, but excludes gradual “wear and tear” that has been sustained over time.

- **Legal liability**

This covers expenses incurred if a law suit arises as a result of a tenant suffering bodily injury or property damage or loss where the landlord is found responsible. This is particularly important in a strata situation where the body corporate insurance will only cover the liability in the common areas. The landlord will need a specific insurance policy to cover the legal liability within the unit.

- **Tax audits**

Some landlord insurance policies now cover landlords for up to a certain level of professional fees relating to an investment property audit undertaken by the Australian Tax Office.

Along with looking at what is covered, it's very important that property investors consider excesses applicable to claims. Excesses can vary widely between policies; consumers need to be aware of that and ensure when they are comparing policies that they are comparing like with like. Some policies may be advertised as not having an excess for loss of rent however they may have a condition that excludes the first four weeks of lost rent. Assuming a weekly rent of \$250, if the first four weeks were excluded that equates to a \$1000 excess for a loss of rent claim.

Similarly, check for exclusions; you want to be sure that you have the cover you want – it's too late when you make a claim to find out that you don't have the cover you thought you did. Some building insurance policies for example exclude damage caused by tenants. These policies are fine for owner occupied dwellings but are not necessarily suitable for a rental property.

Another important aspect to be considered is how your property is managed. Some insurance policies, including those provided by Terri Scheer Insurance, are only available to landlords whose property is managed by a real estate agent or on-site manager. Our experience has shown that having properties managed by a property manager can help to lessen the risk as property managers will more often than not have better processes and systems in place to screen tenants, undertake inspections and issue notices in a timely fashion – all of these things help to mitigate the risk. As a property investor myself, I know I simply don't have the time to look after the day-to-day issues of owning the property and very happily delegate that responsibility to a property manager.

An insurance policy that takes into consideration the specific risks listed above can assist landlords to safeguard their investment and ensure they continue to receive a steady flow of rental income.

Carolyn Majda is the General Manager, Insurance Services at Terri Scheer Insurance.

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