

Negative Gearing Assignment

Prepared by: Sanjeev BHAKRI

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1 EXECUTIVE SUMMARY

2 INTRODUCTION

2.1 Objective

The main objectives of this report are to analyse investment potential of a negatively geared residential property in Sydney. It will look into impact of various factors on the success of the investment.

3 ANALYSIS OF INVESTMENT

3.1 Location

Good location of property is very critical for its success as a good investment potential. "Location, location, location," is a common and almost hackneyed phrase in real estate literature. Mostly, "location" is repeated to emphasize that it is extremely important to the resale value of your home. Specially for an investment property which should attract potential tenants for lease and large number of potential future home buyers. A careful choice of location can minimize potential negative influences on future resale value, and maximize positive influences .

The selected property is in inner west Sydney suburb of Burwood. The unit is less than 200 m from the railway station and bus stops. Burwood is connected to Hornsby, Penrith and Liverpool line with frequent connections to city. Bus connects direct to airport and other inner west suburbs. Unit is less than 500m from Burwood Westfield which was redeveloped completely in 2000. Burwood plaza another shopping centre is only 200m away.

MLC ,PLC, Trinity Grammar, Santa Sabina are some of the well known schools of Sydney are within 10 minuter either by walk or car. Primary schools and excellent day care facilities are within walking distance from the unit. Burwood has new Greater Union cinema complex and good quality cafes.

3.2 Physical Attributes

The proposed property is in a 20 years old block of eleven units. It has been recently completely renovated by the current owner. New kitchen, bathroom and timber blinds were added to the unit only 12 months ago. Renovations are done in modern style with steel appliances and vogue light fittings. Property is a security building and have open common area.

3.3 Legal Issues

The proposed property is in commercial zoning with a few high rise residential developments around. This block of units has potential to be redeveloped after 10 years into a high rise(7-8 storeys) block. It doesn't have any significant building restriction for residential development at least

3.4 Rental Prospect

Rental prospects are one of the most important deciding factors in deciding about the residential investments. Burwood suburb is within 10km radius of Sydney CBD with less than 10 minute by train to city and within 20 minutes of other major centres like Parramatta, Hurstville, Homebush and Chatswood. There are two big corporate employers Telstra and EDS-Commonwealth bank in Burwood besides the Westfield shopping centre.

Burwood council is a densely populated council with population of 29,960 in 7.26 square kilometres area¹. It has an increase of 4.8% since 1996 which is in line with increase with Sydney population growth. It has 69% of population in 15-64 years age group.

Professional, intermediate sales personnel and associate professional are the top three occupations in the suburb². Rented properties are on the top in list of type of occupancy in the suburb. The percentage of people born overseas is 47% and increasing in last 10 years. This figure implies that this suburb is attractive to immigrants, who are the main source of population increase in Sydney. Looking at location advantages and the above mentioned statistics Burwood is an attractive suburb for renting for type of people living the area. There is high probability that with constant population growth this demand will remain in future.

The current increase in the vacancy rates in Sydney of rental prospects is too important to ignore. According The Real Estate Institute of NSW(REINSW) the vacancy rates of Sydney were 4.4% in May 2002³. With a few more of new unit developments under way in Burwood the vacancy rates might increase in the near future. Higher vacancy rates will marginally reduce the average rents in the area in the area. With the property growth is expected to slow down in next two years the demand will catch with supply at least in the rental market. Renters, particularly in the middle areas of Sydney, are benefiting from the city's strong property market. Lower rents in the inner west suburbs will attract more tenants from outer suburbs because of less travel time and cost to city.

3.5 Growth Prospects

The growth in value of investment property is the critical success factor. In five to ten year period if the growth is not more the negative cash flow at least than there is no point in investing. Growth in property can be inconsistent in short period but over period 10 years it can be safely said that it can be estimated on the basis of historical figures. After the sharp jump in 1987-88 the property market slumped in

¹ Burwood Council site – burwood.nsw.gov.au/community_profile

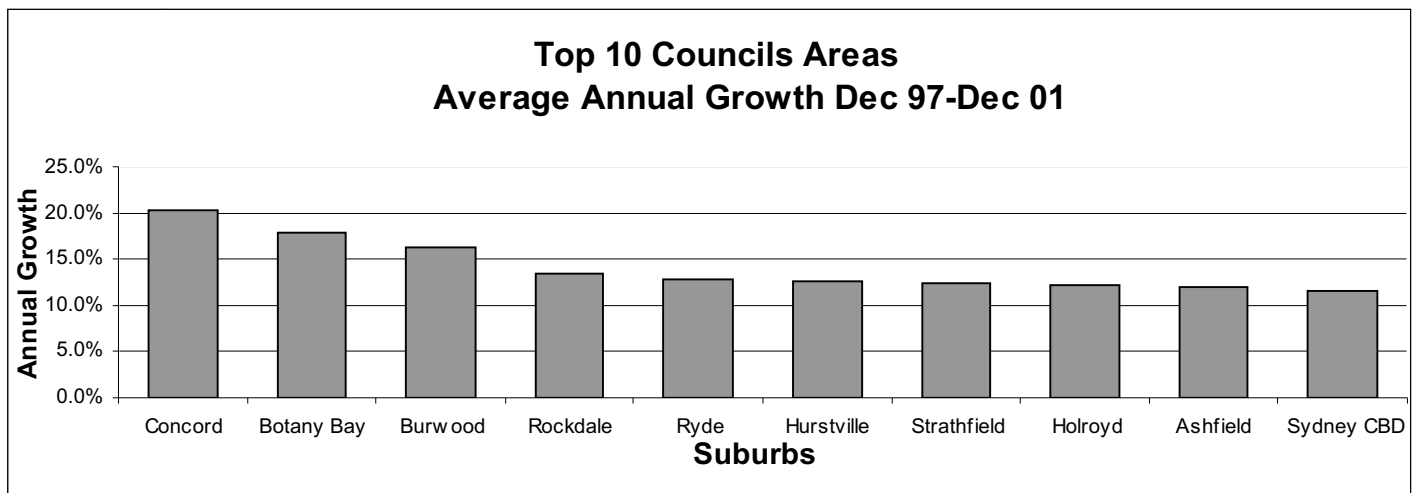
² Snapshot of Burwood from Domain.com.au

³ REIA NSW media release

following years before started recovering in 1993 -94. One of the underlining factors (not the only one) in that period was very high interest rates. Last four years growth in Sydney market is high but not as sharp as it was in 1987 -88.

According to Mr Fitzpatrick of Real Estate institute of NSW “Sydney is currently enjoying the strongest growth in the property market since the Second World War. Over the last 8 years, house prices in Sydney have grown on average by almost 10 percent per annum”.

The average annual growth for units in the Sydney metropolitan area from December 97 to December 2001 was 10.8%⁴. According to the PRD research the Burwood figures in the top 10 council areas for annual price growth for units (Appendix A). The unit prices have increased by 13.67 percent in 12 months to 30 Jun 2002 and median prices is 328,000⁵. Some other sources like Domain.com.au show higher median price of 348,000 as well.



The following graph of price movement of Sydney houses for 70 years (1926-1996) shows consistent growth trends⁶. The growth in terms (by discounting the inflation) is negative especially after sharp rises. One feature is distinct that the recent growth is spread over several years not over 2 years. According to this source prices have gone up by 60% in last 5 year in Sydney market.

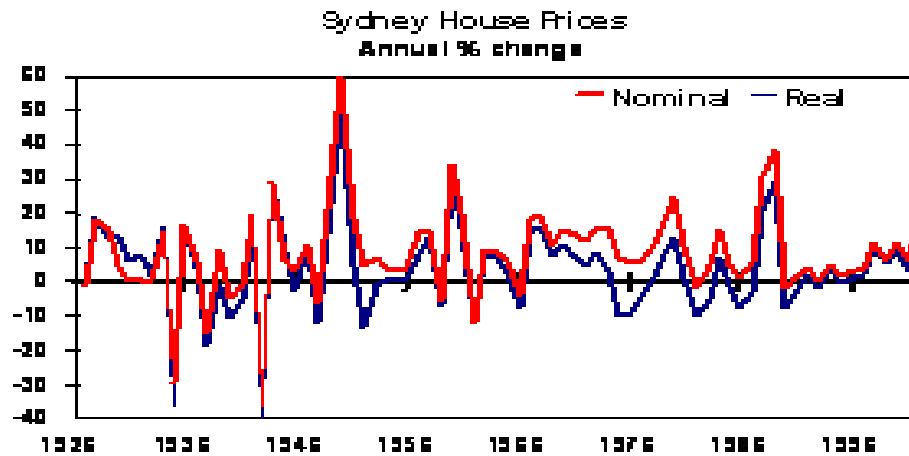
Looking at the growth statistics for Sydney and Burwood in particular it is expected that growth over 10 years period will be positive. But a negative or zero growth is expected in next 2 to 3 years time.

⁴ PRD research website. www.prdsearch.com.au

⁵ Australian property investor October/ November 2002 Issue page 93

⁶ Ninemsn website - investor.ninemsn.com.au/investor/News/MarketWatch/

Sydney House Prices - Annual % change



3.6 Economic Trends

The Australian economy has grown very strongly over the past year, underpinned by a strong housing construction sector and consumption. The economy expanded by around 4 per cent over the year to March, making Australia one of the fastest growing economies in the OECD countries. Looking ahead, it is expected that growth will slow over the coming year, led by a weaker housing construction sector and slower consumption. Forecasts are for GDP growth to slow from around 4 per cent in 2002, to around 3.2 per cent in 2003 – weaker than the consensus expectation of 3.8 per cent.

The interest rate is a critical factor in any investment property cash flows. Australia has enjoyed a very low interest rates for last five years in the range of 5-7% range. Interest rate depends on various factors which include trade figures, dollar exchange rates and interest rates in US. In June 2002 the RBA Governor Ian Mcfarlane increased the official interest rate by .25% and indicated more increases in six months. He also warned strongly against the sharp growth in housing sector. But since then rates haven't increased and growth hasn't stopped yet. US interest rates have further decreased to give required push to the economy to recover after September 11. Australian business performance is encouraging but not even across the board. The interest rates are not expected to increase significantly in next one year. Current five year fixed rate of interest is around 6.9%.

The negative returns from the share market in last twelve months are another factor in strong interest in property market. Share market returns are not expected to improve significantly in short term therefore we can expect at least slow growth in property housing sector for next six months. Inflation is also expected to be contained within 3% limit for next 12 months.

3.7 Political and Legislative factors

The tax law related to negative gearing is always under discussion. There is always a likelihood of changes in these laws which can change the calculation and cash flows in an investment property calculation. NSW state government demanded tax concession and housing grants be capped to push property investment towards the cheaper end of the market to help manage the population growth⁷. The Deputy Premier Andrew Refshauge asked for taxation benefits of negative gearing capped at the city average property price of the city or region in which house or unit is brought. It is not expected that negative gearing will be stopped totally but there may be minor adjustments and it should take care for in the investment calculations.

3.8 Demographic Factors

The recent report “Managing Sydney’s Urban Growth 2002” has indicated that extra 1000 people per week are increasing in Sydney⁸. To accommodate these people Sydney needs 27000 new homes every years. Population of greater Sydney will reach 4.5 million by 2010 much earlier than expected. The immigrants’ most favoured destination is Sydney in Australia and this trend hasn’t changed.

Property Price Trends for Burwood for September 2002⁹

PROPERTY PRICES	2134	NSW
House Prices		
Median Price	\$688,000	\$305,533
High Price	\$3,417,071	\$18,511,078
Low price	\$134,730	\$8,029
Unit Prices		
Median Price	\$366,000	\$294,000
High Price	\$2,009,905	\$5,332,205
Low Price	\$84,109	\$10,201

4 Negative Gearing

Gearing basically means borrowing to invest. An investment property that's negatively geared is purchased with a loan that has an annual net rental income amount that is less than the annual interest paid on the loan, plus the deductible expenses associated with maintaining the property. Tax benefits are achieved by negatively gearing the investment by deducting the costs of owning an investment property from the investor's overall income. The biggest part of this deduction is the interest portion of your mortgage, but we can also claim such expenses as property management fees, loan costs, depreciation and repairs.

Because negative gearing deductions offset the investor's income, they are most beneficial to high-income earners in highest tax bracket. While everyone wants a large tax deduction, you shouldn't over commit yourself in order to get one. You still have to make the mortgage payments and those lucrative tax benefits don't arrive until the end of the financial year. In periods of low inflation, the benefits of negative gearing are usually negligible.

⁷ Sydney Morning Herald Nov 25 2002 – news item “Tax sting to drive investors from city”

⁸ Sydney Morning Herald Nov 25 2002 – news item “Tax sting to drive investors from city”

⁹ Sourced from snapshot of Burwood from www.Realestate.com.au

The investment property should be positively geared eventually otherwise there is some inherent problem with investment.

The conditions required for negative gearing of an investment to be profitable are

- Investors should have enough cash to fund the negative cash flow for the investment property
- Investment property should have positive growth over 5 to 10 years period to cover the cost incurred to fund negative cash flow. Growth should also be more than the inflation in that period.
- Investor should have regular stream of income to maximize the tax benefits generated by negative gearing. Preferably the tax benefit should be in highest bracket.
- Investment property should have some depreciation potential to maximize the tax benefit. Therefore brand new properties are preferred but renovated properties can also generate depreciation.
- Possibility of low rent and high vacancy periods should be expected
- Property investment returns are expected over longer periods at least 5 years therefore short term negative gearing will not be profitable.

5 Financial Analysis

5.1 Borrowing expenses

The costs incurred during purchase will be included in the cost of unit. The stamp duty, application fee, conveyancing fee and similar charges can be claimed over 5 years period¹⁰. The various costs to be considered are

• Basic sale price of proposed unit	\$321,000
• Stamp Duty	\$ 9,935
• Conveyancing Fee	\$ 800
• Application Fee	\$ 600
• Inspection Reports	\$ 500
• Transfer Fee	\$ 55

Total Cost	\$332,890
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5.2 Rental expenses

¹⁰ ATO website ato.gov.au

A deduction for certain expenses you incur for the period your property is rented or is available for rent. However expenses of a capital or private nature cannot be claimed as rental expenses.

Expenses that we may be able to claim include with assumptions:

- Advertising for tenants One week rent every year
- Landlord's insurance \$200 /year indexed 3% year
- interest on loans 5.5% first year then 7% for 5 years fixed
7.5% for 4 years fixed
- Council rates \$800 /year
- legal expenses
- pest control \$100/year
- property agent's fees 5.5%
- repairs and maintenance \$400/year average
- secretarial and bookkeeping fee
- stationery and postage \$4/month charged by agent
- travel and car expenses: \$100/year
- water charges. \$400/year

The deduction for these expenses can be claimed only if these are actually incurred. Some of these deductions are examined in more detail below.

Borrowing expenses, decline in value of depreciating assets (previously known as depreciation) and capital works (special building write -off) deductions may be deducted over a number of income years.

5.3 Body corporate fees and charges

The block of units or townhouses is managed by strata management companies. They charge body corporate fees. Body corporate fees and charges may be incurred to cover the cost of day-to-day administration and maintenance. These fees and charges are claimed as deduction as expenses on the rental property.

The body corporate charges include the building insurance charges. Body corporate may carry out capital repairs and improvements then these are charged to sinking fund. While buying a old unit any outstanding charges should be checked from strata management companies.

If the body corporate fees and charges you incur are for things like the maintenance of gardens, incidental repairs and building insurance, you cannot

also claim deductions for these as part of other expenses. For example, you cannot claim a separate deduction for garden maintenance if that expense is already included in body corporate fees and charges.

Body corporate charges for the proposed property are \$1300/year. Charges are low because there are not any common facilities.

5.4 Depreciation Costs

The investment properties can claim depreciation on building cost over 40 years at the rate of 2.5% for the properties built after 1987. The proposed property will not have the building depreciation because it is built before 1987.

Depreciation can be claimed on the carpets, curtains and other fixtures in the property. A schedule of effective life of various fixtures is attached in appendix B ¹¹. For the proposed property depreciation for hot water system, Venetian blinds and stove will be claimed. The value for these items is \$4000.

5.5 Rental Returns

The rental returns have decreased in last 12 months in most of the Sydney suburbs. The increased vacancy rates also one of the main factors in reduced returns besides decreased rental cost. Assumptions made on rental returns are

- Expected rental/week \$280/week
- Expected occupancy /year 48 weeks
- Rental growth 10% after 3years

¹¹ Somersoft web site www.somersoft.com.au/depreciation.htm

5.6 Sensitivity Analysis

Detailed calculations are done with the assumptions listed above for upto 10years period (see Appendix C). Loan taken is 100% as it is a purely negatively geared investment property. Loan amount is \$332890. NPV is calculated by taking the inflation rate as the hurdle rate. The result for three different scenarios is given below for comparison. First one is closer to current economic conditions.

ITEM	5years	10years
1. Fixed Interest rate =6.69%, Inflation =3%, Growth =7%		
Net Cash flow after Tax @48.5%	-33729	-63726
Property Price	436717	641680
Capital Gains Tax	28061	77765
NPV if Sold($r=3\%$)	-9475	39298
2. Fixed Interest rate =7.5%, Inflation =3%, Growth =6%		
Net Cash flow after Tax @48.5%	-38960	-72993
Property Price	405255	542323
Capital Gains Tax	20432	53671
NPV if Sold($r=3\%$)	-34546	-23601
3. Fixed Interest rate =6.69%, Inflation =5%, Growth =9%		
Net Cash flow after Tax @48.5%	-33794	-61368
Property Price	453118	697178
Capital Gains Tax	32039	91223
NPV if Sold($r=5\%$)	-29442	1439

6 SUMMARY OF FINDINGS

The negatively geared investment provides an opportunity to reduce the tax liability on the normal income and also create property wealth. Negative gearing investments should have sufficient funds back up to finance the negative cash flows for first 10 years. If the current economic conditions are maintained in terms of interest rate and inflation rate then this investment will have positive NPV in 10 years. The expected growth assumed is low at 7% over 10 years. Therefore it is recommended to invest for the period of 10 years. But it is still not recommended for short period of five years.

The other scenarios shows that slight increase in interest rates or inflation figure can reduce the NPV to negative. Property market in Sydney is already on the peak and interest rates have been at their lowest for very long period. These factors indicate that slowing of growth is possible for next two years. Interest rates can also increase by up to 1.5% in next 2 years time. Economy will still take some time to fully recover from the impact of drought and September 11. Returns from negatively geared investment property will in long period and not in short period.

APPENDIX A

AUSTRALIAN HOUSING MARKET : CAPITAL CITIES SUMMARY – March 2002

	Sydney	Melbourn	Brisbane	Perth	Adelaide	Hobart	Darwin	Canberr	National
Current									
Median House Price \$ _{(a)(b)}	350,000	316,000	200,000	171,800	158,000	123,000	190,000	210,000	-
Rent 2 BR Flat \$pw _(a)	270	185	185	138	140	135	190	230	-
Rent 3 BR H'se \$pw _(a)	240	200	200	166	190	165	235	235	-
Vacancy Rate -% _{(a)(c)}	3.8	4.8	n.a.	4.6	2.1	1.8	12.6	1.9	-
Annual Change (%)									
House Price – ABS _(d)	17.2	20.6	9.7	7.7	15.2	3.4	3.4	17.0	15.5
House Price - REIA _{(a)(b)}	14.8	17.0	20.5	8.6	15.3	7.0	5.7	12.3	-
House Price - CBA-HIA _{(e)(f)}	19.5	19.2	26.3	21.8	29.1	6.1	n.a.	22.4	26.3
H'sg Affordability Index _(e)	-5.3	-14.6	-9.6	-7.0	-13.3	10.1	n.a.	-8.2	-6.1
Dwelling Rent - ABS _(g)	2.7	3.0	2.3	2.0	2.9	3.0	0.0	6.1	2.7
Priv. Rent REIA 2 BR _(a)	3.8	2.8	15.6	0.0	12.0	8.0	5.6	21.1	-
Priv. Rent REIA 3 BR _(a)	2.1	2.6	14.3	7.8	18.8	6.5	6.8	11.9	-
Total CPI _(h)	2.9	2.9	3.3	3.2	2.7	2.3	2.4	2.6	2.9

Top 10 Councils for Price Growth in Apartment

(PRD Research)

Rank	Council Area	Average Annual Growth Dec 97-Dec 01	Median Price Dec 01
1	Concord	20.3%	\$398,000
2	Botany Bay	17.8%	\$317,500
3	Burwood	16.3%	\$330,000
4	Rockdale	13.5%	\$290,000
5	Ryde	12.8%	\$320,000
6	Hurstville	12.7%	\$283,000
7	Strathfield	12.3%	\$310,000
8	Holroyd	12.1%	\$232,000
9	Ashfield	12.0%	\$286,000
10	Sydney CBD	11.5%	\$410,000

APPENDIX B**Depreciation Schedule for Investment Properties**

Item of Plant	Effective Life (years)	Previous Accelerated Rates (27-2-92 to 21-9-99) D.V. Rate (%)	New Basic Rates (post 21-9-99) D.V. Rate (%)
Venetian Blinds	20	20	7.5
Curtains & Drapes	7	30	21
Carpets	10	25	15
Furniture & fittings	15	20	10
Hot water system	20	20	7.5
Microwave ovens	7	30	21
Stoves	20	20	7.5
Refrigerators	15	20	10
Fluorescent Light Systems	15	20	10
Motor mower	7	30	21

APPENDIX C

Calculation for Investment Property for 10 years

ITEM	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Rent/week	285	285	285	310	310	310	340	340	340	340
Weeks rented	48	48	48	48	48	48	48	48	48	48
Rent/Year	13680	13680	13680	14880	14880	14880	16320	16320	16320	16320
Real Estate managing Charges @ 5.5%	752	752	752	818	818	818	898	898	898	898
Advertising Cost	285	285	285	310	310	310	340	340	340	340
Account Statement Fee	48	48	48	48	48	60	60	60	60	60
Strata Fee indexed @ 5%/year	1300	1365	1433	1505	1580	1659	1742	1829	1921	2017
Water Bill	350	350	350	400	400	400	450	450	450	450
Landlord Protection Insurance	200	210	221	232	243	255	268	281	295	
Council Rates	700	700	700	700	800	800	800	900	900	900
General Maintenance	400	400	400	400	450	450	450	450	500	500
Borrowing cost /5 years	2378	2378	2378	2378	2378					
Total Cost	6413	6488	6567	6791	7028	4753	5008	5208	5364	5164
Cash Flow	7267	7192	7113	8089	7852	10127	11312	11112	10956	11156
Interest Expense	22270	22270	22270	22270	22270	23302	23302	23302	23302	23302
Cash Flow	-15004	-15079	-15157	-14181	-14418	-13175	-11990	-12191	-12346	-12147
Net Cash flow after Tax @48.5%	-7277	-7313	-7351	-6878	-6993	-6390	-5815	-5912	-5988	-5891
Total Cash flow	-5194	-12507	-19859	-26736	-33729	-40119	-45934	-51847	-57835	-63726
Property Price	321000	346680	374414	404368	436717	471654	509387	550138	594149	641680
Capital Gains Tax	0	6227	12953	20217	28061	36534	45684	55566	66239	77765
NPV if Sold(r=3%)	-28304	-23770	-20275	-15332	-9475	-2082	6794	16601	27384	39298