Statistics Never Lie
But Liars Use Statistics

By David Bradley, Chartered Accountant

This month I'm pleased to provide you with a full financial analysis of a property investment opportunity being sold as a "great buy for the astute investor."

But as you'll quickly see, while the deal looks good from the outside, there are a few key (financial and non-financial) concerns that you must address before proceeding further.

How did I find out about this deal? Well, Steve was recently walking through a major shopping mall and there before his eyes was a booth advertising the sale of prime beachfront real estate in beautiful Cairns, Far North Queensland. He picked up the sales material and asked me to analyse the numbers.

So as you can appreciate a little more about the property, including what it looks like, here's the link: http://www.cairnsbeachresort.com.au/

I also invite you to read the letter that came with the sales material (which I've made available in Adobe Acrobat format) by opening the document titled First_North_Letter.

Where To Start?

I always begin my due diligence by clarifying what it is that I'm actually buying.

In this case, it's a fully furnished one-bedroom apartment situated just north of Cairns at Holloways Beach. Unit prices range from $148,500 and go as high as $195,900.

There are 73 units in the development, and as at 13 August, fifteen apartments (20.5%) had been sold or placed on hold. The units are ordinarily rented out through travel agents and accommodation brokers; you can also book accommodation over the Internet.

It does look, all in all, like a great place to go for a holiday and as the brochure says, the *"taxman and the tourists will help you pay off any borrowings you may have on the property. This is a great way to achieve wealth legally with other people's money."* Let's see what my due diligence reveals!

Financial Analysis - First Step

About all I can remember from High School is when my Year 8 maths teacher said, "Statistics don't lie, but liars use statistics!"

With this in mind, lets examine the numbers that the sales agent supplied, which you can view by opening the document called Sales_Figures.

The unit I have chosen is Unit Number 25, which has one carpark, a living area of 49m² and a balcony of 8m². It is on the first floor of Building C and is likely (from my reading of the Survey Plan) to have beach views. The price is $168,900 and the projected rent is $22,539 per annum, or an average of just over $433 per week.

By now you should be familiar with the *11 Second Solution*, which you can use to determine whether or not a property is likely to be cashflow positive. It is calculated by taking the weekly rent, dividing it by 2 and then multiplying the result by 1,000.

Applying the *11 Second Solution* to this unit, we take the average weekly rent of $433, divide it by 2 ($216.50) and then multiply the result by 1,000 = $216,500.

Since the asking price is only $168,900, at first glance, this property looks like a very attractive deal. But the *11 Second Solution* is really a timesaving tool to help you quickly eliminate properties that don't meet the criteria. Once you have found one that does, then you should complete further due diligence.

Financial Analysis - Second Step

Now we know we have a property that meets the *11 Second Solution*, what do we do next?

The answer is to complete more due diligence, which simply involves asking a few more questions. In the example of the Cairns Beach resort, here are a few of the questions I've asked and the results I've collated:

Exactly How Much Am I Borrowing?

The numbers we're presented with assume we'll be able to find a financier who is prepared to lend not only 100% of the purchase price, but also the closing costs too. Closing costs cover once-off purchase costs, such as stamp duty and legal fees, which are budgeted to be $7,366 on our unit.

In my experience, it is extremely rare to find such a financier. In reality, most financiers require that you put down a deposit of at least 10% of the purchase price *as well as* funding the closing costs from your own pocket. The only exception might be where you have existing equity on your home which can be offered as additional security.

Unless you have other collateral to secure the loan, you can reasonably expect to pay $24,256 as a deposit and closing costs (not $0 as shown in the model) to secure a unit in the Cairns Beach Resort.

How Realistic Is The Forecast Rent?

The quoted rent for this unit is $95 per night.

This in itself is a little deceptive since you could reasonably expect that most tenants would stay three or more nights, when the tariff falls to $75 per week. But you only find this out by visiting the web site - it is not mentioned anywhere in the glossy brochures or on the financial information.

My accountant brain tells me that it would be a lot wiser to use $75 as the base figure and not the higher $95 which is only payable for stays of one or two nights.

What impact does this have?

If you take $75 per night then the average weekly rent falls to $342 and the *11 Second Solution* drops to $171,000. The deal is now only borderline at best.

What Is The Vacancy Factor?

The financial model we are given allows for 65% occupancy, or 237 nights a year. The other 128 nights, or 18 weeks, the unit is expected to be vacant and not earning any passive income.

Eighteen weeks is a lot of vacant time, considering Steve and I allow four weeks with our residential properties. But offsetting this vacancy is the increased rent, set at $95 a night... or is it $75? Hmmmm.

But those of you who know Cairns know that tourists generally stay away in the wet season, which runs from December until March and where the humidity is in the high 90% range and the average rainfall is well over 200mm! That's just over 17 weeks!

Also of interest is that the glossy sales brochure budgets for an occupancy rate of 55% rather than 65%. It seems as though the sales material contradicts itself.

I suggest (again) that we go with the conservative numbers (ie. 55%), which now drops the weekly average rent to $290 and our *11 Second Solution* to $145,000 and below the necessary criteria. But let's continue anyway.

What's The Property Position Like?

The glossy brochure advertises this property as “beachfront” and attempts to sell the number one rule of property being “position, position, position”.

When looking at a map of the region, the brochure stresses the terrific location of the property, both close to the beach and close to Barrier Reef departures, but fails to mention that it is on the final landing path to the Cairns International Airport runway.

The property is also surrounded by swamp, and sits in a flood prone valley too. This shouldn’t pose a problem providing it doesn't rain in the Tropics!

When Do I Repay Debt?

The cashflow summary suggests you take out an interest only loan. But

the problem with an interest only loan
is that you never will own the property.

The result?

First your financier will be concerned that your debt:service ratio is high and you may find your future borrowing capacity limited.

Second, your overall investment risk increases as you become more prone to the effect of rising interest rates.

For example, in this case, for each 1% increase in interest rates we pay an additional $1,763 in interest. Interest rates only have to increase by .79 of a percent for our budgeted weekly after deprecation surplus of $24 to be wiped-out. What are the chances of this occurring? Are we at the bottom of the cycle, or will interest rates continue to fall?

In summary, Steve's grandfather had some good advice, “You don’t go broke if you don’t owe anybody any money." Taking on an interest-only loan means that you don't repay debt, but instead rely on capital gains to make a profit.

What's My Exposure To Changes In Interest Rates?

The cashflow summary has assumed that you will be able to borrow money at 6.6% per annum. Whilst it may be possible to find a 6.6% loan, the main question is “Can I find a 6.6% loan from a financier who will also lend me 110%?”

From a financier’s perspective, they are unlikely to give you the cheapest rate on the market <u>and</u> allow you to purchase the property with no money down.

What Management Fees Are Payable?

The management fees charged are set at 12% of the rent collected. This is very high when compared to the 5% Steve and I pay to our property manager on our rental houses.

Generally I'd say that the industry charges between 5-8%, so we must ask, "What additional services can we expect to receive for the premium we pay?"

Looking at the risk to return ration for the property, I'd rather be the manager receiving $2,705 per annum than the investor who only receives a surplus of $1,229!

What Allowance Must I Make For Maintenance Costs?

The detailed cash flow summary does not have any allowance for maintenance costs.

Does this mean that there will be no maintenance on the property? In my experience every property will require some degree of maintenance.

Depending on the property, I think a minimum allowance of 1% of the property value is reasonable for maintenance costs, which in this case would be $1,689 per annum.

What Is The Impact Of Depreciation?

The numbers only show a positive cashflow ($1,229) because of the depreciation benefits.

Without these depreciation benefits, this property will be negative cashflow which means it will take money out of your pocket and keep you in a job.

Depreciation is an accounting term for 'wear and tear' and is based on the assumption that the value of your asset falls as you use it more.

Indeed, you are allowed a tax deduction for the loss in value of those items that are being depreciated.

In the case of fully furnished units, the depreciation will be highest during the first five years, as the new fixtures and fittings are written off. While this provides some tax benefits - you can expect to replace most fixtures and fittings after about five years, which can be a substantial cash outlay.

If you don't, your depreciation stops meaning the property will be negative cashflow - a result compounded by the difficulty in charging premium rents for a property that is dated.

How Much Tax Do I Pay When I Sell?

What the brochure doesn’t tell you is that there is tax payable when you sell the property - which can sometimes be a little misleading.

For example, let's imagine we purchased the unit for $176,266 (after costs) and then sold it for $176,266 in three years time. On the face of it you would imagine that there is no gain or loss, right? WRONG! You will have to repay the depreciation you claimed and in this case you can expect to pay tax on about $19,398 ((2,472 + 3,994)*3), which for those earning above $60,000 will be about $9,400 in tax.

This is how you can pay tax even if you break even - a little known possibility that's never discussed in the sales brochure.

There may also be Capital Gains Tax when you sell the property. Of course this depends upon your ability to sell the property for more than $176,266.

How Realistic Are The Capital Growth Projections?

The brochure tells us that property prices in this area have risen in value over the last ten years by 12.4% pa.

They make the assumption that the property value will continue to grow at a rate of 8% per year. On this basis you can expect the property to be worth $289,465 at the end of year seven. Fantastic because I'm told property prices only ever go in one direction - up!

But if this is true, then why does the letter to potential investors say "...the property market in Cairns (that) has stagnated over the same period?"

Be careful of projections. They may look good on paper, but it's easy to make some wild assumptions to tickle the greed glands of naive investors.

Is There A Better Option?

I've compared numbers for this property with the numbers on one of our 'standard' rental properties, which we purchased 18 months ago for $95,000 (including closing costs) and it currently rents for $245 per week.

For the purposes of comparison, I have allowed four weeks vacancy and $2,500 for property expenses each year.

I have assumed that the detailed cash flow summary for the Cairns Beach Resort was correct and that every assumption in that model was achievable.

Outlined below is a summary my comparison between the Cairns Unit (Deal 1) and our rental property (Deal 2) (which is available by opening the document called Negative_Gearing_Numbers):

	Deal 1	**Deal 2**
Tax Payable	$12,029	$17,688
Rental Income	$22,539	$11,760

Based on this analysis it would be reasonable to conclude that Deal 1 is a better option because you collect more rent and pay less tax.

But it is not until we look at the after-tax effect of the investment that we see the true wealth impact of each investment.

	Deal 1	**Deal 2**
Salary After Tax	$44,904	$45,302

While you pay less tax and earn more rent by investing in Deal 1, your after tax income is lower than if you had of invested in Deal 2.

This difference is even more evident when you compare it over five properties, and then over ten properties. I mean, if these properties are so good, you want to own more than one, right?

Five Properties	Deal 1	Deal 2
Tax Payable	$408	$23,731
Rental Income	$112,695	$58,800
Salary After Tax	$44,259	$51,219

Ten Properties	Deal 1	Deal 2
Tax Payable	$-	$30,982
Rental Income	$225,390	$117,600
Salary After Tax	$29,334	$58,919

You can obtain a full summary of the financial model I used by opening the document called Negative_Gearing_Numbers.

Analysis

There's no doubt that buying the Cairns property mean you pay less tax and collect more rental income, so if this is your objective, you would choose this investment.

But if you wanted to increase your after-tax cashflow, you would choose Deal 2.

A question I often ask is

How many of *these* properties can I afford to own?

The answer is you can only buy a limited number of Deal 1 properties until your after-tax salary runs out. Yet you can buy an unlimited number of Deal 2 properties, because your after-tax buying power increases.

So what do these numbers mean?

The reason the beachfront unit appears to be cashflow positive is because of lower tax paid as a result of depreciation benefits.

But as the property ages, the allowable depreciation benefits will expire. This means the tax related positive cashflow would cease, probably after five years.

The other selling point of the Cairns property is that there are future projected capital gains. Interestingly, the property that we purchased for $95,000 is projected to be worth $120,000 in just 18 months time, that's a massive increase of 31.5% in a market that is stagnant at best.

I don't invest for possible future capital gains - I invest for cashflow returns that I must receive from day one.

Some Concluding Thoughts

What can you take away from this hot topic and the comparison between these two properties?

First, you should always ask, "How many of these properties can I afford to buy?" If we believed the sales brochure for the Cairns resort, we would conclude as many as were available.

The theory should be:

If you can afford to own one, then ignoring limited funding,
you should be able to afford to buy ten - or more.

Yet the numbers I have independently reviewed actually indicate the more I buy, the poorer I become.

Whenever dealing with salespeople always ask, "Who gets paid when I buy?"

It seems that in this deal, many people are paid before you earn any profit. For example, the solicitor gets paid regardless of how the property deal goes, the valuer gets paid for writing his report, the bank gets paid just by lending you the money, the sales agent gets paid once you buy and the management company gets paid out of your rent.

My final comment is to reiterate one of Steve's favourite catch-phrases, "the bigger the hype the bigger the hoax." When it comes to the Cairns Beachfront Resort, you have a slick sales rep, a glossy brochure, unproven quotes and a lot of assumptions. This should give you some warning signals. Never be afraid to seem ignorant by asking seemingly obvious questions

The point of this hot topic was to show you that just because a property seems to meet the *11 Second Solution* test, it does not also mean that you should automatically purchase the property. I hope you now have the confidence and financial acumen to ask a few more questions when deals similar to this one pass your desk.

I welcome any questions or comments you might like to make on this topic. Please post them on the Inner Circle Forum Board.

Best regards

David Bradley