SMSF disaster waiting to happen

Like me, you no doubt would have responded with some alarm if you saw the article in the *Australian Financial Review* on Saturday, 27 July. Apparently incentives paid to financial advisors for recommending property investments to self-managed super investors are 'a disaster waiting to happen'.

The basis of this startling headline was the assertion that 'developers are offering advisors between three and 20 times their usual commissions for selling these properties'.

Recently I heard of an investor whose lawyer picked up a commission declaration of $50,000 on an off-plan contract price of $450,000. In some states this commission would not need to be declared. Apparently the property's market value was $420,000 so this investor would have been down $30,000 from day one. The property value would have to appreciate by 15% in its first year to make up this negative 'capital growth' and to cover the additional acquisition costs of around 5%.

Choosing where to invest wisely and controlling the set-up costs are becoming paramount now that the days of double-digit growth are over.

In my article in the Winter edition of *The Strategic Super Investor*, I introduced the DSR Score. The DSR (Demand to Supply Ratio) Score is a measure of the availability of properties in more than 15,000 suburbs relative to the demand by tenants and buyers.

The DSR is important as it indicates a suburb's likelihood of achieving capital growth in the near term and makes it possible for investors to cherry-pick the best of these locations based on their budget and other investment criteria. The DSR Score is available for free on your smartphone or desktop at www.boomapp.com.au.

Recently I contacted all our data subscribers announcing an investment opportunity we had reviewed. Notably there was no commission to be paid, no developer's profit loaded onto the purchase price and even no stamp duty was payable.

I subsequently got a call from Cathy who said, 'Michael, what's the catch? It seems too good to be true.' I realised she was sceptical as so many investors are nowadays, particularly after reading the *AFR* article I mentioned above.

This particular opportunity offered a discount of $80,000 for a brand-new townhouse valued at $400,000 as if complete today. What's more, it's in a location many industry commentators believe offers some unusual growth prospects. After our research we had to agree.

With this in mind, Cathy continued, 'If the bank says it's worth $400,000 and it's in a desirable location, why on earth would the developer give away $80,000?'

Before going into some detail, I first asked, 'If you buy a new property (e.g. off-plan) and you are promised an upfront cash profit of $80,000 in return for putting down a small deposit of say 5%, 10% for an investment-grade property, then is this too good to be true?'

We agreed nobody could offer a 200% plus cash-on-cash return without it being a little suspect.

Manufacturing property

Cathy also couldn't believe it when I said there were also no commissions to be paid. To put her out of her misery I explained the difference between manufacturing property in super as opposed to buying the finished product. I explained to Cathy that the developer in this scenario was opening his factory doors to her so that she could manufacture her own townhouse without having to pay the usual costs associated with buying on the open market (and paying retail prices).

So to answer Cathy's question about the developer 'giving away $80,000' I put it to her from the developer's perspective (who importantly happens to also be a builder).

Builder: 'If each investor puts in $150,000 to settle the land, I can then build four townhouses on it and still make my usual 15% builder's margin. Each investor can (1) keep the developer's profit, (2) save on stamp duty and (3) save on paying the selling agent's commission. I create these benefits for the buyer for one simple reason: I can take on 10 times as many projects without having to go to the bank for money to settle on the development site and I make myself more money in the process.'

I explained to Cathy that 99% of investors buy on emotion heightened by the glossy brochures and slick salespeople that these 'disaster waiting to happen' commissions can fund.

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Who pays for this marketing hype? The retail investor does (and the cost is buried in the purchase price). It's that simple.

In this scenario, the builder-developer quickly discovered that taking on 10 times more projects, without the headache of dealing with the banks and looking for retail buyers, was just too good to pass up. His suppliers also love the larger orders for materials and this economy of scale is further reflected in the cost price of the completed townhouse,

And that's when Cathy realised that putting up $150,000 to save 20% on the typical retail price by stripping out the 'retail' costs is a fair and equitable exchange, rather than something that is too good to be true.

I then added that two major banks like the model and now fund the construction and take out finance (mortgage on the completed townhouse) for each investor because for them it's low risk. They fund a project that is 100% presold to (SMSF) investors, the land has DA approval and is ready for construction just before they tip their funds in, and on completion they get four mortgages as most investors choose to hold. Not hard to see why they would get behind this.

Best of all, these new bank customers are lower risk as they have an immediate 20% buffer in place (retail price less 'passive developers' cost price) and have put skin in the game (i.e. $150,000 of their own money). If the investor chooses to leave their initial investment in, the borrowing against the property drops to about a 42% LVR. If they recycle their $150,000 investment into the next property, they're still left with 20% equity and no need for lenders mortgage insurance. They've effectively 'manufactured' the deposit and can repeat the process.

Immediate capital gain

SMSF investors in this project also win knowing they have an immediate capital gain of 20% in a smaller, more desirable boutique complex appealing to tenants and owner-occupiers alike. These smaller complexes tend to attract better rental yields and higher resale prices.

So I said to Cathy, 'You can see why it's not "too good to be true"? You need $150,000 to play this game and you need to know the right people to make it happen.' Acquiring brand-new property at absolute cost – not retail prices like the rest of the market – is a great source of cashflow and building equity without relying solely on market forces.

I then cautioned Cathy, saying that obtaining investments at well below valuation requires some careful consideration – some are more profitable and low risk than others.

Do you want to save $100,000 on your next $400,000 investment? I've put together a case study for *SSI* readers here: hotspotcentral.com.au/ssi.

Michael Fuller is the cofounder of property research technology company hotspotcentral.com.au – creators of the DSR Score (boomapp.com.au).

New townhouse	YOU	Retail investor
Market value	$400,000	$400,000
less Development profit	$70,625	$0
Property price	$329,375	$400,000
Plus Stamp duty	$0	$12,425
Plus Commission	$0	$20,000
Plus Extra interest on retail borrowings	$0	$4,970
Total acquisition cost	$329,375	$437,395
Net equity	$70,625	-$37,395
Rental yield	5.8%	4.8%
TOTAL SAVING	$108,020	$0

View Case Study: www.hotspotcentral.com.au/ssi