New vs Old

Thoughts and Opinions by Dr. Tony Hayek

When investing in property, clearly our aim is to try and build as much wealth as possible, with the least risk, in the smallest amount of time. In order to do this, we need to understand what types of property we need to include in our portfolio. More specifically, we need to get clear on whether new or old properties are going to help best achieve the aim.

There are different schools of thought when it comes to the argument of whether to invest in new or second hand property. We're going to try and shed some light on the topic.

There a number of distinct advantages in new property.

- Reduced Maintenance costs
  The simple fact a building is new means the building and it's fixtures and fittings are less likely to require maintenance.
- Lower vacancy rates
  Due to the desirability of living in a new dwelling, vacancy rates are very low
- Higher tax deductions
  The Australian Tax system acknowledges when you buy a new building, the building itself and all its fixtures and fittings depreciate at their greatest rate in the first five years.

Advantages of an older property include:

- Price
  Due to age, you will be able to purchase an older property for a comparatively lower price than a new property.
- Gross Yield (Rental Return)
  Generally speaking, gross yields are slightly higher for older properties than new properties.
- Financing the Property
  Due to the discounted price, you are less likely to have shortfalls with bank valuations so financing the property may be easier.

"Every investor has a finite amount of money they can use to service their investments"

Generally, the advantages of one may be disadvantages of the other and vice versa.

So what does this all mean?

In my opinion, the bigger issue for the investor is how these advantages and disadvantages effect the holding cost of property. Every investor has a finite amount of money that they can use to service their investments and that amount of money will drive the decision around the type of property to invest in.

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To explain what I mean, let's consider an example with two property investors: John and Jane. The two investors both earn $65,000 per annum and have both borrowed 100% to purchase the properties. The most notable difference is that John is buying an older property and Jane is buying a new property. We will use real life examples. The 34 year old property that John is purchasing was taken off realestate.com.au, and all details regarding the property have been confirmed by the local real estate agency who is managing the sale. Jane's property is one that is being recommended to Blue Wealth clients. They are both two bedroom units, of comparable size and features, the main difference being the age. Both properties are located in a southern Sydney suburb and are within close proximity to each other.

The table below summarises the differences in the holding costs of these two properties.

Jane's property is in a superior location, has better finishes and, of course, is brand new. All of this is reflected in the higher price.

In order to keep the analysis consistent, we have used the following assumptions for both properties:

- Jane and John have approximately $100 per week to spend on an investment
- Interest rate on the housing loan is 8% (despite the fact that rates are currently lower)
- Vacancy rate for both properties is 0%
- Real Estate Management fees are 6.6%
- The loan to value ratio (LVR) is 100% plus costs

	Jane - NEW	**John - OLD**
Purchase Price	$375,000	$249,000
INCOME		
Rental Income	$22,100	$16,640
Depreciation	$10,496	$3,113
EXPENSES		
Interest Expense	$31,191	$20,869
Rental Costs	$3,941	$5,068
Shortfall Pre Tax	($13,031)	($9,297)
Shortfall Post Tax	($5,524)	($5,221)
Holding Cost Per Week	$106	$100

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In Jane's case, she will pay $375,000 to acquire the new property. Assuming there is no vacancy; she will collect $22,100 in gross rent and will claim $10,496 in depreciation on the building and its fixtures and fittings. Although there is no actual income stream from the depreciation claim, I have included it on the income side of the balance sheet as it will actually be a positive to Jane's after tax position.
Jane's total interest bill at a rate of 8% will be equal to $31,191, and miscellaneous rental costs (this includes letting fees, management costs, strata costs etc.) will be $3,941. Therefore the total shortfall will be $13,031 in the first year, or $250 per week. This dramatically changes once the tax benefits of investing in property are accounted for with the post tax cash flow being equal to $106 per week.

John's position is easier to cash flow on a pre-tax basis, with the older property expected to cost him $178 dollars per week. However due to the property being older, and the fact a large part of the depreciation claim would have been reduced in the first five years after construction - John's depreciation claim has been estimated to be $3,113 in the first year. Hence the post-tax cash flow will be $100 per week in the first year.

So as it stands, although the new property is worth a lot more, and would cost a lot more to acquire, the cash flows for the two properties are almost identical. The new property costs an extra $6 per week to hold, even though the property is worth $126,000 more. So let's back to the main point - wealth creation.

Let's assume over the next 10 years, both properties grow at 6% per annum. In ten years time the older property will be worth $445,921, and John's profit before tax will be $196,921. Jane's new property at the same growth rate will be $671,567; therefore Jane's profit will be $296,561.

"the cash flows for the two properties are almost identical"

	Jane - NEW	**John - OLD**
Purchase Price	$375,000	$249,000
Holding Cost Per Week	$106	$100
Value in 10 Years	$671,567	$445,921
Profit	$296,561	$196,921

To take this one step further, John's property will need to grow 32.33% faster. This is unlikely to happen as history shows that old property does not grow faster than new property in the same area.

For more information register to attend one of our free educational seminars at www.bluewealth.com.au.

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