How are you going to get passive income from property investing?

By Ross Barnett

I think all property investors aim to have passive income at some point, so that they can retire but still have income coming in. For some this is just to supplement retiring at 65, while others hope to retire younger.

Unfortunately in 2017, if you buy a standard investment property, it is likely to be costing between $5,000 and $10,000 per year with a 100% mortgage. If you purchased one of these, it does the opposite to your goal of creating passive income, and actually needs you to 'top up' the rental each month.

So what strategies can you use to invest in property, in 2017, to create passive income?

1. Buy Cash flow Positive

There are a few ways you can achieve this:

- By putting in a good deposit to reduce debt and interest (borrowing more on another property is still borrowing more, so this needs to be a cash deposit). This could be from property trading profits, for example.
- By buying a property with a good yield.

If the rental property is cash flow positive, then life is easy. The rent pays for all the expenses and you are not personally having to top up. Ideally, the rent would also pay for some principal so that you can slowly pay the loan off over 25 to 30 years. This would give you a long term passive income.

The risk is low as you are not relying on capital gains. In fact, it doesn't really matter if the property goes up or down in value. You are after the passive income long term to give you a good lifestyle and retirement.

Issue – It is extremely easy to say, 'buy a property with a good yield'. To break even, this would need to be around 6.6% Gross Yield based on full 100% mortgage and paying 4.5% interest. But if interest rates just go up to 5.5%, then to break even you would need a 7.7% Gross Yield! It is very hard to find a good rental, in a reasonable location with this rent.

Generally to buy a rental with 6.6% or higher Gross Yield you are looking in low population area's which have risks associated.

A few different possibilities to obtain a high gross yield

a. Rent by room – be aware that this incurs extra costs such as power and needs to be extremely well managed
b. Fully furnished – for a small extra cost (compared to property value) a property can be fully furnished. In the right area with the right demand, extra rent can be obtained.
c. Commercial – This is often a lot more complicated and does have additional risks compared to residential. A good buy for a commercial used to be 10% Yield (tenant pays all outgoings so only interest to pay with this) but in recent times has moved to around 7 or 7.5%. Also banks often require the loans to be repaid over 10 or 15 years, so any profit can disappear in principal repayments, or in many cases the principal repayments are more than the profit meaning more cash has to be injected each year and in some cases money for income tax due too.
d. Leasehold commercial – even more complicated and with even more risks. But can obtain a good return, for example one I looked at recently, the rent would pay all the expenses plus pay of the mortgage over 12 years!

2. <u>Buy Negative but pay down loan quickly</u>

Buy negative, but pay down debt quickly from high personal or business income. Or from trading income.

This works well for high income investors or successful property traders.

For this strategy to work, you really need to have a debt free personal house or be close to it. Otherwise you should be putting your cash into your personal house debt.

For a high income investor with no personal debt, a strategy could be:

- Buy brand new, brick and tile investment property. Quite negative to start with, but over first two years, pay off $100,000 of debt, making it positive.
- Then paying off another $50,000 over the third year. At which point the investment should be able to cover its own expenses and principal over 25 years.
- Buy second rental and repeat the process.

3. <u>Add Value (My Favourite)</u>

Add a minor dwelling, or convert from two bedrooms to three bedrooms, convert garage to sleep out, or subdivide. All of these strategies can improve the cash flow from your rentals. What is often missed or forgotten, is that a well-planned, simple renovation can also improve your cash flow.

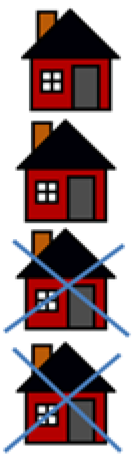
This strategy is great if you are a tradesperson and can add value. It also works in well with Strategy 4.

Done right, this strategy adds both equity and cash flow.

If you have existing properties, it is worthwhile reviewing your portfolio and looking at opportunities to create more cash flow and equity.

4. Half Portfolio

Buy say four properties, keep for reasonable period, then sell say two, so that the two remaining are debt free, giving you passive income. Variations on this are very common.



Long Term

This strategy relies on capital gain. So you would want to ensure you pick a higher capital gain area, such as Auckland.

For this strategy to work and for the two properties remaining to be debt free, then the four properties would need to double in value. So this would need to be a long term strategy.

What happens if there isn't capital gain? And that is the potential problem with this strategy, is that it can quickly turn into 5) , and become a disaster with four properties all being negative and costing the investor considerable cash flow each year.

5. Buy and hope, or gamble on Capital gains

Is this a strategy? Buy a negative property and hope the value goes up. Unfortunately, **most** investors buy rental properties where the rent doesn't cover all the expenses, so they are negative. The investor has to top up every month. Often the investor can be paying in over $5,000 per year in low interest rate times. If interest rates go up, these rentals could be costing $10,000 or more per year.

Interest rate increase? How would higher interest rates affect your strategy?

It is amazing how many property investors fit into this category and are hoping/gambling on a quick increase in value. They have no plans to get the property to become cash flow positive and no plans to gain equity, except to hope the property goes up in value. If you are in this category, I think you need to work on a 5 year plan to turn the negative property into cash flow positive.

These are some extra points to consider that might help your property investing journal and you might like to develop some buying rules

- **Gross Yield.** Do you require a certain Gross Yield?

- **What size town or city will you invest in?** E.g. a rule might be to only invest in a growing town, or one with a population of more than 50,000.

- **Cash flow positive, neutral, or negative.** Cash flow positive is simply where the rent is more than **all** the expenses, including fair repairs. Negative is where the expenses are more than the income and you are having to top up with your personal income. Effectively, you are gambling that your long term capital gains are more than your cash loss over the same period.

- **Don't borrow for non-productive assets from your rentals.** For example, do you really need to upgrade to a personal mansion, do you need that new Ferrari? In the last boom, many investors borrowed more and more on their existing rentals, and really blew the money. Then, when the boom finished, they were left with rentals with high debt and negative cash flow.

- **Bare land has no income.** So be very careful speculating on sections. If you get stuck with one, it can cost a lot in rates and interest to hold for a year or two, with no rent coming in!

- **Finish projects while you can borrow.** There is no point having a site where you could have a minor dwelling as this doesn't help your cash flow. And if you can't borrow later, then you might not be able to do it then. So do the minor dwelling now and capture that extra rent and set yourself up with great cash flow.

- **Think about interest rates and your interest rate strategy** Five year rates are still very low and a spread can reduce risk. If you were moving 1 million eggs, would you want them in one truck? Do you really want $1 million plus loans all floating, or all on 1 year? I like to have a portion (maybe 50%) short term at low interest rates, and the other portion long term (5 years).

- **Be very careful speculating on the boom.** You can make a lot and there are good opportunities, but it is often better to be slightly more conservative, than go too big and go bust, if and when the market turns.

<u>How Waikato Property Investors Association can help you</u>

- Information from experts and sponsors. For example Valuit is a sponsor, they undertake chattels valuations which can increase your depreciation claims and therefore reduce your tax paid, or increase your tax refunds. An example that I recently saw on Facebook was a $17,194 saving from using Valuit!
- Meeting and mingling with other property investors. Learn what other investors are doing, what's working, what's not. Every month we have a meeting, generally with a speaker but this also gives you a chance to chat with other property investors
- Monthly NZ Property Investor Magazine
- Many other benefits, such as discounts from leading NZ suppliers
- Memberships for an individual only $260 per year

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