Switzer Super Report

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# Top 20 East Coast city areas set to grow

Our exclusive data today reveals there are plenty of opportunities for the savvy property investor. In both Sydney and Melbourne there are areas forecast to grow by over 8% per annum for the next five years. In Sydney, Neutral Bay/the Spit are on the top of our list and coming in at a close second is Inner Melbourne, where growth rates are forecast to be 8.42% per annum over the next 12 months.

Also in our property special today, guru Margaret Lomas looks at buying off-the-plan and explains why SMSF investors need to be aware of the risks. James Dunn examines four tips to round out your property investment strategy - for example, considering DFA housing could offer a reliable income stream and reduce some of your risks.

Sincerely,

Peter Switzer

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# Residential property - Top 20 city areas set for growth

by Penny Pryor

Neutral Bay and the Spit are the top areas for houses across the East Coast (Brisbane, Sydney and Melbourne) when it comes to five-year predictions in our exclusive run down of property data.

According to Residex, houses in this Sydney area are forecast to grow by an annual rate of 9.28% over the next five years and 9.59% over the next eight years.

Residex bases its projections on a number of factors, including analysis of historical data over many decades (back to 1901 for some areas) and other factors – such as interest rates, inflation, employment levels – to understand their bearing on the property market.

Its suburb report for Neutral Bay reveals only 27 properties on the market and a 0% discount rate, which is a very good sign. In the last three months alone, 85 properties were sold in a suburb that only has 96 streets.

**Melbourne**

For Victoria, the area predicted to grow the fastest is Inner Melbourne, where growth is predicted to be 8.42% over the next five years and 6.35% per annum over the next eight years.

The Residex suburb report for Melbourne (postcode 3000) shows that 515 properties have been sold in

**TOP 20 EAST COAST CAPITAL CITY AREAS FOR HOUSES**

| | Area | Postcode Range | State | Median Value | Forecast | | Historical growth | | Yield | | No. Sold | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | 5 Year % p.a. | 8 Year % p.a. | 10 Years % p.a. | Annual | Yield | Year Change in Rental Amount | Sales | Year Change |
| 1 | Neutral Bay / Spit | 2088 to 2091 | NSW | $1,991,500 | 9.28% | 9.59% | 3.41% | -7.16% | 3.25% | -10.79% | 411 | 6.20% |
| 2 | Inner Melbourne | 3000 to 3019 | VIC | $607,000 | 8.42% | 6.35% | 6.54% | -0.67% | 3.61% | 3.70% | 1,721 | 4.94% |
| 3 | Manly Warringah | 2092 to 2109 | NSW | $1,024,500 | 8.24% | 8.31% | 2.64% | -1.26% | 4.20% | -5.17% | 2,071 | 3.45% |
| 4 | Sydney Eastern Suburbs | 2021 to 2036 | NSW | $1,497,500 | 7.93% | 8.71% | 3.70% | 0.53% | 3.12% | 2.29% | 1,950 | -0.15% |
| 5 | Sydney Inner West | 2037 to 2059 | NSW | $948,000 | 7.29% | 8.42% | 4.48% | 1.04% | 4.10% | 4.93% | 1,932 | 0.84% |
| 6 | Brunswick | 3049 to 3064 | VIC | $516,500 | 7.21% | 5.66% | 5.24% | -2.24% | 4.32% | -1.15% | 2,733 | 14.16% |
| 7 | Sydney Lower North Shore | 2060 to 2069 | NSW | $1,379,500 | 6.82% | 7.94% | 3.83% | 0.27% | 3.48% | 3.95% | 1,292 | 5.13% |
| 8 | Inner Sydney | 2000 to 2020 | NSW | $900,000 | 6.65% | 8.24% | 4.57% | 1.77% | 4.19% | 3.57% | 573 | -2.72% |
| 9 | Essendon | 3031 to 3041 | VIC | $587,500 | 6.58% | 5.14% | 5.22% | -1.33% | 3.86% | 2.35% | 2,378 | 9.89% |
| 10 | Sydney Upper North Shore | 2070 to 2087 | NSW | $939,000 | 5.65% | 6.39% | 3.15% | 2.16% | 4.37% | 0.64% | 2,612 | 13.07% |
| 11 | Brisbane City | 4000 to 4014 | Qld | $635,000 | 5.20% | 6.92% | 6.71% | 4.43% | 4.48% | 10.10% | 1,085 | 16.17% |
| 12 | Redcliffe Houses | 4015 to 4024 | Qld | $393,000 | 4.12% | 5.77% | 5.89% | 2.03% | 5.21% | 4.00% | 1,444 | 3.88% |
| 13 | Meadow Heights | 3042 to 3048 | VIC | $428,000 | 3.91% | 3.12% | 5.55% | -7.62% | 4.10% | -2.90% | 1,470 | 0.07% |
| 14 | Fitzroy | 3065 to 3079 | VIC | $583,500 | 3.84% | 4.13% | 6.37% | -4.35% | 3.79% | 3.66% | 2,929 | 10.24% |
| 15 | The Gap | 4051 to 4069 | Qld | $592,000 | 3.61% | 5.43% | 5.88% | 2.35% | 4.62% | 6.06% | 3,195 | 6.68% |
| 16 | Springwood | 4124 to 4150 | Qld | $334,500 | 3.50% | 5.05% | 6.74% | -4.63% | 5.93% | 0.00% | 1,592 | 13.23% |
| 17 | Albany Creek | 4025 to 4050 | Qld | $471,000 | 3.36% | 5.22% | 6.48% | 1.01% | 4.96% | 0.00% | 1,626 | 9.27% |
| 18 | Sunnybank | 4103 to 4123 | Qld | $439,000 | 3.22% | 5.06% | 6.22% | -0.77% | 5.00% | 0.00% | 4,139 | 10.97% |
| 19 | Woolloongabba | 4070 to 4102 | Qld | $449,000 | 2.70% | 4.70% | 6.46% | 4.71% | 5.01% | 2.38% | 1,872 | 13.52% |
| 20 | Saint Albans | 3020 to 3030 | VIC | $348,500 | 0.87% | 1.85% | 6.15% | -2.68% | 4.66% | -1.59% | 5,960 | 2.62% |

*Data as at end February 2013. Source: Residex. Capital city refers to areas within a 25km radius of city centre*

this postcode in the last three months. That number also includes units of which there are a total 43,681 but only 753 houses in the area.

The remainder of our top 20 areas highlights the diversity of growth expected across the East Coast.

Queensland doesn't make an appearance until number 10 on our list but it has been dogged by lower sentiment and property experts expect it to be slower to rebound.

There are reasonably priced investment suburbs in our list as well, Brunswick in Melbourne, for example, has a median price for houses of $516,500, forecast growth of 7.21% and a yield of 4.32%. There was also a 14.16% increase in the properties sold there over the past year as well.

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# Things to watch out for when buying off-the-plan

by Margaret Lomas

When the property market heats up, we see an instant increase in the number of off-the-plan properties being offered for sale. With confidence returning to a market, developers seize on the opportunity to ramp up their construction and to make money while the market seems buoyant.

In the old days, off-the-plan was fairly simple. Developers, needing development finance, would offer around 20% of a development to the market at a price which reflected the market price of the day. These 'pre-sales' then provided the strength needed in a loan application and gave the lender confidence to advance the development funds. In return for these early sales, on what was essentially a risky product to invest in, buyers taking the risk took delivery of a property in a few years' time for which they paid a price reflective of 'yesterday's' value. Everybody won – the early buyers made money as soon as they settled and the developer sold the remaining 80% for a profit.

**A strange new world**

These days, though, developers attempt to sell out the entire development on irreversible contracts, which force a buyer to settle once complete, regardless of the underlying value of the property. In addition they usually attempt to set a buy price that is indicative of what they think it will be worth once settled, rather than at a discount to the future price. Suddenly the risk is placed completely in the buyer's court, with no recompense or reward available for taking this risk.

When you buy a property 'off-the-plan', you are entering a contract to purchase a property prior to its completion. The builder or developer produces a building plan, and you are essentially purchasing the intention to construct.

Once the contract is signed, you will pay a deposit, and you are then required to settle on the property once it has obtained its occupancy certificate from the local authority.

When considering any off-the-plan purchase, it is important to fully understand the contract and the obligations placed on both the purchaser and the builder or developer. Some legal firms now specialise in conveyancing services for off-the plan purchases as the complexities are beyond the experience of the average conveyancer.

**What to watch out for**

Buying an off-the-plan property must be considered to have a higher risk for a number of reasons.

They include:

- An inability to be sure that what is promised will be delivered;
- An inability to effectively visualise the final product;
- A reduction in the capacity to buy at market value – you can't forecast market value of any area three years beforehand;
- An inability to determine future demand for rentals, and actual future yield;
- An impossibility to determine future demand factors, as well as the potential future supply in that same market;
- The potential for you to reduce your ability to buy more property as you wait for the off-the-plan property to complete – while you are under contract for that property, a lender may be unwilling to advance funds for more property, effectively stalling your property acquisition; and
- Disaster if the final product does not value up to purchase price and your lender only agrees

to advance 80% of valuation – you are left with an unconditional contract to proceed, and if you are unable to raise the difference in cash or equity elsewhere, you may have to default on the contract and lose your deposit. This will be particularly problematic for self-managed superannuation funds, where equity in other property held in the fund may not be used to raise any difference, and where, if there are not sufficient funds available to meet the shortfall and you have reached your maximum contributions limit for that year, you will run into certain default on your contract.

**Other risks**

Additionally, many off-the-plan contracts include a clause that allows the developer to rescind at any time, for any reason. There have been many purchasers who have bought property off-the-plan and when, some years later and just before settlement when it is actually worth more than they agreed, find that the developer exercises his or her rights to terminate and pulls out of the deal, preferring instead to reap the profits him- or herself. Developers who do this have used the buyers' promises to buy (which are expressed in their purchase contracts), to raise funds from lenders to proceed with their developments, only to keep the profits and provide no reward to the buyers.

It is incredibly sad to see people caught up in this kind of trap, and off-the-plan purchases are particularly dangerous as you are dealing with the unknown future. It is definitely not an appropriate strategy for someone to undertake if he or she is in a weak financial position to begin with, or if they are using a self- managed superannuation fund with limited assets or available funds. In the past few years we have seen a prevalence of off-the-plan properties completed and being worth well below the purchase price and many purchasers defaulting on their contracts. Developers can, and will, pursue the contracts, forcing the buyers into difficult financial circumstances.

As an owner occupied option, an off-the-plan property may be suitable where the buyer has access to enough funds should their finance fall through or not cover the agreed purchase price. As an investment, though, they are risky and uncertain, and in most cases should be avoided.

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# Four tips for an SMSF property strategy

by James Dunn

Australians love residential property, and so do a lot of SMSFs. Residential property offers SMSFs a sound diversification, relatively low volatility compared with other growth asset classes, and historically strong returns – with the caveat that an individual property carries a large degree of idiosyncratic risk.

The flipside to that caveat, however, is that residential property is an inefficient market that, to the expert buyer, offers the equivalent degree of idiosyncratic opportunity.

Here are five things that an SMSF should consider when assessing its property strategy.

**1. Use the super tax concessions to the full**

SMSFs gain huge advantages from holding a property in the concessional tax environment of superannuation. Once the property is in the super environment, capital gains tax and rent are taxed at the super fund rate of 15%, and when the fund moves to pension phase after age 60, where the property is backing the payment of a superannuation pension, the income from the property and capital gain on its eventual sale are tax-free. This means that if you wait until the pension phase before selling the property, you can legally take capital gains tax (CGT) on the final sale out of the equation.

**2. Combine the tax concessions with the ability to borrow**

SMSFs are allowed to borrow to buy property if the recourse for the loan is limited to the asset in question. Under the rules, there is a "single acquirable asset," meaning that only one property at a time can be bought under each separate borrowing arrangement.

The lender can be a related party: this means that a person can lend money to their super fund to buy a property.

If the fund borrows to buy the property, it can claim interest payments as a tax deduction and potentially reduce tax liability. This gives the fund the ability to diversify its investment portfolio through prudent borrowing, while giving significant tax advantages as well.

**3. Consider government-offered residential property packages**

Defence Housing Australia (DHA) and the National Rental Affordability Scheme (NRAS) are federal government schemes that provide several benefits – and mitigate several prominent risks – and are thus worth considering by an SMSF wanting to invest in residential property.

Defence Housing provides housing to members of the Defence Force and their families, and offers investors the opportunity to buy individual dwellings and lease them back to DHA. Investment can be a lease of nine to 12 years or three to six years. Investors have no tenanting or management responsibilities and their rental income is backed by the federal government.

DHA costs a lot more than standard property management, but vacancy risk is virtually nullified. Also, DHA pays for total refurbishment of the property on the exit of a tenant – a cost not normally paid by a tenant.

NRAS is a tax-effective property investment in which investors rent approved houses at 20% below current market rates to eligible tenants, in return for a financial incentive of a minimum of $9,981 tax-free per house annually.

The tax advantages of SMSFs are particularly well-suited to NRAS. Cashflow is usually positive from the outset, out-of-pocket costs are minimal and there is a tax-free grant at the end of each year.

The drawback with both of these ownership structures is that you do not control your property.

**4. Consider a syndicate to lower your entry cost**

Property syndicates enable SMSFs to be involved in investments they could not make on their own. Most syndicates set up these days are SMSF-compliant, reflecting the huge demand from SMSFs for property investment. It is common to see syndicators offering a $20 million office building funded by SMSFs (and other investors) putting in anywhere from $50,000–$100,000 each, and enjoying 9%-plus yields for their trouble, with any capital gain on the building a bonus down the track.

An interesting alternative structure is DomaCom's "fractional ownership" online property platform that is scheduled to be launched in the third quarter of 2013. Using the DomaCom platform, residential and commercial property will be made available by owners and developers, and SMSFs and other long-term investors will be able to buy (and sell) fractional interests in these properties. DomaCom will also lower the entry cost of property investment.

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# Some smaller targets to consider – The Reject Shop, Cash Converters and Silver Chef

by Roger Montgomery

As private investors searching for value, it is easy to be daunted and overwhelmed by the amount of money in the share market controlled by fund managers. Indeed it can feel like turning up with a knife to a gun fight.

However, those gun-toting fund managers are only able to shoot in one direction – for example, they're restricted to dealing in large companies, or mid-sized companies or small 'caps'. For those carrying elephant guns, they need a Woolworths, a BHP or an ANZ to pass through their cross hairs before they can pull the trigger. Others can never shoot at cash and they have to have a ute-full of 'trophies' at all times.

But as a private investor we have the luxury of being as selective or as generalist as we like. We can use a shot gun or a water pistol and can even put the arsenal down and do nothing for a time.

Ok, I am starting to feel uncomfortable taking this analogy any further…

At Montgomery Investment Management, we have insisted on the same level of freedom as a private investor. I believe that the best value can be found in companies of any size and often it can be found in stocks that receive the least attention. Remember, you pay a high price for a cheery consensus. With this in mind, here are three companies (for you to investigate further and seek and take personal professional advice about!) that are unlikely to appear on the radars of the major funds.

**The Reject Shop**

The Reject Shop is a discount-variety retailer that I have written about on numerous occasions. Discount-variety retailers have the unfortunate perception among some consumers that they offer 'junk'. But not all customers, and certainly not all investors, are turned away. Indeed, investors who take a second look at The Reject Shop will discover that it is an extraordinary business with an unrivalled brand awareness, if not an unrivalled distribution network within its sector.

The Reject Shop currently has a network of 267 stores across Australia, but its two distribution centres in Ipswich and Melbourne alone have the capacity to service 400 stores. This offers incredible and profitable growth potential. When you consider that management is aiming to open a third distribution centre in the coming years to service Western Australia, one can see the path of margin improvement quite clearly.

The strength of this network is demonstrated by management's response to the recent failure of a major competitor. Retail Adventures went into voluntary administration in October 2012, and consequently many leases became available that were previously occupied by their stores (which included Sam's Warehouse, Crazy Clarke's and Chickenfeed).

The Reject Shop secured as many of these former leases as they could that suited the company's store rollout. As a result, management is well on track to open 40 new stores this financial year – well above the number predicted by analysts, and their eyes are keenly set on securing a number of leases that are coming due next year. Analysts are not forecasting quite the same number of openings next year but we reckon they might be behaving unduly pessimistically.

**Cash Converters**

The next retailer worth researching is Cash Converters. CCV owns a network of stores that has grown along with earnings per share growth of 13% each year since 2004.

Cash Converter's franchised and owned network of stores sell second-hand goods and provide short-term 'micro' finance. The business model has become so profitable that management is repurchasing stores from their franchisees to capture a greater share of earnings. The company has a lot of potential to increase earnings further in this manner. When one considers that half of the 104 stores in Australia and 161 stores in the United Kingdom are franchisee-operated, the profit growth potential from repurchasing and refitting stores becomes rather more clear.

Cash Converters' main earnings stream is providing short-term finance to clients who typically have a poor credit rating. Over many years, Cash Converters has a built a vast database of its customers' credit profiles, providing an intimate understanding of their capacity to repay their loans. This helps to mitigate bad debts while increasing customer loyalty. Over recent periods, management has been growing the loan book at a considerable rate in Australia and the United Kingdom – if bad debts are maintained at low levels, this will also contribute to higher earnings as the loans are repaid.

**Silver Chef**

The final retailer is one that you may not have heard of as a consumer – but you definitely would want to know about as an investor. It's Silver Chef – a company that has grown earnings per share at an annual rate of 38% since 2004!

Silver Chef is a provider of the popular rent-try-buy model of capital-intensive goods for restaurants, coffee shops and takeaway outlets. Silver Chef's rental programs put less stress on a business' cash flow in their start-up phase – this has allowed the company to remain profitable during the recent downturn.

Silver Chef enjoys a limited competitive landscape because the banks and large finance companies are reluctant to deal with many small café owners. Indeed, this model has proven so successful that management has expanded into industries outside of hospitality under the brand name "GoGetta".

Management believes that GoGetta equipment financing will be just as big as the café/restaurant business. This is an exciting prospect when you consider that GoGetta has $73 million of assets under management, while the hospitality division has $157 million of assets under management. The growth prospects for the hospitality division are just as promising, with the company experiencing initial success from its recent expansion into New Zealand.

The Reject Shop, Cash Converters and Silver Chef have a combined market value of just over $1 billion. This may not seem much when you consider that the market capitalization for the Commonwealth Bank of Australia is over $100 billion, yet we believe that these are excellent investment opportunities which should not be overlooked because of their size.

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# Fundie's favourite – Zurich on Austbrokers

by Patrick Nobel

**How long have you held company Austbrokers?**

We have held it since our Small Companies Fund inception back in October 2010.

**What do you like about it?**

Austbrokers has a unique "owner driver" model whereby it takes stakes in insurance brokers. The brokers receive the benefits of scale, along with administrative and strategic support. Austbrokers receives revenue primarily from insurance commissions and fees. The company is well run, having delivered strong growth for investors since it listed on the stock market.

**How is it better than its competitors?**

The company is one of the largest broking networks in Australia with a strong regional presence. Austbrokers has been very successful at consolidating broking firms, though growth has been achieved both organically and via acquisitions.

**What do you like about its management?**

Management has a track record of delivering strong earnings growth in excess of market consensus. At its most recent results, full year guidance was once again upgraded. The dividend was also increased.

**At what point would you sell it?**

On valuation grounds and/or other compelling investment ideas, which could displace the stock in the portfolio. For example, deterioration in the SME sector could hurt earnings and an increase in competition for acquisitions could also crimp growth.

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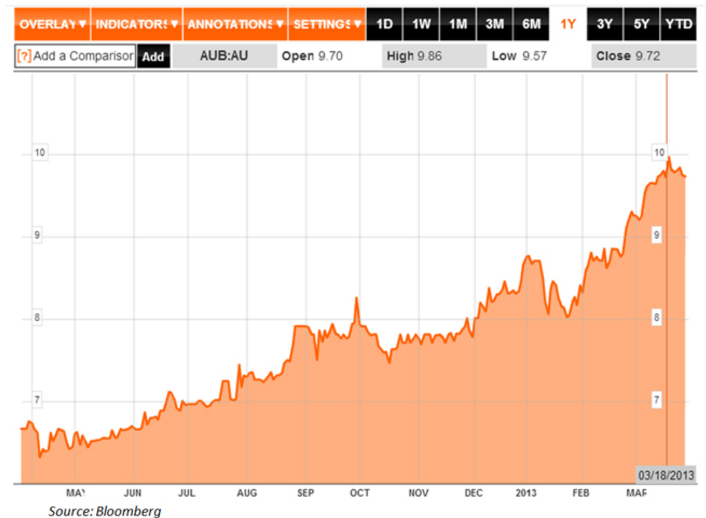
**Stock Chart for Austbrokers (AUS)**




**How much has it added to your overall portfolio over the last 12 months?**

The stock is up in the vicinity of 50% over the last 12 months. As one of our larger positions, Austbrokers has provided a strong contribution to our portfolio's return over this period.

**Where do you see the value?**

The premium rate cycle is 'hardening', which is a positive for Austbrokers, though the company notes that some segments, such as property, are stronger than others. Cross-selling opportunities, growth in other business lines, along with further acquisition opportunities are positive drivers of earnings and supportive of the share price.

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# Question of the week – Investment properties and SMSFs

by Tony Negline

**Q:** *Can a couple buy an investment property that their SMSF owns (at market price)?*

**A:** Thank you for your question.

An SMSF can only acquire a limited range of assets from its related parties, which include the fund's members, their relatives, close business associates and entities any of these control or are deemed to control.

This limited range of assets doesn't include residential property. Typically, only business real property and listed shares are permitted.

An SMSF can, however, sell any asset to any of its related parties.

Any acquisitions and disposals between the SMSF and another party must be done on an arm's length basis. Effectively this means the super fund can't pay more for an asset than market rate (but can pay less) and can't sell for less than market rate (but can sell for more). CGT and stamp duty for all concerned are generally worked out on an arm's length basis.

If a transaction is completed that sees the super fund with more assets than it ordinarily should have, then the ATO generally deems the increase amount as a contribution for contribution cap purposes.

To answer your question – yes, however, only at market price.

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## Did you know?

I spoke to Walkley Award winning documentary maker David White earlier this week about the future of Fairax. Turns out, it may not be that bright.