



3 ways to retire

on property

Investors can use property to create a retirement income in a number of different ways.

PART of the beauty of property is the range of choices it opens up to investors. You can invest in many types of properties: residential (houses or flats), industrial, retail or office. Or you can invest in land.

In terms of investing strategies, you could:

- buy and hold
- renovate
- be a developer

That's to name just a few! An investor can mix and match between these too, for example by developing a plot of land into a duplex, selling one dwelling and holding the other, which is added to a portfolio. Not all investors realise, however, that there are also many choices available to property investors in terms of how they retire on property.

In the same way that there are multiple means of investing in properties, there are also multiple ways to use property to retire wealthy - or early.

We'll look here at three ways to do that and the ins and outs of each, as well as examples of how an investor might use each one to retire.

Before we do though, we need to make a quick detour via assets and passive income.

Assets and passive income

As obvious as it sounds, in order to get somewhere you need to know where you're going. In the context of investing to retire on property, that means having a clear understanding of your financial target - how much income you'll need to retire. Investing is about generating passive income - that is, income that comes to you without any effort on your part. When your passive income exceeds your expenses you're able to retire.

This boils down to knowing two things:

- the amount of your expenses (so that you have a target for how much passive income you require to retire), and
- the size of the asset base required to generate that level of passive income.

The first of these is easier to estimate than the second, so you'll want to calculate the asset size on a conservative basis, that is, tend to over estimate your needs rather than under estimate them by building in a margin of safety.

Better to factor in extra time or a larger number of properties required to retire than not enough - after all who wants to be caught short in retirement?

As we'll soon see, the way that asset base generates passive income is different in each of the three methods. The principle however is the same: know your expenses so that you know the passive income you need to retire. Then estimate the assets required to generate that income. And don't forget to account for tax.

Method 1: Retire on rents

This is the 'plain vanilla' approach to retiring on property and probably the most common: the investor accumulates a leveraged portfolio of properties over time and then sells some properties to pay down debt. The remaining properties in the portfolio are either unencumbered (that is, there's no debt associated with the properties) or have only such a small amount of debt associated with them that the interest on the loan is minimal. The passive income supporting the investor in retirement is the rental income generated by the unencumbered properties.

With this method, extra properties have to be added to the portfolio; these serve the purpose of generating equity that's used to pay down debt (when preparing to retire later on). The remaining properties are the ones that generate the rental income used for living expenses rather than repaying loans.

In this method then, properties serve two purposes: they generate rents to live off, and equity through capital appreciation to pay down debt.

The twist here is that the properties used to add equity that pays down debt are themselves debt-financed, until retirement. That debt must also be paid down.

All of this makes the calculation of how many properties are required to retire and the size of the asset base needed to generate the retirement income quite complex.

Example. An investor calculates that she needs five unencumbered properties to retire. She acquires eight properties over a period of years, lets them appreciate to a value of \$8 million financed by \$3 million in borrowings, then sells three properties (paying sale costs and capital gains tax), leaving five unencumbered properties. The rent from these five properties provides the funds to pay the investor's living expenses in retirement.

Method 2: Refinance in retirement

This is the riskiest of the three approaches. In this method a property portfolio is accumulated, as in the 'Retire on rents' approach. But instead of selling properties to pay down debt, the entire portfolio is refinanced in retirement so that the loan to value ratio (LVR) is 'topped up' periodically to provide funds.

METHOD 1: Retire on rents

PROS

- Rents rise over time with inflation.
- Can benefit from spikes in rents.
- Borrowings are reduced in retirement so there is negligible debt or interest rate risk.

CONS

- Still dealing with property matters in retirement.
- Retirement is subject to the vagaries of rental cycles; rental vacancies can arise leading to reduced income.
- Capital gains tax payable when properties sold to pay down debt.

With this method the passive income is the additional borrowings made available by refinancing in retirement. In effect, the investor adds to their borrowings to pay for the groceries. The interest is capitalised, that is, it's added to the principal and interest is payable on the new, larger borrowing amount.

If that makes you a bit nervous, that's probably because we are accustomed to using debt to finance capital items that are tax deductible rather than consumption items that can't be claimed on tax. The other fly in the ointment with this approach is that the investor needs to have an accommodating bank or lender that's willing to grant additional borrowings when there's little or no increase in capacity to service the larger debt. In fact the only factor boosting the ability to service debt is the rise in rents, which is likely to be moderate.

The investor may need to rely on low doc loans.

A bank will likely be happy to lend to a borrower with an LVR of 50 percent or less without the

METHOD 2: Refinance in retirement

PROS

- No capital gains tax is payable because no properties are sold.
- Funds used to live off in retirement are not taxed.

CONS

- Highly leveraged retirement: borrowing and interest rate risk are carried into retirement. Overall borrowings rise with only rental growth service a growing debt.
- Need a bank or lender willing to accommodate refinancing when there is little or no increase in capacity to service additional borrowings.
- Relies on ongoing capital growth to underpin refinancing.
- Property management and tenant responsibilities are retained.

borrower having to show a 'real income'. Another consideration is that there must be ongoing capital growth somewhere in the portfolio to enable refinancing to occur without affecting the LVR.

On the plus side, however, the funds generated by the refinancing aren't classed as income for tax purposes and hence income tax isn't payable.

Example. An investor has accumulated a property portfolio worth \$6 million with \$3.5 million in borrowings associated with it. The investor's LVR is therefore 58 per cent (3.5 divided by 6 equals 0.58 which is 58 per cent). The investor refinances to 60 per cent and pulls out \$100,000 in tax-free funds to live off for the year. The \$100,000 is added to the \$3.5 million debt, taking total borrowings to \$3.60 million.

Method 3: Sell up and park the proceeds.

The third approach to retiring on property involves accumulating a leveraged property portfolio, selling all the properties in the portfolio and investing the proceeds in a low-risk investment vehicle such as a managed fund. Lower risk often means lower return.

In this approach the passive income which supports the retirement is the distribution from the managed fund. (A distribution is the regular income component of the return on a managed fund in the same way that a dividend is the income component of the return on a share).

The 'sell up' method treats property investing as a means of accumulating wealth to retire but not of generating income in retirement.

The capital growth of the portfolio is what creates the wealth with this approach, and the wealth is then transferred to a different vehicle that has no borrowing commitments, nor any tenant or property management concerns.

An investor using this approach would build their property portfolio focusing on high capital growth properties rather than high rental yield properties. The trade-off for these benefits, however, is that in retirement the income is subject to other forces such as the stock market if you park your capital in a managed

fund that invests in shares, or interest rates if you park the capital in a cash management trust.

Example. An investor builds a high capital growth portfolio of four properties worth \$3.5 million financed by loans of \$2 million. He sells all four properties and, after extinguishing the loans and paying capital gains tax on the sale plus sale expenses, is left with net proceeds of \$1.1 million. This amount is invested in a managed fund which pays an average 6 per cent (or \$66,000) distribution per year, providing the passive income that pays the investor's living costs in retirement.

Mix and match

One thing to bear in mind is that many investors will likely have some funds coming to them in retirement from compulsory superannuation. These funds could be used to pay down debt in the 'Retire on rents' or 'Refinance in retirement' methods. Or they could be used to supplement income in retirement, while keeping the tax advantages associated with borrowing, provided that there's sufficient income to meet the investor's desired standard of living. Each of these three methods uses property wealth in a different way to support retirement and each generates passive income in a different form.

It's useful to note though that these three methods are not completely mutually exclusive: you can mix and match elements of each according to your preferred trade-off of risk and return.

For example, you might choose to adopt the 'Retire on rents' approach but refinance to access funds on an ad hoc basis or in case of an emergency.

Or you might favour the 'Sell up and park the proceeds' method but retain one rental property and some debt in retirement in order to improve the tax effectiveness of your situation.

The possibilities and permutations are endless. And it's good to know that considering we're talking here about planning for how you're going to spend the latter part of your life, that you have many options open to you.

Which brings us full circle to the range of choices that property investing affords, not only in the type of property you accumulate and the investment strategy which guides your accumulation efforts, but also in how you use property to fund your early - or wealthier - retirement. Each investor has different needs and unique tax implications on retirement funds. The information in this report is intended as information only and your Homestead team strongly encourage all our clients to seek their own independent professional advice when determining their retirement strategies.

If you are still in the 'Building' phase of your property portfolio, we can help. Our prime inner city location, together with our Baldivis and Kalamunda/Darlington Division, and local reputation means we always have many potential investment properties for sale. Our website is a great place to start or please call us to find out about our current listings, or our 'silent' sales.

METHOD 3:

Sell up and park the proceeds

PROS

- No vacancy or property issues to deal with in retirement.
- No loan repayments or borrowing commitments after retirement.

CONS

- Large capital gains tax bill incurred when property portfolio sold.
- Retirement income can be buffeted by fluctuations in the share market or interest rates, or corporate conditions.



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is Your Guarantee**

7 Good Reasons To Choose Homestead Realty

Why you should choose us:

1. PROFESSIONAL

Real estate is a serious business that should be handled by professional people. Homestead Realty has been successfully serving our clients real estate needs since 1987 and has forged a proud reputation for success. Motivated, highly skilled professionals are essential to get you the best outcome and we will only employ passionate, committed people.

2. INTEGRITY

At Homestead Realty it's the things we won't do to get a deal that defines the way we do business. We will not compromise our reputation just to 'chalk up another result on the board'. We will act in a manner that at all times earns, creates and demonstrates trust. We know that not all business is good business and we strive for a win/win in all our dealings.

3. CLIENT FOCUSED

We understand that real estate and property is all about people. Our business systems have been designed to exceed the expectations of our clients, and to keep our clients coming back to Homestead Realty. Client feedback continues to shape the way we do business, and we measure ourselves by the level of your satisfaction after the deal is done.

4. RESULTS FOCUSED

We know that ultimately our clients employ us to do the job and we believe in active decision making and getting on with the job. Nothing else matters unless we succeed in this mission. The team at Homestead Realty has the focus & energy to 'go the extra mile' and achieve outstanding results. Our actions speak louder than our words and we expect to be held accountable for our performance.

5. FLEXIBILITY

As an independent boutique real estate agency, and REIWA member, Homestead Realty has the capacity to provide you with complete flexibility and a choice of method of marketing, sale or management, of your property. All backed by a recent track record across all accepted forms of property sales and property management.

6. INNOVATION

Advancing technology & the changing ways to access information mean that the only constant is change itself. We stay close to industry leading developments and have been 'early adopters' of new products that help bring buyers and sellers together or match quality tenants with our rental properties. Our website (www.homesteadrealty.com.au), and our presence across all the major real estate internet portals mean we reach more people more often. All our listings are optimised for viewing from mobile phones which is now the fastest growing method of internet access.

7. REPUTATION

We know the importance of a good reputation, and we are known by our reputation for good business. Our reputation is the lifeblood of our business. Many Homestead Realty clients have bought and sold with us more than once, and many of our property owners trust us to manage their entire investment portfolio. We only want mutually satisfied client negotiations with all reputations intact & enhanced afterwards.