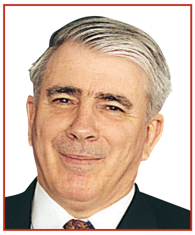
Warning to dentists re: property investment or property basics 101

By Graham Middleton, BA, MBA



"Almost universally, dentists' homes and practice premises are much better investments than residential rental property... As far as residential rental property goes, those homes on their own land are much better investments than high-rise units..."

Overwhelmingly, the two best property investments a dentist makes are:

1. Their family home. Typically, successful dentists have started out with a modest home, built up their equity and then upgraded to their long-term family home. Aside from being capital gains tax free, their home is an important part of their family identity. As owner-occupiers have a greater incentive to look after their home and improve it compared to tenants, a family home invariably turns out to be a much better investment than residential rental properties; and

2. Their dental premises. Ownership of dental premises provides them with greater long-term control of their dental practice, including control of their often-expensive fit-out. Since most dental premises are sold by previous practice owners to the buyers of their practices, transactions involving dental premises are rarely seen by real estate agents and hence real estate valuers have difficulty in finding evidence of them. Dental premises invariably turn out to be a much better investments than rental properties. However, no real estate spruiker is going to tell you this truth, nor is in all probability an accountant with a financial interest in assisting developers to sell investment properties to their dental clients. This introduces a serious bias in advice regarding investment property vis-à-vis homes and practice premises.

What about residential rental property?

27 years of measuring the advancement of the wealth of an extensive dental client list has demonstrated to me that a disturbingly high proportion of residential rental property investments turn out poorly. Statistics don't differentiate between owner-occupied houses and rental housing. The owner-occupied houses are generally worth much more and are far more likely to be extensively renovated and extended. Mixing the sales data presents an inflated picture of the possible gains from investing in residential rental properties.

The worst real estate investments

These are high-rise apartments sold off the plan by highly sophisticated selling teams with models and artists' impressions of what units will look like on completion. The cost of marketing can be up to 20% of the developer's total budget and dwarfs any stamp duty saving gained from an off the plan purchase. Investors find that when they try and sell an individual unit a year or two later, not having a highly tuned marketing team but reliant on a conventional agent selling an isolated unit in a tall tower, with particular access problems, results in:

a. A resale price in the secondary market which is substantially lower than the price they paid for their off the plan purchase;
b. There is a new development a short distance away being sold by the same slick marketing team that sold them the original unit and which has a great advantage over the agent trying to sell their unit; and
c. The unit they purchased looks much smaller on completion than did the artist's impression in the promotional material put before them by the sales team.

If nothing else, this tells investors that it would be better to buy the slightly used unit on the secondary market and bargain the price down than to buy new units off the plan. All tall towers will become slightly shopsoiled within a short time after completion.

Yield

Residential properties have low net rental yield because their residential landlord has to pay all of the outgoings, including water rates, municipal rates, insurance, body corporate fees, repair and maintenance charges and leasing agents' fees. It's often the case that the net rental yield turns out to be a paltry 1-3%, even before taking interest costs on borrowings into account. Forget negative gearing; high-rise apartments are poor investments to start with.

The next worse real estate investment

The next worst investments are new residential rental townhouses or cluster houses; if a high proportion of them are being sold to investors rather than owner-occupiers. Generally speaking, the fact that accountancy firms are in league with property developers to sell them as investments is an indication that a high proportion of them will be tenanted rather than occupied by owners. Once again, the cluster can look decidedly grubby within a relatively short time and the renters amongst the occupiers have little incentive to look after their tiny patch of garden or to clean up oil spills in parking areas.

The best residential investment properties

While none of them are as good as owning your own house or practice premises, a look back into the 1950s and 1960s gives us an inkling. The post-war immigrants with concrete and plaster in their blood but little money preferred to buy structurally sound properties which were badly in need of maintenance because they could buy them more cheaply and were prepared to do the work on making them habitable themselves. These were the investors with a natural affinity for building who crawled underneath houses and into the roof cavities to find out the structural issues before buying and used their skills to add value. Such properties may be harder to find today, but the basic rules are:

1. They must be structurally sound; and
2. They must be situated on their own land.

A small apartment, which in reality is a box of air in the sky, has no land content and it will be miraculous if its value keeps pace with inflation. It cannot be extended and has no control over the rest of the building. There is usually too little space inside to make significant alteration. It will never look as attractive in its afterlife as it did on the presentation brochures provided by the real estate developer's sales team.

Dodgy developer projections

It's normal for selling teams attached to high-rise developers to produce projections of rental income and capital growth. All of the ones that I have seen over the years have been built around an expectation of capital growth being much greater than inflation. Since over the long-run, inflation is basically a measure of wage movements, such projections are illogical. They are really saying that rents will go up twice as fast as income, but in reality that cannot happen.

The trick

If challenged, the producers of these projections will argue that median prices of houses have gone up by a lot more than inflation. However, there's a trick to this: a great deal of the housing which is sold has been substantially renovated, extended and modernised by the owners during the period of ownership. All the real estate statistics measure is the price at which titles transferred. In extreme cases, the statistics ignore the fact that an original house was bulldozed and a new, modern, architect-designed home and pool were put on the same block, because all the statistics measure is the price at which the title of the land transferred. All of the capital insertions inflate the statistics because in a great many cases, what is being sold has been dramatically improved compared to what has been bought in the first place. When residential units are mixed in with the wider housing stock and the statistics used to justify their investment potential, the statistics are presenting a big lie. High-rise units cannot be extended, nor do you have a backyard in which you can insert a swimming pool.

Syndicated commercial property

Syndicated commercial property with small to medium sized properties included in the syndication are also much riskier than indicated at first impression. Part of the problem is an inadequate secondary market compared with the big listed real estate investment trusts which can be bought and sold on the stock market.

Syndicates become troublesome when economic circumstances change and some members need to exit, or where capital needs to be spent on renovation but some syndicate members are unable or unwilling to contribute.

The pits - accountancy firms flogging property

This creates an enormous conflict of interest but it's worth dwelling on why it happens. The quality of investment is inversely related to the difficulty in selling. No owner of a Sydney harbour foreshore property or a house in Toorak would approach a firm of accountants to help them sell their property. That would indeed be bizarre. The reason is simply that properties in those locations will always attract interest in the normal real estate market.

Warning signals

If a product is so hard to sell that its promoters have to approach firms of accountants or financial advisers to make sales, this is a warning signal that the property itself has features which no professional investors would touch. As an example, for many years a horde of unscrupulous accountants with a single product licence from ASIC flogged eucalypt plantation investments to their clients for the likes of Great Southern Plantations. They were usually paid 9% or 10% commissions. About 50% of the commission was paid upfront and the other 50% on a volume bonus provided that they met a predetermined sales target. The accountants had financing packages ready for signature. On close analysis, the financials of Great Southern Plantations and some other timber companies screamed out a message that no professional investor would touch it. However, greedy and unscrupulous accountants grabbed the 10% commission and put on fancy presentations to their professional clients, who they loaded up with the investment. The sales were based on accountants' projections of tax savings which were actually a tax deferral rather than a saving and they ignored the fact that the underlying investments were unsaleable to professional investors.

The final sale and volume bonus

Who would've liked to have been the client that the accountants needed to make their final sale in order to obtain their lucrative volume bonus? Particularly if their business plan depended on that volume bonus being paid to them?

27 years

In 27 years of advising professional clients, I have come across many who were sold plantation-style investments through accountants and financial advisers, but I've never yet met one who did not subsequently regret having purchased it. This does not augur well for real estate investments promoted by firms of accountants either.

Indicator of poor investments

If developers have to make these arrangements with accountants and financial advisers, then there's inevitably something wrong with the product that they have to sell. Doing deals with accountancy firms to sell the properties is equivalent to an admission that the properties are not of a standard that professional, well-informed investors would touch.

Numerous accounting groups have involved themselves in flogging property over the years. All the ones of which I am aware have created problems for lots of their clients. At the same time they have ignored their clients' true priorities and needs and sullied their own reputations.

Recently an accounting group previously not widely known in the dental world proclaimed itself as the industry's leading accounting firm and invited dentists to receive a free appraisal. This immediately created doubt as to who they are. Drilling down through their website revealed that they were proclaiming themselves to be specialist property investment accountants with links to developers.

Dentists are warned to take extreme caution in dealing with such groups, as they will quickly find that:

1. Their actual knowledge of the business of dentistry is likely to prove to be a great deal less than claimed; and
2. The financial info that they have provided is likely to be used behind the scenes to identify them as potential targets for the firm's property investment advisers.

Dentists seeking advice as to whether and how much to spend on upgrading their homes, or renovating their practice premises, or investing in new equipment, are likely to find that the solution to every question they asked is advice to buy investment rental properties. Advisers become blinded to client needs.

The message

The message is avoid such groups.

What works best for dentists?

27 years of advising large numbers of dentists Australia wide and looking at their assets and liabilities as well as their actual tax returns has demonstrated to me that those who have concentrated on the basics are, as a group, financially much better off on average than those dentists who have bought residential rental property and/or eucalypt plantations on the advice of their accountants. I regard it as a privilege to have been able to observe the wealth patterns of a large client group of dentists over such a long period of time. To me it offers empirical proof as to what works best.

Why?

For as long as there are property developers, some projects will be hard to sell and property developers will seek out accounting and financial advisory firms to help them sell their product. Once a professional adviser starts down the path of aligning themselves with property developers, they inevitably embark on a slippery slope. Bit by bit the finances of their firm tend to become dependent upon how many properties they can sell and to what value and this gets put before the interests of the client in upgrading their home or extending their dental premises. Inevitably, their dental clients end up with portfolios of poor investments. Remember, the rule is that the harder a development is to sell, the more likely it is that accountants and financial advisers will be induced to assist in the selling process.

Melbourne house prices falling - real estate code

On Saturday, April 12, the Saturday before Easter, 1261 homes were auctioned in Melbourne. The Sunday Age report was illuminating, even though it was at pains to put the best slant on the market because of a wish to protect its diminished amount of real estate advertising. The headline word was "rebalancing", subtitled "market swings back in favour of buyers". Decoded, this meant that the market fell.

Of the 1261 homes auctioned, it was reported that the clearance rate was 72% from 944 auctions, meaning that 315 results were not reported. Since the non-reported are invariably non-sales, the actual clearance rate was just below 54%. That would have improved slightly in subsequent days if there were a few after-auction sales.

The Real Estate Institute of Victoria, which included Geelong auctions in its figures, reported a 70% clearance rate from 1023 auctions, with 332 properties passed in, meaning a real clearance rate of 52.85%. Of the 332 properties passed in, 130 of them were on a vendor bid. Under Victorian rules, only the auctioneer can make the vendor bid and a pass-in on a vendor bid means that either there was no bid by buyers, or that the buyer's bid was so far below the owner's reserve price that the agent was obliged to dress up the pass-in by making a vendor's bid, which is the figure that's shown in the auction results in the press.

All of the above indicated a falling market. The press further reported that some property commentators were warning that the market had peaked and is now 'downshifting'. In other words, the market is falling. The press further referred to a "rebalancing in favour of buyers". Decoded that means the market is falling.

The report went on to say that family homes between $650,000 and $900,000 in the ring of suburbs 10km-20km from the city were "attracting fewer bidders at auction" - Decoded: the market is falling.

Further commentary indicated that the same trends were occurring in the well-supplied market for $1 million to $1.5 million houses in the inner suburbs. Decoded, that market is falling too.

What actually happened

A Melbourne-based firm of buyers' advocates said houses priced in the early $1 millions were attracting less competition than those priced at $2 million. Since buyers' advocates are more realistic about the market, we can take as serious comment their words that the market started to ease in May 2010, was weak in 2011 and 2012, began to recover in September 2012, recovered for about twelve months and has since started to slide.

If there is strength in the market, it appears to be in houses of $2 million and above, which are few in number.

Subsequent reporting in the *Australian Financial Review* suggests that markets in a number of other capital cities were also weaker.

Desperate developers

We can expect property spruikers to go into overdrive inviting people to come to real estate investment seminars. This will be a reflection of the desperation of some developers to sell enough units off the plan in order to get their bank's green light to commence building. *The Australian Financial Review* of 17 April reported that there was a back up of 2000 units for sale in inner Melbourne. Units were taking longer to sell. The high-rise market can go from buoyant to bust very quickly.

Harry Triguboff selling

In a separate item, Sydney property billionaire, Harry Triguboff, was reportedly in negotiations to sell his Meriton development arm to Chinese buyers. Whether Harry is selling because of his age and succession issues, or because he is canny enough to sense a change in the market, is unclear.

Vital issues

Remember, almost universally, dentists' homes and practice premises are much better investments than residential rental property. As far as residential rental property goes, those homes on their own land are much better long-term investments than high-rise units. Buildings in which high-rise units are located can only deteriorate in appearance.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 26 years, the last 19 as a founding partner and director of Synstrat Management Pty Ltd and Synstrat Accounting Pty Ltd. He was once a regular army officer, and later Director Human Resources Manager, Attorney General's Department of Victoria. He is considered an expert on dental practice valuation and practice performance benchmarking. He has spent many years advising dentists in respect of their business and financial strategy and measuring their practice and financial performance. He is the author of the Synstrat Guide to Practice Management, 50 Rules for Success as a Dentist and Buying & Selling General & Specialist Dental Practices. He is a long-term contributor to the Australasian Dental Practice magazine. The Synstrat Group is an independent data-based organisation providing management, benchmarking, valuation, financial and accounting services to the dental profession. Synstrat Management Pty Ltd is a Licensed financial services company owned by its directors who work within the Synstrat Group. For more info, call (03) 9843-7777 Fax: (03) 9843 7799 visit www.synstrat.com.au or email dental@synstrat.com.au.

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