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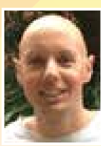
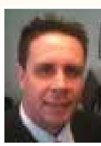


MARK KELMAN Negotiated $122,000 off listed price

TODD POLKE Bought $102,000 below property value



MATT SKINNER Bought $110,000 below market value

EMMA CELIS Bought $57,000 off listed price and nabbed an extra room

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4 WAYS TO EVICT YOUR TENANTS WITHOUT THE HASSLES

BUYING UNDER MARKET VALUE

If you make money when you buy, it goes without saying that buying under market value should ensure a big fat profit for you in the future. *Jeremy Sheppard* explains what you should look for to ensure you are buying a genuine gem, not fine-scented junk

One thing property investing has over share investing is that it offers the opportunity to buy under market value. There is no concept of buying under market value in the stock market since the only purchase you can make is at market value. That does not mean you cannot buy shares at a bargain price. It just means the buyer's idea of a bargain is different to the market's idea.

Capitalising on the discrepancy between different valuations of an asset is how one of the richest men in the world made his billions. Warren Buffet performs a valuation on a company and then compares that to the share price. If the share price appears cheap when compared to his valuation, he buys – a pretty simple and profitable strategy.

You can employ a similar approach when investing in real estate. And you can do one thing Buffet cannot: you can buy under market value. But there are a few 'gotchas'.

Defining the concept

Before going any further, there are three terms I would like to clarify:

- buying at a discount
- buying under market value
- buying a bargain

Buying 'under market value' is often confused with buying at a 'discount'. Buying at a discount is buying a property for less than the original asking price. This happens almost all the time. Real estate agents routinely add an extra amount to the expected sale price. This is so that buyers like us can feel better about ourselves after successfully haggling the seller down to the price he was going to sell at anyway!

Many investors actively pursue heavily discounted properties, believing this to be an effective investment strategy. Although there are plenty of success stories from those who have used this strategy, there are some problems with the principle in general that make it either quite tricky to pull off or not as profitable as first thought – more on this later.

Buying a bargain can be different from buying at a discount. It is possible to buy a property at a heavy discount and still pay too much for it. And a bargain is also different from buying under market value. For example, it is possible to pay more than the asking price and still get a bargain if the seller doesn't know the potential the property really has.

Buying a property under market value, as opposed to buying at a discount, is buying a property for a price that is less than the perceived market value of that property at the time of purchase. The 'perceived' value is subjective. In whose eyes is the property really under market value?

> Buying under market value is buying a property for a price that is less than the perceived value at time of purchase

Market value

Before a property has been sold, we actually do not know its market value. Once it has sold, the market value is the price it sold for. So technically it is impossible to buy under market value. What we mean when we say 'under market value' is that the sale price is less than what the property should have sold for in someone's opinion. And there's the crux of it – opinions.

The usual method of determining market value is to find the sale price of similar properties that have sold recently in the same area. Your lender's valuer will do exactly this, but they may interpret the data differently

IT'S A MATTER OF OPINION!

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to you and will probably be more conservative in their final figure.

So, who has the final say on valuation? How can you determine the true value of a property? It depends on the strategy you choose to employ. If you are looking to buy a bargain, your opinion is the only one that matters. But investors looking to profit from buying properties under market value should put their own opinions aside. There are only two opinions that count: the opinion of your lender's valuer and the opinion of the next buyer.

Let me just back up a bit. There are two ways to cash in on the equity you have acquired in a property:

1. You can either borrow against the equity or
2. you can sell the property.

To borrow against a property's equity you need a lender, while to sell a property you need a buyer. How much you can borrow comes down to the opinion of the lender on the value of the property. And how much you can sell for comes down to the next buyer's opinion about the value of your property. So your lender's opinion and the next buyer's opinion are all that you should consider when establishing market value for this strategy.

Note that a lender's valuation may not be taken as gospel when it comes to market value. It is pretty accurate in general, but there are some exceptions. For example, when a buyer places an attractive offer on a property, their lender may perform a valuation that comes in at a price lower than the agreed sale price. The buyer will probably use this to haggle the seller down in price. But that is not always the case. Sometimes buyers will simply tip more money into the deal.

For example, a seller may staunchly reject an offer of $400k, even after being shown a bank valuation for that amount. But they would sign a contract if the offer was $405k. This does not mean a transaction cannot occur. It simply means the buyer will need to find an extra $5k from their own funds, not from the lender. The buyer may believe this is worthwhile.

This discrepancy between buyer and lender opinion, where the buyer is prepared to pay more, is rare. It would be a game investor who based an investment strategy's success on finding a buyer willing to pay more than their lender's valuation. So the true market value is probably going to be the valuation of the next buyer's lender for this particular strategy.

You can get an idea of value by asking your own lender. Keep in mind that valuations can differ from one valuer to another. Once you've got a good idea of value, the profitability of the strategy comes down to the difference between this independent valuation and the sale price.

Note that many valuers will request the contract price prior to performing their research, as a gauge for them to determine the value. If the value they initially come to is above the contract price, they will slide that value down to the contract price to err on the side of caution. So getting an accurate valuation may require not disclosing the contract price to your lender.

There are only two opinions that count: the opinion of your lender's valuer and the opinion of the next buyer

How to buy under market value

In most cases the genuine 'under market value' opportunity comes from a distressed seller. However, real estate agents and developers will often flaunt a valuation that is above the sale price if one particular valuer happens to overestimate. Be careful of this ploy, and be sure to get your own independent valuation.

A distressed vendor may be a developer who has run into financial difficulty or a homeowner who has lost their job. Or maybe the owner is very ill and needs to sell to pay for medical treatment. Maybe it is a deceased estate and the next of kin do not care what the property sells for – they just want to get rid of it. Or maybe the sale is part of a divorce settlement.

These types of deals can be found on the National Mortgagee and Deceased Estate database at www.NMDdata.com.au. Buyers' agents are also presented with these opportunities through their contacts in the industry.

There are no real characteristics of a location that you can look for to find a suburb that offers many of these opportunities, except perhaps one: oversupply.

Developers have a tendency to focus on demand and ignore supply. They often build in locations where there are numerous infrastructure projects, which have been mentioned in the news, without considering whether there are already enough properties available for sale. If a developer has trouble selling, they may become desperate. Looking for locations with a large percentage of stock on market (SOM%) will uncover these problem areas.

SOM% is shown in the data section at the back of this magazine. SOM% is just one of the search criteria available on the 'DSR Data' app, which you can use to search for these high SOM% suburbs. The app is available at www.DSRdata.com.au. Table 1 contains a list of these markets extracted from DSR Data.

Buyer beware

The greatest discounts and the greatest number of distressed sellers are in the worst locations for capital growth. But if you are hell-bent on this strategy, see Table 1 for a list of Australia's highest discounted markets as at the end of January 2013.

Table 1: Highest discounted markets as at end of January 2013

State	Postcode	Suburb	Property type	Discount	Demand-Supply Ratio (DSR)
ACT	2540	WRECK BAY	Houses	9.20%	20
ACT	2914	BONNER	Houses	9.10%	28
ACT	2540	JERVIS BAY	Houses	8.00%	24
NSW	2108	PALM BEACH	Houses	21.20%	13
NSW	2104	BAYVIEW	Houses	18.80%	15
NSW	2576	BURRADOO	Houses	16.80%	13
NT	820	LARRAKEYAH	Units	8.90%	22
NT	870	ARALUEN	Houses	8.70%	23
NT	870	GILLEN	Units	7.60%	26
QLD	4184	RUSSELL ISLAND	Houses	25.40%	18
QLD	4223	CURRUMBIN	Houses	20.30%	18
QLD	4877	PORT DOUGLAS	Houses	20.10%	4
SA	5540	PORT PIRIE WEST	Houses	19.50%	24
SA	5464	KOOLUNGA	Houses	16.00%	22
SA	5521	REDHILL	Houses	16.00%	24
TAS	7190	BUCKLAND	Houses	16.30%	17
TAS	7190	CRANBROOK	Houses	16.30%	15
TAS	7190	DOLPHIN SANDS	Houses	16.30%	15
VIC	3232	LORNE	Houses	18.40%	18
VIC	3260	CAMPERDOWN	Houses	15.40%	20
VIC	3323	BERRYBANK	Houses	14.40%	20
WA	6009	DALKEITH	Houses	16.90%	16
WA	6450	WEST BEACH	Houses	16.60%	12
WA	6503	GINGIN	Houses	15.70%	13

Source: www.DSRdata.com.au and Australian Property Monitors

As you can see from the data, there is a correlation between markets with low demand-to-supply ratios (ie weak markets) and high discounting. When demand is weak with respect to supply, a vendor will find little interest from buyers and too much competition from other sellers. But when demand is high and supply short, there are very few distressed vendors – they pop their property on the market and away it goes for close to the asking price.

GOTCHAS

As a general rule, I avoid heavily discounted or under-market-value properties. Not to put you off the strategy, but here is a 'heads up' on some of the issues so that you are better prepared.

1 Ethical issues

Personally, I have an ethical problem with buying under market value, knowing that the seller is distressed. I do not feel comfortable kicking someone in the teeth when they are already on their knees, or if I find myself trying to argue yet another dollar out of someone else's pocket just to line mine with it.

Some would argue that if the vendor signs a contract it means they are agreeable, and you may even be helping them out of a tight spot. And some will consider mercy to be ill-placed if the vendor is a developer – they are 'the enemy', after all. But if it does make you squirm, and you want to pursue a distressed sale, you can always employ the services of a buyer's agent to palm off these 'awkward' jobs.

2 Difficulty in establishing genuine good deals

How do you know the vendor is actually distressed? Did they provide you with their balance sheet, or was it just a marketing ploy by the real estate agent? What's worse than kicking a distressed vendor in the teeth is discovering that they were not distressed at all and instead were

licking their lips right from your first offer.

The question you should ask yourself is: why were you able to snap up this bargain and not someone else? If you did not have your finger on the pulse of the market or you were not quick to make an offer, how come you – rather than someone else – got it for below market value? Is nobody else looking? If so, then you need to question the demand for property in this market.

The question you should ask yourself is: why were you able to snap up this bargain and not someone else?

Inexperienced investors will find recognising a genuine opportunity difficult and the timing challenging. Obviously, if an excellent deal does come on to the market, you will need to identify it straight away and move fast and with confidence. But rushing into a deal worth hundreds of thousands of dollars is not something you should do when you are new to the game. This is where industry professionals can come in very handy for young investors.

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3 The low price you pay becomes the new value of the property

Another problem with the strategy is that once you have bought at below market value, the purchase price becomes the new market value of the property. The next buyer will see a record of the sale and will know the real value of the property. You could try to on-sell before the information about your sale appears in various databases available to the buyer. But your timing has to be spot on or you will not get away with it.

There is also no way you can approach your lender straight after settlement to ask for a top-up based on the so-called equity you now have. The new valuation will be the price you just paid, and the lender will have undeniable evidence to support this claim. They could remind you that a property exactly the same as yours, in the exact same location and condition, sold only the other day for that amount – and would be surprised you did not know this, given that you were the one who just bought it!

4 You cannot refinance within six months

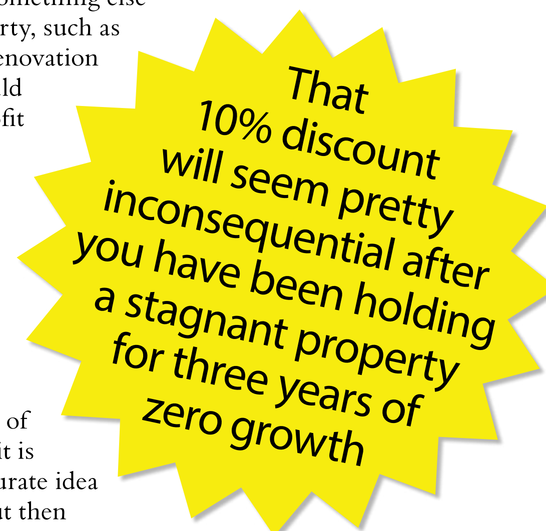
Many lenders will not consider a revaluation until at least six months have passed. If the market has not collapsed in that time, then you may be able to cash in on your strategy. And why would the market collapse? Well, the stronger the market, the less likely you will find a distressed seller. In a hot market, demand exceeds supply. Sellers have no problem selling so they do not get distressed. Sellers get distressed when they really need to sell, but the market is so weak that they cannot.

If you bought from a developer in a new complex, your cheap purchase will guide the price of future purchases. This could potentially drag down values. If there are enough sales of the same value, you can give up on getting a higher value from your lender six months down the track.

5 You overlook capital growth potential

Another problem with the strategy is that it can distract investors from more important and lucrative aspects of the property, such as the capital growth, renovation or development potential. If your sole strategy is to buy under market value, then once you have bought, you have locked in your profit. The clever part of your plan has ended for the rest of the life of ownership of that property.

Unless there is something else going for the property, such as capital growth or renovation potential, there could be little further profit to be made. That 10% discount will seem pretty inconsequential after you have been holding a stagnant property for three years of zero growth.



If there are loads of similar properties, it is easier to get an accurate idea of market value. But then

your property will be the same as many others and you will lose the uniqueness factor. But the strategy becomes harder to get right if the target property is unique, because of the inability to accurately determine market value. This is where a professional property rating system becomes invaluable.

Another problem is that finding a true property under market value by a significant amount can be difficult. By significant I mean enough to buy, sell, pay tax and make a profit. Remember there are entry and exit costs such as stamp duty, legal fees, building and pest inspections, valuation fees, loan establishment fees, sales agent commission and more legal fees on the sale, plus the cost of your own time and capital gains tax (CGT).

6 Difficulty in making handsome profit

Unless you are buying for around 15% or more below true market value, you will find it hard to buy and sell and make a worthwhile profit after tax. Remember that if you sell within 12 months you will not get the 50% CGT discount. At best, you can buy in a company name and pay 30% of your profits to the Australian Tax Office.

If you buy and hold rather than sell, then you will need to ensure there is adequate upward pressure on prices forecast for the future to make the holding costs worth it. This research will be more time-consuming than researching market value. But if you get that right, the upside on profit is much more rewarding.

7 Difficulty in sizing up a good deal

Another potential trouble spot of this strategy for novice investors is the lure of 'fine-scented rubbish'. If a tin of rubbish was for sale at half-price, would you offer to buy the whole crate to maximise your savings? Are you able to do enough research to know it is truly a bargain and not just a cheap rubbish dump?

Recognising the difference between trash and treasure will often come down to the state of the market. Once again, if the market is hot, there will be not too many distressed vendors and therefore not many under-market-value opportunities.

I prefer to find deals where something has been overlooked by everyone else, some potential not spotted by others. Then I can pay above market value to secure the deal that may also be in a strong seller's market.

I am not saying you cannot make a profit from buying under market value. I am not saying genuine deals do not exist. I am just presenting my concerns about the strategy and therefore my preference for others. I would rather pay top dollar to secure a property with loads of potential than scrounge around looking for a seller who has all but given up trying to offload their problem. ■

Jeremy Sheppard is director of research at DSR Data, and a keen property investor. He created the Demand to Supply Ratio (DSR) and is the author of How to Find Property Hotspots. *Visit DSRdata.com.au.*

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