mikephippsfinance

Mike Phipps. **0448 813 090**
mike@mikephippsfinance.com.au
Paul Grant. **0448 417 754**
paul@mikephippsfinance.com.au
Cameron Wicking. **0477 776 859**
cameron@mikephippsfinance.com.au

Head Office
4/31 Mary Street
NOOSAVILLE QLD 4566
Office. 07 5470 2194
Fax. 07 5455 6626
www.mikephippsfinance.com.au

The Great Australian Dream Is My Worst Nightmare

"It's tangible, it's solid, it's beautiful. It's artistic, from my standpoint, and I just love real estate."
Donald Trump, 45th President of the United States of America

Now that I have the attention grabbing headline out of the way a confession. Australia's obsession with property and home ownership is not my worst nightmare. In fact, my worst nightmare may well be the property developer quoted above, albeit you only have to turn on the TV to witness serious competition from our own so called leaders. To give The Donald his due he got stuff done and I guess the yanks had to first experience the Joe Biden incompetence benchmark in order to better appreciate his immediate predecessor.

But, as usual, I digress.

Aspirational land and home ownership has been a core part of the Australian psyche pretty much since the white fellas arrived in 1788. Prior to that it seems the indigenous population managed to exist happily enough without the need for freehold titles, subdivisions and negative gearing. Reckon they might have been onto something, but I guess that horse has bolted.

How times have changed. From land grants to keep freed convicts from returning home and to reward officers and soldiers, we are now one of the most property obsessed countries on earth. In fact, 75% of the population list home ownership as a core value or aspiration. Our obsession has only been further fuelled by Covid. Research suggests that looking at real estate has become a national pastime. If we're not watching someone renovate a bathroom on TV, we're trawling the real estate sale sites and researching current values. Recent research suggests Australians spend twice as many hours each week looking at real estate as they do going to the gym. Sadly, the research also suggests that both activities exceed the time we spend talking to our parents.

The national obsession is manifesting itself in a variety of ways but there's one that seems to be triggering the afore mentioned nightmares. Yep, it's the strata scheme owner occupier. Before an owner occupier reads this and takes offence, please know that you are not the cause of my unpleasant dreams. My concern is the owner occupier trend being played out in my client's permanent management rights businesses. Given that I'm an investor in some of these businesses I take a particularly keen interest in any trend that diminishes the letting pool.

While I suspect that like all property cycles the current Covid spike will eventually swing the other way, the fact is who knows when? In the interim I think the usual strategies designed to maintain the letting pool need to be seen through the prism of the actual bottom-line impact of losing a unit. It's never good to see the letting pool drop but maybe it's not as bad as it seems. Rental demand is extremely high and likely to get higher as owner occupiers buy up previous investment stock. Supply and demand is driving up rents and with it letting commissions. The management rights model is also underpinned by a caretaking salary which is usually increased annually by CPI or 2.5% to 3%, whichever is the greater. So, if you're doing your caretaking job and managing rent reviews your income should be rising, before any loss of rental stock.

fresh ideas...

The trick is to calculate the net impact of all the dynamics at play. Let's start by making some assumptions. For the purposes of this exercise, I shall use the dreaded data grid. Makes for riveting reading !

Assumptions	
Units in the complex	60
Units in the letting pool	50
Current annual caretaking salary	$75,000
Annual caretaking salary increase	3%
Current average weekly rent	$400
Assumed rental increases 7.5%	$30
Current net profit per unit in the letting pool	$2,500
Annual Projected Increase in Revenue	
Caretaking salary increase at 3%	$2,250
Increase in letting commission	$6,250
Increase in letting fees	$1,500
Total Annual Revenue Increase	$10,000

In this scenario the business could "afford" to lose 4 Units (or 8.0%) from their letting pool without a decrease in net profit over a 12-month period. It's important to note that there are numerous other variables at play here and operators should do their own calculations based on the specifics of their business. A good example is the potential loss of additional services provided to tenants, such as lawn mowing of back yards and general R and M.

Most lenders have letting pool conditions in their finance documents so it's critical that if you lose more than the specified percentage of units you tell the bank. When we are assisting a client, we provide the bank with these type of calculations to paint the most positive picture we can. We also recommend that if the calculation suggests a revenue drop the borrower should seriously contemplate loan principal reductions to ensure prudent gearing levels are maintained. Better to get on the front foot than wait for the bank to call the shots !

As most of our readers know Tony Rossiter (Holmans Accountants) and I assist many syndicates within the management rights industry. I am indebted to Tony for his assistance in better understanding the real revenue impact of unit losses in a rising rental demand market. Consider us the perfect team. I can write a lot of funny nonsense and Tony can bring me back to earth ! He's an accountant of course so no surprise there.

In closing you may be wondering why I have confined my comments to permanent management rights. Surely holiday properties lose units too. Yes, they do, but the variables around what that means for revenue are significantly more complicated and I'm a simple bloke.

I've got an accountant looking into it.

Mike Phipps F Fin
Director | Phippsfin Pty Ltd

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