Fast profits

Subdividing a corner block and constructing a second dwelling will allow Kathy and Matt Sherman to walk away with $90,000 in cash and give them a new house for their portfolio. NICOLE NAVARRO

Already armed with a strong asset base of properties, Kathy and Matt Sherman decided to find a project where they could make "a large chunk of cash quickly".

"We wanted to top up our buffer account and help with the shortfall between rent and expenses," explains Kathy.

They also wanted to reduce the debt against their principal place of residence (their home) and use the remaining amount towards significant time off work when their first baby arrives.

To achieve this, a block subdivision and the construction of a second dwelling on the same block appeared a logical answer.

THE PROPERTY SEARCH

"We targeted the northern suburbs of Adelaide because we thought we could find a house on a large enough block within our budget of about $200,000," explains Kathy.

"We wanted a simple subdivision where we didn't have to demolish an existing dwelling, and we also wanted to have rent coming in throughout the subdivision process to help with holding costs, so we were looking for quite a specific property."

Ideally they wanted to find either a corner block where the existing house was forward far enough to chop off the backyard, or a long block where the house was well over to one side.

They even used Google maps to view aerials of the various properties for sale to assess the position of the existing house on the block and to eliminate any properties where the house was centrally positioned.

They also asked local agents what tenants and owner-occupier buyers wanted from properties in that area.

The agents told Kathy that it wasn't very common to see a battleaxe block (or 'hammerhead' block), and supposedly those that were starting to appear weren't selling as well as blocks with street frontage. But Kathy and Matt had already seen this activity warming up in the area.

"We already had all the information from the council about required setbacks, minimum block size, dimensions and percentage of private open space needed for each block," Kathy says.

"We'd spent about a month searching for properties and attending viewings when we happened to drive past a large corner block in Elizabeth Downs with the existing house right at the front of the block and a big 'For Sale' sign outside."

After enquiring if the block was still available, Kathy and Matt discovered that the property was already under contract. So they left their contact details with the agent just in case the contract crashed.

Two weeks later the agent phoned them to reveal that the contract had crashed and it was theirs if they wanted it. So they swiftly made their move.

THE DUE DILIGENCE

"We put the property under contract and used the time given under the building and pest and finance clauses to do some more due diligence," explains Kathy.

They spoke to the planning officer at the council again, who checked the allotment size and situation. "He advised us that there was a sewerage easement on the rear of the block but that he did think it was possible to do a subdivision without demolishing the existing house," she notes.

They then contacted a subdivision-

SIMON CASSON

specialist surveyor who arrived at the property for some preliminary surveying. "This cost us $495 but would be taken off the cost of the subdivision later on."

The surveyor's report told Kathy and Matt that the subdivision was possible within the council guidelines, as long as it was a community title because of the easement. While this doesn't adversely affect the land value, explains Kathy, it does mean that whenever the property title is transferred buyers need to be aware there are rules of access.

The easement ran three metres wide across the block's width, so while they wouldn't be able to pour a concrete slab on top, they could pave or bark chip it. So that's exactly what they decided to do.

Due to the restriction of not being able to build directly above the easement, Kathy and Matt sat down with council and came to an agreement that allowed the house to be only two metres from the rear fence, for the length of one bedroom, instead of the required four metres. This also allowed room for either a second living area at the front of the property, or a double garage. On agents' advice Kathy and Matt opted for the second living area, knowing that people in the area were likely to have families, but not as likely to have two cars.

"Prior to going unconditional we also ran some figures to check the financial feasibility of the project," says Kathy. "In hindsight this was over-simplified and the end figures didn't turn out exactly as we estimated, but we're still happy with them."

CRUNCH TIME

While waiting for their contract to become unconditional, the couple sought advice from their accountant on what to do with the completed subdivision. "He suggested that we sell the existing house, build on the vacant block and keep it as a rental property," says Kathy.

"Then, when the original house sells, and we pay off that mortgage, we'll walk away with cash rather than equity."

They calculated that once fees and capital gains tax are taken into account they will gain a cash amount of almost $90,000 after tax.

"Our accountant suggests we pay this amount off our PPOR (principal place of residence) debt," reveals Kathy. "Because it's cash and not an equity loan there are no tax implications in its use and then if we wanted to we could have our PPOR revalued and the equity withdrawn as an investment loan to use for investment purposes."

While they did discuss holding the front dwelling as a cash flow positive property in addition to the negatively geared new house on the back block, Kathy reveals that to meet their personal goals unrelated to property they decided on the first option.

"The idea is we'll still build an asset base for the long term, but along the way sell the odd property to release cash to enable us to reach our personal goals, like buying a boat or going on holiday," she reveals.

GETTING THE PROPERTY TENANTED

Once the property was settled, a quick $11,000 cosmetic touch up was required "just to make it liveable".

This included a termite treatment, rubbish removal to clear the back block ready for subdivision, a new front door, a lick of paint on the house front, a new letterbox, and landscaping, including a new-look garden and garden path.

"However we didn't get the three dollars to every dollar back in value like you're supposed to when renovating," says Kathy.

Instead their property value was boosted by $15,000 to $210,000, just enough to cover the expenses, however the asking rent remained the same at $225 per week.

"We probably did get a little carried away," she says. "I also think the area and the timing weren't right to see the value increase."

To service overhead costs it was important for Kathy and Matt to move tenants in pronto. So their property manager presented them with an interested tenant – a single, 18-year-old mum of two kids with no rental history.

But within six months, while Kathy and Matt were overseas on their honeymoon, the tenant fell behind on the rent. After a letter from the agent the rent was paid and a second chance was granted. On the next inspection, however, the agent found the house in a mess, there were dirty nappies scattered everywhere, children's drawings all over the walls, a smashed wardrobe, and sour milk throughout the house.

The tenant was given one more chance to lift her game, but again she stopped

THE NUMBERS	
PROJECT DESCRIPTION	
Originally a three-bed house on 800-sqm corner block, subdivided and added a three-bed house, Elizabeth Downs, SA	
Date purchased	November 2008
Purchase price	$195,000
Purchase costs: stamp duty and mortgage insurance	$4,700
Total purchase costs	**$199,700**
Renovation costs	**$11,795**
SUBDIVISION COSTS	
Legal fees	$3,974
Surveyor	$2,775
Subdivision application	$700
Water connection/levies	$1,978
Council open space levy	$4,493
Lands Titles Office search fees and plan prints	$260
GST	$326
Development assessment commission lodgement fee	$1,052
Lands Titles Office outer boundary plan lodgement fee	$895
Total subdivision costs	**$16,454**
Projected building costs	**$144,215**
Total development costs	**$160,669**
Estimated value of new property on completion	**$250,000**
Anticipated equity gain	$89,331
Total gain as a percentage of cost	55%
Loan-to-value ratio (on entire property prior to expected sale of front house, including renovation and turn key extras from existing equity bin)	72%
Equity gain = current value – total cost. LVR = current loan / current value	

Front before

Backyard subdivided

Front after

paying rent so her tenancy agreement was finally terminated.

The property manager then took the tenant to the tribunal because she wouldn't vacate the premises. The tribunal found in favour of Kathy and Matt, but while they kept the bond, it didn't cover the damage or cost of cleaning up the house to make it liveable for the next tenant.

Kathy and Matt cleaned up the rubbish, fixed the broken wardrobe, replaced the damaged carpets, repainted the walls, and signed up a new tenant.

STARTING THE SUBDIVISION

The surveyors took care of everything, according to Kathy.

Because the surveyors didn't have to re-measure the block, their initial payment of $495 was deducted off the end bill. The measurements and technical drawings were then submitted through council.

After a very lengthy one-year subdivision process, council approved it with specific requirements regarding two rainwater tanks – both of which must hold a minimum capacity of 1000 litres. It also stipulated that the first tank must be plumbed into one utility within the house to comply with Australian standards.

Matt explains that the second rainwater tank needed to be attached to the first to collect any overflow from the first tank once it was full.

"The purpose of the second tank is to act as an overflow container with a much smaller outlet (eg. a hose turned on half-flow at all times) to allow the water to empty from the second tank into the stormwater system at a slower rate than it would if it ran through the normal 75-millimetre stormwater pipe.

"The clause was listed as being a safety mechanism for the one in 100-year storm.

"The purpose of this is to hold back some of the water flow on heavy rain days so that the drains in the street aren't overflowed with excessive amounts of water."

It took Kathy and Matt one year to start the subdivision process, then another full year of waiting for the subdivision title.

"We ended up entering into a 'family agreement' joint venture with my parents at this stage of the project, as we didn't have the cash for the surveying fees at the time and they did. It worked out great and we've since bought another investment property together," Kathy explains.

"The water meters caused us a few headaches," remembers Kathy.

"Because the subdivision had to be a community title there needed to be common area, like with a strata title. In our case, because of the easement servicing both blocks, the rules state that the front house has to be able to access the sewerage pipes at the back of the rear block, meaning the owner's representative can enter that area if necessary on application."

She adds that as with a strata title, the rules on a community title state there must be common ground. So Kathy and Matt decided to allocate this common area to a small area at the front of the block and placed a new water meter for the back block beside the existing water meter.

At the time this seemed to be the most logical option, but in hindsight the couple reveal they wouldn't do it again because it meant the pipes needed to run 20 metres underground from the water meter down through the front block to the back block, costing an additional $800 in plumbing and digging.

Their subdivision title certificate only arrived in August this year. This month, the slab will be laid and construction will finally begin.

"When we achieve our sale price on the existing house of $205,000, we'll be able to pay off the mortgage and walk away with about $90,000 after fees and taxes."

SHIFTING FINANCE

When Kathy and Matt originally bought the property in November 2008 through a mortgage broker, they were set up on a standard 90 per cent interest-only loan using equity from other properties as their deposit.

Before they sell the existing house, they will borrow against the value of the newly subdivided block of land. Using 90 per cent of this value Kathy and Matt will pay down the original debt of $175,500 (which will be fully assigned to the old existing front house), so that when they sell the existing house they can walk away with cash.

They'll borrow 90 per cent of the combined value of the block of land ($95,000) and the house construction ($122,215 not including the turn key extras such as air conditioning and floor coverings which will be drawn out of Kathy and Matt's equity bin on completion), meaning a total loan of $195,493.

Of this loan, the bank will retain the full cost of the construction (thereby requiring no deposit from Kathy and Matt) to pay the builder, and will release $73,210 to pay

The block subdivided

down the original debt of $175,500. But to do so Kathy and Matt need to pay mortgage insurance ($3000), solicitor's fees ($500), release mortgage fees ($300), and a discharge fee ($300), leaving $69,110 available for use.

Because they currently owe $175,500 on the entire property, they'll use this $69,110 to reduce the loan to $106,500. "When we achieve our sale price on the existing house of $205,000, we'll be able to pay off the mortgage and walk away with $90,000 after fees and taxes," Kathy says.

SELLING THE EXISTING HOUSE

A fence installed along the back border of the existing house now divides the two blocks, with the existing house currently up for sale.

Kathy and Matt expect $205,000 on the sale of this property, slightly lower than their original asking price of $220,000 due to it being in direct competition with other houses in the area with larger yards (after the subdivision their block size was reduced to 450 square metres).

But considering they've only spent $195,000 for the house on the original block size (800 square metres), $11,000 on cosmetic touch ups, and $4700 on purchase costs, they're essentially looking at selling the block at half the size for a greater price just two years later, which would mean almost a 100 per cent profit.

They understand that there are still many large blocks in the area and the feedback from buyers was that the backyard is too small, "particularly in an area where people like to own a dog or two", she says.

However, while these factors might work against them achieving $220,000, it will still be an attractive option for elderly couples or investors not wanting a property with a big lawn to mow or significant garden maintenance.

THE NEXT STAGE

Kathy and Matt have contracted a builder to construct a three-bedroom, two-bathroom, two-living area home on the new block for $122,215, which should be worth about $250,000 and rent for about $260 per week when complete.

"There will be a further small equity gain once the build is complete but we expect this to be swallowed up by the landscaping, air conditioning and other extras," Kathy notes.

"Our plan at this stage is to hold on to the new build for about five years and then sell to realise the capital gains, which will be shared with my parents for their part in the project," reveals Kathy.

The slab will be down this month and they anticipate a six-month build time.

While expecting to walk away with fast profits, the entire process has taken the couple two years just to get the subdivision completed, perhaps a little longer than initially anticipated.

"The hardest part has been sitting around doing nothing and waiting for things to happen," says Kathy.

But the great part, she adds, is the substantial cash they'll walk away with initially and the potential future profits they'll make on the back block when the entire project is completed. api

API Connect

Do you have a question for Kathy and Matt? Email it to forum@apimagazine.com.au and we'll do our best to publish the answer in a future issue of API.