

# Granny flats

## Hidden profits right in your own backyard

**Dual incomes have long been a proven strategy for families facing insufficient cash flow. A granny flat just might be your property's ticket to a dual income and capital growth in a flat market. *Jon Tkach* shows you what investors need to know in order to jump on the granny-train**

**R**obyn Perry never expected the old garage out in the back of her Manly Vale home to serve as a bachelor pad for her 23-year-old son Ben. But he was looking for a bit more space and independence, and the smelly, dusty old shed once used by Ben's grandfather as a toolmaking workshop fit the bill – for a while.

The problem was it would flood



every now and again – a high price to pay for a little independence.

“So, he’s actually a third-year apprentice carpenter and one day we were just sitting around and he said, you know I should just knock this down and build a granny flat with a bathroom and a toilet,” Robyn remembers. “And that’s how it started.”

Around three months and \$50,000 later, the Perrys now have a brand new 20m<sup>2</sup> one-bedroom ‘granny flat’ in the yard, and Ben has a dry place to call his own – for a while.

“I’ve already said, ‘look you can have it for 12 or 18 months,’” Robyn laughs. “After that he can come back into the main house if he wants, but we borrowed to pay for it, so you know we’ve got to pay it off.”

Robyn says she wants her son to be happy, but like a lot of property owners across Australia, she and her husband are also counting on the extra income they will be able to generate from the new house out back.

## » The new rules override councils and make granny flats legal in most residential zones

“So from my husband’s and my point of view, obviously it is going to add to the resale if we want to sell, but most importantly we can rent it out.” Robyn says this with a proud, and slightly mischievous, little laugh, saying she figures it could fetch as much as \$300 per week – a rental yield of more than 30%.

In NSW, and increasingly across the rest of Australia, a brutally tight rental market and flat home prices seem to have made conditions ripe for a ‘granny flat’ boom.

### Granny to the rescue?

Robyn found out right at the start of her research that they picked the right time to build their granny flat. The game changer, in NSW at least, is the state government’s 2009 Affordable Housing State Environmental

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## What is a granny flat?

It’s not your granny’s granny flat anymore. Spurred by the relaxed approval rules in NSW and a growing market, builders have a wide variety of options available ranging from a simple studio addition, to detached 60m<sup>2</sup> two-bedroom units complete with ensuites.



A secondary dwelling, or granny flat, is usually defined as a self-contained unit that can be either within, attached or separate from the house but on the same lot of land, and not in a strata plan or community title scheme. So if you are looking to build a granny flat, you might have three choices on how to build:

**Within:** if you have some extra space you’re not using, you may be able to convert part of your existing home into a granny flat by blocking off the new unit area from the main living space and adding a front door, new kitchen and other details to make it an independent flat.

**Attached:** you may also choose to build out, and add a granny flat on to your existing home. This option may be the best choice for smaller lots, or yards with extensive landscaping or a pool that limits backyard space.

**Detached:** the quintessential granny flat is built apart from the building, with a separate entrance and often a separate yard. These are the most popular options and builders offer everything from basic one-bed-sitters to 60m<sup>2</sup> two-bedroom fully outfitted homes.

Homeowners might prefer any of the above but from a rental perspective, it is not too hard to see that a more private detached home is more likely to draw more attractive tenants and higher rents.

Also, Serge Panayi of Granny Flat Approvals says attached granny flats and existing structure conversions (like a garage) are typically much harder to get approved and often require additional fireproofing, which can drive up costs dramatically. He says often a whole new structure ends up being more cost effective, and more attractive to tenants.

Garage conversions, in fact, typically will not fall under the NSW government’s new granny flat expedited approval guidelines because of setback requirements, forcing you to seek approval through your local council.

Planning Policy, or AHSEPP, that is designed to encourage granny flats as a way to combat the state’s affordable housing woes. The new rules basically override local councils and make granny flats legal in most residential zones, streamlining the approval process. In fact, if a property fits the AHSEPP’s guidelines, homeowners can get the go ahead in as little as 10 days.

“Prior to the introduction of this legislation every council had different rules and pretty much 90% of them

just about said no – no granny flats are allowed,” says Serge Panayi of the NSW company Granny Flat Approvals. “This unified the whole thing into one, and so it was a huge change for property developers. It opened the doors basically.”

Panayi opened his company’s doors just after the policy change, seeing a growing market for investors eager for a new source of cash flow, and owners looking for room to have their ageing children and elderly family members close but not too close.

## Tax implications

If you are renting out your new granny flat like the Perrys plan to do down the line, there are several important tax considerations to consider. Tax professional Jimmy Prince, the author of *Tax for Australians for Dummies*, says the two main considerations are income tax and how that income generating property may impact your capital gains liability if your situation is like the Perrys' and your granny flat is part of your primary residence.

"The income tax side of it is pretty clear, because the law says that if you lease a property, and it is irrespective of what the property is, the expenses you incur in deriving that rental income are tax deductible," he says.

So the council rates, the insurance, the interest on the loan to build the property are all tax-deductible. The ATO makes it pretty easy by letting you calculate everything on a land area basis. So using the Perrys as our example, their little granny flat covers about 25% of their total property. Using the land area basis to apportion the expenses, here is how their net rent would be calculated:

<b>Rental income:</b>	300 X 52 = \$15,600
<b>Expenses:</b>	
<b>Interest on \$50k second loan:</b>	12 X 290 = \$3,480
<b>Council rates (25%):</b>	\$500
<b>Insurance (25%):</b>	\$750
<b>Total expenses:</b>	\$4,730
<b>Net rent:</b>	\$10,870

But Prince says the tricky part comes in if the Perrys later decide to sell their primary residence and previously rented granny flat. Now, Prince says, "that portion of gain that relates



to the income producing granny flat would be subject to capital gains tax (CGT) because you are selling a property that has been used to derive assessable income."

Prince says CGT only applies to the gain that occurred while the granny flat was earning income, so all the gain that occurred during all the years that they owned the property before they added the flat, and even during the time their son lived in the flat is all exempt. It is just the gain that occurs while they earned income that will incur CGT. But also, he says, to remember that since the Perrys have owned their property for more than 12 months, they also get to claim a 50% discount.

So again using the Perrys as an example, we will say they purchased the property in 2001, built the granny flat last year, and will kick their son out in 2016 in order to rent it out until they sell the whole property in 2021. Here is what the Perrys' CGT liability would look like:

<b>Purchase price in 2001:</b>	\$500,000
<b>Value in 2016:</b>	\$1,000,000
<b>Sales price in 2021:</b>	\$1,500,000
<b>Relevant capital gain:</b>	\$500,000
<b>(-75% primary residence)</b>	-\$375,000
<b>Subtotal</b>	\$125,000
<b>(-50% CGT discount)</b>	-\$62,500
<b>Capital gain liability</b>	\$62,500



Many WA councils are streamlining approvals and scrapping restrictions on renting to unrelated third parties

A draftsman by trade, Panayi had mainly been doing design work for larger commercial projects, but since 2009 more than 70% of his business comes from managing the granny flat approval process for homeowners and builders across the state.

"The good thing about the whole thing is that it's very mathematical – it's very empirical," Panayi says. "We know if it's going to be approved so we present the plans to be approved at the same time as we are presenting to builders to be quoted on."

"And then 10 days later we have the approval in our hands," Panayi says. "The builders are a little slower, so a couple weeks later we have a few quotes from the builders and we pass them on to the clients." He says the whole process is so streamlined now that owners often can start collecting rents within a couple of months.

According to Panayi's figures, his company has handled more than a quarter of the just over 400 developments to be approved under the new rules. He says business is really starting to pick up more now as a shaky economy and flat property market are pushing people to get a bit more creative.

"It's more about education and letting people know that they can

really get a win from a block. You know they can really relieve financial pressure, even for an owner who lives on the land they can gain an instant rental. The shortage of rental housing, after all, is quite severe.”

**Other states slow to follow NSW’s lead**

While homeowners in NSW are reaping the benefits of the easier rules, for the time being at least, investors in other states face a frustrating battle with unsympathetic local councils or rules that flat out bar owners from renting out their granny flats to anyone but, well, granny.

But with rents far outpacing income growth creating a crisis in affordable housing across much of Australia, local planners are increasingly seeing granny flats as a viable fix and taking steps to encourage development.

Several local councils in historically granny-unfriendly Western Australia have already streamlined local approvals and are doing away with rules that restrict renting to unrelated third parties. Also officials at the state level are looking to do away with those restrictions state-wide.

“It’s a very dynamic period we’re about to go into with granny flats and we are definitely focusing on it,” says Mike Nicholls of Granny Flats WA, a Perth-area building company that has already started to see a big bump in business. He says investors are definitely starting to flow in, lured by what he sees as a solid strategy to squeeze solid rental and capital returns in a flat market.

“Really we’re just using the same

**Hot tips for investors**



“There are a number of strategies for creating a cash flow positive property investment, but now the granny flat one really seems to be the easiest,” says buyers agent Alan Fox of Propertunities on the NSW Central Coast. Here, he outlines his key rules for locating a property with income boosting granny potential.

- Make sure the property meets the minimum size requirements of 450m<sup>2</sup> and a 12m frontage
- Target properties where the land slopes to the road. He says this will save you thousands in future costs to remedy stormwater and other drainage problems.
- Carefully inspect the property’s 149 Certificate in order to ensure it is not in a flood or a fire zone. While you may still be able to build a granny flat in a flood or fire zone, in NSW they will not qualify as a complying development and require you to go through the much more laborious council approval process.
- Look for side access, or better yet a corner lot, in order to make it easier to give your future tenants their own private entryway.

Additionally, Cid Daher of Granny Flats Australia warns investors to make sure there are no major trees (over 4 metres in height) within three metres of the build zone. “The minute there is a major tree – watch out. Tree removal can’t go through the AHSEPP – it actually has to go through the council.”

“If you say you want to remove a tree because you want to put a granny flat in, it is almost always an automatic ‘no,’” he says. “They are using it as a bit of a monopoly.”

processes and systems that we’ve used in Sydney and are bringing them across to Perth,” says Paul Giezekamp, director at Sydney-based property investment consultants Property Secrets. The group, which focuses solely on properties with development potential, is the largest builder of granny flats in Sydney, and they are increasingly gobbling up Perth-area homes with lots that will support a

granny flat. “We get investors from around Australia who want to buy in Sydney or Perth, and I would say the majority of them don’t want to go right in and build five or six townhouses at \$500,000 or \$700,000 for construction.” But granny flats are a much less daunting task, he says, “so they look at what we do for \$80,000 and the yields are around 18% just for the granny flat.”

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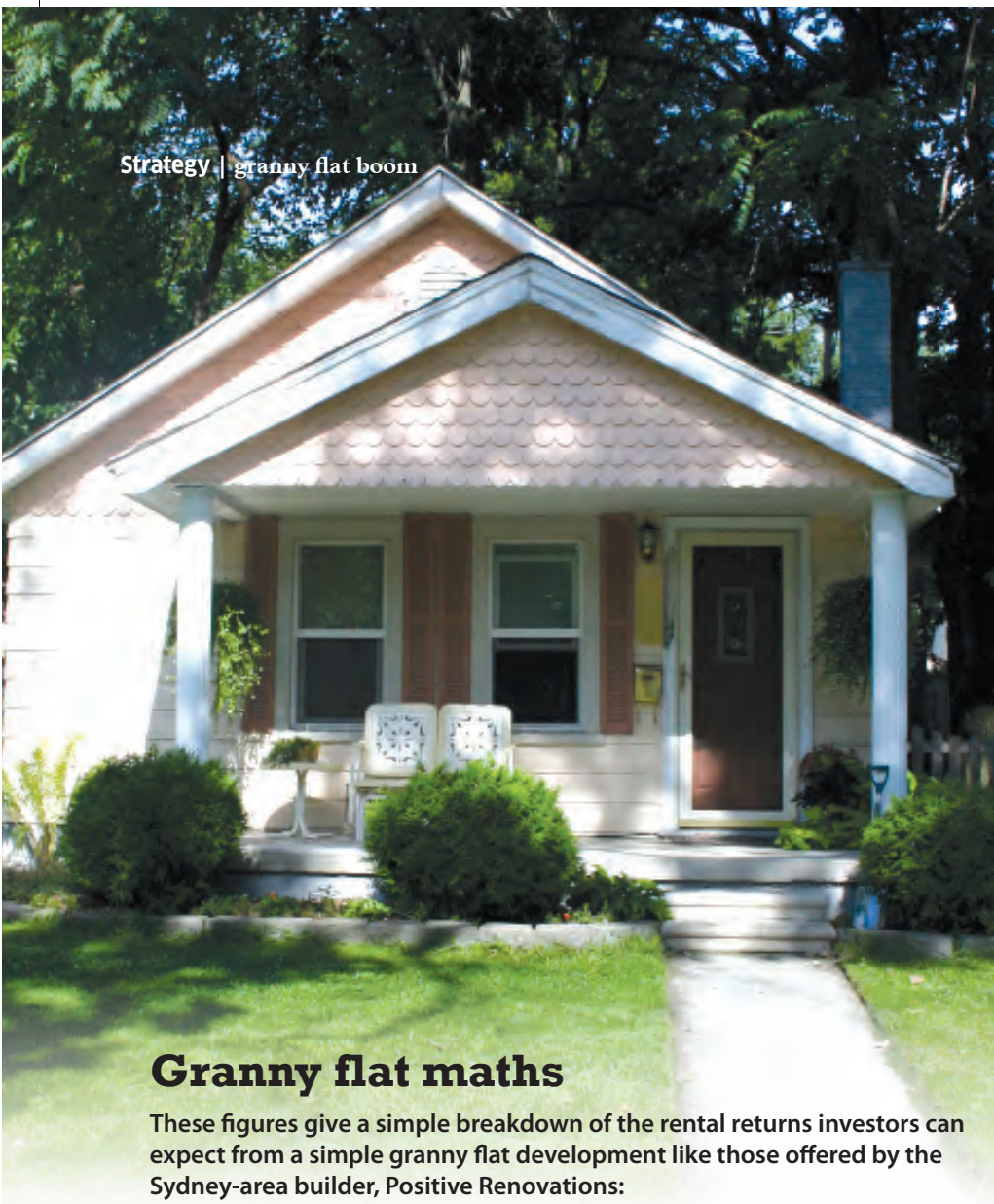
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## Granny flat maths

These figures give a simple breakdown of the rental returns investors can expect from a simple granny flat development like those offered by the Sydney-area builder, Positive Renovations:

Size	Building costs	Weekly interest @ 7.5%	Weekly rental return	Weekly cash flow	Gross rental yield
One bedroom	\$68,000	\$98	\$240	\$142	18.4%
Two bedroom	\$73,000	\$105	\$300	\$195	21.4%

Source: Positive Renovations

The following example outlines how adding a granny flat can be a sound strategy for making the cash flow in, instead of out, on a new investment property.

### NO GRANNY FLAT:

Purchase price .....	\$320,000
Stamp duty .....	\$9,910
<b>Total costs.....</b>	<b>\$329,910</b>
Rent per annum at \$400/week .....	\$20,800
Interest payments @ 7.5%.....	\$24,000
Annual cash flow .....	-\$3,200
Rental yield .....	6.3%

### WITH GRANNY FLAT:

<b>Cost of 2-bedroom granny flat.....</b>	<b>\$73,000</b>
Weekly rent.....	\$300
Rent per annum .....	\$15,600
<b>Combined yearly rent .....</b>	<b>\$36,400</b>
<b>Total cost w Granny Flat .....</b>	<b>\$402,910</b>
Interest payments @ 7.5%.....	\$30,218
Annual cash flow with Granny Flat .....	\$6,182
Rental yield .....	9.0%

## Granny's capital effect

Cid Daher of Granny Flats Australia offers several examples of the potential impact a well-made granny flat can have on the right property, producing as much as a 48% return on investment.

### 2-bedroom granny flat in Carlingford, NSW

Cost:.....	\$120,000
Original house valuation: .	\$680,000
New valuation:.....	\$855,000
Added value: .....	\$55,000 (45% ROI)

### 2-bedroom granny flat in Ermington, NSW

Cost:.....	\$108,000
Original house valuation: .	\$585,000
New valuation:.....	\$745,000
Added value: .....	\$52,000 (48% ROI)

Giezekamp says the major trick in WA is that things can be so different from council to council, and he warns that interested investors really need to do their homework before buying. He says Property Secrets focuses on several Perth council areas that are granny-friendly, but he is hesitant to share.

"We're not prepared to pass that information over – that is intellectual property."

Your Investment Property did a little bit of homework and found the following Perth-area councils have removed restrictions on granny flat rentals pending state approval: Fremantle, Belmont and Vincent.

Officials in nearby Mosman Park are also considering lifting the restrictions. But perhaps most notably, Western Australia's Planning Commission has signalled that it could go even further and follow NSW's lead, while officials in Queensland are also considering reviewing their own policy.

So granny flats are clearly not just for granny anymore. They are increasingly becoming a favoured strategy among seasoned property investors, and an ideal entry vehicle for a homeowner to become an investor without ever leaving their own backyard.

## Your step-by-step guide to investing in granny flats



Whether you are like the Perrys looking to make their son, and eventually their hip pockets, happy, or an investor looking for a creative way to boost sub-par rental yields, a granny flat might just be the way to go. Here, we have put together a quick guide to help you get it done right.

### 1 Check your council

This may be the trickiest step, as regulations regarding granny flat building requirements and occupancy vary from council to council if you live outside of NSW. So the key thing if you're dealing with a non-NSW property is to check with your local council to make sure secondary

Kit homes make it possible for experienced DIYers to go it alone. The NSW approval process has been streamlined enough that you could DIY the approval process as well

dwellings are permitted and whether occupancy rules allow you to rent it out to a non-family member. Call your local council directly, or get in touch with a local builder or buyer's agent who specialises in granny flats.

While the road is a lot smoother for NSW homeowners, Granny Flat Australia's Cid Daher warns homeowners to be on the lookout for council fees called Section 94 contributions, originally meant to help local councils recoup the costs they face due to a new development. While a number of councils keep the fees to 1–2% of the cost of construction, Daher says others are clearly aimed at knocking developers back.

"I won't totally go against the contributions, but some councils are ridiculous. As it is supposed to be under the Affordable Housing SEPP, when you're charging \$10,000 for a \$100,000 construction, that certainly doesn't align with affordable."

### 2 Gather the troops

A number of companies have developed kit homes or designs that make it possible for experienced DIYers to go it alone, though keep in mind that most states and local councils will make you get insurance and take an approved builder course. Also, the NSW approval process has been streamlined enough that you could DIY the approval process as well.

If you are looking to manage the project yourself, you will likely need a licensed architect to draw up your plans. Companies like Granny Flat Approvals will come out and assess the site, knock together a plan to your specifications and manage the approval process for you, which will run you a little more than \$5,000. They will then set you up with a couple of their recommended builders or you can take the plans to the builder of your choice.

A number of building companies

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have dedicated teams that deal with granny flats, and can take care of the entire process for you. Builders like Granny Flats Australia and Granny Flats WA offer a wide range of designs and will work with you to customise the unit to fit your needs, come out to make sure the property fits all the criteria, and make sure there are no hidden surprises.

### 3 Pick your design

Under the NSW government's guidelines, you have three basic choices on how to build. You can convert part of your existing property, add on an attached granny flat, or put in a detached unit. The consensus among developers and experienced investors is that you get more bang for your buck by going ahead and adding on a fully detached unit.

While Robyn Perry and her son Ben were happy with the results of the 30m<sup>2</sup> simple bedsitter, NSW regulations allow dwellings up to 60m<sup>2</sup>, enough room for inventive builders to fit as many as three bedrooms into a unit.

But Rick Stapleton of Positive Renovations warns against overbuilding, saying his research shows that in many areas return on investment tends to decrease above 40m<sup>2</sup>. "In Western Sydney, for

example, in the suburb of Whalan, a typical three-bedroom home rents for \$280–\$300 per week while a two-bedroom 40m<sup>2</sup> granny flat would rent for \$250–\$280 per week. In this situation building a larger granny flat would not be worthwhile given that the granny flat would never rent for more than the house and by building a smaller granny flat you would save yourself a minimum of \$20,000."

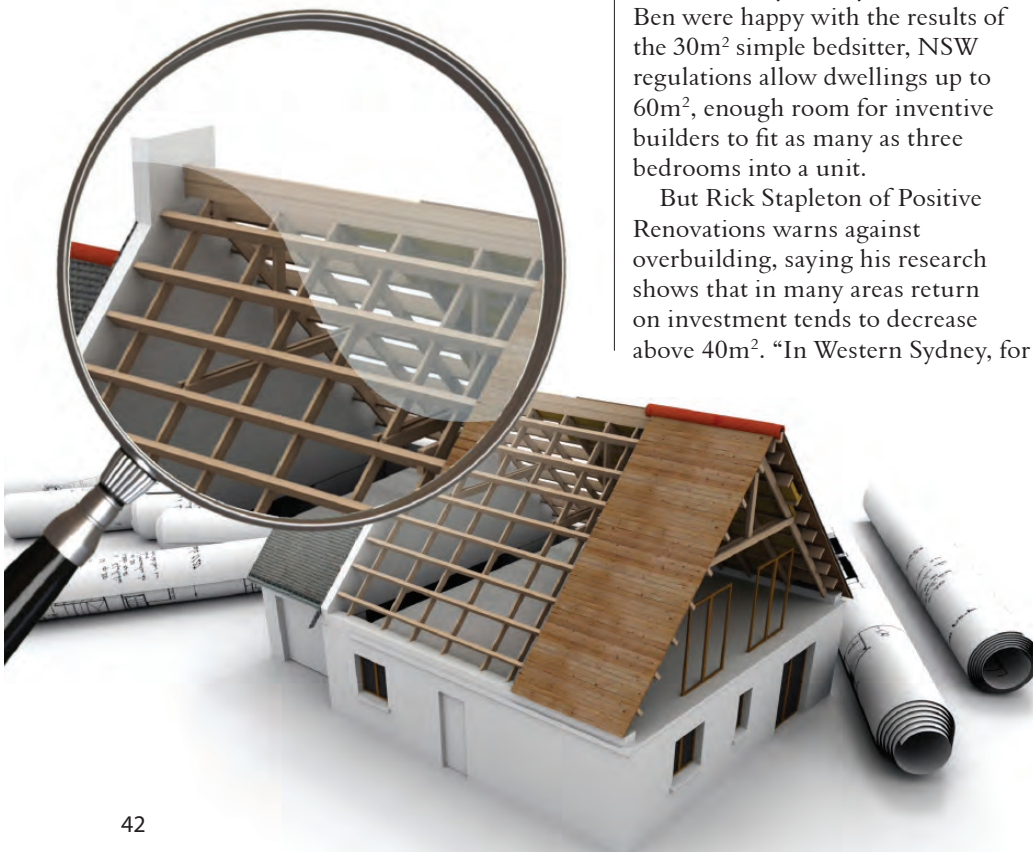
Stapleton's company specialises in smaller granny flats, offering a one-bedroom 28m<sup>2</sup> design for \$68,000 or a 37m<sup>2</sup> two-bedroom unit for around \$73,000. Stapleton says another key consideration is that a larger granny flat will take up more of the backyard and could have a negative impact on the rent an investor can get from the main property.

Other builders such as Granny Flats Australia offer a wide range of designs, with many taking full advantage of the 60m<sup>2</sup> limitation. The company will also customise the design, but standard one-bedrooms (\$60,000–\$75,000) run from 45m<sup>2</sup>–55m<sup>2</sup> and two-bedroom units (\$75,000–\$95,000) tend to use all the space allowed.

Daher says he finds investors win by going with a larger, more fitted out granny flat. "Most of our clients are after a long-term investment with capital growth and high yields along the way," he says. "So with a custom built home they are actually getting much better rental, because the tenants that are renting them out feel like they are in a real home."

Buyer's agent Alan Fox says it is important to know your rental market prior to settling on a design in order to make sure your granny flat is attracting the right tenants, but he warns against overdoing it as well.

Property investor San Kumaradevan, who is working on adding a granny flat to his investment property near Parramatta, NSW, says he realised he would also have to find a way to keep his current tenants happy considering they would be losing a large chunk of their backyard. His creative solution was to offer to pay the water bill for the rest of their tenancy. Since it amounted to basically a \$40 savings to them per month, he says they were happy to accept, and



the move saved him headaches down the line.

**4 Line up your financing** Now that you have the design, there is the little issue of the money... If you do not have the spare \$60,000–\$100,000 a granny flat will likely cost you, you will want to think about the right strategy when approaching a bank or mortgage lender.

Rick Stapleton of Positive Renovations often handles financing for his clients who go with one of the company's granny flat options, and he says the good news is that banks actually look at the new dwelling as a positive because of the additional revenue stream.

Lee Dittmer, a Melbourne-based mortgage broker with HOW Mortgage Loans, says homeowners are faced with two basic options: using their existing equity in order to get a loan increase or equity loan, or going the construction loan route.

"If the equity is there, then the

best choice is almost always going to be tapping into that equity, she says. "Construction loans bring up a lot more complications."

She says banks require you to let them know about the construction, but if you have equity in the property as is they will generally be happy to increase the current loan or add on a new equity loan. The added bonus of getting a second loan, according to Jimmy Prince, author of *Tax for Australians for Dummies*, is that it will make it easier to keep track of the interest expenses for the granny flat come tax time.

Things get a bit more complicated if you do not have the equity in the property as it is and therefore need a lender to consider the finished value after construction. In this case a construction loan would be your primary option.

Dittmer says construction loans are certainly possible especially when you can show your lender that there is a strong demand for rentals in your area.

## Section 94's bite

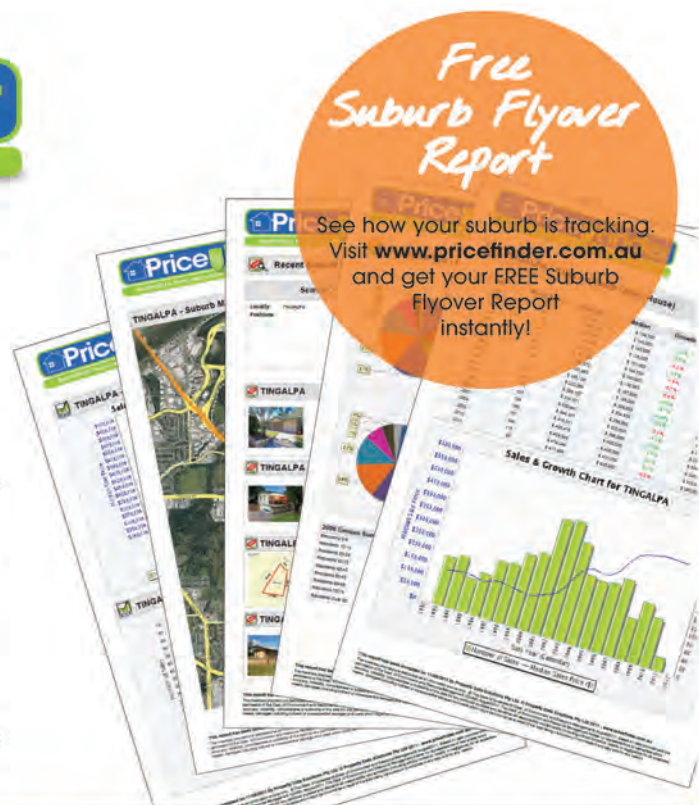
While the NSW state government has streamlined the granny flat approval process, some local councils have found a way to take a bite out of potential profits. Several councils across the state charge what are called Section 94 Contributions for granny flat developments. The fees can run from several hundred dollars, all the way up to a ROI-killing \$20,000.

Buyers agent Alan Fox of Propertunities advises investors to avoid these areas altogether, though he says it is important to double-check with the councils themselves, because many have started to shed them and others have added exemptions.



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## The Perrys' backyard money-maker

Private Certifier fee	\$2,000
Building and demolition costs	\$45,000
<b>Total costs</b>	<b>\$49,900</b>

Projected annual rent at \$300/week	\$15,600
<b>Potential rental yield</b>	<b>31.26%</b>



Robyn Perry and her son Ben sat down and drew up the plans for the granny flat themselves, and decided to enlist Granny Flat Approvals to put the stamp of approval on their work and handle the NSW approval process. The company double-checked the design and site, made a few suggestions, and found a couple of small issues the Perrys would have to address in the final construction.

The property met the requirements for size and all setbacks, but they did find out that one corner of the proposed granny flat was poking into a fire zone. Though they worried this might pose a problem, Robyn was relieved to discover they just had to change the unit's exterior cladding and put in aluminium screens to meet the extra requirements.

A week or so later the approval

company lodged the paperwork with an independent certifier they work with regularly. This is one of the key features of the NSW government's new rules, because using a private certifier will typically get you an approval in 10 days.

The Perrys worked out a deal with the construction company where Ben was working, allowing him to build the flat, yet still get paid and make sure they had all the right insurance.

Robyn says the fun part came when she and her husband joined Ben in knocking the old shed structure down. Because of worries about asbestos, they had to suit up in full protective gear and masks.

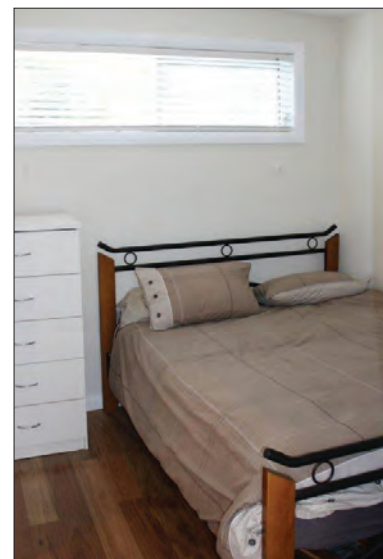
"It was a really hot day and so my mask kept slipping down my face," she remembers. "But you know what, it was worth it when you

see it now and you say I'm glad we made that effort."

Next came laying the foundation. The old structure had been flooding, so Ben fixed that problem by ordering an extra thick slab poured in to raise the unit up a bit.

The construction itself took just a few weeks, with Ben being joined by several workers during the day, though Robyn says he would often work late into the night on his own.

Now the Perrys are looking to put in a fence in order to improve privacy in both the unit and the main house. Twenty-three-year-old Ben will get to enjoy that privacy for a while, until his parents turn it into a money-maker. At \$280 per week, they would be looking at a whopping 36% yield and their investment would pay for itself in less than four years.





DIY builders often overlook how complicated it can be to arrange the utility hookups, including sewer and stormwater

You may need to get a local real estate agent to work up a rental forecast for you. Dittmer warns that bank valuers can be very conservative when considering the added value of the flat, and that it is important to see a broker or bank with experience in dealing with secondary units.

**5 Build it, and they will come**  
If you have picked the right builder, this part should be easy. Most builders should be able to finish the work from initial foundation to installing the doorbell within four to six weeks.

Daher says one thing that do-it-yourself builders often overlook is how complicated it can be to arrange for all the utility hookups, including electricity, water, sewer and stormwater. His company works all this out ahead of time in order to ensure that there are no hidden surprises once the structure starts coming together.

Another decision homeowners face is whether to meter the granny flats separately for water and electricity. Though there is an extra charge associated with both of these, many councils stipulate that landlords cannot charge tenants for utilities in secondary units if a separate meter does not exist.

Finally, Panayi says it is important not to overlook the finishing touches in order to make your new flat a magnet to tenants. He especially emphasises adding interior fencing in the yard in order to ensure that tenants in the granny flat and the main house enjoy a fair amount of privacy. ■

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