TIPS FOR BUYING OFF-THE-PLAN

Use Only Industry Experts

Eight to ten years ago, quite a few canny management rights operators made a lot of money by buying complexes "off-the-plan", establishing them as "going concerns", then selling out to move on to the next one!

Sadly, the halcyon days of creating a small fortune in a short time by adopting this plan have gone but buying off-the-plan can still be a lucrative endeavour for someone who is willing to do their homework, tread carefully and adopt a slightly higher risk profile than what exists in buying a going concern.

So why did the halcyon days end? Well, for a start, developers worked out they were selling their off-the-plan projects too cheaply! Seven or eight years ago, quite large complexes were selling off-the-plan for not much more than 2 to 2.5 times projected earnings, while the same sized established complexes were worth 4 to 4.5 times actual earnings at the time. By the time a good manager "value added" and increased the projected net substantially, the value soared. It is easy to see that there was big money to be made. The differential is now about one times but in a sizable complex this is still not to be sneezed at, and as you will see below there are some other advantages for the foundation manager of a complex.

So, let's look at the benefits and the pitfalls but first a word to any developers who are about to build a complex incorporating management rights.

Developers must remember that the value of the managements they wish to sell is intrinsically tied to the validity and market appeal of the caretaking and letting agreements. All too often, we as brokers, are confronted with a project that is nearing completion and we find the agreements are full of provisions that make the rights well nigh unsaleable! Too many developers do not use a recognised MR lawyer to draft the agreements and it always ends in tears. The purchaser's lawyer (and often the financier) will not allow the sale to proceed without extensive changes to the agreements. The developer has already pre-sold 80% of the units with the faulty agreements attached to each contract as part of the disclosure process. Now he has to change the agreements, perhaps presenting an opportunity for pre-sales to pull out! A very sticky situation and one so easily avoided by having the agreements drafted by an expert in the first place.

It is not only buyers who should use industry-expert advisers when it comes to management rights! It applies to developers as well.

Let's now look at some practical aspects. Because off-the-plan complexes are generally still appraised by applying a multiplier to a net profit, we must gauge what the anticipated profit will be. Normally the developer, in concert with his marketing broker, will have done some projections on the anticipated number of rentals in the pool, the average rent in the area, the other income that can be expected and the average costs of running the business. These are assumptions that the buyer must be comfortable with.

If the assumed rent is $450 per week but when you look on the Internet you find that current weekly rents in the area are $375, it is time to ask some tough questions of the broker and the vendor! Experienced brokers are fully aware of the basic and reasonable assumptions in common use for establishing projected profits. Space does not permit me going through them all here.

The assumption concerning the number of rentals that will be in the rental pool is obviously important because it impacts greatly on the final profitability of the business. The common mechanism to protect a buyer from paying too much or a seller selling too cheaply is to incorporate "claw-back" and "claw-forward" clauses in the contract of sale. In the event that the final number in the pool falls short, the price is reduced; if the final number exceeds the projected number, the price increases. Normally an adjustment figure in dollars (per shortfall or overshoot) is agreed on and becomes part of the contract.

The taxation and stamp duty treatment is different for off-the-plan purchases. In a going concern purchase, there is normally no GST payable on the business or the unit but stamp duty is paid on both. In an off-the-plan sale, GST is payable on both components but no stamp duty is payable on the business. The ramifications of these differences to your personal situation must be discussed with your management rights accountant before you start signing contracts. Sometimes, your accountant can save you money by considering the correct entities for the purchase.

I have always believed that one of the greatest advantages of being a foundation manager is the ability to draw up the initial forms 20a (in Queensland) with your investor owners. This form is the document that sets out the terms of your appointment by the owners to manage their properties. Ensuring that your fees and charges are correctly established from day 1 is a boon to any business. Too often we see in established businesses, old forms 20a that do not reflect modern day realities and it is always easier to set fair, industry average charges at the beginning than to try to alter them later on!

One of the drawbacks of the off-the-plan purchase is that building defects often show up in the first six to twelve months and it often falls to the manager to supervise the correction of such problems. This can be an inconvenient nuisance and it is important that a good rapport is established with the builder and his staff to ensure that problems are attended to with a minimum of fuss.

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In my experience, off-the-plan purchases are best suited to managers who have had previous experience in running a management rights business. That is not to say that someone who has good people skills and sound commercial experience in another field could not do equally as well, but the early days of an off-the-plan can be hectic. A computer system to set up, filing systems to establish and many empty units to fill - it may make for a few sleepless nights - but two years down the track, as you look at your successful and valuable business, you probably will not remember them!

As always in the management rights business, you should only use industry expert advisers. There is always a greater risk in buying off-the-plan than buying established (that is why the multiplier is lower) but provided the correct professional advice is sought before and during purchase, there is no reason you cannot join the many others who have survived the thrills and spills of being a foundation manager!

10 Tips for Buying Off-the-Plan

There are few simple reasons why people want to buy management rights off-the-plan. A major reason is that there is no stamp duty on the initial grant of the management rights. There is still duty on the unit. Other reasons include expectations that:

- the multiplier will be lower when buying from the developer; and
- the profit could ultimately be a lot higher than that projected by the developer (especially for short term accommodation).

Although there is GST on an off-the-plan management rights purchase that is eventually remitted back to the buyer as an input tax credit. While the legal fees and general delays can be much greater than a normal purchase, the duty saving more than makes up for that! Of course, there are also other risks. But, if the items in this article are considered and acted upon, the risks can be substantially minimised.

Tip One - Trust but verify. The agent and the developer can be an excellent source of information. But, it is critical to distinguish between information and 'blue sky'. Information can be verified, blue sky cannot be. Blue sky includes, for example, unsupported estimates about likely rental or occupancy rates.

It is important to identify, check, and verify any important assumptions about the business. Get good advice from an accountant with expertise in management rights to help with the verification.

Tip Two - Deal with competent and respected people and get good advice early.

Importantly, the first person you need to check out is yourself!

Do you have the skills to bring this kind of business together? Permanent complexes are fairly straightforward. Many of my existing clients hear about a holiday building years before it is completed. Developers often approach experienced managers directly. Warning bells should ring if you have no experience and are approached six weeks before a major holiday building is to be finished!

Never sign an off-the-plan management rights contract without expert legal and accounting advice. These contracts are never standard.

Dealing with an experienced management rights agent is important. Remember, they are the developer's agent. Nevertheless, experienced agents will not want to risk losing a sale or your future patronage and will usually be honest with you. Remember those agents are not solicitors or accountants! They cannot provide all of the detailed advice that you will need before the contract can go unconditional.

Tip Three - The developer and its selling agents – ideally, the developer will have a good track record – find out about the developer's other complexes. Speak to the managers of those buildings.

What support will the developer offer you? This could include marketing support for web sites and advertising, and assistance with identifying and rectifying building defects. Managers often need to spend significant time and money setting up the business and fitting out the office in the months leading up to settlement.

Who are the selling agents? What have they promised the buyers? Obtain copies of marketing material.

Tip Four - Obtain copies of the off-the-plan unit sale contracts and disclosure statements. The developer and its selling agents should have copies of these to provide to you. These documents should have all sorts of useful information: copies of survey plans, floor plans, budgets, lists of inclusions, caretaking and letting agreements, by laws and so on.

Tip Five - Initial financial due diligence, what is the settlement time frame? Is there enough time to obtain letting appointments from owners? Enough time to find tenants? Some marketing and advertising needs a long lead in time especially in holiday buildings.

Often, the developer or its selling agent will provide you with a projected profit and loss statement. That projection will usually be for the second or even the third year in a holiday complex.

As above, make sure your own accountant verifies the projections and identifies and checks any underlying assumptions. It could take three to six months to fully tenant a permanent complex. My clients tell me it can easily take 18 months or more to achieve projected occupancy levels in a holiday building.

Projected profit does not equal cash flow! Consider preparing separate cash flow forecasts. Again get your accountant to assist in this regard.

Tip Six - Establish price calculation and related assumptions. What is the breakdown between body corporate remuneration and letting income? What expenses have been allowed for? What is the expected occupancy? What are the other income sources (electricity supply, internet services, parking fees)? Is it appropriate that those Income sources be included in the projections for sale purposes?

Nobody 'buys' GST. The figures quoted for remuneration and the off-the-plan management rights price, are usually *plus* GST. The unit price would normally *include* GST.

One of the things that you need to determine is how much each unit is worth in the letting pool. For example, if the projected letting income from a unit is (say) $6000 and the multiplier on your purchase is 4.5, then that unit alone is worth $27,000 to your letting pool.

Tip Seven - Initial legal due diligence, you should make sure your lawyer has a copy of the unit contract and disclosure statement very early in the negotiations.

There will be items of critical importance that need to be resolved before the contract can be signed. Your lawyer should identify any immediately obvious issues in the agreements. Developer's solicitors frequently use 'off the shelf' caretaking and letting agreements. Often, we see permanent townhouse complexes with agreements that seem drafted for a high rise holiday building and vice versa. High risk items that might need to be considered include, for example, strict office hours, or window cleaning requirements.

Are the duties, office hours and remuneration appropriate? What are the rubbish removal arrangements? Is it a holiday or permanent complex? Are the courtyards accessible for maintenance? What degree of office fit out will the developer supply? Consider PABX, Internet, electricity supply, car parking, furniture packages and the like. Developers are usually highly reluctant to make any changes to the caretaking and letting agreements. That is because any changes have to be disclosed to all the other buyers. If those buyers are materially prejudiced by the changes, then they are allowed to terminate their contracts. Developers usually don't want to risk that.

It is important for buyers of off-the-plan management rights to distinguish between their 'wish list' and 'deal breakers'. Given the understandable reluctance developers have to making amendments to the documents, my view is that if there are significant pre-sales, only deal breaking amendments should be put to the developer.

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Tip Eight - Minimum available units in letting pool at settlement? A critical question that is sometimes ignored is, "How many units do I need in the letting pool to settle?"

You can have the best clawback clause but if there are not enough sales to investors, the business might not stack up even with a major price reduction. This can be a difficult issue for all parties: You may not want to settle unless a certain percentage of units in the complex are sold to investors who have signed a form 20a with you.

In a holiday complex, consider if you require a minimum number of units to be fully furnished.

Tip Nine - Clawbacks are probably the biggest single bone of contention when buying off-the-plan management rights. Some developers simply refuse to consider clawbacks or minimum numbers to complete. If that is a commercial risk that you are prepared to take, then in some ways that can be a relief. It can certainly save a lot of negotiating, legal costs and delays!

But most managers would require a clawback. Consider the example in *Tip Number 6*. If you are expecting 50 units in the letting pool and there are only 45, the value of that discrepancy is 5 x $27,000, that is, $135,000.

Ideally, other features of clawback clauses include: not paying for units retained by the developer or its associates, only paying on receipt of a signed *PAMD* Form 20a letting appointment, and only paying for completed, furnished units (if applicable).

All of these items are negotiable.

Tip Ten - In principal agreement of developer to clawback/other amendments. An expert lawyer will be able to help you with straight forward 'in principal' clauses for the purposes of negotiating with the developer. The final contract will of course be quite detailed.

It is important that in principal agreement be reached on critical items such as price, clawbacks, minimum numbers to settle, and any obvious due diligence issues, before a contract is signed.