The 4 key risks in Off-plan purchases

BY JAMES BUYER ADVOCATES 24TH JULY 2010

Some people think buying off the plan is an easy way to buy property and a fast way to make money. You put down 10 per cent now or, in some cases, as low as 5 per cent, with the balance payable in six, 12 or 24 months. This gives you additional time to save and the ability to lock in a price today rather than having to pay future prices, which may be substantially higher.

In Victoria, there are stamp duty concessions when buying off-plan, as the government tries to stimulate new construction. The New South Wales Government has recently introduced similar concessions.

The truth is buying off the plan is one of the highest risk strategies that a conventional property investor or home buyer can engage in.

I am a big believer in investing in real estate, and I also think purchasing off-plan can be a very effective way to secure quality property and make money. My concern is there are far too many people who purchase off-plan property without knowing what they are getting into and the risks involved.

Investment is about Risk versus Return, so the first step when investing, in all instances, is to identify all potential risks and identify the potential return.

You may have been to a property seminar recently where “so called” experts in the field are telling you how positive the market is and how they have managed to selected the cream-of-the-crop stock. They provide cash flow analysis and, in some cases, even provide capital growth projection over three, five, seven and ten years. I know this because I have been to a number of these seminars.

Please understand that these seminar organisers have a vested interest in you buying specific property from them. They are not economists, demographers, solicitors, property valuers, accountants, or even clairvoyants; they are Salesmen and they only get paid when you have bought from them. All the information they provide is to promote their product and they have an abundance of material, both good and bad, to choose from.

Don’t get me wrong: I’m not saying all those who are selling off the plan are deceiving people into buying property based on incorrect or filtered information. What I am saying is that you should complete your own due diligence, in addition to reviewing the information they are providing to you.

What you will not hear from developers or real estate agents or at most, if not all, of these seminars is the four keys risk that I have outlined below. This article is not meant to scare you into buying established property; it’s meant to make you aware of some very real risks that could eventuate.

Developer Risk – This risk involves the developer going bust, producing a substandard product, or taking far longer to complete the project than originally advised. A developer going bust or producing a substandard product can drag on for years through the courts and, while the law is there to protect you, it’s costly and it will be at your own expense to fight initially – this is a sad, but very true, fact about our legal system.

Real Value Risk – What you may or may not realise is most off-plan purchases are not open market transaction. The developer simply sets a price and you either pay it or you don’t. The real question is, is this property worth this much in today’s market? In my experience, developers price their property at the upper end of the marketplace and, in some cases, above market levels.

Market Risk – Let’s assume you paid the right amount to begin with and, when the property is complete, the market has dropped 15 per cent. The bank will only lend on the property’s value upon completion, not the sale or contract amount and you, the purchaser, are obligated to pay the difference. Let’s assume you sign a contract to purchase a property at $1 million and, upon completion, the bank valued it at $850,000 because of the decline in the market. You would have to cover the difference.

Finance Risk – The first questions you need to ask yourself are if I was to purchase this property today do I have capacity to repay the loan, and will the bank lend me the money? If the answer is no, I strongly suggest that you stop right now. If the answer is yes, I would still proceed with caution, as what guarantees do you have that you will be in a position to get finance in the future? Have you considered things such as what would happen if you could not work because of injury or illness, what if you or your partner had a baby and you went down to one income, what would happen if you lost your job or got demoted, and are you protecting your credit file. Will the banks’ lending criteria change between now and when you settle on this property? Banks have recently tightened up their loan to value ratios and some economists are forecasting this to contract further as the debt crisis unfolds in Europe.

The above four risks are not simply not relevant when buying established property so the question begs whether buying off the plan is really worth it. My opinion is that off-plan property is a great investment strategy for seasoned investors, as there is a huge upside if you choose the right market conditions, right developer, right property and buy at the right price. But off-plan property is definitely not for everyone. It’s not for those who are just starting out, it’s not for those that are still financially fragile and it’s certainly not suitable for those who have not done their homework and don’t understand the risks.

There are various ways you can manage a number of the risks outlined but I will leave this for another article. I know a number of people who have been burnt very badly buying off the plan and it may take some of them a decade to recover.

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Matt & Sarah

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