your investment property

Are Serviced Apartments Really Too Risky For Your Portfolio?

By YIP

15/05/2014

Are serviced apartments really too risky for your portfolio?

The promise of high yields and long-term rental guarantees will see most property investors jumping for joy. So why is there so much doubt and suspicion surrounding investments in serviced apartments? Your Investment Property takes an in-depth look at the pros and cons of this type of investment

A serviced apartment is a furnished apartment, similar to a hotel room, available for long- or shortterm stays. Most of these apartments offer kitchen facilities and separate bedrooms to accommodate clients for stays of a week or longer. The apartments are often housed in resort- or hotel-style complexes with added amenities such as a pool, gym and other recreational options. These apartments are usually strata-titled and sold to individuals as separate investment opportunities.

What are the risks?
Search the net and you will find a plethora of websites dedicated to the benefits of investing in these kinds of properties. Take a look and it is easy to see why many investors choose to sign on the dotted line. These beautifully furnished apartments, often with water views and excellent amenities, offer high yields and long-term rental guarantees. Add to that the advertised list of benefits to investors and the offer seems almost impossible to resist.

But before you go dialling your bank manager, experts advise that it pays to do some research first. According to Club Financial Services senior finance consultant Paul Bieg, the first thing you need to consider with this type of investment is the financial risk. “While companies selling these apartments often offer rental guarantees, investors need to ensure that the guarantee will stand up if things don’t go as expected, especially on off-the-plan purchases,” he explains. “Like any property, location, price and what the market is looking for is the first rule of due diligence. You need to know exactly how long the lease runs for, and the terms of the lease are also very important.”

Bieg says investors should also review the return and make sure the proposed amount is ‘after costs’, as a 6% return can easily become 4% if maintenance and management fees have not been taken out. It is worth noting that the latest ABS report shows that serviced apartments in Australia had an occupancy rate of 63% in the June quarter of 2013. Overall, the statistics show a decline of 1.2 percentage points in occupancy rates of hotels, motels and serviced apartments with 15 or more rooms, compared to the same quarter in 2012. This decline occurred in all states and territories except the NT and Victoria, which increased by 2.1 percentage points and 1.1 percentage points respectively.

What are the benefits?
Corporate travellers, tourists, and fly-in fly-out mine and gas sector workers are just some of the clientele currently placing high demand on serviced apartment availability. Serviced apartments are becoming more widespread across major cities and are also starting to emerge in regional areas. Australasian investors interested in these kinds of investments have a wide range of options to choose from, with almost 30 companies in the serviced apartment industry.

Together they offer a total of 57,220 serviced apartments across 1,104 locations. This equates to 8.72% of the global serviced apartment market. Paul Constantinou, chairman of Quest, a market leader offering 150 properties throughout Australia, New Zealand and Fiji, says that by investing in serviced apartments investors have the opportunity to own high-yielding strata-titled apartments without the hassles of property management fees, potential extensive vacancy periods and tenants damaging the investment or failing to pay rent on time. "Investors benefit from long-term commercial-type lease and rent returns.

The franchise operator becomes the tenant and the arrangement has inbuilt annual rent reviews, coupled with the consistency of a quality residential property that outperforms standard real estate investment yields," he explains. "Additionally, a dedicated franchisee manages your investment to the highest possible standard, ensuring all maintenance is performed in a timely manner and your asset is always in tip-top condition." Despite current occupancy rates of only 63% nationally, Constantinou says this can be mitigated by choosing the right property and company to invest with. For example, investors buying the company's property will be guaranteed:

- A fixed rental income
- No vacancies (100% tenancy)
- A long-term lease
- No management fees
- No letting fees
- No repair and maintenance obligations

Other companies may offer a variation of the above, so make sure you read the fine print and ask a lot of questions. Also, make sure any property you buy will experience capital growth in the future. Capital growth is harder to measure with executive rental properties, and this is something you need to get your head around. Make sure you get a good balance of capital growth and rental return on your investment property.

What kind of return can I expect?
In a review by Australian financial services advisors Atchison Consultants, serviced apartment returns of 8–9% p.a. are predicted over a three- to five-year period. Company founder Ken Atchison says most serviced apartments currently only provide income returns at this stage.

"We would expect growth in rents in 2014 as demand for the apartments remains positive," he says. "Cap rates of serviced apartments have remained stable, with hotel cap rates having marginally increased." Likewise, Constantinou confirmed that Quest serviced apartments are currently achieving rental yields in the vicinity of 6.5% or higher.

How do I get finance for a serviced apartment?
This is where things can get a little tricky. A lender considers a serviced apartment to be a unit that has either a management agreement in place or a pooled rental scheme, or restrictions on the use of the unit as an owneroccupied home. Therefore, the type of existing management agreement the property has will go a long way in determining whether your finance gets across the line.

Jessica Darnbrough from Mortgage Choice says a lender will only provide up to 70% of the value if the property has a 'restrictive management agreement' in place. "If the serviced apartment does not allow for permanent occupancy under the terms of the management agreement, this would be considered a 'restrictive agreement'," she explains. Serviced apartments with 'restrictive management agreements' are considered by lenders to be high risk because they can be difficult to resell if the buyer defaults on the loan.

"However, if the serviced apartment is in a management agreement but the investor can prove that it will be released within six months of purchasing the property, a lender may then be willing to lend up to 80% of the value of the unit," Darnbrough says. Other elements vital to having finance approved are your credit history, income, and revenue provided by the property. The first thing a lender will do is ensure you have a strong credit history and can therefore make the repayments. They will also consider your annual income and the size of your deposit. Then the banks will look at the earning capacity of the property before approving any finance.

What kind of investor do these types of apartments best suit?

Serviced apartments don't suit all investors, for three main reasons:

- A deposit of 30% is usually required
- It can be a high-risk investment
- You need some property investing experience

Bieg says these investments may only suit about 10% of investors. "Because lenders will only ever go to a maximum LVR of 80% but in most cases it is 70%, this will rule out most investors who are trying to build a portfolio and maximise their cash or equity," he says. "Serviced apartments are usually best suited to an experienced investor using an SMSF."