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Commercial Property Offers Top Yields For Self Managed Super Funds

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Australia's army of self-managed super funds (SMSFs) has discovered property investment. But it is slowly weaning itself from its predilection for residential property.

Commercial, retail and industrial property are the new frontiers for SMSFs. According to the Australian Taxation Office (ATO), more than 15 per cent of total SMSF assets – which amount to more than \$400 billion – are invested in residential and commercial property assets.

SMSFs have always been able to own property: if it is residential property, they are not allowed to buy it from a member of the SMSF, and they must buy it as an investment, not to occupy. But if it is "business real property" – a building with a business operating inside it, generating revenue such as rent – business proprietors who owned their business premises could transfer it into their super fund.

Ken Atchison, managing director of property investment consultancy Atchison Investment Consulting, says this is the most common type of non-residential property held within an SMSF – where the trustee is using the property for their own business, on a leasing arrangement.

In September 2007 the government allowed SMSFs to borrow to buy property if the recourse for the loan was limited to the asset in question. This was poorly understood, so in July 2010 the government clarified the rules. There is now a "single acquirable asset," meaning that only one property at a time can be bought under each separate borrowing arrangement; a property cannot be improved once it has been bought under the arrangement (it can be repaired and maintained).

The government also clarified who the lender could be: it can be a related party. This means that a person can lend money to their super fund to buy a property.

The advantages to the SMSF are holding the property in the concessional tax environment of super: once the property is in the superannuation environment, capital gains tax and rent are taxed at the super fund rate of 15 per cent, and when the fund moves to pension phase after age 60, the income from the property and capital gain on eventual sale are tax-free.

If the fund borrows to buy the property, it can claim interest payments as a tax deduction and potentially reduce tax liability. "It gives the fund the ability to diversify its investment portfolio through prudent borrowing, while giving very significant tax

advantages as well," says Atchison. "We believe we are only just starting to see the demand for investment property from SMSFs."

Matt Nichols, managing director of south-east Melbourne-based commercial property agency Nichols Crowder, sees the demand all the time. "It is absolutely massive. Every property we have sold since January 1 for under \$600,000 has involved a SMSF as purchaser."

The majority of that activity – about 70 per cent – is from owner-occupiers, says Nichols. "At the moment the owner-occupiers are the most active – investors are a bit slower to move. But we are doing three presentations on this a week, and they are so well-received, because the attractions are so strong. You can have rental income that well and truly covers your interest bill, and an asset that becomes tax-free when you turn 60."

If the SMSF borrows to buy a property, it must be able to service the proposed loan from existing and proposed investment income and member contributions. With that condition met, Dr. Steven Enticott, managing director of accountancy firm CIA Tax, which specialises in after-tax cash flows, says the potential benefits for a geared SMSF investment in property include:

- The acceleration of wealth accumulation – unlocking cash for investment purposes.
- Further diversification of the SMSF's investment portfolio
- The rental income assists in repaying loan – rent paid directly to the trustee can be used to repay the loan.
- Negative gearing benefits – the trust is able to offset loan interest and expenses against rental income.
- Income tax benefits – concessional tax rates apply for income after expenses.
- Limited recourse – the lender only has recourse to the property being purchased, not any other assets held by the SMSF.
- Capital Gains Tax (CGT) benefits.
- The ability to acquire real business property for lease to a family business.

Atchison says SMSF investors interested in the retail sector at present would be looking at relatively low yields, in the 4 per cent –5 per cent range. But in the industrial sector, business park-style investments are offering 9 per cent-plus yields. In office, it is the same story, with business parks and suburban office buildings pushing up toward 10 per cent yields.

There is greater opportunity for a yield premium in regional commercial property, he says, but greater risk is attached to the exit prospects.

Tim Grossman, associate director at CBRE, agrees that yields vary across the asset sectors. "Our Brisbane office sold two Shell service stations last week, at about \$2 million each, at low-7 per cent yields. Industrial is going to be a lot softer than that – you're probably looking at 8.5 per cent. It depends on the price point. At a bit over \$2 million, the Shell service stations were in the sweet spot for the mum-and-dad/SMSF investors.

We're looking at a regional Centrelink office at the moment, that's returning about 10 per cent at about \$5 million. Typically in the past that would have traded better than that. Even though that's in a regional location, the tenant is great – it's the government – and there's four years left on the lease, but when you start getting up over \$5 million, your purchaser pool reduces: there are not too many of those investors around. Even a \$3 million–\$5 million purchase in a SMSF, unless it's quite a large fund, that's going to be a high concentration risk."

A way of getting around the concentration risk is the smaller investment amounts enabled by fractional ownership methods such as property syndicates. Grossman says syndicators are coming back into the market: vvery few joint-owned syndicates set up these days would not be SMSF-compliant.

"We're doing some office buildings down in Wollongong at the moment, we're talking \$15 million–\$20 million, for A-grade office buildings – even with potential vacancy risks and so on – and we're seeing syndicate interest. It's probably a bit too big for high-net-worth, and a bit too small for institutions – but it's in the sweet spot for syndicates," he says.

Steve Gillard, managing director of syndicator GDI Property Group, says demand is very strong from SMSFs. "We only do office buildings: our investors put in as little as \$50,000 to whatever they like, and they get a piece of a CBD office investment. It's an opportunity they would not get on their own. 90 per cent of our investors are SMSFs."

GDI has just launched its latest property trust, the GDI No. 36 Perth CBD Office Trust, which will own an A-grade office building located in Perth's Central Business District. "We expect to have between 400–600 investors, mostly SMSFs, putting in on average \$100,000. We're projecting 9.25 per cent a year, which for a SMSF is very attractive. We bought this property on a capitalisation rate of 10 per cent, but yields can compress pretty sharply when confidence builds. Pre-GFC, this building would have been on a cap rate of 6.75 per cent. We think that there is going to be significant yield compression, and going through a syndication is a very good way for super funds to buy a piece of a CBD property," says Gillard.