Building Wealth Using Compounding Rental Profits

Stephen Fay ACA, of **Fylde Tax Accountants**, considers how property investors can become financially secure by investing wisely in residential property.

Many property investors want to use property to generate long-term wealth - but too few put in place a business plan and financial budget to achieve their aim. Being financially disciplined, and committing to a long-term plan, can lead to financial security sooner than you think - using compounding rental profits and occasional sales to reduce debt and build up equity.

There is a lot of hype around property investment, but the truth is that the average investor is trying to build a moderate-sized portfolio to allow a comfortable and early retirement, and to pass on wealth to their family.

Step 1 - Develop a plan to satisfy YOUR requirements

Many investors with large portfolios now wish that they bought fewer properties - they failed to plan ahead and now have a 'property management headache'. For most people, simply owning 10 mortgage-free properties would provide a very good income and with an index-linked capital base.

Set an income figure that you would be happy with - let's say £60k per annum. Work back from the gross rents, and deduct (say) one-third for letting costs. This would mean a 'gross' annual rent roll of £90k - meaning each property must rent at £750pcm. Tweak the figures until you have your own combination of properties/rents/net income that suits you.

Realistically, £60k is a fantastic income for most investors - and eminently achievable - and is far more useful as a target than a poorly-defined plan to become a 'property millionaire'.

Step 2 - Work your plan

Set a property acquisition timeline that is realistic - remember that these days cash deposits are required, so for most investors, building their portfolio slowly but surely is the best approach. Too many investors are in a hurry - better to build a business based on solid foundations than to rush things - when things go wrong in property, they tend to go badly wrong!

A realistic timeline might be to acquire two properties per year for (say) seven years (more on that later). The old proverb 'measure twice, cut once' is sound advice - property is an expensive business to be in, so make sure the property you do buy has a good yield and is bought at a keen price.

Step 3 - Re-invest rental profits

A little-appreciated factor in building wealth in property is the effect of using rental profits to pay down debt. Like a repayment mortgage, it's a simple yet powerful process of chipping away at the debt, which in turn means lower interest bills, and in turn higher profits. This is where buying property which is in good rental demand, and is cheap to maintain, will enable consistently high rental profits to be made.

Try to differentiate yourself and your property - and so command a premium rent. Across a portfolio, the compound effect of superior rents can have a fantastic debt-busting impact.

The basic model is a static or reducing cost base (mainly mortgage interest), combined with a rising income (rent), resulting in an ever-widening gap between income and costs.

Step 4 - Sell off the occasional property

A powerful way to accelerate the debt repayment process is to sell off some properties that have appreciated in value - especially where the rental yield has not kept pace with the capital value. A good strategy is to run a portfolio that is larger than the planned 'end portfolio'.

In the example above, buying a total of 14 properties, and selling off 4 properties once a decent capital gain has accumulated, will often dramatically reduce debt. It may be that developing existing property (e.g. adding additional rooms) can increase the rental yield.

Step 5 - Don't let tax concerns get in the way of business sense

Many investors will refuse to pay down debt, or sell property, because they are unwilling to pay tax on profits and gains. No-one likes paying tax! But, there are lots of strategies to minimise the various taxes the investors may pay.

Many investors are only ever going to pay 20% income tax (there is no National Insurance on rental profits), and so will actually receive 80% of their profits - sometimes more. Using a property company is a good way of 'parking' profits and avoiding Higher Rate income tax - for later tax-efficient withdrawal.

Tax is a fact of life - minimise it, but don't let tax concerns override good business sense.

Step 6 - Winding down and paying off!

Imagine the personal satisfaction of making that final mortgage payment - no more debt, no more interest rate worries, no more direct debits and lender hassles. Many investors find that they haven't quite been able to pay off all mortgages - so then need to decide whether to sell off a final property, or two, or extend their property plan a year or two. It's a personal decision - would owning 9 mortgage-free properties, rather than 10, make that much difference?

Summary

Despite what some 'property education' gurus may say, property investment is relatively simple. Good property selection, financial discipline, and a patient long-term plan can mean a mortgage-free small portfolio in 15-20 years. For most investors starting in their early 30s, this can mean financial security by their mid-40s. It's not a sophisticated plan - but it does work! Like many business plans, it's more about 'doing it' than having a 'genius plan'. PIN