

Why SMSFs choose commercial property investment

A white paper on how self-managed super fund members are using commercial property investment to **create wealth** and **secure their retirement**.

About this document

This document does not advise on the suitability of a Self-Managed Super Fund (SMSF) to the reader's personal purposes. If the reader has an SMSF, or is considering using an SMSF, they should seek independent advice. Properties & Pathways Pty Ltd, the author, is not licenced to provide taxation advice and readers should seek such taxation advice from a suitably qualified professional. Past performance is no guarantee of future performance. The information provided in this document is general in nature only. Any information provided in this document is based on current legislation and taxation rules which are subject to change.

Properties & Pathways is holder of Australian Financial Services Licence 438152. We do not provide advice on or set up Self-Managed Super Funds for investors. As the author, Properties & Pathways specialises in commercial property investment and structured investment syndicates. The purpose of this document is to assist those who already have an SMSF, or those considering opening an SMSF, with the investment options available to them (in the case of this white paper, commercial property investment; the author's specialisation).

+61 8 9381 1300

contact@propertiesandpathways.com.au

Suite B3, 431 Roberts Road, Subiaco WA 6008

propertiesandpathways.com.au

CONTENTS

Page 1. Introduction

Page 2. SMSF privileges

Page 3. 3 reasons: Why SMSFs choose commercial property investment

Page 4. 1. Tax effective Structure

Page 6. 2. Outperforming regulated super funds

Page 9. 3. Safe investment avenue

Page 11. Conclusion: How you can invest in commercial property

Introduction

“ We always try to understand what drives investors. What is the behaviour behind them choosing commercial property as an investment? And what structures do they have in place to ensure their investment is smart, secure and rewarding? ”

In September 2007, the SIS Act 1993 was amended to allow self-managed super fund (SMSF) trustees to borrow money to invest in real estate.

Since then we've seen a real emergence of SMSF investors, to the point where the majority of our Australian investors are using an SMSF as their chosen investment vehicle.

Sure, SMSFs are growing in popularity. But the real trend is where they are investing.

SMSF investment in commercial property is proving to be a robust solution to these challenges.

This guide will outline what we're hearing from our SMSF investors say are the three main reasons they choose commercial property. This may be useful if you're thinking about diversifying your portfolio or using a stable investment vehicle to put more shine on your retirement.

“ The majority of our Australian investors use an SMSF. ”

So, why are SMSFs choosing commercial property investment?

Savvy investors planning for retirement want to create wealth but their appetite for risk is low. They want the wealth created during their career to now start working for them but without the risk of denting or losing it. That's why many avoid volatile investment avenues (like shares and equities) and are less motivated by low-yielding investments (like term deposits and savings accounts).

Retirees want to create wealth with low risk. Sounds like a simple goal, but it has the following key challenges:

- **Tax implications:** Good investment decisions can carry large tax burdens
- **Low yields:** Cash flow is crucial but often difficult to find in many regular investment avenues
- **Hazards:** Volatility, inconsistent cash flow and lack of regulation can scare off those who are ready to invest.

This document explores some of the trends we're seeing from our investors, but it is by no means prescriptive and does not constitute as advice.

We hope you enjoy this general insight into SMSF investment in commercial property. For more information on investing alongside us in commercial property, please get in touch with us.

Who are we?

Properties & Pathways is a dynamic commercial property investment firm in Australia. We handpick our properties to ensure growth and high yielding returns for our investors. We invest alongside our investors and this commitment to each commercial property breeds absolute transparency at every turn.



SMSF privileges

Those already using an SMSF will be privy to a few perks:

Limited Recourse Borrowing Arrangement (LRBA)

SMSFs give investors the privilege to finance their property purchase under a Limited Recourse Borrowing Arrangement (LRBA; also known as a limited recourse or non-recourse loan).

Under an LRBA, should the bank attempt to recover the outstanding debt, it typically only has access to the property itself as security against the loan. An LRBA differs drastically to recourse loans, where the bank may recover unpaid debt using assets held in the borrower's personal name.

As other commercial property is held in a separate trust, SMSFs can invest without exposing the remaining wealth held in the SMSF (while still allowing any investment returns to flow to the SMSF trustee on a monthly or quarterly basis).

If the borrower defaults on their loan obligations under an LRBA, the bank has no recourse over the borrower's other assets. For example, the borrower's car, home and cash holdings cannot be repossessed or sold to recoup any residual debt. This is imperative.

Those nearing retirement find comfort knowing their personal assets are safe, which is the first reason LRBAs (and with it, SMSFs) are popular for commercial property investors. Using LRBAs is a cornerstone of Properties & Pathways' investment mandate. (It is the trustee of the SMSF's responsibility to set their own mandate)

Those with an LRBA should consider the risks and costs involved in setting up this financial arrangement (and the associated SMSF). Furthermore, the rules that govern both LRBAs and SMSFs change regularly and it is the responsibility of borrowers to stay abreast of them. This is one of the reasons our SMSF investors enjoy our transparent structure - it removes the burden but maintains absolute clarity.

Repay debt quicker

SMSF members who work and who invest in commercial property can potentially salary sacrifice additional income into an SMSF. This can bolster their fund balance faster. Rather than investors paying their marginal tax rate on the income, with the right tax and accounting advice they can pay a fixed 15% tax on salary sacrifice (subject to certain caps and means-tested thresholds).

Combine family income

Instead of being assessed as an individual, the income of all members participating in an SMSF can be considered by the bank. This might open doors to stronger borrowing power and investment opportunities.

“ All our loans that we take out for our commercial properties are non-recourse. And that's very comforting from our position. ”

T. & H. Berryman

Investors since 2010 using their SMSF



reasons SMSFs choose commercial property investment

“ The SMSF member is typically more risk averse. So, they want to see a robust return but with very low levels of risk. And that’s what the commercial property avenue allows them. ”

Cal Doggett
Managing Director, Properties & Pathways

1

Tax effective structure (Page 4)

The ATO says SMSFs are a way of saving for retirement. Those nearing or in retirement can have a reduced propensity to earn, as they slow down or cease working. So, preserving income through a tax effective structure is a high priority.

2

Outperforming regulated super funds (Page 6)

Many retirees look for strong, consistent cash flow. But even the best performing regulated super funds are falling short of commercial property returns.*

3

Safe investment avenue (Page 9)

SMSFs can provide the necessary discretion to create a fully diversified, high yielding portfolio which is hand picked by the members, rather than the typical fund manager.

1 Tax effective structure

Sending hard-earned profits to the taxman can water down investment return. We continually hear our investors saying they want smarter strategies to minimise tax bills.

Commercial property can form a part of those strategies.

“Those in the 55+ age bracket want bang for buck.”

What we're seeing is investors nearing or already in retirement want a tax effective investment structure. In later years they tend to have reduced ability to earn income from working and therefore want to drive their dollar further.

The most common income sources for retirees include franking credit refunds, share dividends, residential rental income and cash distributions from super. Usually this income is lower than their pre-retirement salary so the need to protect each dollar is far greater for retirees.

An SMSF's tax effective structure is one reason over a million Australian investors use an SMSF. Those in the 55 and above age bracket are looking to get bang for buck on the dollars they are investing.

So, how can SMSF investment into commercial property be tax effective?

Pay less income tax

Earnings from an SMSF (i.e. rental income from a fund-owned property) are taxed at the flat concessional tax rate of 15%. For most sophisticated investors, this will be far less than their individual marginal tax rate. And when a member of the fund reaches 60 years' old and retires, or a member reaches the age of 65 (as of 1 July 2007), any income received from their SMSF will be tax-free.

When comparing a potential 37% or 45% marginal tax rate to a 15% marginal tax rate (or sometimes a tax rate of nil), the benefit of an SMSF structured investment clearly comes into focus.

Pay less Capital Gains Tax¹

Usually, for investment vehicles other than SMSFs, the capital gain from a commercial property sale is taxed at an investor's marginal tax rate (the taxable value may be reduced by 50% for some investors). But the current legislation says commercial property held in an SMSF for over 12 months is only exposed to capital gains tax of 10% - another great tax advantage our SMSF investors are enjoying.

¹ <https://www.ato.gov.au/Super/Self-managed-super-funds/investing/Tax-on-income/Capital-gains>

*Readers should seek independent advice before setting up an SMSF or making any investment decisions.

How does 'wear and tear' add value?

Depreciation deductions

Plant & equipment found in the commercial property can be depreciated over its 'useful/economic life'. The amount the economic usefulness reduces each year (called annual depreciation) can then be claimed as a tax deduction. Younger plant (i.e. air conditioning units, light fittings and security systems) is typically depreciated at higher rates than older items, which allows for larger annual depreciation claims during the earlier years of each item's useful life.

At no additional expense, an investor can add value to their after-tax earnings by claiming depreciable items.

Capital allowance deductions

The original cost of a commercial building, on top of any improvements since the original build, can be tax deductible. Termed 'capital allowance', these tax deductions occur every year and typically amortize over a 40-year period following the building's inception. The younger the building the better, because the remaining annual deductions decrease over time as the building ages. Like depreciation from plant & equipment, investors might consider capital allowance deductions as additional 'tax free' cash flow.

“ At Properties & Pathways, we are strategic with every asset we purchase and have found the tax benefits of annual depreciation to be anywhere between 10% and 40% of a property's otherwise taxable income. The tax effectiveness of this structure has meant a much larger after-tax cash flow for our investors. ”

Why SMSFs choose commercial property investment

2 Outperforming regulated super funds

Top super performers no match for SMSF investment in commercial property

A 2018 study by Superannuation research group Chant West found government regulated growth super funds are only offering total annual gross returns of 2.8% and below. The median growth in 2018 of all funds on the list provided total gross returns of 0.8%.³

Top 5 performing Australian growth funds in 12 months to December 31, 2018:

Fund	Year 1 (%) Return
QSuper Balanced	2.8
Media Super Balanced (MySuper)	2.6
HESTA Core Pool	2.5
Statewide Super Active Balanced	2.5
Club Plus MySuper/Balanced	2.2

Source: AFR/Chant West, full performance list of growth funds for calendar year 2018, released Feb 1, 2019

Compared to long-term commercial property investment

Industrial and office property produced total gross returns of 14.8% pa and 13.7% pa respectively for investors over the 12 months to Dec 2018. Zooming out to five-year annual averages to Dec 2018, unlisted property returns looked even better.⁴

Commercial property returns in 12 months to December 31, 2018:

Investment	Year 1 (%) Return
Industrial Property (Australia)	14.8
Office Property (Australia)	13.7

Source: Property Council of Australia, March 2019 Quarterly Report

“As at June 2019, completed Properties & Pathways commercial property syndicates gave investors average returns of over 19.16% pa.”

Gross Return Comparison 12 months to Dec 18	Top Performing Regulated Super Fund	SMSF investment in industrial property (national average)	SMSF investment in office property (national average)	SMSF investment in commercial property (Properties & Pathways) ²
Initial Investment	\$250,000	\$250,000	\$250,000	\$250,000
Yr 1 Return	2.8%	14.8%	13.7%	13.25%
Yr 1 Return on Investment	\$7,000	\$37,000	\$34,250	\$37,500

² Past performances not indicative of future returns. See website for full disclaimers.

³ <https://www.afr.com/personal-finance/superannuation-and-smsfs/find-your-super-fund-in-the-top-performers-20190130-h1an6s>

⁴ <https://www.afr.com/real-estate/commercial/investment/unlisted-property-funds-outperform-in-2018-20190308-h1c659>

Why SMSFs choose commercial property investment

How does commercial property differ to other investments?

Safer to leverage and more able to add value. We think these are key reasons commercial property investment outperforms top regulated super funds.

Beyond the tax advantages of investing with an SMSF, commercial property investors have a bag of value-add tools available to bolster their returns:

- Upgrading the premises
- Renovating or entering capital works to improve the property's appeal to tenants
- Increasing signage, accessibility, functionality and exposure
- Taking advantage of re-zoning, and improving underlying land usages
- Negotiating favourable outcomes with tenants
- Negotiating favourable rates and terms with the bank

Commercial property is known as a more sophisticated investment than residential property. Which is why the right strategy and the right team are so important when creating and maintaining value. This is perhaps why we're seeing investors turning to commercial property syndicates rather than residential property and other investments.

How do other investments perform?

We've seen commercial property can achieve returns of 14.8% pa (industrial) and 13.7% pa (office). What are investors seeing elsewhere?

Shares

The ASX reports that in the 10 years to Dec 2017, Australian shares have averaged 4% gross annual returns.⁵ Shareholders could have created about the same wealth by keeping their money in cash (3.5% gross annual returns in the same period according to the ASX).

Residential Property

Australian residential investment property has surpassed Australian shares in the 10 years to Dec 2017, says the ASX, with average annual gross returns of 8.0%.

Cash and Term Deposits

According to the ASX, cash gave average annual gross returns of 3.5% in the 10 years to Dec 2017.

Current overall term deposit rates as at May 2019 sit at approx. 3.0% pa⁶:

- Term deposits have not matched returns from shares since 2013 (when overall term deposit rates were 4.15% pa).
- Term deposits have not matched returns from real estate since 1995 (when overall term deposit rates were 8.5% pa).

⁵ <https://www.asx.com.au/documents/research/russell-asx-long-term-investing-report-2018.pdf>

⁶ <https://www.finder.com.au/historical-term-deposit-rates>

ARTICLE:February 14, 2019 | www.propertiesandpathways.com.au/news-views

Top Super Performers lose to SMSF commercial property investment

SMSF NEWS:

In February 2019, the AFR listed 2018's top performing super funds. With no fund producing annual returns over 2.8%, why doesn't SMSF investment in commercial property get a mention?

When the country's best performing super funds in 2018 were listed in the AFR's Smart Investor on Saturday, 2 February 2019 – the funds most Australians would use for their super – we expected to see notable annual returns.

On the contrary, the median growth fund returned 0.8% in 2018 and the leading super fund brought in annual yields of 2.80%. This is comparable to the average term deposit or residential property.

Those preparing for or already in retirement are potentially missing out on the growth and yield they truly deserve. Here's why:

Shares volatility

"Our members tell us protecting the value of their superannuation accounts from the worst effects of share market downturns is especially important to them," says Brad Holzberger, CIO of market leading super fund QSuper.

Shares have copped many punches in recent years, with 2018 generating the lowest returns since 2011. Australian shares dropped 8.5% in December 2018 and international shares slumped 13.5%.

"Many superannuation funds perform well when share markets are strong but not necessarily when they're down," says Holzberger. When stocks go down, super fund members feel it.

So, what's the solution for super fund members who want higher and more stable returns?

Commercial property investment

Ian Fryer, Chant West head of research, says the data of super fund returns "shows the benefit of its diversification into a wide range of unlisted assets. Diversification really is king."

We couldn't agree more.

Commercial property has typically given Properties & Pathways investors annual cash returns of 8.0% and above (and an average annualised return of 19.16% for completed syndicates). With the tax concessions involved, those placing commercial property in their SMSF are seeing even bigger benefits.

This is why we're seeing more investors use self-managed super funds to take advantage of high commercial property returns.

The message we keep hearing from our investors is that moving their nest egg away from the volatility of the share market has given them peace of mind without compromising on return.

Meanwhile, SMSF investment in commercial property can be a brilliant investment vehicle which has gone under many radars. You might be in an ideal position to take advantage of it.

3 Safe investment avenue

“The third thing we’re seeing is that self-managed super funds want to place their funds in an investment avenue that is safe.”

SMSF investors are telling us they want an investment which is safe politically, economically and environmentally. These investors want to know that rent from their tenant is still going to come in the door tomorrow regardless of any economic and political headwinds today.

“The self-managed super fund is allowing people to ‘do it yourself’ and get in and manage their money. Rather than relying on someone else to manage it.”

With SMSFs, the members are in charge. Most of our investors opt to diversify their SMSF investments by including commercial property in their portfolio. They say it feels safer than depositing hard-earned funds with a regulated super fund (many of which are heavily weighted with shares). After all, the wrong environment can be detrimental to investor return, particularly when retirement is looming and stability is vital.

Critical to note is that SMSF members accept all responsibility for complying with super and tax laws. Independent advice should be obtained before setting up an SMSF.

Politically safe

When taking the SMSF investment vehicle and using it to invest alongside an unlisted commercial property syndicator, there’s another level of regulation sitting behind it governed by Australia’s financial watchdog, ASIC. ASIC seeks to give SMSF members comfort the nest egg they’ve created over many years is safe and their investment is managed by professionals with the right precautions, processes and skills. This is why each Australian Financial Services Licence (AFSL) is so heavily regulated by ASIC.

Economically safe

Economies experience peaks and troughs, and any investment performance can be aligned to such cycles. Commercial property is not immune to economic cycles. But the relative illiquidity of the commercial property market and the solidity of commercial lease agreements can provide significant shields from a slowing economy.

Environmentally safe

Australia has the **second most transparent real estate market in the world**.⁷ From investment performance measurement to regulatory and legal systems, Australian commercial real estate is a hub for reliable investment. The average investor may not be a commercial property expert, but they can have comfort they’ve invested in a globally recognised transparent and reliable environment.

Unlike shares, which can have jagged price movements (literally overnight), commercial property can provide a more stable investment environment, if done strategically and professionally.

Commercial property investment an SMSF winner

3 December 2018

Cal Doggett | Published in The West Australian

Make no mistake, self-managed super funds come with a price tag. Financial planners aren't shy to charge up to \$5000 a year to run and audit the SMSF, set-up costs are roughly \$2500 and compliance costs can balloon the bill ever further.

And that's before considering the complexities. SMSF compliance is usually too complex for investors to navigate by themselves. A simple Google search on the subject shows a flood of results on the rising costs and fears for SMSF investors.

The key for combating high costs is the same thing that likely brought investors to manage their own super in the first place: high yields. If returns can be structured to far outstrip the establishment compliance and ongoing costs of setting up an SMSF, then the investment flexibility and tax advantages of an SMSF are yours to reap.

The key is finding a solid investment vehicle to drive these high yields. Residential property typically serves sub-5% yields, which can tightrope even further after financial planner's or property manager's fees. Nor will the ASX, which in October 2018 had its worst session in five months. And depositing your funds in the bank is no way to grow real wealth.

What can foot the bill for your SMSF is commercial real estate.

As at December 2017, SMSF investors had invested \$80.1 billion in non-residential property and you can see why. Being part of a big-league commercial property investment can provide robust annual returns well above the SMSF set up and compliance costs.

A big commercial asset, housing a strong commercial tenant on solid lease terms, can be more secure than any house in the suburbs leased to even the most affluent family or couple.

A huge pocket of savings can also be found in the tax benefits of owning commercial property in an SMSF. There is a reason why 69% of Australia's high net worth investors now have an SMSF and would otherwise likely be taxed in the 37% tax bracket.

The relatively high yields of commercial real estate investing might seem too expensive or too complex for some but with quality syndicated offerings now available, your SMSF can leverage expertise and gearing all in one place.

We've found the majority of our investors use their SMSF to invest alongside us in stable commercial property and enjoy returns which significantly outstrip the cost of setting up and maintaining an SMSF.

As always, the best investment is good advice from a renowned finance professional first.

Cal Doggett is managing director of Properties & Pathways



How **you** can invest in commercial property

Investing in commercial property can be complex. And there are many questions any investor may struggle to answer while on their pathway to prosperity.

An alternative to investing alone is investing alongside a commercial property syndicator. Syndicators allow investors to leverage from professional expertise, substantial networks and performance driven from experience.

For more information on how you can secure your investment alongside us, get in touch today.

+61 8 9381 1300

contact@propertiesandpathways.com.au

Suite B3, 431 Roberts Road, Subiaco WA 6008

propertiesandpathways.com.au

Testimonials

“I’ve had great success with numerous investments with these guys. Highly recommended.”

G. Skinner

“We would highly recommend this most forward-thinking company to anyone wishing to invest in property management.”

J. Hibbard

“We feel fortunate to have had and continue to have great outcomes in all our investments with Properties & Pathways over a number of years.”

N. Simons

“In all of my dealings with P&P the team have been first class.”

B. Stokes

“We have now invested in several of their syndicates and have no hesitation in recommending them to any potential investors. Their integrity, transparency and attention to detail are second to none and the results they achieve match or exceed their targets. We will be looking at further investments with them in future.”

A. Hearne



Properties & Pathways Pty Ltd is holder of Australian Financial Services Licence 438152. The term syndicate is used by Properties & Pathways Pty Ltd to describe wholesale property syndicates, unlisted property trusts and registered managed investment schemes. Investment in the syndicates or trusts is only available via the relevant offer and/or disclosure documents. The information in this document has been made available for information purposes only and does not constitute advice on which reliance can be placed, nor an offer for the issue, sale or purchase of securities or units. This document has been prepared without taking into account the objectives, financial situation or needs of any particular investor or reader and therefore professional advice should be sought prior to making any investment decisions. Any investment is subject to risk, including possible delays or suspension of payments, loss of income and principal investment. Neither Properties & Pathways Pty Ltd nor any of its associates, related entities or Directors warrant or guarantee the performance of any investment or repayment of monies invested. Whilst every care has been taken in the preparation of this document, Properties & Pathways Pty Ltd gives no warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts or opinions. This information is current as at 26 June 2019.