A bargain price isn't the same as a good buy

PROPERTY WATCH
MARK ARMSTRONG

THINK about the people you know who have bought investment property. Chances are at least one of them claims to have bought it "below market value".

It is impossible to buy below market value because a property's market value is ultimately determined by one thing – the price you pay for it.

When someone says they have bought below market value, what they mean is that they bought the asset for a lower price than other properties in the area, or that they bought it at a lower price than would have been possible six or 12 months previously.

If you buy a property for less than the worth of others in the area, that does not mean you have secured a bargain – you may have bought a second-class asset.

If other properties in the area have sold for about $650,000 but you buy one for $600,000, perhaps its value has been compromised by a poor structural condition or a noisy main road.

In the second scenario, buying a property for less than it would have been worth earlier does not necessarily mean you have bought well. It could mean that property values in the area are falling.

There are two possible reasons for this. First, there is less demand than supply. In this situation vendors are competing strongly for the attention of fewer buyers, so they are more likely to discount their asking price.

If you buy into a market like this, it is critical to ask yourself two questions – how much more prices will fall, and how long it will be until the trend reverses. In other words, how much money you will have to lose, and for how long, until your asset starts working for you.

The second possible reason for buying a property for less than its previous market value is that the asset has a low land-to-asset ratio – in other words, the building makes up the bulk of the asset's value.

Land appreciates in value while buildings depreciate. If you buy a property for less than its original sale value, chances are the building's value is falling faster than the land's value is growing.

The net result? An asset that will continue to lose value after you have bought it, until all the depreciation has been used up. Meanwhile, you are paying holding costs like interest, rates and maintenance on a property that is delivering nothing in return.

> You may have bought a second-class asset.

Instead of buying property that is cheap and will remain so because of poor location or high depreciation, focus instead on researching the market to identify properties that represent good investment value.

High-quality assets generally cost more than poor ones, so if your research shows that you may be priced out of a certain type of property, it is better to compromise on the size (for example, two bedrooms instead of three) than on the location.

Mark Armstrong is an independent property analyst and adviser.