THE 10 BIGGEST RISKS IN OFF-PLAN PROPERTY INVESTMENTS AND HOW TO AVOID THEM

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Introduction

This guide is not designed to discourage you from investing in off-plan property!

Buying before or during construction is an approach that is attractive to many investors.

There is no reason your future investment can't be one of the many success stories.

Over the last 20 years, I've seen many projects that have made really good returns for investors, both in terms of capital growth and rental income.

Some close friends of mine made HUGE sums of money buying and flipping off-plan property in Dubai, during the first boom in that particular market.

Not so long ago, I monitored one development near to Tower Bridge in London, where prices start at around £800,000 when it launched with a 2-year construction timeline.

Shortly after completion, the same units were changing hands for well in excess of £1 million.

£200k in 2 years is a pretty handsome return, especially on a small studio in London!
But not all off plan investments go well, including some that I've made myself.

Sometimes, rental returns are a little bit lower than expected, or running costs are higher.

For most people, that's not the end of the world.

But some projects fail entirely.

When that dreaded scenario happens, it hurts – I've been there.

Just as with almost any investment, in almost any asset class, failure means a loss of capital.

Most people can't easily ride that out and forget about it.

So if you are considering off plan investments, you should go into it with your eyes open.

Take your time, do your homework and don't cut corners on your desk research.

Most importantly, pay attention to red flags and make sure you buy with your head, not your heart.

Follow those simple rules and your chances of success will increase significantly.

Regards,
Dan Johnson, CEO
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OFF-PLAN ADVANTAGES

Before looking at some of the risks, it's worth reviewing some of the key reasons that so many investors favour buying off-plan:

Passive Investment

Given the choice, most people would probably prefer to make money without doing a lot of work.

Off-plan investment is a largely passive way to invest, that shouldn't take up a lot of time.

You find the development, arrange financing if required, choose the property, make some decisions about finishes or furnishings, pay your deposit and then wait for the development to be built.

On completion, most investors will engage a lettings and management company to find tenants to rent the property; the agents will typically then deal with any day-to-day issues that arise.

It's a process that offers very little scope for you to add value once the property is bought.

For international investors, or those who don't want to make a time commitment, the ability to earn passive income from an arm's length is a definite plus.

Developer Incentives

Sometimes, developers need to sell a certain number of units as a condition of their construction finance, or to unlock a better rate on their borrowing.

In this scenario, they are likely to place a high value on achieving the necessary sales quota.

To help the early pace of sales, developers may offer price discounts, or incentives with a cash value to the buyer, such as parking spaces, white goods, furniture packs, free legal fees or even interest payments for the duration of the construction period on any sum paid as a deposit.

Incentives are also offered to shift the final units of a phase.

However there is often a reason why some units are less desirable, so make sure you understand this and don't buy the worst property on the block.

Potential for Capital Growth

For investors who buy early with price discounts, it's possible to make good capital growth returns on off plan property – even in a flat or slowly growing market.

That's because of the payment structure.

Investors typically pay between 10% and 50% of the purchase price during construction.

Meanwhile as the owner, they receive the full benefit of increases in the total price of the property.

So in the London example earlier, an investor could have secured an £800,000 unit during construction with a 25% deposit - £200,000. Had they sold prior to completion at £1,000,000, this would have represented a £200,000 return before costs and taxes, on an outlay of £200,000.

In a rising market, or when the required deposit is low, the potential for off-plan growth is highest.

Low Maintenance

If you have ever owned an old house, you'll be aware that they have an incredible ability to continuously empty your bank account. No matter how much work is done, there always seems to be something that needs refreshing or repairing and the costs can mount up. I live in a house that was built in 1847, which finally needed a new roof after the original one started to fall to pieces – this came at an eye-watering cost of around £40,000. .

In contrast, new build property is very low maintenance.

The structure of the building should be covered by a warranty, often for as long as 10 years. Everything inside the property is new – the carpets, wall finishes, white goods and furnishings.

So hopefully, for the first few years at least, there should be very little work required on repairs or redecoration and certainly no major works that cause those huge out-of-pocket expenses.

Ongoing Demand

Busy, young professionals have long-preferred the convenience of moving into new property.

It just makes sense; young people don't generally have as many belongings, so need less space. Compact, furnished, new properties are designed for the kind of lifestyle young people lead today.

Although Covid 19 had a noticeable impact on rental prices for urban apartments, with falls of 10% to 20% widely reported in many city centres, it's unlikely the market will stay depressed for long.

Yes, some workers moved away from cities as they were able or required to work remotely, but by far the biggest impact on prices came from a dramatically increased supply of rental properties.

During the pandemic, there were virtually no tourists occupying Air BNB or short let serviced accommodation. Most domestic & international students stayed away. Very few corporate rentals were needed. So the market was temporarily inundated with vacant studios, 1 & 2 bedroom flats.

Future-proof Features

In many markets, buyers and tenants are increasingly demanding when it comes to smart home technology, energy efficiency and achieving a low carbon footprint.

These demands are far easier to satisfy with new homes, as app-based operations, the "internet of things" (smart devices) and green considerations can be built into housing design from the outset.

Investors should be mindful of the changing requirements of younger generations - not just for the properties themselves, but also the communal spaces and on-site amenities.

There is a real trend towards coliving & community with many developments now featuring a concierge, gym, spa, rooftop gardens, cinemas, games room, workspaces, cafés & lounge bars.

With this kind of lifestyle on offer, how does a room in a shared house compare and compete?

As these various groups return to cities in ever-greater numbers, properties will fill up, demand will catch up with supply and the market will see the normal scenario of upwards pressure on prices.

POTENTIAL RISKS & (HOW TO AVOID THEM!)

Across the lifespan of an off-plan investment, there are a number of common areas of risk to be aware of and to watch out for:

Planning Failure

Some developers, brokers and agents will market new projects for sale that don't have full planning permission (and sometimes, they haven't even fully completed on the land purchase!).

Unless the money is held in a protected escrow account by a reputable solicitor, paying a reservation fee or deposit at this stage of a project is generally extremely risky.

You run the risk of the funds being absorbed into the operation of the developer or agent, which could make the money extremely difficult to recover in the event of something going wrong.

Avoid this by making sure you obtain and check planning documents before sending any funds, then ensuring you engage a specialist lawyer to act for you in the transaction.

Unsecured Deposits

Problems can occur when a developer is juggling cashflow on multiple projects and investor deposits are not kept segregated from developer funds or ringfenced for a specific project.

When developers get into unexpected difficulties, reckless individuals may be tempted to move money from one project to another in order to solve a cashflow problem - this rarely ends well.

To reduce this kind of risk, it's better to work with established, experienced developers, who can demonstrate a healthy track record of robust financial management and on-time completions.

If possible, you should also try to understand how the project is being financed and whether your deposit will be accessed to fund the construction programme, as sometimes your money will be held on trust or in escrow and not directly used by the developer (they may be fully funded or able to secure the finance they need by achieving a certain number of deposits in a ring-fenced account).

Some developments may offer a guarantee scheme that insures all or part of your deposit, up to a certain sum of money or percentage of the property value – this is a useful security feature!

Financing Difficulties

If you are relying on a mortgage to finance an off-plan purchase, then you need to consider how long the construction period is and whether this presents a significant or increased risk that lenders will not offer you a mortgage when the financing needs to kick in.

Most lenders in the UK will only keep an offer open for 6 months, so for projects with a longer timeline, you may not be able to get a firm decision in principle at the point of reserving a unit; this obviously means you're taking a risk by going ahead with the purchase without that security.

Various factors influence appetite for lending on a development – the size of a unit, the number of floors, valuation, how exposed a particular lender is to a project and other lender-specific criteria.

Plus you have to consider whether any external factors could influence a decision in future, such as changes to your own financial situation, valuation of the properties or general appetite for lending.

Talk to a reputable broker and get as much confidence about your likely eligibility as possible.

Sales Hype

Most agents are unregulated and often don't belong to any kind of industry organisation or redress scheme – this makes it more difficult to take action if it turns out you've been sold a pack of lies!

While factually inaccurate marketing material may make an agent legally liable in the future, your ability to seek compensation will depend in part on them still being in business at that point in time.

So do yourself a favour and don't blindly believe sales hype without doing your own homework.

And for additional security, choose an agent with professional indemnity insurance and who is signed up to a redress scheme with a legally binding code of conduct.

Overpaying

While some investors do secure genuine discounts on off-plan property, a lot of new homes are sold at a premium to market value – often as much as 10% to 15%.

This is partly because people will pay more for a new property that hasn't previously been occupied, but also because some future growth in the market may have been be factored into prices - this creates a risk that the value on completion may actually be slightly less than you paid.

If you're holding the property for the long term, overpaying at the point of purchase doesn't have any really significant consequences, but if you need to exit, then you'll be left with little choice but to crystalise those losses.

Contract Terms

It may seem like an onerous task, but without reading the various contracts you may be asked to sign when buying off-plan, you could be opening yourself up to all sorts of conditions, obligations, covenants, cost increases and other requirements that could impact how an investment performs...

Contracts can include stipulations on how the property can be used, how any centrally charged fees are calculated, what rights you have as an owner, even things like whether pets are allowed!

To avoid nasty surprises, you should always, always, always carefully read the sales contract and other legally binding documentation such as leases or management agreements.

And make sure you engage with a legal representative that specialises in this type of purchase.

Rental Agreements

Many off-plan investments are sold with a rental management agreement in place, which contractually guarantees a specific level of rental returns for a certain length of time.

This provides peace of mind and an assurance of a set income level for the initial contract period.

This is can be great for investors... provided the agreement is honoured by the contracting party; if that company goes out of business, the agreement is effectively worthless.

It's not unheard of for the assured by the rental contract to be higher than the market rent (subsidised by an artificially increased sales price) and that after the rental agreement ends, the achievable rent drops significantly.

So be sure to do your own analysis of the rental market to ensure you're confident of how much similar properties are renting for and what level of income your property will be able to achieve.

Location Factors

Location is one of the biggest factors that contributes to success and failure of off-plan investment.

Aside from general market changes, certain factors will influence the level of tenant demand in an area or specific location – regeneration, gentrification, population change, employment opportunities, transport links, other developments, new amenities.

Major shocks can have an effect too - let's say you buy a property in an area where a large proportion of the local workforce is employed by a large car manufacturer and they close their factory; this could have a catastrophic effect on property prices and rental incomes.

It's safest to focus on areas with a stable and robust local economy that has a broad enough base of employers so as to be naturally resilient to changes in the fortunes of one particular company.

Look for locations where there is ongoing inward investment from a number of sources, where improvements in the local quality of life will ensure continued appetite from tenants and buyers.

Hard to Sell

At some point, you may need to liquidate your investment to free up cash for some other purpose.

If that situation arises, you don't want to be left with a property that's hard to sell.

Maybe you chose the cheapest unit, ignoring the fact it was an odd shape, likely to be very noisy, or had some other feature that might detract from its desirability to a future purchaser who may be looking not as an investment, but as an owner-occupier.
Such factors may not make that big a difference to the rentability (particularly for any category where there's likely to be a higher turnover of occupants), but can come back to bite you when it comes to selling.

So be sure to think about who will buy your unit and the long-term ease of resale.

You!

Last in the list, but probably the biggest risk of all...

Greed, over-optimism, laziness – these are traits that can really get you into hot water.

Be realistic, be rational, do the desk research.

Don't let your heart get the better of your head.

CONCLUSIONS

No investment is without risk - if you want a virtually risk-free return, your only real option is a tier 1 government gilt, which will pay next to nothing in real terms.

Risk management comes down to understanding the nature of the risks inherent in any investment, doing what you can to minimise risk that you can control and taking an objective view on whether you're comfortable tolerating those risks that remain, in pursuit of the returns you're seeking.

Risk tolerance is a very personal decision and none of these risk factors necessarily dictates whether an investment is good or bad; but do pay attention to red flags – they indicate danger!

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