HOW TO EXTRACT EQUITY FROM YOUR HOME

Property Investment Explained

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What is equity?

Equity is how much of your home you actually own (not the bank, but you). It's the difference between what you still owe and the current value of your property. Thanks to huge growth in house prices in many areas of Australia, vast numbers of people have significant equity in their home. Of course any reduction in a mortgage also increases home equity.

How much equity do you have in your home?

The current equity in your home will depend on both the outstanding amount on your home loan and, crucially, a lender's valuation of your property. Note that what an estate agent tells you your home is worth is not relevant here. It's a lender that will dictate what you can extract in equity.

> "Say you originally purchased your home for $500,000 but it is now valued at $800,000 – you have $300,000 in equity plus any of the original loan you have paid off."

So how do you access your equity?

You extract equity by refinancing your mortgage: either renegotiating a higher loan amount with your existing lender or taking out a whole new, larger loan with a different lender. The additional amount you borrow can then act as a deposit for a second loan for your new investment property. This is important because it means all the tax deductions for investment costs (including interest on that portion of your home loan) will be available to you.

When determining the exact amount of equity you can invest, a lender will use a loan to value ratio (LVR) (just like when you originally took out the loan).

What is an LVR?

An LVR is the amount you are borrowing represented as a percentage of the value of the property being used as security for the loan.

You can think of your LVR as the opposite of your equity – if equity is the proportion of a property you own, the LVR is the proportion you owe.

Different lenders will advance different loan amounts against your property, with the express intention of retaining a buffer for themselves. To work out how much you will be able to extract, you just need to apply the maximum LVR to the equity you have available.

How to calculate the amount of equity you have available:

Original purchase price	$500,000
Original loan (at an LVR of 80%)	$400,000
Current property value	$800,000
Equity held	$400,000
Equity available (At an LVR of 80%. The 80% is of the $800,000 property value minus the $400,000 outstanding loan)	$240,000

What does cross-collateralisation mean?

There are two ways of using equity to fund your new purchase:

1. Extract the money from your home as a deposit for an investment property;

2. Deploy it as security for loans over both properties. In this option the loans will be linked by the fact that you have used your equity as collateral for both.

Some investors prefer to take out their home and investment loans with separate lenders, as keeping every property as a stand-alone transaction does not complicate a future sale.

CASE STUDY:

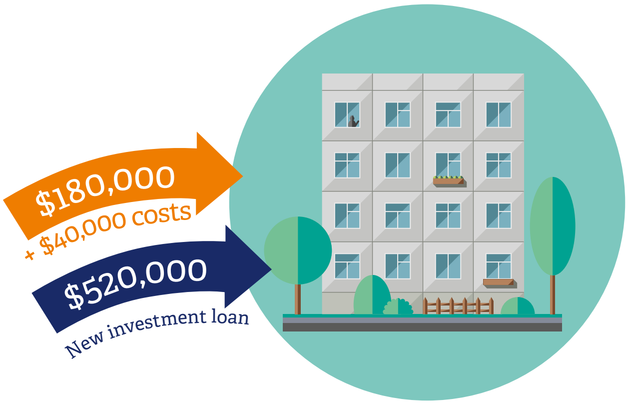
How Donna and Bob extracted equity to fund an investment property

1 Current Propery

2 Equity extracted for deposit

3 Investment Property

$220,000 is 80% of the equity held in the original property. Lenders typically won't lend you the full amount without you taking out mortgage insurance.



Value: $900,000
Equity held: $400,000

Value: $700,000
New investment loan : $520,000
+
Equity from home : $180,000*
*Note $40,000 of the original equity accessed went to costs.

Donna and Bob have owned their house for 15 years and enjoyed decent capital growth. They have also diligently paid down their mortgage over that time. Their house value has grown to $900,000 and their loan shrunk to $400,000, so they have decided to extract the equity to buy an investment property.

Their bank operates on a maximum loan to value ratio of 80 per cent so, Donna and Bob could borrow an additional $220,000 (80% of their $900,000 house value, minus the $500,000 they still owe).

They decide to spend $700,000 on a new apartment in a highly sought after, inner-city location. They borrow $520,000 via a second loan to quarantine their home from this investment transaction (note they paid $40,000 in costs from their deposit). This was below an 80 per cent LVR for the investment property so represented a big saving: they didn't have to pay expensive Lenders' Mortgage Insurance, which is required on higher LVRs and protects only the lender in the event of default.

Donna and Bob were thrilled they didn't have to dip into their own pockets for a cent of their investment. What's more, investment property deductions are still available on the full price they paid for the property, which also has the advantage of reducing their tax bill.

1. Donna & Bob want to use the equity in their home to fund an investment property. The bank values their property at $900,000 and Donna and Bob hold $400,000 equity in it.

2. Using an LVR of 80% Donna & Bob can access $220,000 (80% of the equity they hold in their current home) as a deposit for an investment property.

3. Donna and Bob find an inner-city apartment for $700,000. They use $180,000 of their equity plus take out a new investment property loan of $520,000 to fund the property (note they use $40,000 from their equity to cover costs).

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