

Residential Property as an investment

Many investors have a strong affinity for residential property investment. Quite often it forms the bulk of their investment portfolio. Property is tangible, unlike shares, and it is relatively easy to understand. Unlike shares. It is also within reach of most individuals where the bank will allow you to loan against it. Again, unlike shares.

So, when we review investor portfolios, and we see a significant bias towards property, we should question its value as an investment. To our minds it needs to compete for its space. Often it is the default option, with other investments – local and offshore shares for example, fighting over the scraps.

Below we investigate the investment merit of residential property investment. Not too long ago one could have been lynched for simply raising the question. However, a few years of weaker growth, rising costs and political uncertainty provides us the opportunity to test this beloved asset class without the prejudice of past performance making the discussion moot.

Some context

Recent memory points towards a past where property returns surpassed even the most bullish of equity portfolios. Since 1998, which is when property started making the news, domestic residential property, as measured by the ABSA House Price Index for Large properties, outperformed inflation by over 5% per year which is a significant number. Not as significant, however, when you consider the extent by which the return was magnified because most investors took on debt to finance the purchase. This meant they could earn a return on the full value of the property by putting down just a small percentage of its value, which could *double* their annualized return. This form of financial leverage was a significant creator of wealth in South Africa over the past 20 years, illustrated by the chart below:

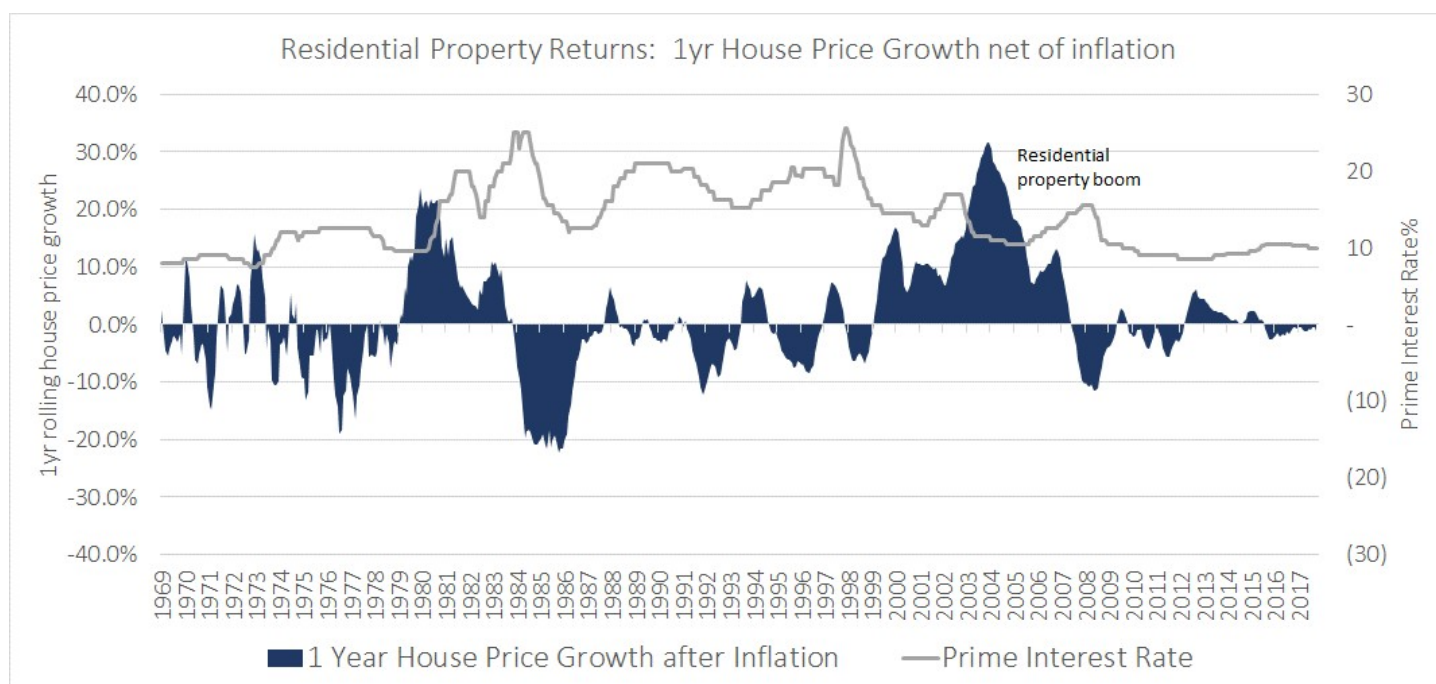


Chart 1: 1-year annualized price appreciation from property, after inflation

However, when you take the full property experience of the past 50 years, the return after inflation is a mere 1.5% net per year. And importantly this is before you pay for: maintenance costs, rates and levies, utilities and the big ones: transfer costs and the estate agent fees. The average residential property holding period is generally expected to be between 7 and 9 years^[1], with each transfer consuming a significant part of the return, implying that for a long-term investor in property, costs are high. At this point we are

skeptical of the sustainable level of return which property can achieve, and sense that the inherent investment risk may also be higher than expected.

What has been driving our property market?

There are a few key items which are critical in establishing a sound investment case for property:

- *The level of real interest rates* (i.e., prevailing rates less inflation). When these rates are high, it is generally very negative for property investments as the cost of borrowing is high in relation to the general strength of the underlying economy. In the past (pre-2000's) our Reserve Bank used the interest rate mechanism, via the repo rate, to help protect the currency. To do this they would raise interest rates aggressively to attract foreign investment, thereby strengthening the rand. The last significant (and futile) attempt at this was post the 1998 emerging market crisis where the rand weakened by 50% relative to the US\$. In response, the Reserve Bank raised interest rates by 8% points, where Prime interest was 26% p.a! This was relatively ineffective and served only to plunge our economy into recession. However, this set the scene for the property boom to come, in that a) property was cheap, as the real interest rates were at historical highs, and b) the Reserve Bank decided to ditch the use of interest rates in protecting the currency and set about targeting a narrow band for inflation instead. This set in motion a decade long bull market in property, as interest rates declined, inflation declined, and the economy was strong.
- *Supply and demand*. Unlike shares, property tends to have stronger supply and demand drivers. After all, there is limited quantity. The property bull market of the 1980's was in part due to the release of additional erven by the government, feeding demand from the baby boomers^[2]. On a micro scale we can see this effect in areas such as Cape Town (foreign ownership, and semi-gration from Gauteng and KZN), as well as cities such as Sydney, Hong Kong, New York and London where the attraction is strong and space is limited. In South Africa, the stability provided by an inflation targeting policy, as opposed to a volatile currency protection approach, drew many buyers into property creating significant new demand.
- *The strength of the economy*. In general, if wealth levels are increasing, the base of potential buyers is increasing, and this creates support for the property market from an affordability perspective. During the boom from 1999 until 2008, SA's GDP averaged over 4% real growth per year. Contrast this to today where we have been in structural decline for 10 years and are currently in recession (i.e. the economy is getting smaller). Currently we have weak conditions for property returns.

Offshore comparatives:

Looking offshore, we can get a sense of what property can do when it doesn't need to deal with currency protection and emerging market crises. Thirty-year average returns after inflation for the UK and Australia have averaged around 3%, which is a fair return but hardly exciting. In the US, this has been closer to 1% on average with the GFC unwinding all of the excess gains made prior to that time.

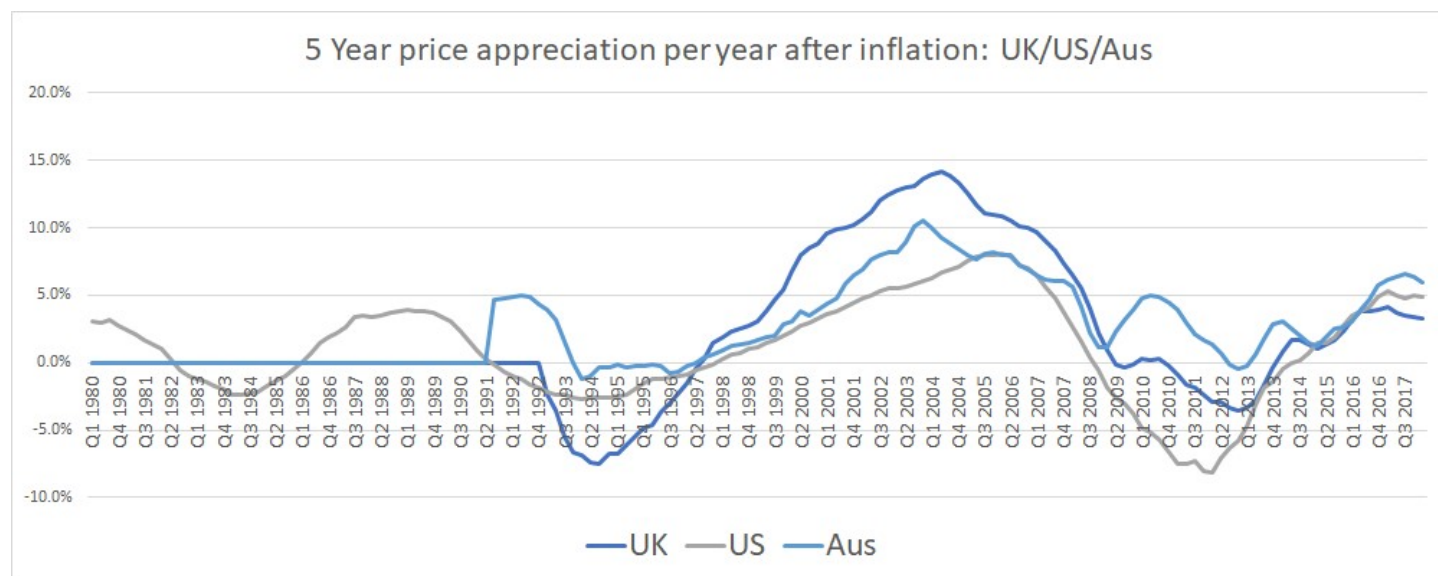


Chart 2: Price appreciation after inflation for residential property in UK, US and Australia.

Buy to let?

Second or third properties bought with the intention of letting them out have been significant drivers of return due to relatively few buyers (those with access to finance) buying up properties in the boom times and renting out at decent yields. The chart below shows however that average rental returns may not be what they are initially expected to be, and again this is before costs, maintenance and taxes.

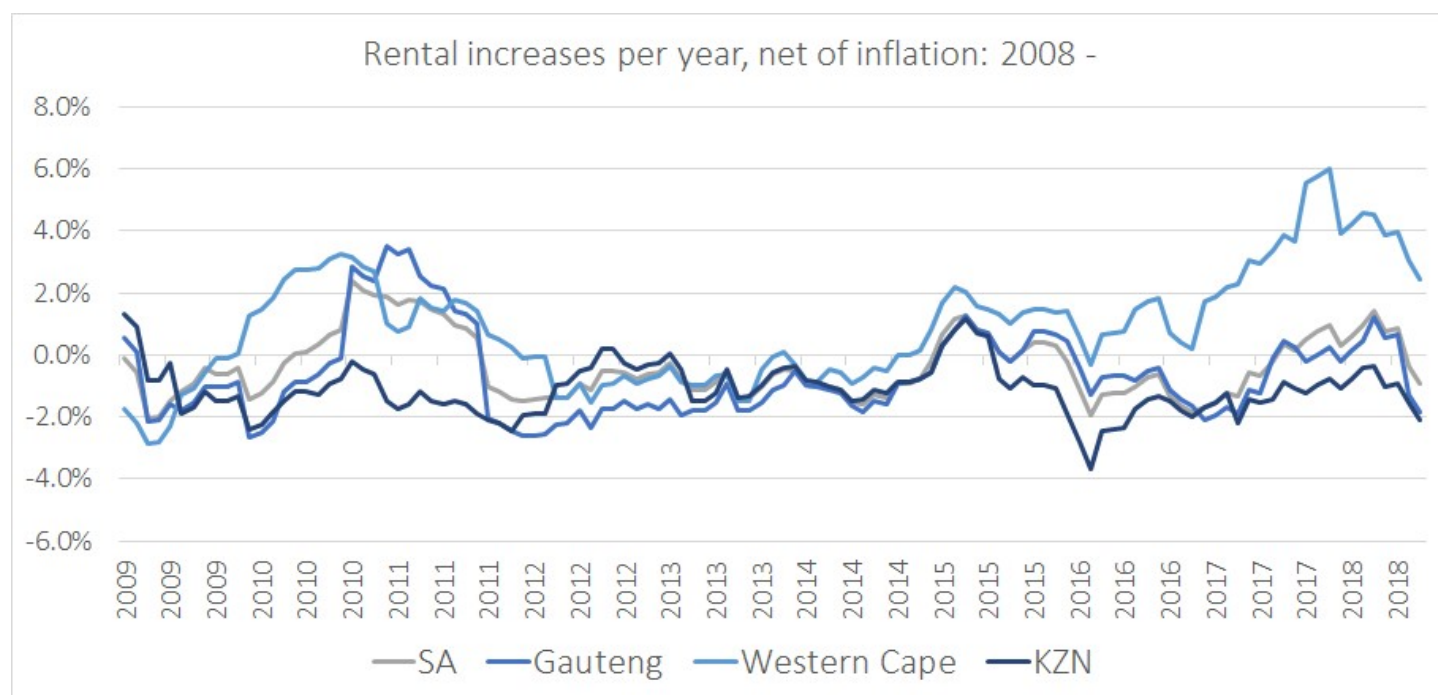


Chart 3: Annual rental increases across South Africa

Over the past 10 years (unfortunately data was not available for a longer analysis), rental escalations have been relatively poor across

SA, except for the Western Cape. Escalations have generally been lower than inflation, in line with the weak economy. On average we would expect escalations in line with inflation for the average property. Without a significantly high starting yield^[3] (10% plus), it's quite difficult to get excited by 'buy to let' as an investment.

The Business Cycle

The boom of the 2000's was driven by sound economic policy, declining interest rates and a general global recovery post the dot-com bomb and the 9/11 terror attacks. Along with this optimism and higher levels of wealth and economic activity, came an escalation in debt levels as consumers acted on their higher confidence levels and used debt to buy property, amongst other items. By 2008, the SA consumer had amassed over 80% household debt relative to their disposable income (from an average of 50% historically) – the highest level reached, ever. Since this point, and in part due to the reluctance of banks to lend post the GFC, as well as the implementation of the National Credit Act, consumers have been reducing debt levels albeit to relatively high levels (currently 71% of disposable income).

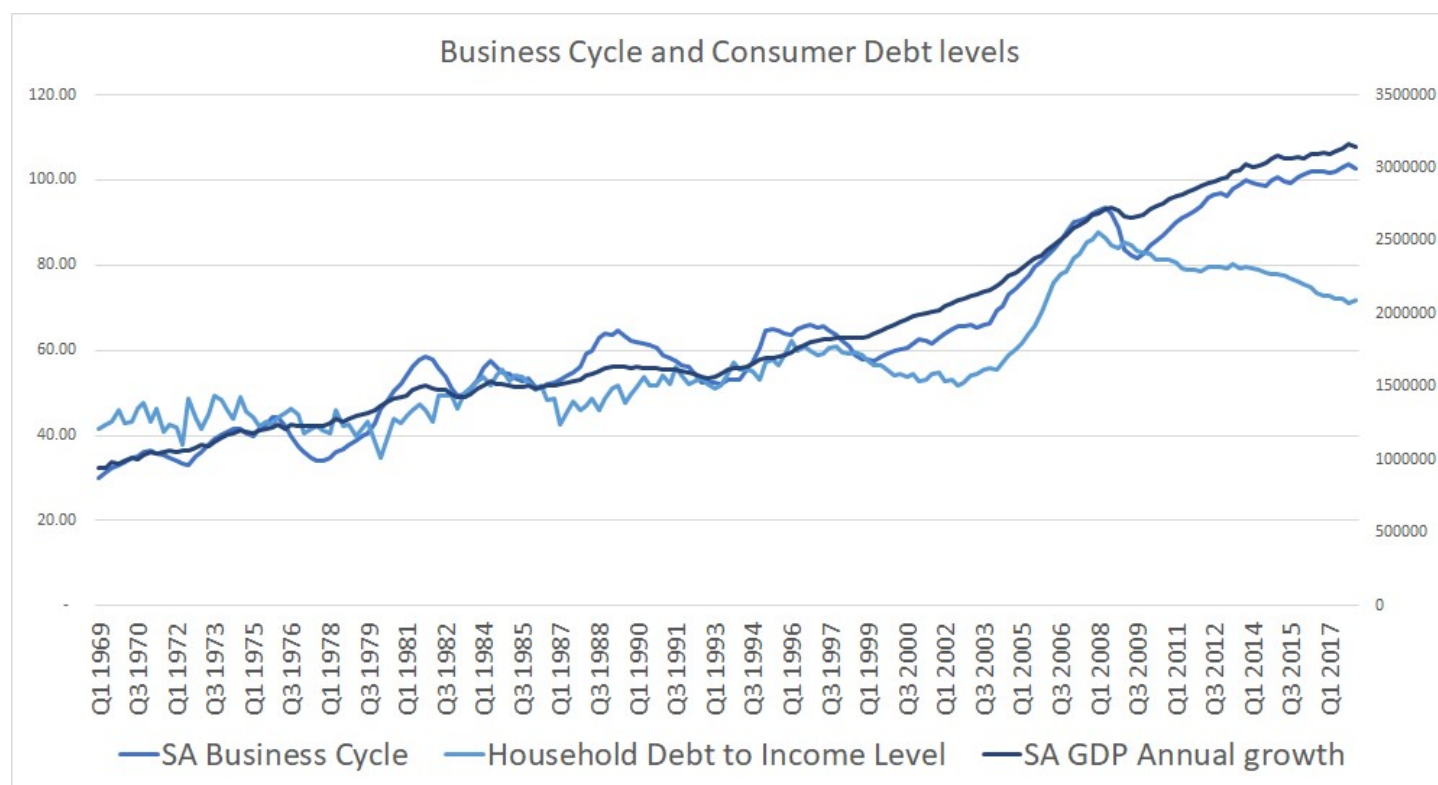


Chart 4: 2000's property boom driven by strong economic growth, low debt levels

As we stand, the ability for consumers to 'leverage up' and support property prices is very limited. Without the tailwinds provided by a strong economy, the prospects will be below average. This does put those investors with significant capital at an advantage though: when the banking system is less inclined to lend (which is the case), and consumer protection and regulation create additional debt hurdles (also the case), the capital provider is in demand.

Risk and Return: what to expect

In 2000 or 2001, a residential property could be rented at out an annual gross yield of 15-20%. The subsequent step-change in property valuations (as a result of doing away with currency protection as a mandate for the Reserve Bank), as well as the strong economy and debt-fueled growth, drove property values higher. What this means is that the house which could be rented for a 15% yield in 2001, is now a 5% yield in 2018. Looking back at the return drivers:

- *Real interest rates*: currently high, as CPI remains low due to weak growth, and interest rates remain high due to supply and demand dynamics with the banks. This is negative for property but should create opportunities as prices reduce.
- *Supply and demand*: as a general rule, demand levels nationally are weak, reflected in lower rental escalations, new building activity and declining prices. In certain niche areas (Atlantic Seaboard for example), the underpin for demand has always been strong as foreign investors have been able to buy when locals can't, however even this segment has weakened.
- *Business Cycle*: having just entered technical recession it's hard to say the economy is going to be supportive of property investing. Hopefully though, we are nearer to the recovery than to the decline.

In most liquid investments, prices would reflect this gloomy outlook, creating an investment opportunity. Less so with property, where the fixed nature of it makes transferability and price discovery more elusive. Prices are therefore 'sticky', and prospective sellers will hold back hoping for the recovery (in Cape Town this is simply seen as 'summer'). The behavioural bias of anchoring^[4] is hard at work here.

Stepping outside of our current situation, we can assess long term residential property returns along these lines:

In a normal world where the economy is working, and the consumer is not overly stretched, support for property will persist. Unlike shares which have variable products and services which need to adapt and evolve over time, the use for property does not change.

With a starting income yield of around 6%, escalations of inflation minus a bit, a significant level of costs to be incurred, it is not difficult to see that the investment case for residential property is quite speculative, and at best, a lower return option than equities.

Where it does make sense is where:

1. Significant financing of the property allows the return profile to ratchet up to a more attractive level. Contrast this with a fully paid off property (for example someone in retirement) – a substantial amount of capital tied up, earning a low return, with no income distribution and high costs.
2. It is a 'unique' opportunity, and there is the ability to add value to a property, materially changing its valuation profile. But beware of the property bull market, where everyone can play and the market quickly becomes saturated.
3. Opportunistic market timing: where a suburb rerates, or where there is a supply and demand based rebalance.
4. Strong economic recovery: simply where you are able to access a property relatively cheaply, ahead of a strong economic recovery. The time to be looking then is when the market is low, sentiment is negative, and the early signs of recovery are in place.

Reading through these strategies, property starts to look quite high risk. Taken in context, it is an undiversified, illiquid, immovable asset, subject to the laws of the land, and quite often geared up with debt. For this reason, we believe it should be placed in the "high risk" part of an investment portfolio. In most cases, a diversified portfolio of shares will be a preferable investment over the long term, with higher returns, lower costs, tax efficiency and liquidity. For unleveraged properties, it is likely there are better alternatives offering both higher yields and capital returns when costs and tax are considered.

[1] Lightstone

[2] Rode, 2003

[3] Rental yield is the annual rent received divided by the purchase price or market value of the property multiplied by 100.

[4] Anchoring – waiting for a price at least as high as what you paid, despite what your property may be worth

data provided by Reuters and Datastream

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	4.9%	0.3%	6.9%	8.5%	10.0%	11.0%	10.4%	14.3%
FTSE/JSE SA Listed Property	ZAR	-1.9%	-20.1%	-12.4%	-0.3%	8.7%	13.4%	13.8%	13.7%
SA All Bond Index (ALBI)	ZAR	-0.7%	4.5%	8.0%	7.5%	7.9%	8.8%	7.9%	7.3%
SA Cash Index (SteFI)	ZAR	1.8%	4.8%	7.3%	7.3%	6.8%	6.9%	0.2%	0.4%
Balanced Benchmark	ZAR	6.2%	4.3%	9.2%	9.0%	10.7%	11.3%	6.9%	8.8%
SA Inflation (1 month lag)	ZAR	1.4%	3.6%	5.1%	5.2%	5.4%	5.4%	1.3%	1.3%
GLOBAL MARKET INDICES									
Global Equity (Datastream World)	USD	4.5%	5.3%	13.7%	12.6%	10.8%	7.7%	9.8%	16.0%
Emerging Markets Equity (Datastream EM)	USD	-4.5%	-6.9%	-0.3%	11.8%	5.4%	3.8%	14.9%	22.0%
Global Bonds (Barclays Global Bond Index)	USD	-0.9%	-1.5%	-1.7%	2.3%	0.8%	2.2%	5.3%	6.4%
Global Cash	USD	0.6%	1.5%	1.9%	1.2%	0.8%	0.7%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	4.9%	0.3%	6.9%	8.5%	10.0%	11.0%	10.4%	14.3%
Global Equity (Datastream World)	ZAR	20.8%	24.6%	28.2%	16.4%	19.1%	14.9%	14.4%	14.6%
Emerging Markets Equity (Datastream EM)	ZAR	10.5%	10.1%	12.4%	15.6%	13.2%	10.7%	12.8%	15.2%
SA All Bond Index (ALBI)	ZAR	-0.7%	4.5%	8.0%	7.5%	7.9%	8.8%	7.9%	7.3%
Global Bonds (Citigroup)	ZAR	14.6%	16.5%	10.8%	5.7%	8.3%	9.0%	13.5%	14.9%
COMMODITIES									
Gold (US Dollars)	USD	-7.8%	-7.7%	-8.6%	2.1%	-3.0%	3.7%	13.4%	17.9%
Gold (Rands)	ZAR	6.7%	9.2%	3.0%	5.5%	4.3%	10.6%		
CURRENCIES									
Rand / Dollar	ZAR	15.7%	18.3%	12.7%	3.4%	7.4%	6.7%	14.8%	16.9%
Rand / GBP Pound	ZAR	13.0%	13.7%	13.7%	-2.3%	3.7%	3.1%	16.0%	15.9%
Rand / Euro	ZAR	15.3%	14.7%	10.3%	4.7%	4.8%	4.2%	13.7%	13.6%

Spot Rates		31-Aug-18	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	14.65	13.71	13.00	10.24	7.69	6.43
Rand/GBP	Rand	19.05	18.10	16.75	15.84	14.03	10.76
Rand/EUR	Rand	17.05	16.00	15.45	13.50	11.31	-
RATES							
Libor 6m \$	US\$	2.54	2.50	1.45	0.39	3.12	5.59
Repo Rate	Rand	6.50	6.50	6.75	5.00	12.00	21.85
Prime	Rand	10.00	10.00	10.25	8.50	15.50	25.50
All Bond Index Yield	Rand	9.58	9.44	9.36	8.49	-	-
COMMODITIES							
Gold (\$/oz)	US\$	1,202.84	1,251.13	1,316.02	1,397.63	834.60	275.15
Platinum	US\$	792.00	851.00	986.00	1,514.00	1,479.00	350.00
Oil (Brent Crude) \$	US\$	77.66	79.44	52.31	116.20	113.45	12.08
INFLATION							
SA Inflation	%	5.1	4.6	4.8	6.4	12.0	-

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