Thursday 29 June 2023

focus

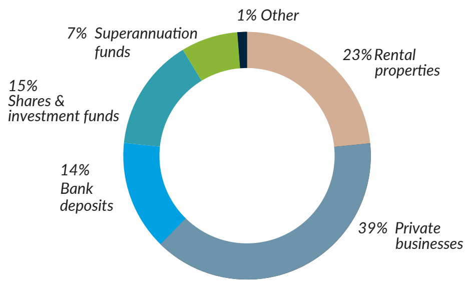
Stocks vs. Property: The House Doesn’t Always Win

Many Kiwis have a love affair with investment property. It is easy to understand why. Residential property prices have boomed, up about sevenfold over the past 30 years. Annual house price growth of around +7% has only modestly lagged the share market but has been delivered with less volatility along the way. You can also fund part of the investment with debt, further boosting the return on equity. So with house prices having dropped sharply is it now a no brainer to jump into rental property? We think not. The property market dynamics are dramatically different today than in the past, and, despite the pullback, New Zealand house prices are still amongst the most expensive in the world. We believe a repeat of the last 30 years is unrealistic and expect far more modest returns in the years ahead.

FORSYTH BARR

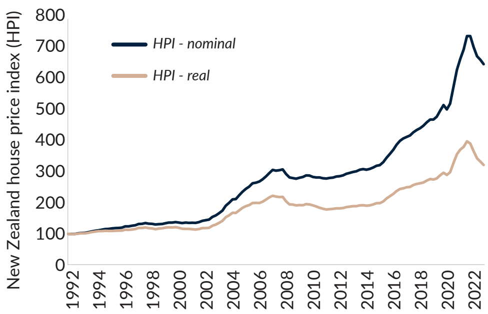
...Over the last 30 years, the ratio of median property prices to median household disposable income has risen from 4x to 9x...

MANY KIWIS LOVE INVESTING IN PROPERTY: NZ HOUSEHOLDS INVESTMENT ASSETS



Source: Forsyth Barr analysis, Statistics New Zealand

NEW ZEALAND HOUSE PRICES HAVE SURGED



Source: Forsyth Barr analysis, Statistics New Zealand, REINZ

The drivers of historic house price inflation (HPI) can be divided into three categories:

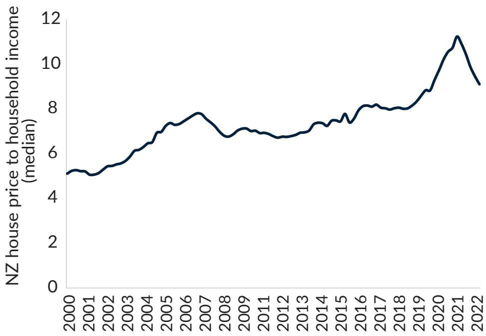
(1) **Inflation**, or the value of your money going down. Average inflation in New Zealand has been about +2.5% per year over the last 30 years. This is most likely roughly repeatable over the next 30 years.

(2) **A massive jump in median house price versus median household disposable income.** Over the last 30 years the ratio of median property prices to median household disposable income has risen from around 4x to 9x, an average increase of about +3% per year, driven by a combination of, 1) strong population growth, with housing supply struggling to keep pace, and 2) a steady and substantial decline in interest rates.

So could this trend continue? New Zealand house prices are already amongst the highest in the world relative to income. If it were to continue it would mean the ratio would have to rise to 20x over the next 30 years. Realistic? We say definitely not! More realistic is to expect a return to the global average of 6x to 8x, implying a -1% drag on HPI per year.

... many property investors may have overly optimistic expectations...

NEW ZEALAND HOUSE PRICE VS. HOUSEHOLD INCOME



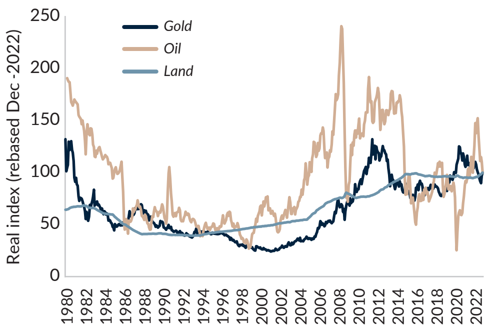
Source: Forsyth Barr analysis, RBNZ

(3) Other factors; around +1.5% per year, can be attributed to factors such as **real improvement in housing stock** (e.g. adding insulation, heating, amenities) and population growth, which reduces available land per capita. These factors will probably persist.

Over the long-term, unless you think Kiwis will spend an ever increasing share of their income on housing, HPI is unlikely to significantly deviate from the growth in household disposable income. New Zealand's household disposable income has grown by approximately +4% per year which, in our view, is a realistic long-term expectation for HPI.

While some hardened property investors will shake their heads and think that +4% per year sounds unreasonably low given history, it's actually normal for physical assets. The value of gold and commodities in real terms (adjusted for inflation) have been relatively flat over a long-term period of time, while farmland has increased by productivity, approximately +2% per year.

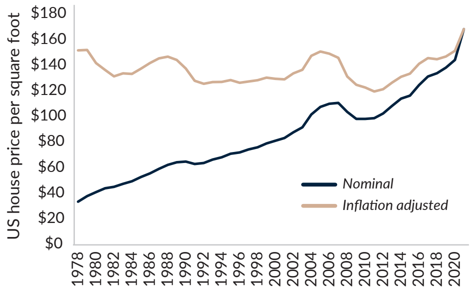
MOST HARD ASSETS SIMPLY MAINTAIN THEIR REAL (INFLATION-ADJUSTED) VALUE: GOLD, LAND AND OIL



Source: Forsyth Barr analysis, Thomson Reuters, USDA

Countries with more balanced property markets and greater land availability, like the United States, exhibit more sustainable long-term HPI trends. In the U.S., price per square foot has closely followed inflation, meaning the real value has been largely stable over time.

THE REAL VALUE OF US HOUSES HAS BEEN LARGELY STABLE



Source: Forsyth Barr analysis, US Census, FRED

We are not suggesting that individuals should avoid investing in property. It serves various purposes, such as accessing leverage (or debt), maintaining real value over time, and providing a stable cash flow when unlevered. Property ownership also instils savings discipline through mortgage payments. Additionally, some costs can be reduced by personally managing the property. It is, however, highly unlikely that the exceptional growth observed over the past 30 years will be replicated, and many property investors may have overly optimistic expectations regarding the three key factors that drive property investment's success: price increases, rental yield, and the total cost to maintain the property's real value.

Working through the numbers

Let's examine the realistic long-term return on a $1 million investment property, financed with 50% equity and 50% debt:

(1) Average rental yield over the past 20 years has been around 4%, it's currently around 3.5%. This equates to about $35,000 per year.

(2) An interest-only mortgage at an interest rate of 6% (slightly below the long run average and today), the interest expense would amount to around $30,000 per year.

(3) Estimating building life cycle and running costs is challenging. Full life cycle costs depend on factors such as property type, location, personal involvement, use of agents, and tax regulations. Estimates range from 1% to 4% of the property value per year. A realistic scenario suggests around 2%, or $20,000 per year. Major costs for freehold villas might include a new kitchen, roof, heating system, while apartments could involve body corporate costs and infrequent but major refurbishments. Apartments also have a finite life, with limited residual land value. To capture average property price increases (that +4%), ongoing upgrades and maintenance are essential – you need to keep up with the Joneses (and regulation).

TABLE 1: A REALISTIC LOOK AT RETURNS FROM AN INVESTMENT PROPERTY

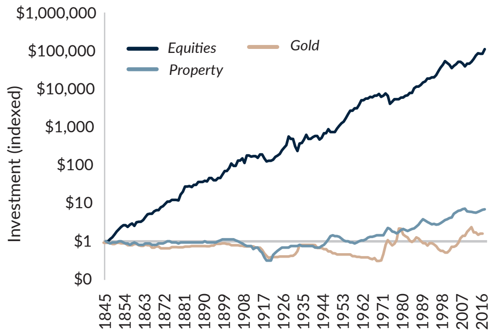
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Equity	500,000	540,000	582,000	625,000	670,000	717,000
Mortgage	500,000	500,000	500,000	500,000	500,000	500,000
Property value	**1,000,000**	**1,040,000**	**1,082,000**	**1,125,000**	**1,170,000**	**1,217,000**
Rental income @ 3.5%	35,000	36,400	37,900	39,400	41,000	42,600
Interest payments @ 6%	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)	(30,000)
Building/life cycle costs @ 2%	(20,000)	(20,800)	(21,600)	(22,500)	(23,400)	(24,300)
Profit/(loss)	**(15,000)**	**(14,400)**	**(13,700)**	**(13,100)**	**(12,400)**	**(11,700)**
HPI @ 4%	40,000	42,000	43,000	45,000	47,000	49,000
Return on Investment (ROI)	**5.0%**	**5.1%**	**5.1%**	**5.1%**	**5.2%**	**5.2%**
ROI with building costs @ 1%	7.0%	7.0%	6.9%	6.9%	6.9%	6.9%
ROI with building costs @ 4%	1.0%	1.3%	1.3%	1.5%	1.7%	1.8%

Source: Forsyth Barr analysis

Combining points 1, 2, and 3 result in a loss of approximately $15,000 or 1.5% of the property value, assuming no effective taxes are paid and before any capital gains (HPI). As discussed, a realistic expectation for long-term HPI is around +4% per year, amounting to $40,000. This leaves an annual profit of $25,000, equating to a 5% pre-tax return on your $500,000 equity investment.

Looking forward, realistically we see limited real growth in property. This is logical - after 30 years an investor still owns the same property. While positive cash flow for a modestly leveraged property might be achievable after expenses, most investors rely on capital gains for returns.

LONG TERM EQUITY RETURNS



Source: Forsyth Barr analysis, Jeremy Siegel, BoE

Property vs. investing in the share market

Investing in the share market is owning small slices of listed companies. In contrast to property, the real value of a company can grow. Over the last 200 years the real value of your investment has doubled approximately every 10 years if you re-invested the dividends. Using the house analogy above; after 10 years you have two houses, after 20 years four houses, and so forth. Companies grow in real terms by re-investing a proportion of their profits into new equipment.

Let's consider a "normal" company, assuming it has $100 of equity, no debt, and makes a 14% return on equity, of which it pays out half or $7 in dividends and re-invests the rest. The share market would value this company somewhere around $250 (assuming a P/E or price-to-earnings multiple of 18x).

In your first year owning this company your return will consist of +3% in dividends ($7 on your $250 investment), plus a +7% increase in the share price. Why does the share price go up? Well, next year the company will have +7% more assets and +7% more equity and, if the company maintains that 14% return on equity, it will have +7% more in profits.

The above example closely resembles an average global company and results in a +10% per year return. In reality, earnings do not go up by +7% every year and the P/E does not remain stable at 18x, but over the long-term these are realistic assumptions. The US S&P 500 share market index, the largest market in the world, has increased by +10.5% per year since 1988 (when it was introduced). Overall, the share market has delivered about +9% return per year.

You can benefit from increases in residential property prices via the equity market

If you still want to invest in residential property the share market also provides options. One example is Summerset, a New Zealand aged-care operator, which builds retirement villages.

When Summerset listed in 2011 it had 1,352 retirement units (mostly villas) about one for every 160,000 shares on issue.

Since Summerset listed, properties have approximately doubled in price and the number of Summerset units have increased by a factor of 4x. This has resulted in a lift in book value per share by a factor of 8x and the share price by a factor of 6.5x.

TABLE 2: COMPANIES GROW IN REAL TERMS BY RE-INVESTING A PROPORTION OF THEIR PROFITS INTO NEW EQUIPMENT

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Opening equity	**100**	**107**	**114**	**123**	**131**	**140**
Profit @ 14% return on equity	**14**	**15**	**16**	**17**	**18**	**20**
Dividends @ 50%	7	7.5	8.0	8.6	9.2	9.8
Reinvested @ 50%	7	7.5	8.0	8.6	9.2	9.8
Closing equity	107	114	123	131	140	150
Market equity value (18x P/E)	**252**	**270**	**289**	**309**	**330**	**353**
Total shareholder return	**10%**	**10%**	**10%**	**10%**	**10%**	**10%**
Dividend yield	3%	3%	3%	3%	3%	3%
Capital return	7%	7%	7%	7%	7%	7%

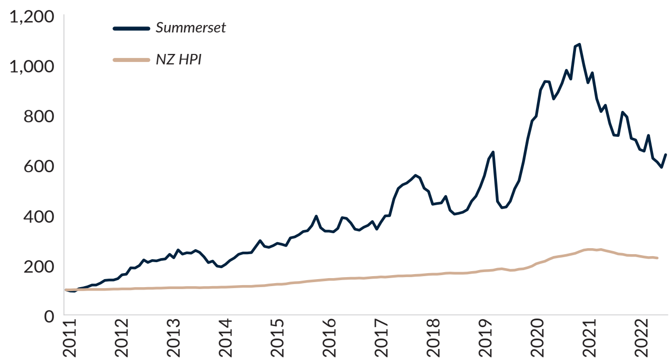
Source: Forsyth Barr analysis

...we would expect the shares in these companies to materially outperform a rental property...

Summerset has been one of the best performing shares in New Zealand over the last decade, helped by the booming property market. But to be clear, while we consider Summerset to be a good long-term investment, its extraordinary performance over the last decade is unlikely to be repeated (unless Kiwis start to pay 20x their income for property!). Contrary to owning an investment property, however, Summerset doesn't solely rely on HPI to deliver appropriate returns. Over the long-term Summerset and other companies' ability to reinvest in their business means we would expect the shares in these companies to materially outperform a rental property.

Aaron Ibbotson, CFA
Director / Senior Analyst, Equities

SUMMERSET PERFORMANCE VERSUS NEW ZEALAND HPI



Source: Forsyth Barr analysis, Thomson Reuters, REINZ

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

0800 367 227

forsythbarr.co.nz

Copyright Forsyth Barr Limited. You may not redistribute, copy, revise, amend, create a derivative work from, extract data from, or otherwise commercially exploit this publication in any way. This publication has been prepared in good faith based on information obtained from sources believed to be reliable and accurate. This publication does not contain financial advice - for financial advice, please speak to your Forsyth Barr Investment Adviser.