Inquiry into Home Ownership

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Overview

Although negative gearing is shown in the tax white paper to create no distortion theoretically compared to the 50% capital gains discount, the leverage that investors have undertaken since 1999 has clearly been excessive, as pre 1999 gains and losses on tax deductions was almost neutral.

So overall, we have moved from a neutral to negative level in costs to government and yet at the same time we have driven down home ownership.

Current Property Values in NSW

Looking at the current data shown in Table 1, the current yields in Sydney of 2.6% to 3% on gross yield versus the 7% floor from APRA suggests that it would take a decade or two before investment properties turn a positive cash flow.

A column with PE ratio and neutral gearing LVR has been added to show what investors would be lent.

In the final column I have added if the deposit required where a PE ratio cap of 20 times (5%) rental income if implemented. This is generally taken as the balance point between renting and buying and was the ratio back in 1999 in western Sydney.

Table 1 – NSW Housing Rent and Sales Report No111

	3 Bedroom House					
NSW Location	Median Price $	Rent $ / week	Gross Yield	PE Ratio	Neutral Gearing LVR RBA Std Var = 5.45%	Deposit Required if (Lending Cap of PE = 20)
	Dec-14	Mar-15				
Greater Sydney	$801,000	$450	2.9%	34.2	54%	42%
Inner Ring	$1,470,000	$845	3.0%	33.5	55%	40%
Middle Ring	$1,100,000	$550	2.6%	38.5	48%	48%
Outer Ring	$625,000	$425	3.5%	28.3	65%	29%
Greater Metro Region (Newcastle & Illawarra)	$455,000	$380	4.3%	23.0	80%	13%
NSW	$555,000	$380	3.6%	28.1	65%	29%
Rest of NSW (Country)	$345,000	$310	4.7%	21.4	86%	7%
Reference: www.housing.nsw.gov.au, Rent and Sales Report No111						

The ASX 200 Price to Earnings Ratio as of June 2015 is about 16.

Table 2 shows the prices and rents for Parramatta in the western suburbs of Sydney, NSW. From 1999 to 2001, prices and rents were stable at a PE ratio of about 20 or gross yield of 5%. In 2002/2003 and in 2013 to 2015, prices rose rapidly mostly driven by investors. The last two columns highlight the neutral level between interest rates and what would be the deposit.

After a rapid rise in prices it takes nearly 10 years for prices and rents to return to their norm.

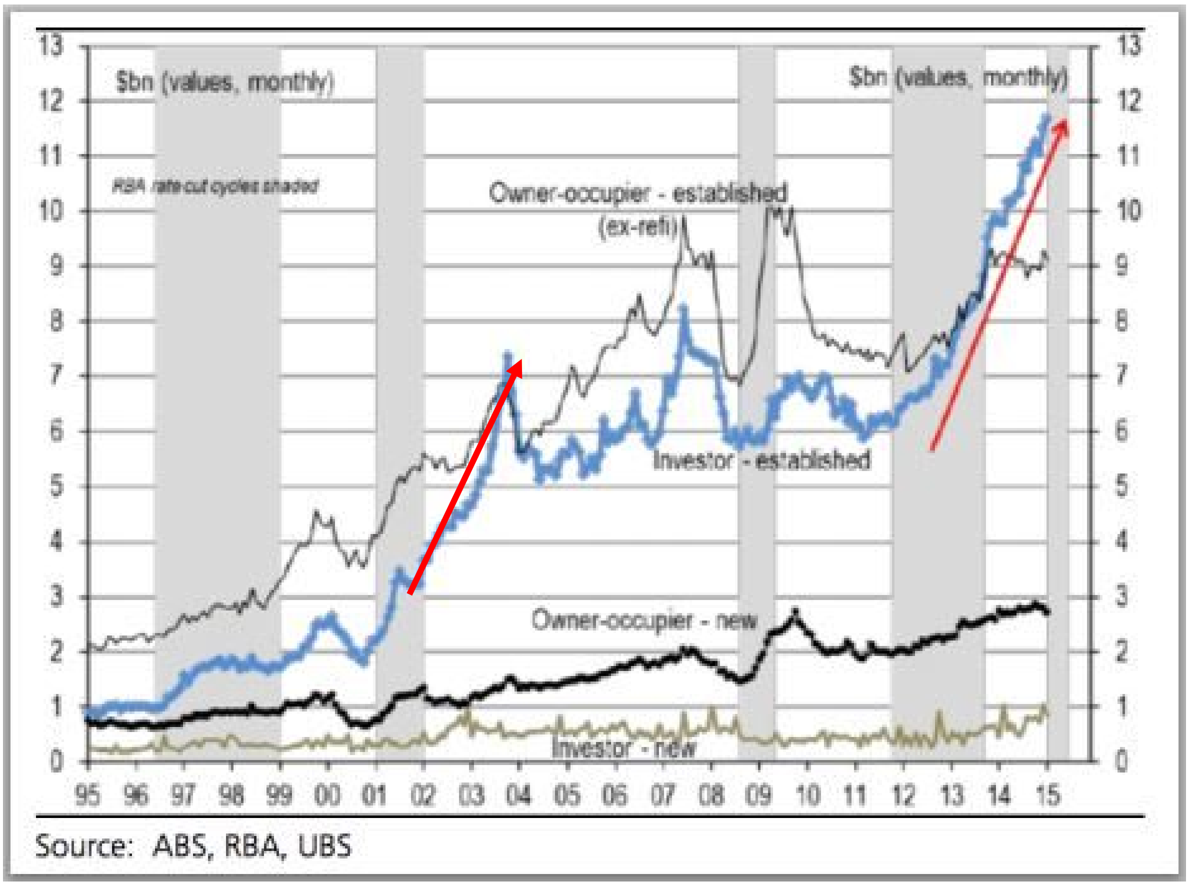
Table 2 – Parramatta LGA Prices and Rents (NSW Housing Rent and Sales report No 111)

NSW, Parramatta LGA - 3 Bedroom House							
						Neutral Gearing	Neutral Gearing
	Median House Value	Gross Rent $/week	RBA Std Var	Gross Yield	PE Ratio	Loan to Valuation LVR	Deposit Required
31/03/1999	$ 245,000	$230	6.50%	4.88%	20.5	75%	$ 61,000
31/03/2000	$ 275,000	$250	7.30%	4.73%	21.2	65%	$ 96,918
31/03/2001	$ 285,000	$270	7.30%	4.93%	20.3	67%	$ 92,671
31/03/2002	$ 346,000	$260	6.05%	3.91%	25.6	65%	$ 122,529
31/03/2003	$ 441,000	$260	6.55%	3.07%	32.6	47%	$ 234,588
31/03/2004	$ 475,000	$260	7.05%	2.85%	35.1	40%	$ 283,227
31/03/2005	$ 450,000	$270	7.30%	3.12%	32.1	43%	$ 257,671
31/03/2006	$ 435,000	$280	7.30%	3.35%	29.9	46%	$ 235,548
31/03/2007	$ 421,000	$300	8.05%	3.71%	27.0	46%	$ 227,211
31/03/2008	$ 450,000	$340	9.35%	3.93%	25.5	42%	$ 260,909
31/03/2009	$ 455,000	$375	5.85%	4.29%	23.3	73%	$ 121,667
31/03/2010	$ 520,000	$400	6.90%	4.00%	25.0	58%	$ 218,551
31/03/2011	$ 550,000	$420	7.80%	3.97%	25.2	51%	$ 270,000
31/03/2012	$ 561,000	$450	7.40%	4.17%	24.0	56%	$ 244,784
31/03/2013	$ 606,000	$450	6.45%	3.86%	25.9	60%	$ 243,209
31/03/2014	$ 740,000	$465	5.95%	3.27%	30.6	55%	$ 333,613
31/12/2014	$ 829,000	$480	5.95%	3.01%	33.2	51%	$ 409,504
31/03/2015	*$ 853,870*	$490	5.65%	2.98%	33.5	53%	$ 402,897
Average			7.1%	3.8%		55.1%	

Lending

Rapid rises in lending to investors in existing housing occurs in 2002-03 and 2013-15. None of which lead to new supply of housing. Take these out and what would it look like. ?

Figure 2 – Lending to investors and owner occupiers (the eureka report, ABS, RBA, UBS)



Another perspective shown in Table 2 is the speed at which investors can buy another property when banks have a very low deposit requirement. Note the low rate of return required to purchase.

Table 2 – Comparison of Deposit and Leverage capability (*For conceptual appreciation, paydown of principal, stamp duty and other fees and charges and losses applied to income have been ignored*)

	The increase in price and % required to purchase the next property							
	5% Deposit		10% Deposit		20% Deposit		30% deposit	
	$ Price	% Increase required	$ Price	% Increase required	$ Price	% Increase required	$ Price	% Increase required
Principal Home	$ 500,000		$ 500,000		$ 500,000		$ 500,000	
Investment Property No 1	$ 526,316	5.3%	$ 555,556	11.1%	$ 624,220	24.8%	$ 714,286	42.9%
Investment Property No 2	$ 539,811	2.6%	$ 584,795	5.3%	$ 694,444	11.3%	$ 840,336	17.6%
Investment Property No 3	$ 548,960	1.7%	$ 604,961	3.4%	$ 744,048	7.1%	$ 933,707	11.1%
Investment Property No 4	$ 555,909	1.3%	$ 620,472	2.6%	$ 783,208	5.3%	$ 1,009,413	8.1%
Investment Property No 5	$ 561,525	1.0%	$ 633,135	2.0%	$ 815,842	4.2%	$ 1,073,843	6.4%

When comparing shares to property, an Australian index share fund requires about a 25% to 30% capital loss buffer for margin lending. Buying shares also comes with significant volatility. Given that shares currently have a high dividend ratio, the losses applied to income are a lot closer to neutral lending.

Property however requires a very low deposit, has very low volatility, low downside risk, and when combined that it’s in Sydney (it never goes down !!!), it’s obvious to see why there is such high demand from investors.

Table 3 on the following page takes the greater Sydney sales and rent prices from Table 1 and highlights the losses applied to income at different interest rates assuming a Loan to Valuation Ratio of 80%. It also shows what deposit would be required under neutral gearing when compared to the RBA’s standard variable rate.

When you consider that in 1999 the net yield looking at Table 2 was about 4% (Gross of 5%), the current market has effectively moved to a net yield of 2.30%. The difference between the two using table 3 means an additional $300,000 or 60% increase ($800,000 - $500,000) that first home buyers are having to pay in the Sydney market.

But for someone on middle to high income, the extra losses from the $300,000 is about $15,000 to 20,000 per year and they get back 37% or 45% of this on their tax return. This highlights how competitive investors can be to owner occupiers of first home buyers.

It also means it is $300,000 plus interest less for retirement.

Table 3 – Example to highlight losses applied to income using Sydney Region sales and rents

Example from Table 1 - NSW Housing Sales and Rents							**Losses applied to income versus Interest Rate %**								
							Assumes the loan is 80% of Price								
							Interest Rate								
Rent $/week	Yearly Income $ (Rent - $5000)	Price	Neutral Gearing Deposit	Std Var Int	PE Ratio	Net Yield %	5.0%	5.5%	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%	9.0%
$ 450	$ 18,400	$ 350,000	$ 24,336	5.65%	19.0	5.26%	-$ 4,400	-$ 3,000	-$ 1,600	-$ 200	$ 1,200	$ 2,600	$ 4,000	$ 5,400	$ 6,800
$ 450	$ 18,400	$ 400,000	$ 74,336	5.65%	21.7	4.60%	-$ 2,400	-$ 800	$ 800	$ 2,400	$ 4,000	$ 5,600	$ 7,200	$ 8,800	$ 10,400
$ 450	$ 18,400	$ 450,000	$ 124,336	5.65%	24.5	4.09%	-$ 400	$ 1,400	$ 3,200	$ 5,000	$ 6,800	$ 8,600	$ 10,400	$ 12,200	$ 14,000
$ 450	$ 18,400	$ 500,000	$ 174,336	5.65%	27.2	3.68%	$ 1,600	$ 3,600	$ 5,600	$ 7,600	$ 9,600	$ 11,600	$ 13,600	$ 15,600	$ 17,600
$ 450	$ 18,400	$ 550,000	$ 224,336	5.65%	29.9	3.35%	$ 3,600	$ 5,800	$ 8,000	$ 10,200	$ 12,400	$ 14,600	$ 16,800	$ 19,000	$ 21,200
$ 450	$ 18,400	$ 600,000	$ 274,336	5.65%	32.6	3.07%	$ 5,600	$ 8,000	$ 10,400	$ 12,800	$ 15,200	$ 17,600	$ 20,000	$ 22,400	$ 24,800
$ 450	$ 18,400	$ 650,000	$ 324,336	5.65%	35.3	2.83%	$ 7,600	$ 10,200	$ 12,800	$ 15,400	$ 18,000	$ 20,600	$ 23,200	$ 25,800	$ 28,400
$ 450	$ 18,400	$ 700,000	$ 374,336	5.65%	38.0	2.63%	$ 9,600	$ 12,400	$ 15,200	$ 18,000	$ 20,800	$ 23,600	$ 26,400	$ 29,200	$ 32,000
$ 450	$ 18,400	$ 750,000	$ 424,336	5.65%	40.8	2.45%	$ 11,600	$ 14,600	$ 17,600	$ 20,600	$ 23,600	$ 26,600	$ 29,600	$ 32,600	$ 35,600
$ 450	$ 18,400	**$ 800,000**	$ 474,336	5.65%	43.5	2.30%	$ 13,600	$ 16,800	$ 20,000	$ 23,200	$ 26,400	$ 29,600	$ 32,800	$ 36,000	$ 39,200
$ 450	$ 18,400	$ 850,000	$ 524,336	5.65%	46.2	2.16%	$ 15,600	$ 19,000	$ 22,400	$ 25,800	$ 29,200	$ 32,600	$ 36,000	$ 39,400	$ 42,800
$ 450	$ 18,400	$ 900,000	$ 574,336	5.65%	48.9	2.04%	$ 17,600	$ 21,200	$ 24,800	$ 28,400	$ 32,000	$ 35,600	$ 39,200	$ 42,800	$ 46,400
$ 450	$ 18,400	$ 950,000	$ 624,336	5.65%	51.6	1.94%	$ 19,600	$ 23,400	$ 27,200	$ 31,000	$ 34,800	$ 38,600	$ 42,400	$ 46,200	$ 50,000
$ 450	$ 18,400	$ 1,000,000	$ 674,336	5.65%	54.3	1.84%	$ 21,600	$ 25,600	$ 29,600	$ 33,600	$ 37,600	$ 41,600	$ 45,600	$ 49,600	$ 53,600
$ 450	$ 18,400	$ 1,050,000	$ 724,336	5.65%	57.1	1.75%	$ 23,600	$ 27,800	$ 32,000	$ 36,200	$ 40,400	$ 44,600	$ 48,800	$ 53,000	$ 57,200

Opportunities for Tax Reform

As per my tax white paper, my focus would be on lending rather than tax.

Lending standards from APRA should target segments of the market, such as existing housing as the last 15 years of over-investment in existing housing has occurred.

Either:

- A PE ratio cap of 20 of 5% yield (fixed) for investors in existing homes
- Neutral gearing (which is variable).

This would encourage investors to save more and would level the playing field with first home buyers who are also forced to save.

Using the PE ratio cap for investors into existing property could be implemented incrementally over time. For example starting at 30 and stepping down to 20 or the neutral level over time.

Another opportunity with a macro prudential tool like neutral lending is that it may bring the PE ratio back closer to a 5% yield. This yield becomes attractive to retirees and super funds for stable income that is probably linked to wages or inflation. This would also provide diversification opportunities to a retiree's portfolio thus providing a demand to supply rental properties.

Conclusion

Implementing some form of macro prudential tool that targets investors buying existing property provides some significant benefits.

These include:

- Forcing more savings from investors which aligns with first home buyers
- Could target existing housing
- Allows negative gearing to continue for new housing supply for investors, meaning high income earners can invest to reduce tax.
- Improves Financial stability
- Creates opportunities for super funds and retirees as yields rather than capital gains will be the focus.

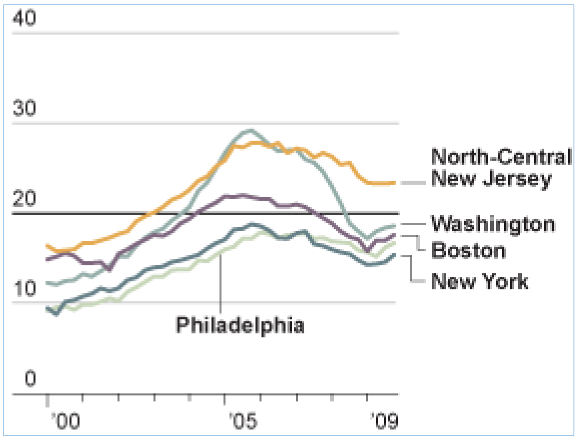
APRA currently does not have currently have a mandate for these tools.

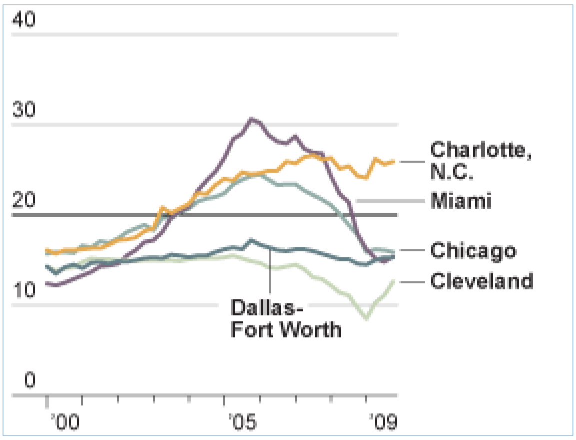
Appendix A

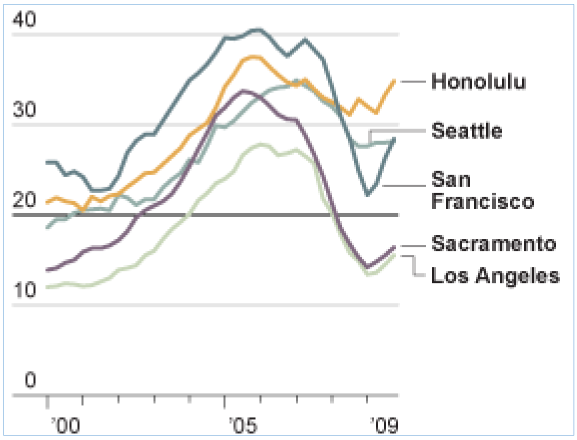
A PE ratio of about 20 is chosen as some real estate investment commentators suggest this is the balance point whether to buy or rent.

The following link and data is from the New York Times and discusses that a PE ratio of 20 is the balance point between buying and renting.

http://www.nytimes.com/interactive/2010/04/20/business/20100420-rent-ratios-table.html?_r=0







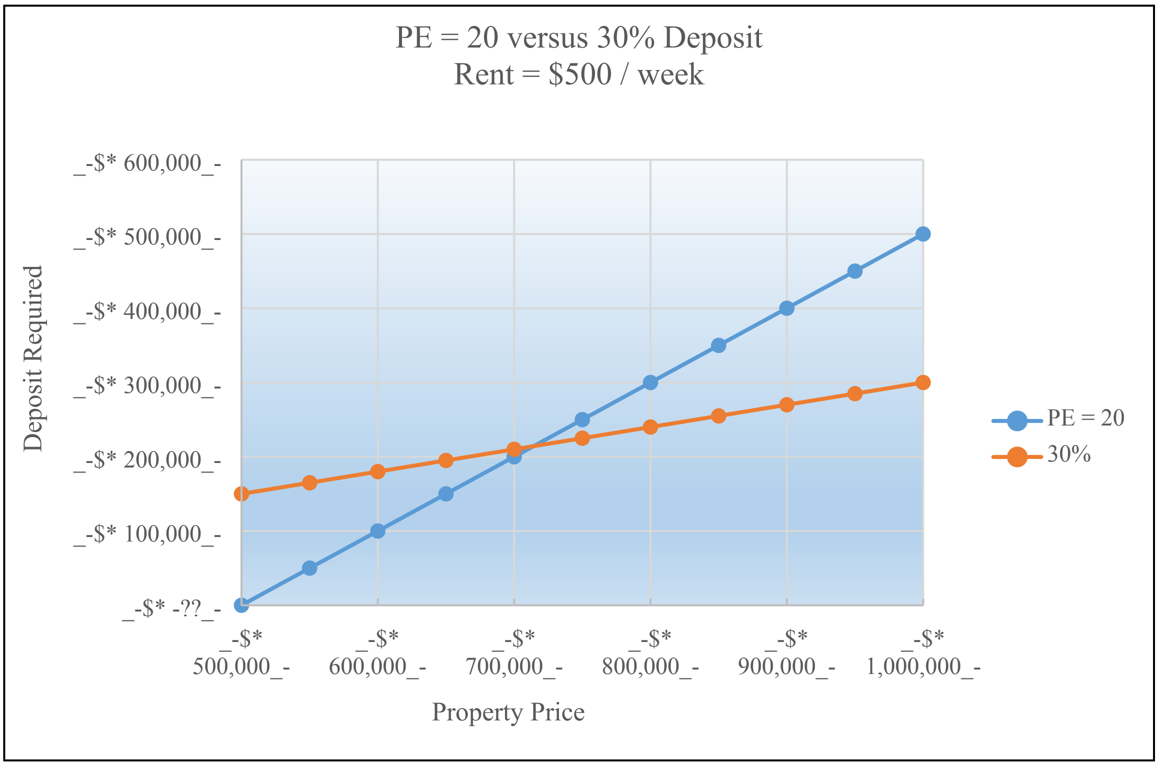
<u>Appendix B</u>

To compare the PE of 20 with the RBNZ approach of 30% deposit, Table 3 and figure 1 shows an example of a property rented for $500/week.

Table 3 – comparison of a 30% deposit and PE ratio of 20.

PE Ratio	Deposit 30%	Deposit (PE=20)
20	30%	0.0%
22	30%	9.1%
24	30%	16.7%
26	30%	23.1%
28	30%	28.6%
30	30%	33.3%
32	30%	37.5%
34	30%	41.2%
36	30%	44.4%
38	30%	47.4%
40	30%	50.0%

Figure 2 – Comparison of Yield versus % Deposit



The analysis shows that beyond a PE ratio of about 29, the PE 20 ratio increases the deposit required substantially more. For every $100,000 above $500,000, the 30% deposit requires $30,000, whereas the PE 20 ratio requires $100,000.