

# Property Falls, But Is

THE RECESSION THAT WAS PREDICTED BY THE SHARE MARKET EIGHT MONTHS AGO HAS NOW HIT THE PROPERTY MARKET, WHICH IS EVER THE LAGGARD. BUT HOW MUCH FURTHER WILL IT SLIDE?

By Neville Glaser

I learned of a new term this month, while sharing a beer with real estate executives. It is “leveraged locked”, which was mentioned several times before I demanded: “what the hell does it mean?”

Apparently a property investor is leveraged locked if he acquired a property for say \$700,000, against which he raised a mortgage of \$600,000. The fact that the deal was cash negative for the investor even after a tenant had moved in didn't matter much while property values were rising.

But now that they are falling the investor is getting nervous and so are his bankers. To avoid trouble the investor puts feelers out into the real estate market, only to learn that the \$700,000 property with its \$600,000 mortgage could attract only an offer of \$550,000.

The investor is “leverage locked” because he cannot sell below mortgage debt, and the banks would make sure he doesn't until he comes up with the shortfall in equity.

On the other side, the buyers too are struggling to make an offer because the banks have stringent new demands that call for substantial deposits to reduce the risk on the properties they finance. If you add the deposit requirement to the fact that NZ still has among the worst property affordability ratios in the world, you can begin to see the pressure on buyers.

So, the vendor cannot afford to sell, and the buyer cannot afford to buy, which explains why many deals simply

are not made and a big gap has opened between the buying and selling price.

Clearly, property investors (as opposed to home owners) are in a spot of bother right now. To make matters worse, bankers are unpredictable and they do strange things under pressure.

For an investor who can afford the deposit or who can leverage another property, 2009 might well be the year of real investment opportunity. But there is a lot of debate at the moment around timing. Are we in the middle of a decline or at the end?

One property trader has seen it all. Olly Newland has experienced both great success and some failure in a lifetime of property investment.

From his office in Remuera, Newland contemplates the chaos around him.

## Is it going to get worse?

Undoubtedly, says Newland, but by how much and for how long is hard to say. “As far as the much trumpeted lower interest rates for mortgage is concerned, it is all a charade,” says Newland. “New mortgages might be lower at 6.5% or so, but this is only for new borrowers or those on floating rates. The majority receive no relief.”

“Worse still, the banks have greatly increased the amount of deposit required to purchase a home. This move effectively cuts out large potential home owners who now need around \$70,000 – \$80,000 deposit to buy the average house with a median price of \$427,500 in Auckland.”

When you do the sums, says Newland, the average house simply cannot

be bought by the average wage earner, a sure sign the market ran ahead of itself.

But Newland is not in the camp of extreme pessimists who are writing another 30%-40% from property values. Newland believes the housing market will stabilize in 2009 well short of the worst case scenario, followed by a long flat period of little growth. That, of course, will allow affordability to catch up as wages rise with inflation but property prices stay behind.

What prevents the worst case scenario, he says, is the proactive action of politicians and central bankers in dropping interest rates and managing the situation, which is utterly different to their actions in 1987, when property last fell out of bed.

“In 1987, they did nothing, and the property market couldn't recover for years,” he says. Interest rates were allowed to remain high up to 1991, with devastating consequences.

## Is it time to start investing?

So, is it time to start investing in that second or third property you always wanted? “At this moment, I would not buy an investment property unless it was such a good deal – and by that I mean either it is selling well below the market's valuation, or the property is so special – that you cannot walk away from it,” says Newland.

There are so many deals to be had, he points out, that you don't have to be pressured into anything that does not meet your criteria.

BUT you also have to be aware that the collapsing interest rates are starting

# It Time To Buy?

to create deals that weren't there before.

"It's a numbers game and low interest rates change the rules," says Newland.

"Recently, a friend of mine bought a CBD building for \$9 million. Granted, it is not the highest quality building, but it is giving a 10% yield from rentals; while the funding to acquire this building is at 5.25% in long term finance. That is an unprecedented situation. I have never seen the sums stack up so well for the buyer."

A couple of years ago, says Newland, that same building would have sold on a yield below 10% while the finance costs could have been nearly double the 5.25% now being charged.

## Tactical Advice for a Troubled Market

**When to Buy.** Let the numbers dictate, says Newland. You know you have a good deal if the numbers – the gap between rental yield and finance costs – indicate a good deal. Market statistics give you the general

direction of the market but those are average figures that don't give a detailed picture. Even worse, says Newland, the house price statistics are themselves very misleading. Firstly, sales statistics are compiled months after the event, which is no help in a dynamic and falling market. Secondly, sales statistics are compiled from settled sales only and essential information, such as what buyers are offering, is ignored. Thirdly, the median price for an entire market is used, which can be distorted by the number of expensive or cheap properties being sold.

**What to Buy.** "You still can't beat a three bedroom house on a bit of land," he says. But surprisingly, Newland is very positive also on a second category, the much maligned inner city apartment. "If I was 20 years younger, I would be buying CBD apartments by the truckload," claims Newland. This even applies to those of less than



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outstanding quality, with four main provisos: It must have freehold title (not leasehold); must have at least 2 bedrooms; with a car park; and at least 50 square metres in size.

But what about the claim that many CBD apartments will be inner city slums in 20 years? “They said the same thing about Sydney, where terrible inner city apartments sprang up after the 1960s. Today they are still terrible apartments, filled with termites, but they are fully rented, expensive and have delivered great capital gain”.

“They are close to town, and in an increasing population, that is all that matters.”

**How to buy.** Property ownership is a lonely business, says Newland, and a business that requires very specialised skills in different areas. For that reason, investors should seriously consider entering in a syndicate or joint

venture. From an investment point of view, there’s no difference between one investor buying one property or two in partnership buying two properties and having some scale with it.

The best partnerships are between people with different skills: one is an excellent details person and property manager and that is what he/she does; the other has negotiation power and networking power. Each sticks to their strengths and they should be different strengths.

Newland warns, though, that a partnership that goes wrong tends to go terribly wrong, “and I have experienced that”. But at the same time he has had his greatest successes while operating in partnerships.

When buying get advice, says Newland. “And I’m not talking about legal advice. A builder and a valuer’s advice are essential. I wouldn’t buy a dog box without talking to a valuer,” he adds.

**What to avoid.** This is not the time to buy new developments, particularly if they are being sold off the plan. “You are paying top dollar, there is the development margin and GST”, he says. And these developments might not fully capture the reality of the market. “You are better off buying a second hand or third hand property from a distressed seller, on which you negotiate hard.”

Feng Shui matters, says Newland. By ignoring Feng Shui taboos, like being able to see the back door from the front door, or having a poor colour scheme or unlucky street number, you can turn off a surprising number of potential tenants and buyers, says Newland. So follow the broad rules.

The materials used in building the property has never been a bigger issue than now, says Newland. Modern, fashionable cladding is at the heart of the current crisis in leaky homes. But is not the first time that cladding turned out to be the nemesis of home owners, going back several decades, he says, as early cladding cracked.

The simple structures built of weatherboard, tiles and bricks and used

## Property Facts of Life

By Neville Glaser

Q. When is the best time to invest in property? A. In a recession.

Q. When is the worst time to invest in property? A. In a booming market.

Q. When do most people rush into a property market? A. In a boom.

Q. When do they avoid property like the plague? A. In a slump.

The fact that, when it comes to investment, we are primed to do exactly the wrong thing at the wrong time has fascinated behavioural psychologists for a long time.

We are social creatures. Human thinking is built around stories, and the story that sustained the housing boom is that houses are a one way bet, they only go up in value and you cannot go wrong investing in them. It’s the easiest way to get rich.

We also place a lot more value on recent information than on past trends. So the fact that houses have risen in value five years in succession, and doubled in price over that period, is more important in my investment decision than the fact that 100 years of research on trends shows that in no period has housing risen that sharply without then collapsing.

Our tendency to only absorb the most recent information is said to stem from our caveman days, when survival depended on finding out who had discovered the latest source of food, where it is, and getting in on the action.

Whatever the reason, smart investors know that you only really make money by acting against the popular crowd sentiment and not with it. A seasoned real estate investor told me that, although holding a \$5 million line of credit, he refused to buy a single property in the past four years.


However, just when property is now exactly where he wants it, the bank withdrew his \$5 million line of credit. It just shows that being a smart investor doesn’t always guarantee success.

by builders before 1980 cannot be beat, and modern cladding should be avoided, he says.

Newland says the basics of property investment are more important now than ever, because you are in a market where you can tick off exactly what you want and you are unlikely to be competing against the bids of a half dozen other aspiring investors.

With time and market conditions on the buyers side, he/she needs settle for nothing less than a property in a good location, close to transport, in a growing working population, with plenty of like properties all around, a history of rental growth, and delivering a very attractive yield at the price the property is being offered.

## Conclusion

Investing in property is not unlike investing in shares. It is best to invest in a recession. It is best to buy the best quality you can afford. Market information is important, but ultimately you are buying a specific property or share, and the potential for that particular asset to deliver a good return over time is what counts. The market trends are the noise in the back ground that should certainly be heeded, but should not dictate the decision to buy, sell or stay away. 

## Baches Take A Beating

By Neville Glaser

It is clear by now that all segments of the property market are sliding. But one sector stands out as the worst affected. This is the coastal property/bach market that was all the rage a few years ago.

There has been a tide of new listings amid warnings of a deteriorating economic outlook in the first half of this year. On Waiheke, 149 properties in the \$1 million-plus category, worth \$240m in total, were on the market last month. On the Coromandel, there are 119 properties in the \$1 million-plus category. But sales in both areas are extremely slow and there is a glut of inventory.

And still, the argument for buying that bach with a sea view sounds so compelling, based on the fact that sea front property is in limited supply.

But the prices went crazy. In the property peak, bidding for these beachfront properties became hysterical, with multiple bidders arriving to view the latest weatherboard hut on the sea, and bidding prices past even the wildest expectation.

What buyers didn't seem to factor in is that the income potential is limited for a seaside home. On a modest mortgage you could recover your outgoing expenses with the money raised from visitors in the summer months. But when these baches hit well over \$1 million, there was no way you could recover your outgoings during our relatively short summers.

If you were filthy rich, you didn't care. If you were average you could run into big trouble in an economic recession or where your main source of earnings was threatened. That is why these properties are flooding onto the market.

In years gone by, the bach was not meant to be status symbol. It was more likely to be a rough as guts caravan with lean-to attached. The big upgrade was to a ramshackle hut, which served as a place to sleep and store for your fishing tackle.

They were dirt cheap, certainly not meant to involve a big mortgage if any.

In the current economic slide, and with property values falling at the same time, this is not the kind of asset you would want to be funding, especially if it is mortgaged to the hilt.