What the numbers say about property

When it comes to house prices, supply and demand rules

ROGER MONTGOMERY

To avoid experiencing an uncomfortable dinner party silence simply raise the topic of property prices. Nothing stirs emotions more — other perhaps than religion or politics.

That property voyeurism, investment and speculation are national pastimes is inarguable, what is up for debate is the direction of property prices themselves.

Most recently, a report published by Variant Perception’s Jonathan Tepper provided a plethora of anecdotal evidence that Australian property prices are at an extreme level and concluded they could fall by 40 per cent, and bank shares by 80 per cent.

But anecdotes about aggressive or improper lending practices are less important than the fact the Australian Securities & Investments Commission’s own investigation into a handful of interest-only investor loans found borrowers were not fully conversant in risk or all aspects of their obligations to lenders.

Similarly, it is less significant to the argument that a bubble exists that a taxi drivers owns multiple properties than it is that a generation of people maintain their employment status. In the debate about property prices, anecdotes aren’t important, only demand and supply matter.

In 2010, we wrote that iron ore prices were headed for a substantial fall. When we then met resource sector analysts, we discovered each anticipated the value of the iron ore producers they covered would rise in value, primarily because production volumes were set to rise.

It seemed nobody had taken a step back and asked what would transpire if all companies met their production targets.

In May 2012, we wrote to investors: “By 2015, we estimate that two entire Pilbara regions (700 million tonnes) in supply ... will come on to the market. It’s a far stretch to expect China to absorb 420 million tonnes (60 per cent) of that. The impact we expect is pressure on iron ore prices.”

Of course, by 2012, prices had already peaked, but industry experts were vehement in their rejection of the oversupply and lower-price thesis. As Oaktree’s Howard Marks noted, “being far ahead of your time is indistinguishable from being wrong”.

What does any of this have to do with property prices? It’s simple: demand and supply.

By looking into the near future’s supply and demand balance, we can reach some reasonably confident conclusions about prices. Sure, there might be exceptions to the findings of basic supply and demand analysis, but exceptions by there very nature are unusual and typically aren’t sustained. And we also don’t need to be too precise.

As Berkshire Hathaway’s Charlie Munger once observed, it’s far better to be approximately right than precisely wrong.

What we know of property is that demand is determined by household formation. Indeed, demographer Bernard Salt said as much in this publication in August 2014. According to 2015 Australian Bureau of Statistics report, entitled “Household and Family Projections, Australia, 2011 to 2036”: “The number of households in Australia is projected to increase from 8.4 million in 2011 to between 12.6 million and 12.7 million in 2036.” The implication of this is that households will form at the rate of 1.65 per cent a year, which is higher than the 1.52 per cent growth rate previously projected by the ABS in 2010.

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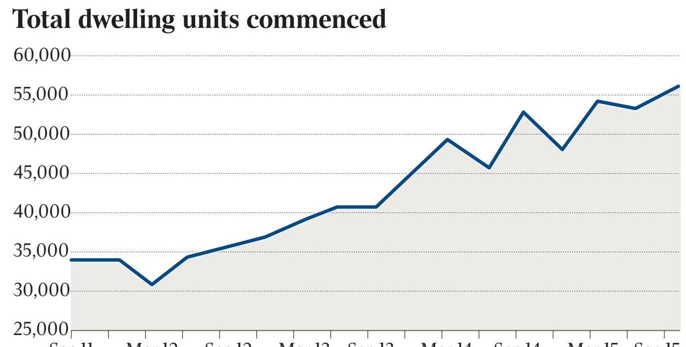
Total dwelling units commenced



Source: ABS

More importantly it means that by 2017 dwelling demand will amount to about 150,000 a year, growing by 1.65 per cent a year. This is 12,000 more households for 2017 than was projected in 2010. Sadly, it won’t make too much difference to the oversupply thesis.

First, let’s look at dwelling approvals. About 19,000 dwellings are approved each month. When you annualise that number, you get roughly 228,000 dwellings. That’s more than the 150,000 needed and results in an oversupply of almost 80,000 dwellings. Of course 80,000 extra dwellings would be absorbed in about six months at the present rate of household formation, so there’s no problem right?

Well, sort of. The oversupply, as measured by approvals, has been going on since 2011. So we have had about five years of oversupplying residences. It could take up to two years, at the present rate of demand, to absorb the residences estimated to be supplied by the approvals statistics.

Second, let’s look at dwelling commencements. Now, it’s true all approvals don’t culminate in construction and completion. But thankfully the ABS comes to the rescue again with its “dwelling unit commenced” statistic, which is about 56,000 a quarter.

The number is now at a record high and has been rising steadily from 35,000 a quarter in 2011.

So if we say the average level of commencements a quarter since 2011 is about 47,000, we arrive at a supply of 188,000 dwellings every year for the past four or five years. Taking the lower estimate, we end up with an oversupply that amounts to about a year’s worth.

That doesn’t seem all that bad. And it isn’t. Sure, approvals are still near records, so the oversupply will continue — but only if the approvals lead to construction, and on that front, the jury is out.

January housing finance data showed January investor commitments were down 14.8 per cent year-on-year, representing a plunge in demand for investment loans. That suggests a lot of developers that have recently gained approval for their developments won’t be selling as many units as hoped. Their developments may not reach sufficient presale commitments to begin construction. And if that happens new construction/supply will slow, and demand will naturally soak up existing oversupply.

Employment impacts on the ability of borrowers to meet commitments, so it’s important jobs are maintained. And because the level of borrowings determines the toxicity of any bust — rather than being a predictor of a bust — the present levels suggest property speculators and investors need to be cautious.

It’s also important to remember the supply of individual property configurations and geographies will experience their own supply and demand effects.

Generally speaking, however, our assessment of supply and demand conditions suggests some weakness is possible. But notwithstanding the fact prices overreact on the upside and the downside, there is a lower probability of a substantial crash occurring.

Importantly, just as early awareness of the rising supply of iron ore didn’t prevent iron ore prices from registering new records, so knowledge of a dwelling oversupply hasn’t prevented property prices from doing the same.

Hey big spenders, spend a little time on minding the ‘buy’ business

RICHARD HEMMING

One of the big lessons from the 97 per cent fall in the share price of law firm Slater & Gordon over the past year is to be sceptical of brokers when they tell you to buy a company where its business consumes capital faster than it can make it.

Stockbrokers and other capital markets operators cheered when the Australian listed law firm acquired the professional services division of British insurance claims company Quindell for £637 million ($1.2 billion) about this time last year. The brokers would have made out like bandits on the fees alone. Whether it was a good investment or not came a very distant second (if it was even a consideration).

Last Tuesday, the stock in Valeant Pharmaceuticals plunged 51 per cent on the New York Stock Exchange on reduced earnings guidance. Its shares are down nearly 80 per cent over the past year.

Unlike Slater & Gordon though, the company remains a heavy hitter. Even at current levels, its market cap is still $US11.4bn ($15bn).

In common with Slater & Gordon, Valeant was heavily backed by brokers on Wall Street because of its prolific dealmaking. Its debt was the equivalent of three times its sales. It always needed capital of any persuasion; in other words it was a broker’s gift. The pharmaceutical giant made money by buying smaller drug companies, getting rid of research and development, and then hiking the prices of those drugs it sold.

Finally on Tuesday the party ended. Valeant reduced its profit guidance; there was the spectre of defaulting on its debt; and an analysts’ call with management convinced some of the former supporters to downgrade or suspend their “buy” ratings.

It was by many measures, too late. Before the fall, most analysts had been bullish on Valeant, as its share price slid south at a fast rate. By the time they had backed off their buy call, its stock was 80 per cent down on its high. Even then, few were saying sell.

Earlier this week I was asked to give an opinion on a listed social media services provider MigMe (MIG) which one shareholder said was valued by broking analysts at around $1.90, compared with its current price of 62 cents.

Wait a second! Here’s a stock where current share price gives it a market cap of over $145m and MigMe isn’t even making a gross profit! Sure, it grew revenues in the past year from just under $2m to over $12m but its cost of sales were actually $13m and included “revenue share”.

MigMe was founded and run by Perth-born Stephen Goh, who is known for starting of one of Australia’s first online brokers, Sanford Securities. Taiwanese “contract manufacturer” Foxconn owns just under 20 per cent, which is a major coup because its one of the biggest manufacturers in the world: this is the group Apple turns to when it wants to produce 100 million iPhones next week.

Buying into a company which could be clipping the ticket for years to come on increasing volume has the potential to be investing nirvana. Twitter isn’t managing it at this point but Facebook is.

MigMe is sensibly focusing on markets that haven’t been attacked, in places like Indonesia, because there is relatively low internet use. The company has already raised about $21m since reverse listing via the shell of a dormant company back in August 2014, it has about $8m in cash left and make no mistake, it will be coming back for more. Just wait for your broker to call.

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Why everyone wants to know about India

STIRLING LARKIN

To prove one’s mettle as a savvy and long-term investor involves positioning ahead of changing circumstances and not pivoting every time new, trendy or sudden events unfold.

For Australian Ultra High Net Worth global investors, interesting to observe since the 2013 Taper Tantrum has been the somewhat new — but recurring — trend that when developed markets (DM) rally for any sustained periods emerging markets (EM) become heavily discounted. And as soon as those developed markets, such as the US, falter or stall then EM investment opportunities once again return and become all the rage.

Maybe this goes a long way to explaining why investments in India have again become the hot topic among both institutional and UHNW global investors. I have received more investment queries regarding India than any other thematic this year.

Investing in India remains both an exciting and concerning proposition. As Indian activist Kailash Satyarthi observed, “India may be a land of over a 100 problems, but it is also a place for a billion solutions”.

What is agreed by most is that the world’s most populous democracy, which currently enjoys growth metrics better than those seen in China, has much potential, especially under the leadership of Narendra Modi.

Where divisions soon arise, especially within UHNW investment communities, which have had mixed experiences on the subcontinent, surrounds questions of value, longevity and, most important, the redemption of capital. The question surrounding redemption — or return — of capital is highly sensitive in this particular investment community, simply because in previous cycles Indian investments have had a highly dubious record of returning funds back to foreign global investors.

This concern alone is a kibosh for many Australian UHNW investors. Then again, for those who have confidence that these hazards can be managed or avoided, the allure of investing in India has once again returned.

Here’s four key reasons why:

- When comparing India to other popular EM markets such as China, Mexico, Vietnam or, indeed, Indonesia, India is the most under-allocated, when looking at foreign holdings of equities, bonds and FDI relative to GDP.
- In contrast to China, private sector debts are relatively low.
- India is a large beneficiary from lower oil prices, given its oil deficit.
- Unlike China, where heavy industry and state-owned commerce drives almost everything, India’s main engine of activity is personal consumption, something China greatly envies.

Separately, for overseas investors there is the appeal of India’s primary bourse; the Nifty 50 attracts some Australian global investors simply because pricing and valuations appear comparative — both currently priced between 23 x P/E and 20 x P/E and with similar total market capitalisations — yet India has a population of 1.3 billion consumers and growing.

According to a 2015 Credit Suisse Global Wealth Report, even though just 0.3 per cent of the Indian population has a net worth over $US100,000, due to India’s large population this equates to a staggering 2.4 million people, with 254,000 of them in the global top 1 per cent.

But this is where the comparisons end and the investment premises of China and India significantly bifurcate. Everybody knows that, where India is an intensely bureaucratic democracy, China does not enjoy a separation of autonomy between fiscal and monetary arms of government.

On this, the Modi administration 2017 fiscal year (FY2017) budget released on March 1 matters to global investors who have recently been underwhelmed by India’s deteriorating corporate profitability, depreciating currency and concerns that momentum on reform has been slower than expected.

Most notably, this budget provided investors’ confidence that the Modi administration is beginning to address longstanding infrastructure

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concerns, especially those in the power sector. This administration is also importantly raising limits on foreign portfolio and direct investment.

Even though this budget reinforces the trend for domestic lending to gradually shift from state-owned to private sector banks, China’s and India’s monetary systems facilitate credit and the money-multiplier effects very differently and this has a material impact of listed equities, real estate and other FDI investment opportunities.

China’s ability to so easily extend credit through what is known as “total social financing” may not be without its problems, as is being borne out today, but in the context of this discussion it does raise questions about whether India’s banking system can stoke similar continued growth that warrants investment market buoyancy and longevity.

Whereas China has this money-supply amplifier, the US had Quantitative Easing, Europe the ECB stimuli and Japan its QQE programs, the Indian economy, like Australia, is still sitting in positive interest rate territory.

Although the Reserve Bank of India is expected to cut rates one more time in April, clearly India, nor Australia, for that matter, can rely on monetary means to drive future investment returns.

There is little question that India continues to intrigue and seduce, but as an investment destination caution has to be heeded. It may be the home of a billion solutions, but the question remains: which ones?

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