# An evaluation of residential property investments

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Some South Africans prefer the property market (direct investment in property and not listed) instead of financial investments on the stock market. You often hear that investors like to "see and touch" their investment. Individuals in this camp tend to feel there is a high degree of control over rental income and expenditure. In the past there has been a rapid increase in capital value; hence, the "good experience" of South Africans, especially during high inflation years. During those years, rental income more than kept pace with broad inflation while interest rates have fallen significantly since 1998.

### Considering fundamental objectives

Behavioral finance research confirms an emotional component to investment decisions – and rightly so. Nobody enjoys to see capital losses in their portfolio. However, it is of utmost importance to observe the fundamental objectives of any investment such as:

1) Generate an **after tax return above inflation**; i.e. the investor should factor in the various tax scenarios and protect his or her future buying power
2) Retain sufficient flexibility to make adjustments when necessary
3) Gain the appropriate level of diversification (each property is usually unique and tied to a single geographical area)
4) A high degree of cost transparency
5) To only take on as much risk as we can tolerate before making decisions based on emotions (either fear/greed, etc)

Risk could be broadly defined (amongst others) in two ways:

- The possibility of <u>total loss</u> of capital
- Volatility in the value of an investment over the entire investment horizon.

Of course volatility risk is real if we are forced to sell assets (because of cash needs) at depressed (lower) prices. An investor should retain an amount of "low volatility risk assets" in any portfolio – to cover both running and some unexpected costs.

Over the last few years several important factors related to residential property in South Africa has changed:

a) The potential for price increases from greater affordability has severely diminished. South Africans are under financial pressure
b) Security has become an issue
c) Friction costs (the cost of buying and selling) are relatively high; and
d) The cost of owning a property has increased dramatically (insurance, levies, municipal rates, taxes etc.)
e) Political risk, tied to exchange rate risk (Rand depreciation), affects local property.

### Unpacking the detail

**a) Affordability**

Important drivers of property prices are typically:

- Growth in real household income (after inflation) in the relevant city or town
- Interest rates that determine borrowing cost

South African incomes have been under pressure. According to economists, 2019 will be the 5th year of declining per capita incomes. Economists' consensus is that 2020 could well be the sixth. Due to structural issues, this trend is unlikely to reverse any time soon.

**b) Security**

Large properties used to be the aspiration of both wealthy South Africans and foreign buyers. During the last two years this has changed due to, amongst others, the security risk. This particular buyer group now prefers relative smaller properties in preferably security estates. Properties in security estates usually come at a premium. The implication is that owners of large properties (who thought downscaling would help finance their retirement) might be in for a surprise when eventually selling their property.

**c) Friction costs**

The average price of a relatively small sized home is now in excess of R1.25 million. This means the transfer duty at purchase is at least 6%, rising to 13% for more expensive houses (beyond R10m). Estate agents also charge a minimum of 5% to sell property. Therefore, a property bought for R2.5 million today, rising to R5 million over ten years, would be subject to a discount of at least 15% (average 7.7% transfer duty plus an estate agent fee of 5% plus VAT, plus legal fees of 1.15%). Thus, an additional 1.4% return per annum should be factored in when comparing expected returns to inflation. Also, keep in mind that taxing property transactions is a very easy way to score political points, i.e. "taxing the rich". If anything, the tendency for property taxes is only up.

**d) The ongoing cost ownership**

Investments in stocks and bonds (when held to maturity) tend to have a manageable cost of ownership with no direct exposure to an unexpected rise in interest rates. Direct property investments, however, have unpredictable costs of ownership, especially when subject to mortgage financing. Property owners frequently underestimate this cost when considering whether to buy an investment property, or even a property as main residence.

During years of rapid growth in rent, the cost of ownership tends to improve dramatically over a few short years (we are certainly not in such an environment anymore). Rental yields for most residential properties hover around 6%. Some properties in security estates might yield more, but after levies are paid, it is likely that you are back at 6% before agency fees. Once agent fees (11% including VAT or more of the rent), municipal taxes and home-owner's insurance (together around 0.84% of gross value) are deducted, the net yield before maintenance costs is around 4.5%. This calculation does not take into account the potential losses of periods of no tenants or rental payments not received. Furthermore the marginal tax of rental income also has to be noted. Property investments, with the support of a bond, calls for further consideration.

**e) Political risk**

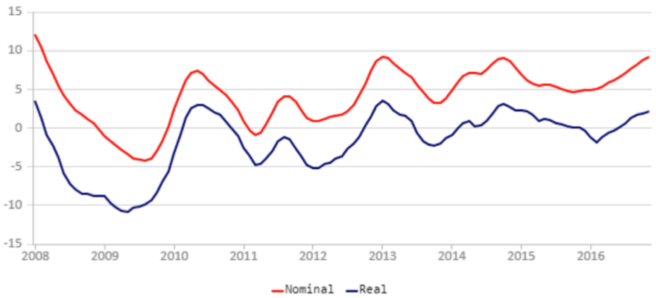
Should the currency exchange rate weaken significantly or inflation increase (due to unforeseen circumstances), the South African Reserve Bank might hike interest rates in order to protect the Rand. This would force some investors to sell which pushes property prices down – just because they cannot afford the cost of ownership. This is precisely what happened in 1992 in the UK, in 1998 and 2001 in South Africa and in 2008 (predominantly in the USA). It could happen again…

Buyers are currently less willing to commit funds to assets that might be at risk if the government proceeds with changes to the constitution in order to expropriate land.

## Putting our picture together…

A direct investment in residential property seeks to achieve above inflation returns from a combination of the following (a) capital appreciation, net of selling costs; and (b) net positive cash flow from ownership (it is interesting to note that investors do not get quarterly statements of their property values, so they are blissfully unaware of the volatility in capital values).

The chart below (from ABSA) shows the annual nominal and real house price growth since 2008 – basically zero real returns on average across the country. If it was simply due to a cyclical downturn, now would be a great time to invest. However, structural issues cast a long shadow over the outlook of South Africa.




Considering the picture painted above, it should be clear that retirement planning based solely on residential property investments is not an obvious strategy.

Having said that, the South African financial market has been disappointing the last several years. However, it maintained a positive dividend yield of roughly 2.5% and could be financed by before-tax Rands in a retirement account. Furthermore it did not expose the investor to the same risks as a geared direct property.

**The past is not a reliable indicator of the future.** Beaten down asset classes of today could become the stars of tomorrow. However, making an informed decision based on the drivers of price growth and a thorough understanding of the costs of ownership, taxes, and financing cost effects, is as critical as ever.

## Our conclusion

There is no argument that many people have, through the years, successfully structured property portfolios as a basis for provision of retirement needs. It is clear that in order to do so, property requires added planning, management and a specific set of skills. If these are not appropriately applied, the result will be sub-optimal at best and could be disastrous.

Investing in property is common practice for many people who in the process rely on advice from a wide variety of sources such as books, workshops etc. A proper understanding of all the factors that play a role in the investment decision process and effort to acquire even basic knowledge is invariably absent. This is in stark contrast to investments in financial markets where risks are well defined and where professional advice has developed to a relatively high level.