REAL ESTATE

Penny On Key Factors To Consider When Making Investment In Real Estate

Over the past number of decades, we note that as countries industrialized and became urbanized, real estate prices generally rose in line with their economic growth. Increased mobility in human capital and liberalization in the financial markets also resulted in greater free flow of capital across borders that led to further price increases in real estate especially during times of exuberance. Investors generally perceive real estate investments as an ideal way to store their wealth as real estate has been a good hedge against inflation over the long run. The investments also tend to form part of their estate planning for the benefit of their future generations. In addition, real estate investment provides diversification benefits to other asset classes like equities, and fixed income. Notwithstanding their immobile and illiquid nature, real estate assets are particularly cherished for their "brick & mortar" attributes. The individual investor feels a sense of security and satisfaction as he is able to see and touch the finished product and enjoys the flexibility to either occupying it or to receiving rental income.

In view of the above positive attributes, it is easy to understand why many individuals could become obsessed with real estate. Many have also seen good gains reaped by their parents in real estate investments. Unfortunately, myths start to form in times of positive experience. Some of these include "you could never lose money investing in property" or "property prices will continue to appreciate over the long run". These misconceptions give rise to false sense of security and contentment. If one were to simply believe in such myths without having done his homework, the chance of disappointment is likely to be high.

A look at recent history in the US shows how irrational behavior of individuals fueled by easy credit coupled with lax banking practices and a low interest rate environment could be a harbinger for a boom & bust scenario. Property prices in the US had been on an upward trend since 1998. Prices rose rapidly on the back of strong economic growth during the years of internet boom and continued to rise unabated despite the recession caused by the burst of the internet bubble. In fact, prices rose sharply and peaked in 2006 after Federal Reserve cut interest rate from 6.57% in year 2000 to as low as 1% in 2003. Finally, an over-stretched household balance sheet together with fraudulent or imprudent lending practices at the banks and an over supply of houses caused the bubble to burst and prices started to collapse in 2008. This eventually culminated into what was later labeled as "sub-prime crisis" which subsequently snowballed into the worst financial crisis of all times since the Great Depression in 1929. As at end of second quarter 2009, home prices have declined by more than 30% from the peak reached in mid 2006.

The Singapore property market also experienced a boom and bust cycle in the 1990s. Home prices went up sharply from 1992 and peaked in 1996 before collapsing at the onset of the Asian Financial Crisis. According to the Singapore private property price index provided by the Urban Redevelopment Authority (URA) as shown in Exhibit 1, the index bottomed out at the end of 1998 and did not recover near its peak until the second quarter of 2008, spanning a period of almost 10 years! Prices soon fell again, this time due to the global financial crisis. Although the index has recently rebounded by 15.8% qoq in the third quarter of 2009, it is still about 13% below its recent peak.

There are clearly many lessons one could learn from past real estate cycles and in this article, we attempt to highlight some of the key factors one should consider before making a real estate investment. Here, we will focus our discussion on real estate as a form of investment rather than for personal use.

What are the things you need to look out for when investing in property

Real Estate Cycle - Cyclical vs Structural

Generally, a real estate cycle demonstrates the inter-relationships between the economic cycle, rental yields and property values. It is important to understand the fundamentals of real estate cycle as this will improve one's ability to identify opportunity, avoid pitfalls and to make more informed investment decisions.

Exhibit 1: Singapore Private Property Price Index as at third quarter 2009

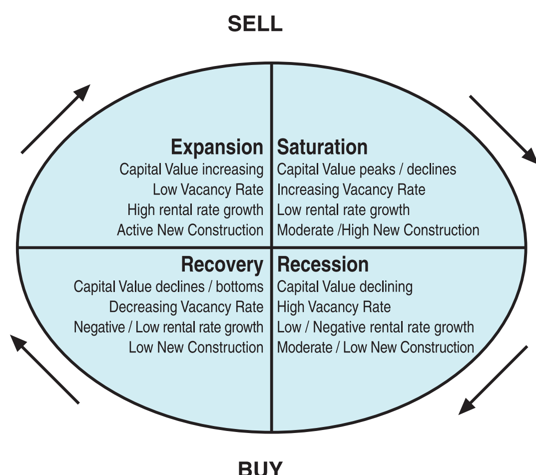
Source: URA

In a typical real estate cycle, we note that as economic cycle declines to hit trough, demand will shrink due to slackened economic activity and there will be over-supply due to prior over-building during boom time. A decline in occupancy rate will then lead to lower rental yields and lower property prices. As the cycle bottoms out, we are likely to witness increasing financial distress, mortgage delinquency and foreclosures. At the same time, bank lending also becomes more scarce as lenders tighten their lending practices due to perceived high risk in this kind of environment. As a result, property prices in a down cycle could be depressed over a period of time. On the other hand, as the economic cycle turns up and demand starts to grow, occupancy rate will rise followed by higher rental rate and rising property values. As the economy becomes more buoyant, lenders become more willing to extend credits, thus further boosting the market. As prices rise above building costs, developers react by building more to meet demand.

In a typical property cycle, the best value can be found at the trough of the market although one may need to have adequate capital to take advantage of the opportunity as credit could be scarce and rental yield could be low due to high vacancy rate.

Exhibit 2 below shows a typical property cycle and an attempt to identify the best time to buy and sell property in such a cycle.

Exhibit 2: A Typical Real Estate Cycle



However, there are times when property prices fluctuate due to structural changes in an economy rather than cyclical factors. With Singapore as an example, we could argue that a number of structural changes have taken place over the last few years. The Singapore government has taken proactive steps to grow the population by encouraging immigration. As a result, the population has been growing over the last five years at a rate of 3.3% compound average growth rate (CAGR), faster than the 2.4% CAGR reached over the last 27 years. As at the end of 2008, the population reached 4.84m. Assuming a CAGR of 2.4%, Singapore population is expected to reach 5.4m by 2013 and 6.5m by 2026. With the building of two integrated resorts, the government aims to turn Singapore into a destination for tourism and conferences. This vision to transform Singapore has attracted huge long term investments from foreign and local investors. This will potentially lead to a permanent and structural change in the supply and demand dynamics for real estate in Singapore.

Demand vs Supply

Demand for property over the longer run should be a function of population growth, rise in wages and rental yield. Nevertheless, in the short term, it can be driven by buyers' sentiments, interest rate (ie borrowing cost), government policy and other macro-economic factors. Supply tends to lag demand as developers will increase supply after existing inventory has started to decrease noticeably and when prices of real estate have risen above their building costs to provide them with good margins. Such frenzy in building often leads to an over-supply situation at a later stage of the property cycle.

It is important to understand the dynamics between demand and supply of the property market as this will give an investor further insight on the future movement of prices.

Fundamentals vs Momentum

It is often said that good bargains are usually found at times of great uncertainty. Nevertheless, in the midst of these uncertainties, much courage and foresight are needed for one to spot such bargains. On the contrary, most people find it easier to make a purchase when everyone seems to be agreeable that it is a good time to invest i.e., when there are more buyers than sellers or when there is a buying momentum.

In good times, it is common to visit a new property launch to be told by the property agent that units in the project are selling fast and there is an urgency to make a quick decision or else one could be "missing the boat". To entice the potential buyer further, the property agent would then draw examples of how others have made good profits by having done a quick subsale in the secondary market within a short period of time. While the trend is in the buyer's favour and there is great buying momentum, many would have made good profits. However, investors should not blindly follow without having considered the fundamentals and their ability to assume potential downside risk as they need to bear in mind that property is illiquid. When the market trend turns, prices could slump and it may take many years for the market to recover.

Property Valuation

The question of whether the current asking price of a property is considered as expensive or good value is probably the trickiest question to find a definitive answer. Property valuers often differ in their valuations even if the valuation methods adopted are the same. The three common methods used are the sales comparison approach, income or discounted cash flow approach and replacement cost approach. One or more approaches could be used for the valuation of a property. This would depend on the type of property, how it is being used and other specific characteristics.

The sales comparison approach is based on the principle of substitution and assumes that a buyer will compare asking prices of similar properties and will seek to buy the property at the lowest possible cost. As it could be hard to find comparable sales that are identical to the subject property, a valuer has to

make upward or downward adjustment to the comparables depending on whether the comparables are more superior or inferior. The income or discounted cash flow approach is the most applicable valuation model for income-producing property. Valuation is arrived by either using a capitalization rate on the property's annual net operating income or in the case of cash flow approach, applying market-supported yields or discount rates to future cash flows. The replacement cost approach is the reproduction cost which refers to the cost of building a house which has the same features, design, workmanship and materials, adjusted for the age of the subject property.

Before you purchase a property, it is prudent to engage a valuer to put a value to the property. However, if borrowing is needed, you should find out the bank's valuation as this could differ from the asking price or the value provided by other commercial valuers. The bank's valuation is used to determine the amount of money you are able to borrow from the bank.

Interest Cost vs Rental Yield

While interest rate is low like what we are experiencing now in Singapore, with a deposit rate of less than 0.5% and borrowing cost of less than 3%, a rental yield of 3.5% could seem attractive as the rental yield is greater than the interest cost. The higher rental yield provides investor with positive carry or positive cash flow after netting interest cost. For investors such as retirees who choose to pay for their properties in cash, the rental yield thus provides good regular income that is more attractive than earning interest on cash deposited in the bank. Existing tenants may also be keen to purchase instead of renting as rental cost is now higher than financing cost. Hence, low interest rate generally could lead to an increase in demand for property.

Nonetheless, the issue of affordability needs to be taken into consideration. Affordability shows the interrelationship of one's annual income or total wealth with the cost of owning a property. It could also be measured by looking at the percentage of one's disposable income that is required to service both the principal and interest payments. The rule of thumb is this ratio should not be more than 35% of one's disposable income. This is because if interest rate were to rise rapidly in the future, it could potentially create stress on the investors' financial health.

Over time, property value and rental should rise in tandem with positive economic growth, rising wages and the overall wealth of a nation. When prices or rental rise too fast, affordability becomes an issue. This could be an indication that the price appreciation might not be sustainable.

Stick to your investment objective and be reasonable in your expectation

In good times when both property values and rentals are rising, it is common to note that many investors are reluctant sellers of their properties despite record prices. Quite often they will comment that they find it hard to find replacement for the loss of the rental income. However, when property prices start to correct, the assumed good rental could possibly disappear. They may now face with both declining capital value and lower rental reversion as well. In addition, the property could also take a longer time to find the next tenant, resulting in a longer vacant period which would translate into further loss of income.

One way to overcome the above problem is to establish your investment objective when making your investment. If your investment objective is to make capital gain of 30%, then when that objective is achieved, make an assessment if you should adjust this objective upwards based on fundamentals. Be reasonable with your expectation and do not be overexuberant in believing that good times will last forever as property market moves in cycle. If the gain in capital value has already surpassed your expectation and your assessment shows an over-stretched market, you should plan for your exit. Do not be greedy as you could end up missing the selling opportunity altogether.

Property is an illiquid asset. Unlike bonds or equities which could be liquidated within a period of less than a week, sale of real estate could take months if not longer. Generally, a marketing period of two to three months is needed to adequately expose your property to potential buyers in order to maximize its value. While it is almost impossible to time the entry or exit of any market perfectly, I always find that the best time to look for an investment is when the market is very quiet with few transactions. This would allow a potential buyer to have better bargaining power. Similarly, the best time to sell is when buyers are exuberant and sellers are few, which mean you could insist on your asking price and need not make any concession to the potential buyers. In addition, do not be too emotionally attached to your investment properties. Otherwise, you could become a reluctant seller and this would potentially impede your decision making.

Conclusion

There are many advantages of investing in real estate. Besides the diversification benefit as a separate asset class in your portfolio, investing in real estate will provide a hedge against inflation, yielding both steady income and potential handsome capital gain.

A word of caution is that we do not encourage investors to speculate in the property market. This is because real estate investment generally requires huge lump sum investment and often involves a certain amount of leverage. Leverage could magnify your gains but it could also destroy your wealth faster than you could imagine. The temptation to flip property in the market for a quick gain might be great. However, the risk is very high and investors could suffer great losses.