Brisbane units crunch to be felt nationwide

ROGER MONTGOMERY

You cannot say you weren't warned: new apartments are being oversupplied by developers, and sold to unsuspecting investors who think interest rates will never go up and property prices can never go down.

In March last year I made an early observation in this column that, "the much maligned prediction of a sell-off in property prices is beginning to come true". Subsequently, in April I wrote "my primary concern remains for those who have leveraged to pay an inflated price for a generic asset such as residential apartments".

Then late last year, those early cracks widened and the process of swallowing investors began.

Brisbane apartment prices plunged on average by $81,000 amid an acknowledged oversupply in the city, and ahead of another release of new units that will flood the market this year. In a report, prepared quarterly by property consultants Urbis, the average Brisbane unit price was reported to be $644,667, down from $745,563 in the July quarter.

This year it is estimated another 7100 apartments are planned for release, continuing the pressure on landlords to reduce rents, and on developers to discount units to move their inventory.

But digging a little deeper I can paint a picture that reveals Brisbane's woes are not confined to the Sunshine State. As it turns out, Queensland and Victorian residents account for the vast majority of the net negative gearing that has been undertaken in Australia in the latest round of credit expansion. That means many of those declining Brisbane apartments are owned by Victorians. This is an issue for Victorian property prices especially if the ability or the willingness to pay off a mortgage declines.

From overseas experience, which includes the US, Ireland and Britain, we know that the ability to pay can be measured by the debt service-to-income ratio, which in turn is driven by interest rates and mortgage contract changes. The "willingness to pay" is driven by the equity held in a property and can be measured by the loan-to-value ratio.

A final factor is unemployment. Income loss affects both the ability and the willingness to pay but it appears that debt service-to-income is a more important contributor to mortgage arrears than unemployment. In the late 1980s and early 1990s in Britain, mortgage arrears rose significantly as higher interest rates caused the debt service-to-income ratio to increase, despite unemployment declining between 1985 and 1991.

During the US subprime crisis, investors with high loan-to-value ratios defaulted at two to four times the rate of owner-occupiers. And in Ireland the experience was similar with arrears rising as a function of debt service-to-income and loan-to-value ratios, and at twice the rate for investors as owner-occupiers.

In Australia, since 1986 variable mortgage interest rates have fallen from near 17 per cent to just above 5 per cent today. During that time, household debt to disposable income has increased from just over 20 per cent to nearly 140 per cent. Cheap money and easy credit has simply been capitalised and the transmission mechanism has been property thanks to the ability to lever.

With Brisbane apartment prices declining materially however, the prospect of negative gearing adversely affecting the willingness to pay is very high. But how can this manifest itself in property prices elsewhere? Surely it is the case that Australian mortgage holders cannot walk away from their obligations? Yes, that's true, but an unwillingness to pay can be reflected in the sale of the asset that is causing all the grief.

Before moving on, we should also note that insufficient guidance is provided by Australian aggregate numbers. There are now more than 1.5 million people with one investment property. But there are more than 770,000 with two, over 350,000 with three and more than 400,000 with four or more investment properties.

Add to this the observation that half of negative gearing losses come from those on the bottom 75 per cent of incomes and it is easy to see a picture of financial stress spreading.

During the global financial crisis, I can remember many managed funds lost a great deal of equity, albeit temporarily. Investors that had invested in multiple funds, however, were reluctant to sell out of those weak funds. Instead, they exited the better-performing funds.

This behaviour may be seen in the aftermath of the Brisbane property market declines. Mortgage obligations met by an unwillingness to pay may manifest in the sale of better-performing properties elsewhere. With so many Victorian investors owning multiple properties, one cannot help but think that reducing the debt burden may also be satisfied by selling Victorian investment properties. It does, of course, all come down to the ratio of a household's debt servicing burden compared to its disposable income. In 2007 it is estimated this number, Australia-wide, was over 14 per cent and, while the ratio is not expected to rise materially from a current estimate of about 9 per cent, thanks to low interest rates, aggregate numbers don't paint the full picture because it is the marginal buyer and seller that determine property price for everyone.

In other words, it is those at the extreme whose financial stress will determine what happens next. Drop a pebble in a pond and the ripples eventually affect the entire pond. It would be extremely unusual if the woes of Brisbane's apartment investors are confined to that city. It's called contagion.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund.

www.montinvest.com

Getting a foot in property market

MY WAY

Arthur Naoumidis is out to change how you invest in housing

RICHARD FERGUSON

STUART McEVOY

Arthur Naoumidis hopes fractional investment will change the way people invest in property

Arthur Naoumidis is the chief executive of DomaCom. He's best known for his advocacy of fractional investing — buying lots of tiny chunks of properties instead on one big house. Is he one step ahead of the curve or attempting the impossible?

How did you come to start DomaCom?

Originally I was in IT. I noticed a lot of administration work in financial services was still manual and I thought there was a better way. I raised a bit of money after the tech wreck of 2000 and started a company called Praemium, portfolio administration platform and also Australia's first separately managed account platform. In 2011, I left Praemium and after a few months I wanted to build something.

And that's how you got into fractional investing?

Looking back at Praemium I asked, was there a problem in the market that needed a solution? And the thing that really struck me was we had 44,000 portfolios on the platform which reported about $40-odd billion. Out of that 44,000, 18,000 were self-managed super funds. Just looking at those: 90 per cent had no property and 10 per cent were all property. That's symptomatic of the problem with property.

What is the problem?

The transaction size is simply too great for most investors, especially self-managed funds. If you want to have asset allocation in your fund you can't have too much property, because really you should have only 20-30 per cent of any asset in the fund.

This is a pretty radical way of investing in property.

We create sub-funds for properties on the fly so investors can syndicate effectively. The new word for syndication is crowdfunding. If you're saving a deposit for a house, especially if you're a millennial, you're not going to be in the suburb you want to live in.

So with DomaCom, let's say in Melbourne, you can effectively crowdfund with your family and other investors and can buy $3000 worth of an apartment in Carlton, and then $10,000 of another one in Carlton.

So it's like investing in stocks?

You can get some really weird reactions when you explain it to people (laughs). So why would you buy just a bit of a property instead of a whole property? Because you'd never ever do that in any other asset class. You'd never put all your money into BHP and then leverage it five times ... that's what you're doing with an investment property. Look at the risk you're taking, you'd never do it with anything else.

You never know what will happen, so don't put all your eggs in one basket.

You're basically killing the traditional idea of the landlord, aren't you?

DomaCom is a very different landlord from Mr and Mrs Smith. We don't care as long as you make good at the end. If you want to go in a pool, we'll let you. This is run as a long-run rental scheme. This is how large tracts of Europe already operate. This idea of "I must buy my house for retirement"? No. Your retirement balance and buying a property are two very different things.

You're focus is on property.

Oh, we're expanding. We're looking at fractionalising mortgages, company bonds, and the like. Basically anything that's big and complicated and can divided into bite-size chunks for investors.

DomaCom has also taken an interest in retirement homes. You were going to invest in an LGBT-only retirement village. What happened?

We had some adviser interest but we couldn't agree with the developer at the time so we didn't proceed with it. But what we have now is thematic investments. People might remember our platform was used to crowdfund a campaign to buy the pastoral property, the Kidman Station. We got about 5500 people to pledge $80 million, but that wasn't enough.

So what "themes" are you investing in today?

One of our thematic investments is a bio-energy project in Casino, NSW, which generates energy from bio-waste. It has an attractive 8 per cent return.

We also have an affordable retirement community in Cobram, on the NSW-Victoria border. Most investors don't live in Toorak and some started working before super funds and they need somewhere where there's facilities and the weather's good. And there's one that's about to start ... a group called Cultivate Farms, which brings together retiring farmers with nobody to succeed them and young farmers who want to get on the land and start owning.

What are your own investments?

I only have one investment and that's DomaCom. Our share price has taken a pounding ... it's hard to create new things in Australia. All shareholders know I have everything on the line. And that makes me feel better, as I'm not hedging my bets. That's not a proper balanced portfolio investment, but I'm the CEO and must lead from the front. (DomaCom has fallen from over 20c in early 2017 to around 12c).

What was your first investment?

I bought a house in the UK and then my second biggest investment was selling it and buying a house in Australia. Property is clearly a great first investment but the problem is the sheer size. Now you can put in two-and-a-half grand and get into the residential market.

Shareholders must consider their options as class actions proliferate

MIKE LANGE

Some of the better-known shares in Australia are facing class actions this year. If you're a shareholder, what will you do?

Twenty-five years after the introduction of the class action regime into the Australian federal court system, procedures for class action lawsuits have evolved markedly.

With 40 open cases now at various stages of litigation, Australia is the second most active jurisdiction in terms of case count after the US and is an increasingly important jurisdiction for institutions to monitor. This is highlighted by a string of high-profile cases such as Commonwealth Bank, Brambles and QBE Insurance.

Originally, cases presented to the Australian federal courts were introduced as open-class, or opt-out, cases.

All potential claimants were included and bound by the court's decision unless they formally opted out or excluded themselves from the class action and introduced their own, private litigation.

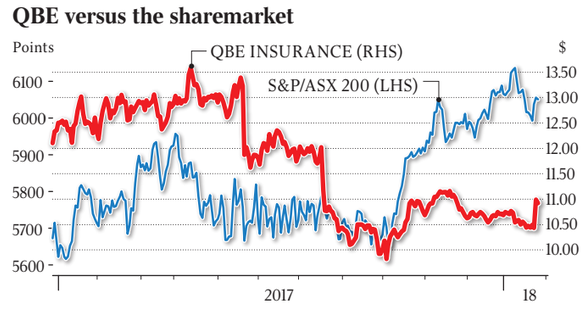
However, since litigation funders were compensated based only upon class members who had formally registered with them by signing a funding agreement, funders were faced with the issue of "free-riding" class members. Cases began to be filed as opt-in or closed classes to protect funders' rights to recoup their costs.

In a closed-class case, prospective claimants are required to affirmatively sign up (or register) with the organising law firms and litigation funders. The funder's compensation is established in registration agreements that are signed by the class members before the case is filed.

In the autumn of 2016, the Federal Court approved the use of a common fund order. These dictate that all class members, whether registered or not, who receive any recovery from the case must pay the funder a court-approved contingency fee and proportionate share of litigation costs based on the settlement of their claims.

As common fund orders become standard practice, the Australian class action landscape will continue to evolve.

QBE versus the sharemarket



Source: Bloomberg

Over time we expect that more and more actions will be filed on an open basis and proceed in a manner like those in the US.

High-profile cases

Commonwealth Bank

Case background: CBA is being investigated for breaching the Corporations Act by failing to keep investors informed of its violation of the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF).

Relevant period: There are multiple organising parties with different relevant periods (August 17, 2015-August 3, 2017 or July 1, 2015-August 3, 2017).

Next steps: Firms should evaluate their trading history to see if they have actively traded Commonwealth Bank securities during the relevant period. Organisers are currently soliciting shareholder interest.

Brambles

Case background: Fund organisers are investigating whether Brambles misled investors regarding its 2017 sales and profit guidance.

Relevant period: October 20, 2016-February 20, 2017.

Next steps: Firms should evaluate their trading history to see if they have actively traded Brambles securities during the relevant period.

Organisers are soliciting shareholder interest.

QBE Insurance

Case background: The claim arises from QBE's public announcements that it was not going to meet certain financial performance targets and, in fact, was expected to incur significant losses pertaining to its North American operations.

Relevant period: August 20, 2013-December 6, 2013

Next steps: On October 27, 2017, the court made orders which require group members to register by 4pm on November 27, 2017 if they wished to participate in any settlement of the QBE class action that may be reached before the trial commences.

What to plan for

With the increasing trend towards opt-in cases, there are a number of things that institutional investors should be doing to be able to participate:

1. Identify cases: Task your legal or compliance departments with monitoring the media for matters, or partner with a service provider who can bring relevant cases forward to you.

2. Registration: Determine whether cases are being pursued on a closed or open basis.

If closed, you must register upfront if you want to ensure participation as the class may not open later.

If filed open, you can still register upfront or wait until the court sets a deadline by which all open class members must register their claims.

However, registering upfront ensures you don't miss later deadlines for registration and enhances the prospects for the open class as funders still require a minimum level of registration to finance litigations.

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