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Quarter 4 Market Commentary
Are New Zealand House Prices Overvalued?

There has been a bit of press over the last few weeks that NZ house prices are overvalued by 25%. This is based on an Economist review that uses an affordability measure – it looks at incomes relative to house prices. Here's the article http://www.economist.com/node/21540231.

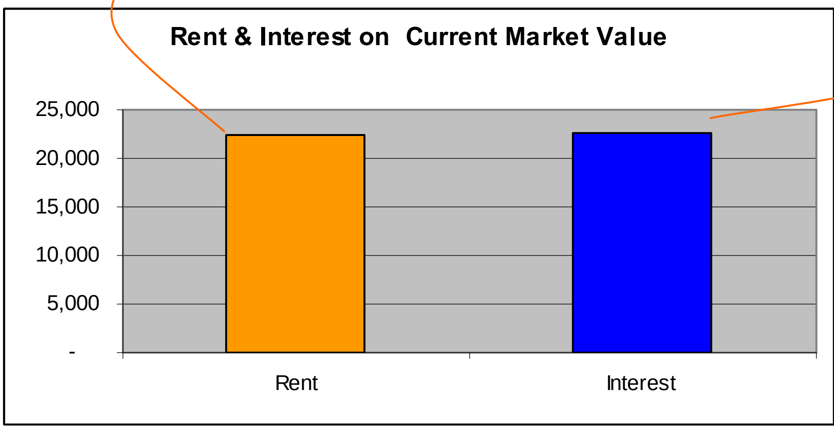
Why home buyers may not let prices drop

If a first home buyer can manage to get a mortgage, pay the bill, and its not that much different to renting, then they probably will. When we are buying for investor clients, our biggest competition is the emotional first home buyer.

The cost to own versus rent on today's prices

Let's look at the numbers. Take a property we purchased for a client

- $425k purchase price
- 3 bed weatherboard home
- $700s/m
- Assuming a 10% deposit, the interest bill each year is $22k (2 year rate 5.89%)
- Rented at $430k per week. That's $22k each year



For the home owner their interest bill is about the same as the rent bill. But the bonus of this deal is that the purchaser can lock in the interest bill for 2 years. The renter on the other hand is subject to rent increases, and there is lot of that going on at the moment.

What this means is, that even before this supposed 25% price drop, there is a strong financial argument in favour of owning over renting

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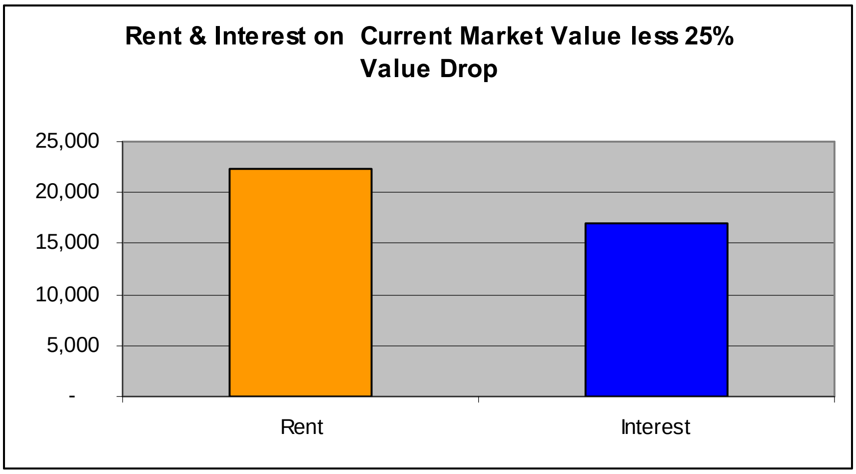
The cost to own versus rent with a 25% price drop

Now lets assume the market drops by 25%. What that means is:

- That $425k property therefore drops in value to $319k.
- The interest bill is now $17k, assuming same $ deposit and interest rate as above
- Rent remains unchanged – because rent is a function of demand and supply – supply is very low at the moment with no sign of abating



That means the interest bill, in this devalued scenario is $5.5k less than the rental bill. Would interest rates jump and eliminate the difference. Hard to see it, if it was an environment where house prices were dropping. Would rents go down? Again, hard to see that happening because housing supply is already very low, and in an environment where house prices are dropping builders are not going to start building.

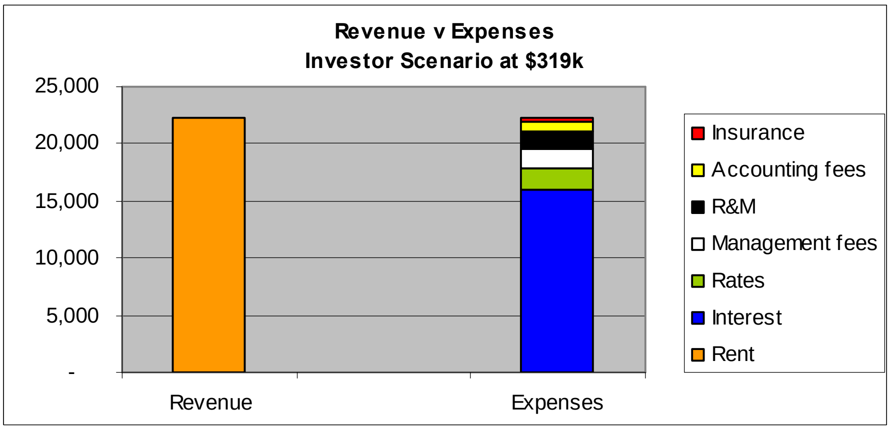
Remember that house buyers, particularly home buyers are emotional and want to own, they want security for their family, they want to nest. So if they can meet the interest payments – that's 95% of the decision made.

Why investors won't let house prices drop

What about the clincial numbers driven investor? Lets take the above example and assume:

- prices have dropped the 25% and
- the investor buys, borrowing 100% of the purchase price (assumes leveraging an existing property).
- She takes the cheapest floating rate she can find, 4.99%, because she is smart and monitors rates closely and knows she can quickly lock in a longer term rate if rates are falgged as going up.

What is it going to cost this property? Nothing. The rental income, at $430 p/w is covering all outgoings including interest, rates, insurance, accounting fees and property management . It breaks even. Remember this property is in a high capital growth area.



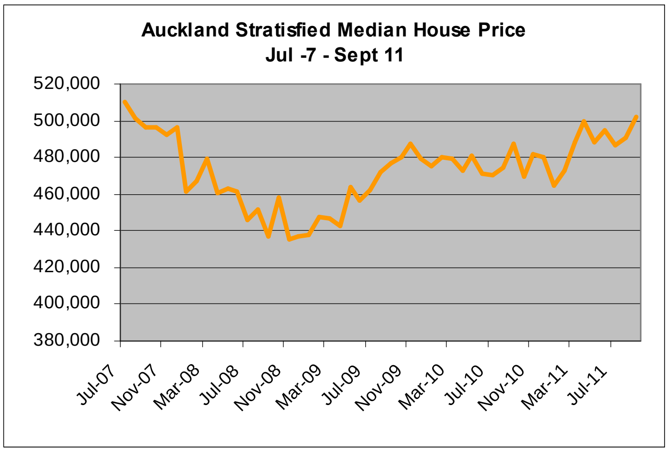
If you could own a property, or multiple properties and it costs you nothing – wouldn't' you?

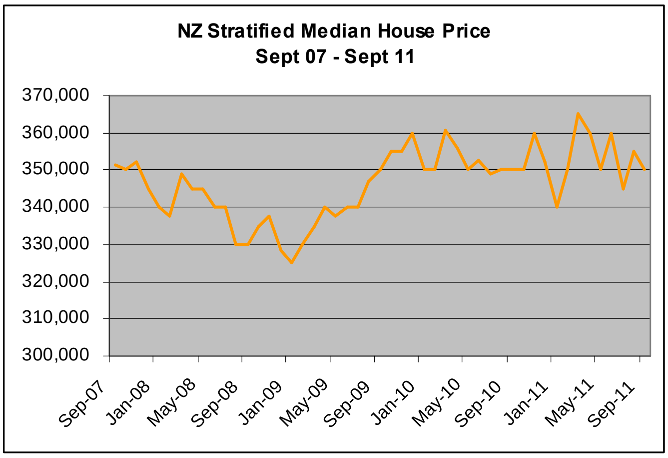
Therefore, we conclude, that it seems unrealistic to think that either home owners or investors are likely to let prices devalue in this low interest rate environment
So what would happen is the savvy investor is going to jump in boots and all and snap up as many of these properties as possible.

Why market data doesn't support a 25% value drop

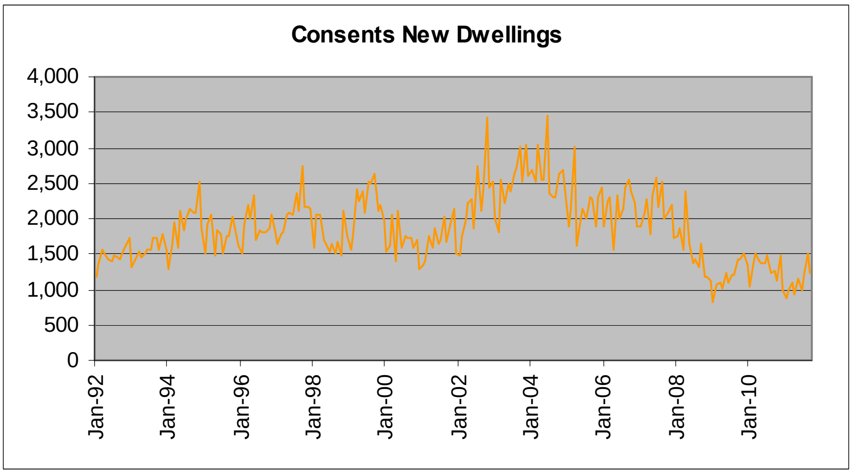
Historical property price trends don't support a nominal 25% price drop in NZ. Look at the graphs below. At the bottom of the financial crisis, Auckland dropped about 12%, and that was over the most severe economic environment we've had in a long time. The NZ graph stells a similar story.

At $502k Auckland house prices are almost back at the 07 peak of $520k, or 97% of the peak. At $370k the NZ house price index is almost back at the 07 peak level of $375k, again 97% of the 07 peak.





What's more, new building consents are currently at their lowest since 1965 and the population has continued to grow over the last several years. So now we have a growing demand yet extremely low supply scenario. 101 economics says when demand outstrips supply prices will go up…not down.



For more analysis of the New Zealand Property Market conisder attending one of our NZ Property Market Update Events hosted in various locations around the world starting Feb 2011. See:

http://www.erskineowennzpropertyinvestment.com/events/

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