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ISSUE TWO CHANGE

RESIDENTIAL REAL ESTATE IN AUSTRALIA - THE CASE FOR CONTINUED APPRECIATION

THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

SEPTEMBER 2010

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THOUGHT PIECE

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THINKING OUTSIDE THE SQUARE

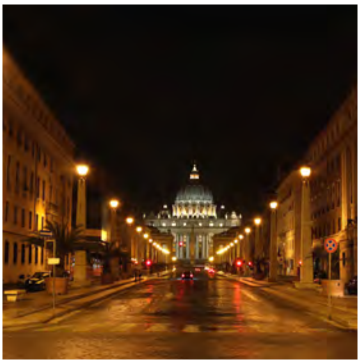
FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

GLOBALISATION

NEW INVESTMENTS & INVESTMENT STRATEGIES

GLOBAL FINANCIAL CRISIS

SOVEREIGN RISK AND DEBT



CHANGE

WE BELIEVE THAT ALL ROADS LEAD TO INCOME!

At the end of the day, regardless of gender, age, relative financial security, employment or retirement, we all seek the same thing as the product of our investment strategy: income.

Put more simply the reason we invest is so that we can have sufficient income to live and hopefully live well at the time when we choose, or someone else chooses that we no longer will receive income from employment.

Balmain Funds over the period ahead will make available a series of “thought pieces” designed to provoke new thinking on why we invest the way we do, challenge investment orthodoxy, such as “modern portfolio theory”, posit and in some cases guess at future risks and opportunities. The overall aim however is to help you create a better future for you and the ones you love.

We have identified five themes that we believe will impact your ability to achieve the income you want. These are:

1. The Global Financial Crisis
2. Sovereign Risk(s)
3. Change
4. Globalisation, and
5. New Investments and investment strategies

We will over time populate these themes with “thought pieces” that are designed to inform you, challenge and provoke your investment thinking and from that hopefully assist you in making better investment decisions.

ABOUT BALMAIN

Using our staff of 140 located in 8 offices in Australia and New Zealand we arrange and deliver financing solutions to Australian and New Zealand commercial property developers and investors. Balmain originates between $2b and $4b p.a in transactions ranging from senior debt to mezzanine and preferred equity.

Over the years Balmain has arranged commercial loans to over 140 lenders, banks, institutions, managed investment schemes and high net worth individuals / family offices. It currently manages over $8b of ongoing loan relationships with over 100 of these organisations.

Balmain is Australia’s 5th largest commercial mortgage fund manager, who on behalf of over 8000 Australian investors, we manage over $800m in commercial mortgage loans.

Balmain in its own name and via AMAL (in which Balmain has a substantial shareholding) provides special servicing skills to loan portfolio owners covering both residential and commercial loans.

RESIDENTIAL REAL ESTATE IN AUSTRALIA
- THE CASE FOR CONTINUED APPRECIATION

Nothing ignites more economic passion than a debate about the future direction of house prices in Australia. This passion fills internet chat rooms, results in high-profile bets between economists, and employs a host of talking heads and TV shows.

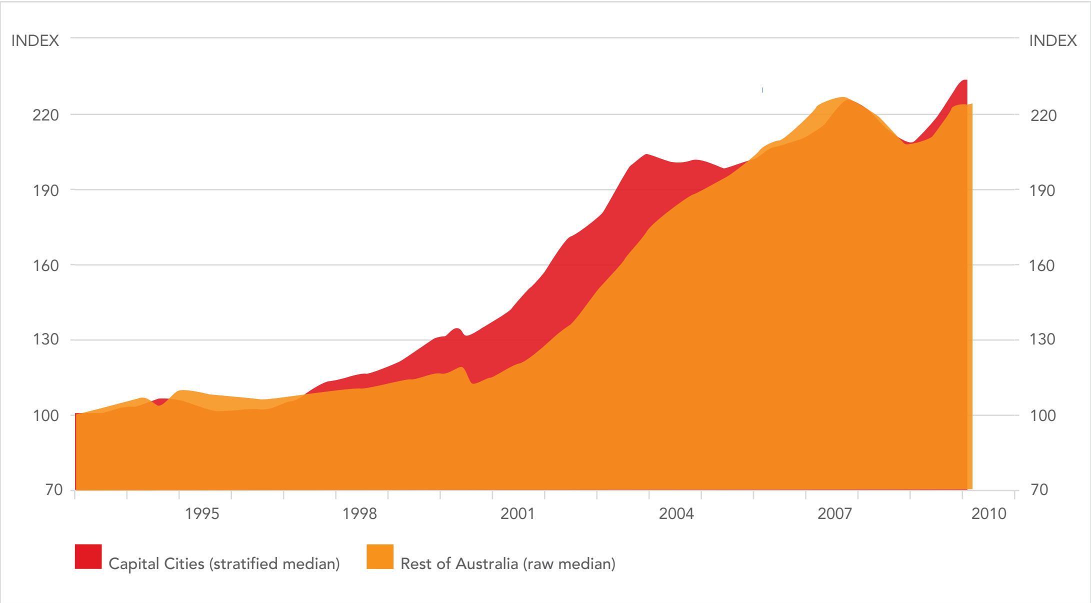
Everyone has a 'position' in property. Two-thirds of households own (outright or mortgaged) their own home - their biggest, and tax-free investment. One third are renters, some who intend to buy eventually, others who cannot afford or choose not to buy.

This paper is in two parts. In Part we explore the case for residential investment. In Part 2 we explore the case against. But firstly, let's look at how Australia's housing market has performed in recent years.

The chart below (presented by the RBA in a speech on 18 May 2010[1]) shows capital city and 'rest of Australia' dwelling prices (houses and units) indexed to 100 and adjusted for inflation. Interestingly, despite a public perception that capital city prices have streaked ahead of the rest of the country, the chart shows otherwise[2].

FIGURE 1: REAL DWELLING PRICES* 1993 =100

Sources: ABS; APM; RBA



1 http://www.rba.gov.au/speeches/2010/sp-so-180510.html

2 Although it pays to be wary of averages. 'Rest of Australia' includes both country and coastal regional cities and towns, for which house prices may have moved at a different pace. Also, individual capital city prices have moved at different speeds (eg Melbourne vs Sydney), which has been masked by averages.

Part One. The case for residential property investment

What drives property prices? Simply, it is demand & supply; the cost of funds vs rental yields/capital appreciation; taxation impacts...and the expectations for all of these factors.

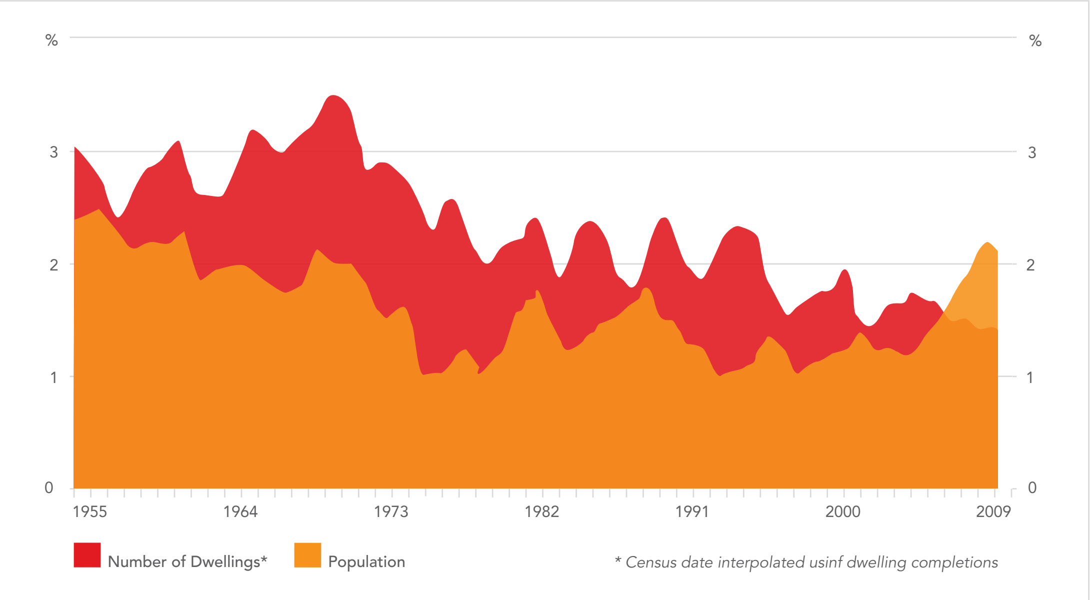
Demand on the rise

Demand comes from population growth, demographics, household formation trends, expat/foreign investor demand, and stability of employment. All of these are currently increasing demand. Consider these factors:

6. Net immigration has been and is likely to continue being robust (approx 6.2 migrants per 1000 Australians per year), adding to household formation. In recent years, immigration policy has favoured skilled workers, professionals and business migrants, meaning migrants today already have the money (or capacity to borrow) to buy. (see table below for population growth)
7. A stubbornly high divorce rate (averaging approximately 50,000 divorces granted per year since the mid 1990s - around 2.5 per 1000 Australians) is also increasing household formation, a factor more significant than it was in the 70s and 80s.
8. Foreign investors and Australian expats (mostly in Asia, London and New York) think local prices are still cheap (particularly relative to the major cities in Asia) and a view that the Australian dollar will rise in the long term, meaning their investment now will benefit from a stronger A$ in future. (which explains why they are buying)[3]
9. Unemployment is near a record low, employees feel secure, and strong economic growth suggests wages and salaries will rise at above trend rates.
10. Pent-up demand has been building since 2003 when at the last peak of high property prices/low housing affordability led to Generation X and Y staying longer with their parents, renting or sharing accommodation.

FIGURE 2: DWELLING AND POPULATION GROWTH year ended

Sources: ABS; APM; RBA



3 Diversification of their assets into 'safe-haven' Australia could also be a factor

Supply continues to suffer

1. It has been frequently reported in the press that there is already a shortfall of 170,000 to 200,000 homes in Australia. As Figure 2 shows, growth in the number of dwellings has been falling while population has been rising. Note that from 1955 until recently, growth in the number of dwellings built has always exceeded growth in population. But since the latter part of the 2000s, population growth has risen well above dwelling growth, which would explain the current shortfall of homes.
2. Baby boomers (representing a large chunk of home owners) are staying put instead of selling for a smaller apartment[4]. After agent's commission and stamp duty, it's too expensive for them to downsize. This means the supply of 'family' homes expected from baby boomers selling is likely to be delayed until they are require institutional aged care (the oldest are now only in their mid 60s).
3. Many small builders were burnt in the aftermath of the 2004 property price downturn (particularly in Sydney) and exited the industry. Those small builders remaining see dealing with local Councils as fraught with uncertainty given the power of council (and organised ratepayers) to delay projects or demand expensive alterations – which can tip 'border-line' development projects into the 'unviable' category.
4. This leaves the big builders/developers who are subject to lending constraints (banks are lending warily), shortages in skilled tradespeople (lured away by the mining boom), and the limited supply of sites suitable for large-scale projects.
5. The two to three year lead-time in taking large housing projects to completion means the GFC-induced downturn in 2008 and 2009 will result in relatively less supply of completed dwellings in 2010 and 2011.
6. State-government uncertainty with land releases, zoning, building regulations, and infrastructure development (transport links etc) results in builders having difficulty in long-term planning, adding to supply constraints. Council levies on developers increase costs and can make the final house price potentially 'unaffordable' for the buyer – so development projects are either cancelled or postponed until the developer believes there is enough profit margin to compensate for the risk.

The result – a demand/supply imbalance and a continuing shortage in housing as reflected in tight rental vacancy rates and rising rents in recent years, particularly in NSW.

Funding costs vs rental yields - after tax

Gross rental yields are 5.1% (units in Sydney. RP Data-Rismark) and after costs of approximately 1.5% results in a net rental return of 3.6%.

With the cost of borrowing around 6.5%, this results in a minus 2.9% return. For an investor, this equates to an after-tax return of around minus 2%, due to negative gearing benefits. This can be seen as acceptable if capital appreciation of around 10.2% -13.7% (in the year to July 2010 in Sydney and Melbourne) is repeated in future years.

For a renter, mortgage repayments would roughly be similar to rent payments. The argument to buy improves when one adds the benefits of home stability (compared to rental uncertainty in the current tight rental market). In addition, a stable jobs outlook gives comfort to most potential buyers regarding their ability to service a mortgage.

Home owners also benefit from the property's capital gains being tax free, making it an attractive after-tax 'investment.' In addition, recent stock market uncertainty and volatility has made equities a less attractive alternative to property.

4 http://smh.domain.com.au/real-estate-news/the-great-housing-dilemma-20100830-13y5n.html

How high could it go?

Gross rental yields in Australia's fastest rising market, Melbourne, have fallen to 3.5% for houses and 4.1% for units, according to RP Data-Rismark. Which means other cities could see yields falling to similar levels under 'boom' conditions. For example, Sydney yields are 4.1% and 5.1% respectively. For Sydney to 'boom' as much as Melbourne has, then Sydney property prices would rise by 17%-24% to reach similar yields. And prices rose by these levels in Sydney in mid 2002, and in Melbourne in early 2002, early 2008 and late 2009.

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Regional development

40% of dwellings are outside capital cities. And land supply in regional centres is less constrained than the cities. With regional development now a government priority due to pressure from the independents, a tree-change movement could grow significantly, particularly if regional jobs and infrastructure can be created by new government initiatives. This should ease both demand and supply issues in capital city housing.

High transaction costs, better investment alternatives

Stamp duty and agents commission can add around 4% in property transaction costs. In a low interest rate environment where returns are in single digits, these costs loom large. In addition, online advances in stock trading have driven equity market transaction costs to 0.3% or less for most investors, making property investment an expensive exercise.

Negative influence of US property markets

The deep malaise in US property prices that is receiving widespread media coverage could dampen sentiment in Australia. And media reports do influence investors. An Australian Securities Exchange survey of stock investors found that newspapers were the biggest source of advice and information about the market.

http://www.asx.com.au/about/pdf/2008_australian_share_ownership_study.pdf (page 24)

So, what has been reported by the press in recent times...?

Gerard Minack, chief economist, Morgan Stanley, Australia. Dow Jones Business News 17 August 2010.

"Australian house prices are expensive on every value metric. They are expensive relative to history, and expensive relative to houses in comparable countries. The real return on residential property over the next decade is likely to be negative, in my view... The more imminent risks include bank tightening credit and/or "Australia's army of loss-making middle-class landlords starting to sell.'

Paul Braddick ANZ head of property research, Smart Company 19 August 2010

"Given the shortage of supply, we think this is going to a problem. Unless something is done about that, we think affordability is going to be one of the biggest social and political issues over the next decade. Our forecasts predict very soft growth over the next 18 months, just close over zero. Largely because we think the Reserve Bank has been hawkish and aggressive...If we see some more price rises over the next 18 months, and that causes the RBA to lift rates maybe 150 basis points further, then minor price falls are quite possible. But the problem is the supply, which is pushing those prices upwards, and that's the long-term issue."

Jeremy Grantham, chief strategists and co-founder of US fund manager GMO.
Smart Company 16 June 2010

House prices are typically 3.5 times family income but at 7.5 times family income, Australia is having a house price 'bubble.'

And others

But RBA deputy governor Ric Battellino responds, "The ratio of house prices to income that are published for Australia tend to focus mainly on prices in the cities, and they are quite elevated. But, if you look across the whole country, the ratio of house prices to income is not that different from most other countries." The house price index produced by RP Data and Rismark suggests when house prices across the country are compared with household incomes, the ratio is actually 4.4 times. (Smart Company 16 June 2010)

*CommSec's chief economist Craig James expects the market to "consolidate" over the next few months, but will still manage to record price growth of 5-8% over 2010. (Smart company 1 June 2010)

*Rismark's Chris Joye expects house prices to track income growth, which is likely to be below 5% in this year. (Smart company 1 June 2010)

*Australian Property Monitors' economist Matthew Bell and SQM Research's founder Louis Christopher both believe the market will see price growth of about 7-10% this year. (Smart company 5 August 2010)

Conclusion and Action

'For and against' arguments have been put forward in this paper. But as mentioned at the start of this paper, property ignites passion...and passion is driven more by sentiment than by cold hard analysis. Unfortunately, sentiment is a fickle thing. For the investor, the key to predicting property prices is to follow this sentiment but to frame it with both of the for and against arguments outlined in this paper.

As an aside, let's look at the inflation outlook (which will drive RBA's decision on interest rates). The table below is the quarterly CPI. Note that as the latest quarterly number is released, one can (simplistically) add it to the previous three quarters to get the annual CPI, which is the number commonly cited as the inflation figure.

Thus, note that Q3, 2009 number (a relatively high 1.0) will be deleted when the Q3 2010 number is released. Should Q3 2010 be say 0.6, then 'suddenly,' the annual CPI will drop from 3.1% to 2.7%.

	CPI quarter on quarter	CPI year on year (annual)
Q2 2009	0.5	1.5
Q3 2009	1.0	1.3
Q4 2009	0.5	2.1
Q1 2010	0.9	2.9
Q2 2010	0.6	3.1

RESIDENTIAL REAL ESTATE IN AUSTRALIA
- THE CASE AGAINST CONTINUED APPRECIATION

Uncertainty spells risk and risk impacts on expectations. With residential property yielding negative returns, expectations of capital gains is the key to future price increases.

According to the RBA, 10.3% of households have at least one investment property and another 6.5% have a property (excluding their primary residence) that does not attract a rental income (mostly meaning a holiday house or a property rented free to relatives). These investors will likely be sellers if they lose their expectations of long term price appreciation.

What will drive these expectations? Consider this;

What if interest rates rise further?

The mortgage rate is half of the yield equation. The RBA is focussed on fighting inflation. House prices accounts for a 19.5% weighting of the CPI calculation according to RPData/ABS.

With the inflation rate already at the high end of the RBA's preferred band of 2%-3%, and with the resources boom expected to lift wages, these conditions will favour a tightening bias. (However, after six interest rises since October 2009 (taking the cash rate to 4.5%) many commentators expect the RBA will likely to adopt a wait and see attitude in the immediate future.)

Immigration rates and tax changes

With the stroke of a pen, immigration rates and tax policies can change. And with a minority government needing the support of a Green and three independents, the risks of change are greater now than in previous years. The introduction of death duties, capital gains tax on homes, higher stamp duties, and negative gearing cuts can quickly reduce the attractiveness of property. In addition, there has been growing pressure to cut immigration rates and this is likely to intensify with the Greens vote, which will slow-down household demand.

Affordability

Housing is already expensive in Australia when measured by the ratio of median house prices to median income. (see comments below by Jeremy Grantham of GMO). This dampens expectations of significant price increases as buyers 'cannot afford it any longer,' thus reducing demand. Global surveys that ranks Australian house prices as amongst the most expensive in the world also dampens expectations. We expect housing affordability to become a major political and economic issues in the period ahead.

Household formation drops as affordability worsens

As Europe has discovered, adult children are staying in their parents' houses for much longer. And in many other countries, having three generations (grandparents, parents, kids) in one household is the norm, driven partly by housing and childcare costs. Given affordability, major metro land availability issues and of course the lack of transport infrastructure spending across Australia in recent years, Australia may trend towards this development, leading to lower rates of household formation.

But there will be an unexpected socio-economic bonus. As three-generation households becomes more common, the public cost of aged care will drop (or not rise as much) as kids and grandkids become care-givers in return for staying in their parent's home 'all these years,' -- a situation already common in many other countries, particularly in Asia.

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