Why gearing of residential rental property is a dead investment strategy

By Graham Middleton, BA, MBA

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The net rental yield from residential property after all the landlord expenses are taken into account, being for rent collection/management of property, municipal and water authority rates, insurance and maintenance plus body corporate charges in units, is abysmally low. The investment then depends upon the gearing of capital growth to be successful.

Why gearing is less effective

Gearing worked well in the early 1980s, when there was no capital gains tax, annual inflation of about 10% per annum and a high marginal tax and Medicare rate of 61%. It does not work well when we have an inflation rate of below 2%, a lower highest marginal tax rate of 46.5% (much lower for income levels below that) and a capital gains tax. Gearing only works well in good yielding commercial purchases with assured long-term tenancy, such as dental or veterinary practice premises where the embedded plumbing, wiring and specialised fit-out make it ultra expensive to move premises.

There are now a multitude of unhappy residential rental property owners, many of them angry because they have been hard-sold by property developers, real estate agents and bankers urging them to borrow.

Net rental yields are poor

Recently there have been a multitude of reports highlighting the depressed property market in most of Australia. Melbourne is particularly depressed, but it is by no means on its own. Property values in areas as far apart as the Gold Coast, Tasmania and Adelaide have also suffered. Apart from a few hot spots fuelled directly by the mining industry, the outlook for residential property is grim.

Recent Melbourne reports of tens of thousands of unsaleable properties in new suburbs on the fringe of the metropolitan area have identified that many of those who bought into those suburbs hoping to accelerate home loan repayments and get real equity in their property have found that, because of plunging property values, they have negative equity. Their ability to trade out of that property into a property in a better location has been put back by years.

Reports on the weekend of 29 July indicate that Melbourne has 250 high-rise projects involving 21,050 units in total in building progress. It's normal for developers to sell 70% or 80% off the plan as a condition of meeting bank financing requirements. However, the developers already have major commitments in land purchase, building design and planning approval processes and a need to keep their overall operation turning over. Recently there has been desperation amongst sellers, with holidays at Palm Cove and other inducements on offer to buyers. Those who bought earlier and now want to sell their units have to compete with new apartments being offered with heavy marketing inducements. The only way they can sell is to take a heavy loss.

Rental guarantees always a sign of over-valued property

In a telling sign that the market is falling apart, developers are offering rental guarantees to purchasers. Rental guarantees always mean that the property is over-valued. When the rent guarantee period lapses, the true rental value, which is much lower, is then revealed. Lower rental equates to lower property values.

High-rise investment usually fails

Investment in high-rise apartments has often resulted in long-term losses. In the long-term, these boxes in the sky lose their lustre as buildings age. Many have the potential to turn into vertical slums, whilst newer and apparently better buildings have sprung up around them. Melbourne's Southbank and Docklands, the Gold Coast, Sunshine Coast and parts of Sydney have concentrations of units which are not on-saleable at their purchase price. Reportedly the June sales of new homes and new apartments in Victoria were 9.6% lower than for the previous month. Australia's two-speed economy is hurting badly in spots. There are a lot of rental vacancies and a lot of financially stressed landlords.

At low rates of inflation, the gradual deterioration of buildings is likely to exceed CPI and hence the values of apartments are likely to decline long-term.

A dangerous strategy

Gearing rental property in superannuation funds is a dangerous strategy. There is continuing pressure from bank loan salesmen and real estate salesmen to gear rental property via a specially designed trust (described in some literature as a warrant), offered by some of our banks, to gear property via a superannuation fund. This strategy is costly and dangerous. Not only is it costly to set this arrangement up, typically $10,000 or more, but it is very difficult and expensive to unwind. It will add hugely to a superannuation fund's accounting and audit complexity every year it is in existence and these are long-term investments. Real estate salesmen and loan hustlers who suggested this strategy have not quantified the long-term cost, nor do they care. Their objective is to sell real estate and sell loan finance.

It's also silly to gear property at a low tax rate inside a superannuation fund, which may have a tax rate of 15% during the asset accumulation stage or zero percent in the pension-paying stage. The truth is that gearing only ever worked at high marginal tax rates and therefore makes no sense inside a superannuation fund.

What is different?

Present day investors whose forebears made money out of property attempted to make the same decisions which worked for their parents and grandparents, or Great Uncle Teddy. It's important to realise that Australia's economic history produced particular circumstances which made property more attractive at certain times.

The post-war boom

Preceding the post-war boom was the period of the 1930s Great Depression followed by the six years of World War II, ending in 1945. During this fifteen-year period, few new homes were built in Australia. In 1945, not only were approximately 600,000 Australian servicemen demobilised, many of them marrying and seeking to set up homes for the first time, but we also had a huge immigration intake of displaced persons from Europe. Those early post-war displaced persons were housed in WWII army training camps, many for quite a few years, whilst they got jobs and saved towards purchasing a home. The pent-up demand created by the returning servicemen and the high immigration intakes created a huge shortage of housing in Australia. The shortage was so acute that new estates were opened up without proper services. Early post-war home builders were often owner-builders building a house on a block of land facing an unsurfaced road without kerbing and guttering and building on a block which had neither sewerage nor gas connected, with amenities limited to water and electricity on a street pole. The authorities, faced with a massive housing need, allowed this rudimentary planning process. Families moved into unfinished houses on underserviced blocks because that was better than living in a WWII army hut or on the back veranda at mum and dad's. In the years to come, services gradually caught up. Roads were surfaced, kerbing, guttering and drainage was added, sewerage lines replaced the night cart and/or septic tanks and natural gas pipelines were connected. All of these capital improvements added significantly to the value of property and the pent-up demand lasted into the 1970s.

Those conditions are quite different to today and explain why early post WWII landlords did much better out of property than today's owners. Additionally, landlords of that period had no capital gains tax to contend with.

The 1970s inflation spiral

During the period of the Whitlam government from 1972-1975, Australia's inflation threatened to get out of control, spiking at about 17%. For the rest of the 1970s and into the early 1980s, inflation of about 10% per annum was common and dentists put their fees up by about that amount every year. There was no capital gains tax until 20 September 1985, so investors who bought property had the good probability of it going up at 10% per year and of writing off the gearing losses at a high marginal tax rate of 61 cents per dollar. When they sold the property there was no capital gains tax. Those conditions favoured gearing of property investments when compared to today's conditions.

Today's conditions

We no longer have the pent-up demand for property which existed in the immediate post-war years, nor do we have high inflation of 10%, with recent inflation figures being 1.2% per annum and the highest marginal tax rate is 46.5 cents per dollar on taxable income above $180,000 with lower rates applying to lesser thresholds. To top it all off, there is capital gains tax. Despite occasional press commentary to the contrary, the Howard government actually increased capital gains tax for most property owners simply because the cessation of indexation of the capital base and the cessation of averaging meant that for a proportion of property owners, the halving of the amount subject to capital gains tax was actually more than it had been previously. The numbers vary for a variety of different scenarios.

The lesson

Negative gearing of residential rental property, whether high-rise units or houses, is a poor investment strategy because of low inflation, lower marginal tax rates and reduced demand. Additionally, landlord ownership costs are quite high in this form of property.

The other relevant factor is that we have an incentive to look after the homes we live in to a much greater extent than do tenants in a rental property.

Residential rental property is rarely going to be as successful as either ownership of dental premises or of one's own home.

Deceptive accounting advice

Recently we heard of an accounting practice which was hard-selling its clients on the idea that they should purchase rental units into their superannuation funds using a sub-trust gearing product offered by certain banks. It is likely that the accounting practice concerned (or its financial services arm) will receive fees from the property developer as well as loan procurement fees for setting up the loans. The resultant complexity of the superannuation funds of two or three of these trusts embedded will lead to significantly increased accounting and annual audit fees. These structures will endure long-term and be very costly. They will probably lead to significant long-term losses in the superannuation funds of the firm's clients. The strategy is expensive and difficult to reverse. It also demonstrates conclusively that the accountants concerned either haven't done their numbers correctly or, alternatively, they have placed their own interests in advance of their clients. Either way, their advice to their clients is wrong.

Dodgy real estate statistics and tricks

Real estate agents love to cite median price statistics, which always overstate true market outcomes because capital inputs in the form of the new bathrooms or kitchens we put into our homes are treated as capital appreciation by the statisticians when we sell. The statisticians who get their raw data from state stamp duties offices have no way of telling what capital expenditure went into the properties that are being on-sold and only measure purchase and sale prices of titles.

The other misleading factor is that agents selling properties and property spruikers consistently project capital appreciation far above the rate of inflation. These numbers are simply untrue. They also quote gross rental yields rather than net rental yields after landlord ownership costs, which somehow always seem to be understated in those sorts of presentations.

A common trick of property spruikers is to present a series of numbers based on property appreciation at, say, 6% per annum even though the CPI which indirectly is a reflection of wages growth is now below 2% per annum. Property cannot appreciate at a long-term compound rate several times larger than the CPI unless it has had expensive capital improvements added during this period.

Another trick is to present a case study of a group of inner city terraces which have had a dramatic lift in price from around the 1970s to now. The statistics don't tell you that many of these properties have been gutted and rebuilt from the inside out whilst maintaining their period-style facades. They also don't disclose the compound impact of the very high inflation of the 1970s and much of the 1980s.

Most telling

The real evidence of the state of residential real estate investment is that many thousands of employees have been displaced from the real estate industry.

Personal disclosure

The author of this article owns no residential rental properties.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 25 years, the last 18 as a partner and director of Synstrat Management Pty Ltd and Synstrat Accounting Pty Ltd. He was once a regular army officer and later Director Human Resources Manager, Attorney General's Department of Victoria. He is considered an expert on dental practice valuation and practice performance benchmarking and has spent many years advising dentists in respect of their business and financial strategy and measuring their practice and financial performance. He is the author of the Synstrat Guide to Practice Management, 50 Rules of Success as a Dentist and Buying & Selling General & Specialist Dental Practices. He is also a long-term contributor to Australasian Dental Practice. The Synstrat Group is an independent data-based organisation providing management, benchmarking, valuation, financial and accounting services to the dental profession. Synstrat Management Pty Ltd is a Licensed Dealer owned by its directors who work within the Synstrat Group. For more information, call (03) 9843-7777 see www.synstrat.com.au or email dental@synstrat.com.au