

NZ Residential Rental Market

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Market Intervention ?

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DATA SOURCE This index has been developed from private sector rental data supplied by the Department of Building and Housing (Bond Centre). Information on wage rates, demographics and the structure of the rental housing stock is drawn from Statistics NZ data. House price information has been extracted from Real Estate Institute and Quotable Value NZ statistics.

Rent Controls

The Christchurch earthquakes resulted in damage to a large number of residential rental and owner occupier homes. Some of these houses are in the process of being demolished, others have repairable damage and a few are being moved to new sections less prone to seismic damage. The shortage of rental accommodation resulting from the earthquakes and delays to the rebuilding program have put upward pressure on rents. Inevitably higher rents have resulted in affordability issues for a number of renting households and calls in some quarters (including the Mayor and some central government politicians) for rent controls to be introduced.

This author believes that rent controls are a bad idea. The experience both in New Zealand and overseas shows rent controls generally create more problems in the medium and long-term than they appear to solve in the short term. The most recent New Zealand experience of residential rental controls was under the Muldoon administration. In this case the existing landlords tended to defer maintenance on their rental properties and the poor returns from escalating costs resulted in a number of rental properties being sold to owner occupiers and taken out of the rental market. From a tenants perspective the queue waiting for rental houses lengthened. In addition, rent controls can result in a misallocation problem with a single tenant living a large house and being unwilling to move. We already see this problem emerging with elderly single tenanted million dollar state rental houses in Auckland where the rent is set on an income related basis.

Another major issue with rent controls is that once imposed it is often very hard to remove them. Clearly rent controls are a political issue. In cities with a large number of renters politicians promoting rents controls and tenant welfare get elected! In the United Kingdom rent controls were introduced as a result of accommodation shortages during World War 1. A two tier market emerged. The top tier were properties that could be freely sold on the open market and the second tier properties with controlled rents. Property selling with controlled rents sold at a considerable discount. The United States, which is often thought of as a bastion of free enterprise, has a surprising number of residential rent controlled properties in cities such as New York and San Francisco. In the case of New York rent controls were established during World War 2 as a result of a housing shortage. Having rent controlled apartment buildings has resulted in an illegal second tier market emerging. Some tenants sublet their apartments at the market rent and only pay the landlord the rent controlled amount. Of course restricting

supply in one section of the market typically results in higher rents in the uncontrolled rental sector.

Lending Ratios and Rents

Having argued for a non intervention approach to residential rent setting the author is attracted to the idea of controls being put in place, by regulation or legislation, to set the minimum deposit for borrowers of home mortgages. Recent history shows that without sensible guidelines in place both lending institutions and borrowers have a tendency to indulge in risky behaviour. On one hand bank staff are incentivised to maximise their incomes, often based on lending volumes. On the other hand borrowers may believe even if they can't service the mortgage house prices always go up and they can sell at a profit. The consequences of this risky lending behaviour in some international housing markets during the 2001-2007 period resulted in a global financial crisis, the effects of which are still being felt. Sadly, history shows without regulation past lessons about the dangers of risky lending are quickly forgotten.

So how would the minimum deposit be set? Perhaps history is of some guide as under the old Trustee Act the rule of thumb was the minimum deposit should be one third of the purchase price. Apparently the idea behind this ratio was house price were unlikely to ever decline by more than a third and therefore the trustee funds would be protected. The legislators framing this legislation were probably influenced by experience from the depression of the 1930s. Of course it can be argued that debt servicing ability is the key parameter involving lending decisions and 100 percent loans will not be a problem provided the borrower can repay the loan. However individual circumstances do change over time as people lose their jobs, have matrimonial difficulties, may suffer sickness and take time out from the workforce to raise their children. In addition, the current very low mortgage interest rates are clearly not sustainable for the seven year duration of most home mortgages.

Another idea put forward by some economists and property academics is to apply an investment approach to home lending using a similar methodology to commercial building valuations. This process would involve capitalising the rent to find out the investment value (as opposed to market value) of the property. Lending decisions would be based on the investment value of the house. In the current market the investment value of most New Zealand houses are below their market value so the margin between the two would provide additional security for the lender. The added benefit creating an attractive investment opportunity if the lender was forced to sell and realise their security.

Valuation Process

From an economic viewpoint the value of a house can be defined as the discounted value of the future cash flows. Applying the suggested valuation methodology would require the independent valuer working for the lender to first establish the market value of a house using the standard comparable sales method. Let's say the market value of the house is \$380,000. The valuer would then capitalise the net cash flows. In this example the estimated gross rent for the subject house is \$400 per week and after allowing for vacancies and expenses the annual cash flow from the property is estimated at \$16,000, excluding debt servicing. After analysing similar properties the valuer calculates the relationship between net income and sale prices from the comparable properties and settles on a capitalisation rate of 5 percent. The capitalisation rate also reflects the risk inherent in the investment. Thus the investment value of the house is \$320,000 ($\$16,000/0.05$). So in this example the minimum deposit would be 15.7% ($60,000/380,000$) of the purchase price with the caveat that the particular borrower could service the debt.

In practice capitalisation is not a one size fits all process as capitalisation rates vary according to the type, age and location of properties. For example the capitalisation rates for flats and apartments are typically higher than single family houses. Similarly more expensive houses often have lower capitalisation rates than less expensive houses. Housing markets showing good growth potential have lower capitalisation rates than markets with static or declining populations and less prospect of

Rental Levels

The national level of rent remained at \$320 per week in May 2012. Over the last 12 months the national level of median rent increased by just 3.2%. A snapshot of rents itemised by the main urban local authorities is shown in the table in the right hand column. The strongest rental increases in rents over the months (May 2011 to May 2012) were in Rotorua (13.0%), Kapiti (10.0%), Christchurch (10.0%), Dunedin (8%) and Auckland (6.3%).

The very low rate of new housing construction over the last few years combined with affordability issues around home ownership seem likely to maintain pressure on the demand side of the residential rent setting equation over the next 12 months. On the supply side of the equation rental housing investment continues to compete with other investment opportunities. Most landlords are currently faced with ever increasing running costs, adverse taxation legislation regarding depreciation and reduced capital appreciation. Consequently landlords are more likely to frequently review their rents to current market levels. Some "accidental" landlords may withdraw from the market.

capital gain. Registered valuers have the skill set to carry out both market and investment valuations.

Median Rents	May-11	Feb-12	May-12
Whangarei	280	290	280
North Shore	430	425	440
Waitakere	360	360	370
Auckland	395	400	420
Manukau	380	390	380
Papakura	350	350	350
Hamilton	300	310	300
Tauranga	325	320	335
Rotorua	230	250	260
Gisborne	250	262	255
Hastings	275	290	275
Napier	300	295	300
New Plymouth	280	300	290
Wanganui	200	200	200
Palmerston North	270	260	270
Kapiti	300	320	330
Porirua	310	350	320
Upper Hutt	280	280	280
Lower Hutt	310	330	315
Wellington	390	410	400
Nelson	320	330	320
Christchurch	300	320	330
Dunedin	250	270	270
Invercargill	210	210	210
All NZ	310	320	320

Massey University Property Foundation

The Foundation is established to sponsor research and education in property related matters in New Zealand. Funding is obtained through sponsorship from corporations and firms within the property industry. The Foundation has established a Real Estate Analysis Unit to operate out of both Massey University's Palmerston North and Albany campuses.

Massey University Real Estate Analysis Unit

The primary objective of the Massey University Real Estate Analysis Unit (MUREAU) is to provide reliable property information to the property industry, the land related professions and the public.

The Director of MUREAU is Professor RV (Bob) Hargreaves. MUREAU also offers a consulting service for individual clients. MUREAU publications available on the internet are:

- 1 The Home Affordability Report (Quarterly)
- 2 NZ Residential Rental Market Report (Quarterly)

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