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Why holding costs underpinned by rising interest rates are the key challenge for property investors

By STUART WEMYSS

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7 Comments

If you are an experienced property investor, you will no doubt be acutely aware of the significant increase in holding costs over the past four years.

With the cash rate climbing from 0.10 per cent to 4.35 per cent alongside persistent inflation, it's been a perfect storm for investors.

While inflation might eventually ease, expenses such as insurance, council rates and maintenance are unlikely to ever revert to pre-2020 levels. These elevated costs are here to stay, inviting me to question their impact on the viability of property investing.

How have property holding costs changed since the start of 2020?

It's easy to gauge the increase in interest rates since most investors are charged similar rates. However, expenses like council rates, insurance, and land tax can differ greatly among properties and investors alike, making it more difficult to ascertain the average increase over the past few years.

Interest rates are up 58 per cent, but land tax is not far behind, rising about 56 per cent over the period. Council rates are up around 30 per cent but, usefully, rental income is up about 33 per cent.

Over the past couple of decades, all property holding costs, excluding mortgage interest, typically equated to 25 to 30 per cent of the gross annual rental income for most properties.

The exceptions to this rule of thumb are apartments with hefty owner's corporation fees, and properties with expensive amenities such as pools and lifts. However, over the past four years, expenses (excluding mortgage interest) have now increased between 30 per cent and 35 per cent of the gross annual rental income, on average.

According to RBA data, the average discounted investment interest rate over the past 20 years was 6.04 per cent per annum. Currently, most investors are paying variable interest rates ranging from 6.6 to 7 per cent per annum, which is up to 1 per cent per annum higher than the historical average.

Therefore, while some relief in interest rates may be anticipated in the coming months, long-term investors should plan for rates of about 6 to 7 per cent per annum.

In terms of rental income, I believe it's quite reasonable to expect an above-average increase in rental income for the next few years, due to the shortage of rental properties. If rental yields return to the long-term average since 2000, there's a real possibility that rental income could increase by an additional 20 to 25 per cent over the next few years.

However, it's important to note that rental growth will eventually stabilise, reverting to the long-term growth rate of 3.8 per cent per annum.

How much capital growth is needed to justify your investment?

I've calculated that a property investment would yield an after-tax investment return of 13.5 per cent per annum if the property is sold after 20 year based on these key assumptions:

● Starting gross rental yield of 2.7 per cent, which grows at 10 per cent per annum for the next 2 years and then stabilises at 3.8 per cent per annum thereafter;

● Long-term average capital growth rate of 7.0 per cent per annum;

● Borrowing the full cost of the property at an interest rate of 6.5 per cent per annum;

● All property expenses amount to 25 per cent of the gross rental income.

If we adjust the assumption that expenses now represent 35 per cent of gross rental income (up from 25 per cent), the property investment would need to appreciate by an additional 0.35 per cent per annum to maintain the overall investment return of 13.5 per cent per annum.

In a situation where property holding costs eventually escalate to 45 per cent of gross rental income in the future, the property would need to generate an additional 0.30 per cent per annum of growth (totalling a growth rate of 7.65 per cent per annum) to maintain the after-tax investment return at 13.5 per cent per annum.

This analysis highlights that investment property returns are not that sensitive to changes in property holding costs.

However, investment returns are a lot more sensitive to interest rates. At interest rates of 5.5 per cent the internal rate of return on your property will be 15.5 per cent. But move your assumed interest rate up to 8 per cent and the internal rate of return drops to 11.1 per cent.

Apart from ensuring that your bank offers you the best deal, investors have no control over long-term interest rates.

The key to successful property investment lies in investing in the right property – one with attributes that can drive substantial and perpetual capital growth over the next few decades. To achieve this, it's crucial to target a property possessing each of these attributes:

● A persistent imbalance between supply and demand;

● Evidence of past growth;

● Strong land value component;

- An undervalued geography.

Seeking advice from a reputable buyer's agent will significantly mitigate the costly mistake of investing in the wrong property.

Of course, it's also prudent to actively minimise property holding costs. This involves actions such as engaging an insurance broker, overseeing property maintenance requests, ensuring regular review of mortgage interest rates by your mortgage broker, and optimising taxation benefits.

That said, the bulk of your future investment returns will depend on your property's future capital growth.

If you anticipate that your property's future capital growth rate will fall below 5.5 per cent per annum, your overall return is likely to be below 9.6 per cent per annum. In such a scenario, you might find it more economical, simpler, and less risky to invest in a moderately geared diversified share fund. Higher holding costs can render average-quality investment properties less economically viable to retain.

Stuart Wemyss is host of the Investopoly podcast

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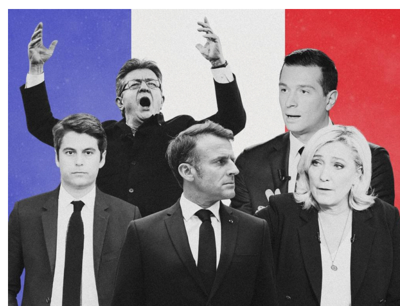

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