<u>Property Cycles & Bubbles</u>

With the rapid rise in value of Auckland property over the preceding years, a lot of comment had been made that this was a financial Bubble situation.

We take this liberty to explain just what an economic Bubble is.

Bubbles, what are they, what creates them and how do you protect yourself from them, particularly when it comes to property investing.

Google suggests an economic bubble (sometimes referred to as a *speculative bubble*) is trade in an asset at a price or price range that strongly deviates from the corresponding asset's intrinsic value (*intrinsic value* refers to the value of a company, shares, currency or product determined through fundamental analysis (what can the item earn you or save you i.e. no more rent to pay out) without reference to its market price. It is also frequently called fundamental value.

It is ordinarily calculated by summing the discounted future income generated by the asset to obtain the present value. It could also be described as a situation in which asset prices appear to be based on implausible or inconsistent views about the future.
Because it is often difficult to define intrinsic values in real-life markets, bubbles are often conclusively identified only in retrospect, when a sudden drop in prices appears and people get burned and the doom merchants gloat with "I told you so".

Let's consider a few examples of world renowned bubbles that had significant negative impact on those that had "invested"

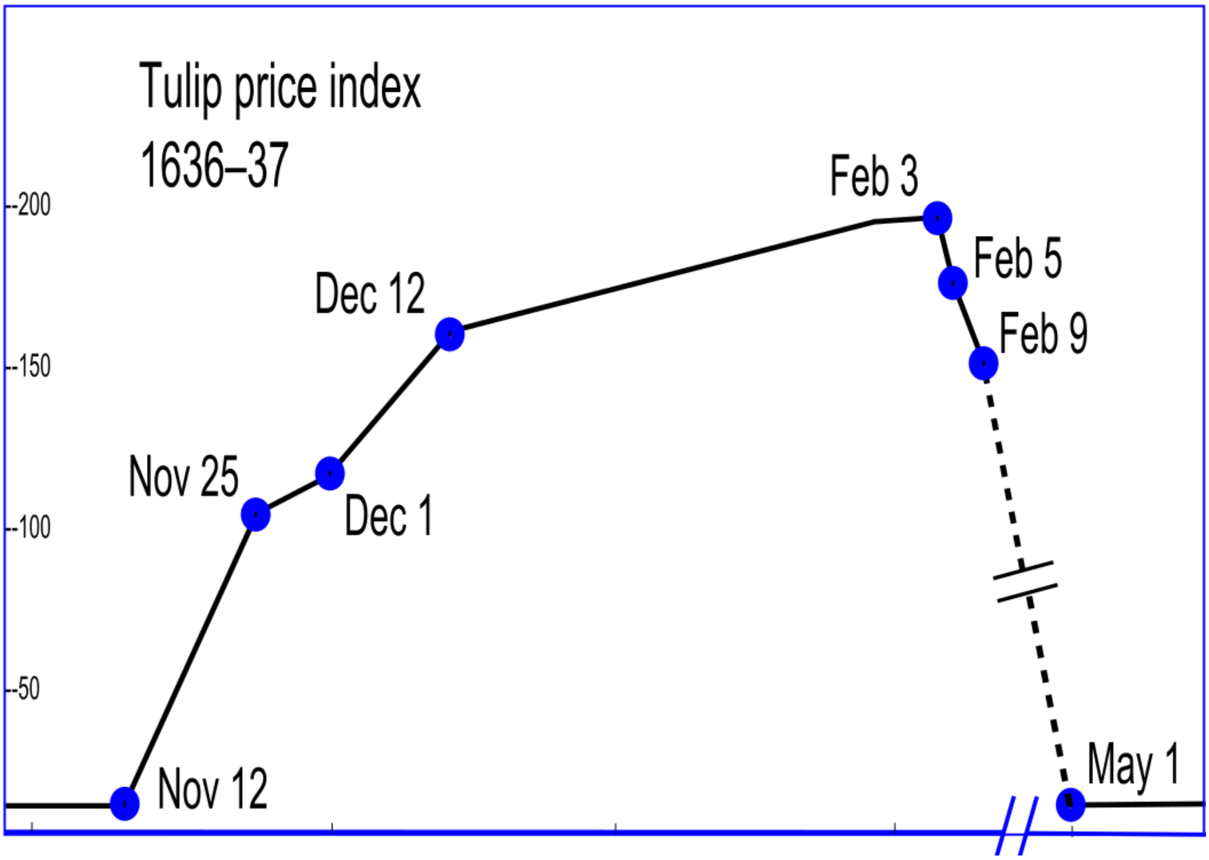
<u>*Tulip Mania of 1636-1637 The Netherlands*</u>

The Dutch have long had a history linked to the tulip, probably introduced from Turkey centuries ago. Turkey is widely quoted as the source of Tulips even though cultivation of the tulip is believed to have begun in Persia (modern day Iran), probably around the 10th century. 14 species can still be found in Turkey, but Holland is still famous for its fields of tulips.

This bubble is probably the earliest recorded and well known.

The Tulip was exotic, colourful and could with stand the harsh Dutch winter; initially the scarcity made it a status symbol to have in one's garden too.

The tulip mania phase



A standardized price index for tulip bulb contracts, created by Earl Thompson. Thompson had no price data between February 9 and May 1, thus the shape of the decline is unknown. The tulip market is known, however, to have collapsed abruptly in February. Thompson, Earl (2007), "The tulipmania: Fact or artifact?" (PDF), *Public Choice* **130** (1–2): 99–114, doi:10.1007/s11127-006-9074-4, retrieved 15 May 2008

The direct cause of this bubble is disputed but from the graph the price rose from the usual one Guilder to 200 guilders (and in some cases even higher) only to collapse in the space of 7 months.

The fuel to this was, everyone (figuratively) was talking about them, everyone wanted one, everyone saw the price rise and everyone thought the price would keep rising to enable them to sell to the next person, thus making it no risk and profitable to them.
"the growing popularity of tulips in the early 17th century caught the attention of the entire nation; "the population, even to its lowest dregs, embarked in the tulip trade" Scottish journalist Charles Mackay[†] in 1841

It would be fair to say the price rise had become unhinged from the intrinsic value of the bulbs

"South Sea Bubble"

The **South Sea Company** was a British joint-stock company founded in 1711 in , created as a public–private partnership (curious this notion is being promoted by New Zealand's current government) to consolidate and reduce the cost of national debt and it was granted exclusive rights to trade with South America

The shares were promoted to the public (also even as far away as Holland, see illustration) to purchase on the expectation of vast wealth from trade with its exclusive rights to South America, despite the limited likelihood this would ever happen.

The shares rose as greed, lack of due diligence and herd mentality took over.

"When Sir Isaac Newton was asked about the continuance of the rising of South Sea shares… He answered *'that he could not calculate the madness of people'*." He is also quoted as stating, "*I can calculate the movement of the stars, but not the madness of men"* *

*John O'Farrell, An Utterly Impartial History of Britain - Or 2000 Years of Upper Class Idiots In Charge (October 22, 2007) (2007, Doubleday, ISBN 978-0-385-61198-5)

As the company failed to deliver the share price fell and many “Investors” lost money with absolutely nothing to show for their failure to do due diligence.

The "night singer of shares" sold shares on the streets during the South Sea Bubble. Amsterdam, 1720.

The dot-com bubble

The **dot-com bubble** (also referred to as the **dot-com boom**, the **Internet bubble**, the **dot-com collapse**, and the **information technology bubble**) was the speculative bubble covering the period between 1997–2000 (with its peak on NASDAQ at 5,132.52 in intraday trading in March, 2000, during which share markets in the OECD saw their equity value rise rapidly from growth in the Internet sector and related fields.

The period was marked by the founding (and, in many cases, spectacular failure) of several new Internet-based companies commonly referred to as *dot-coms*. Companies could cause their share prices to increase by simply adding an "e-" prefix to their name or a ".com" to the end, which one commentator calling it "prefix investing."

A combination of rapidly increasing share prices, market belief and expectation that the companies would become profitable, individual speculation in shares, and widely available venture capital created an environment in which many investors were willing to overlook traditional prudent rules, such as P/E (price/earnings) ratios, in favor of basing confidence on technological advancements and greed.

The collapse of the bubble took place during 1999–2001. Some companies, such as pets.com, failed completely. Others lost a large portion of their market capitalisation but remained stable and profitable, e.g., Cisco, whose shares declined by 86%. Some later recovered and surpassed their dot-com-bubble peaks, e.g., Amazon.com, eBay.com, whose shares went from 107 to 7 dollars per share, but a decade later exceeded 400

Xero Bubble

Xero is a New Zealand started company as a provider of online accounting software for small businesses with its shares defying gravity and would satisfy our definition of a Bubble.

Xero was established on July 6, 2006, as Accounting 2.0 Limited with capital of $1.5 million. The company changed its name to Xero in November 2006, March 2007 saw another $1.3 million of additional capital raised.

Xero registered its IPO (Initial Public Offering, share float on the NZX (New Zealand Stock Exchange)) prospectus in May, 2007, to issue 15 million new shares at $1 each.

Thus the company had a market capitalisation of $55 million at the $1-a-share IPO price. The more prudent investors were concerned about Xero because the company had no operating revenue and a $15 million war chest was way too small to establish a global software-as-a-service company.

Xero (XRO) listed on the NZX on June 5, 2007 and its shares closed that day at $1.10. It reached a high of $1.14 four days later.

The stock hit its low of $0.68, in January 2008.

Xero's share market recovery began in early April 2009 with a capital raising of $23.2 million at 90c a share.

Its share price immediately shot up to $1.51 and then settled to the $1.20 to $1.40 range.

Xero's share price hit $10.70 in March 2013.

March 2014 saw Xero hit its all-time high of $40.50

At time of writing the share price is below $15

One could argue that this is a classic Bubble in that the share price well exceeded the fundamentals of the company's value in that its NTA (Net Tangible Assets) sit around $2.06 its EPS (Earnings Per Share) is negative .542 cents and it has no P/E (Price to Earnings) recorded on their NZX page, as it is yet to make a profit.

Yet the company has a capitalisation on the NZX of approx. $2.5 Billion

Please note we are not attacking Xero and acknowledge it is a company growing rapidly, with a potentially global reach, that may, in time, deliver its shareholders an excellent return.

What we are attempting to point out that this investment would clearly fall into a high risk or speculative category based on prudent fundamental criteria.

So what can we discern from these examples, just what foundations were underpinning these Bubbles, we believe they can all be categorised as speculative, based on the following

1. Net Tangible Assets do not support the price, usually hundreds if not thousands of percent above the NTA

2. It is not profitable and this event looks someway off

3. Purchase is a rolling of the dice in that you buy in hope

4. If it fails you are likely to lose everything

So to get back to our topic heading, the media loves to report that the RBNZ (Reserve Bank of New Zealand) is talking about a housing property bubble in New Zealand and in particular in Auckland. It is concerned if the Bubble bursts or corrects it could cause economic damage to the New Zealand economy.

The Auckland property, (shall we say) “boom”, is really only a supply and demand economic principle, when demand falls or supply increases things will stabilise. It is interesting to note, Kiwi property owners do not sell in a panic especially if doing so realises a loss for them. Our observations support that they take the property off the market and wait for the property price to rise again, which it has always done.

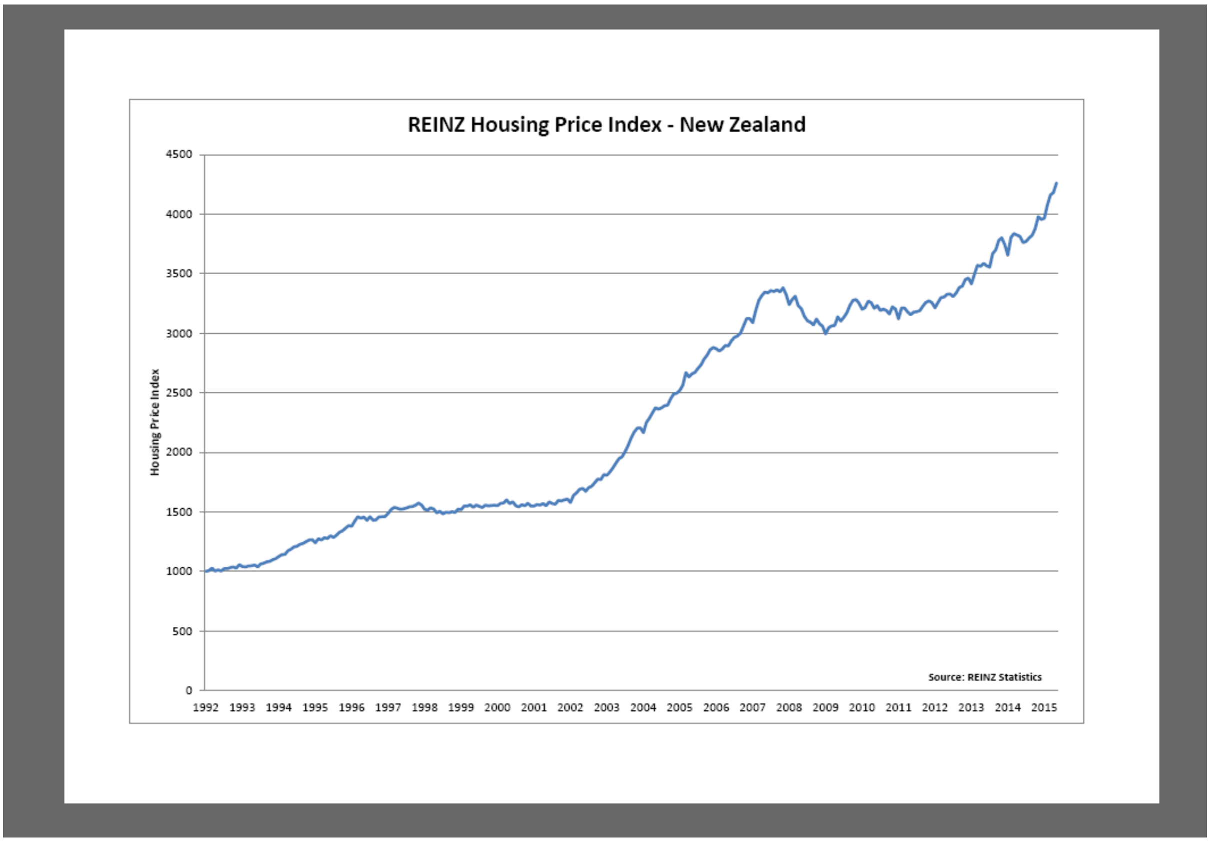
If the Lenders panic and force mortgagee sales then this could easily create a real fall in prices.

Property Cycle/Phase

It is well known and promoted that property values go through cycles or phases, although you will find different names and interpretations on the Internet, we think the ones used capture what is happening.

A **property cycle** can be simplistically seen as a recurring sequence of events reflecting demographic, economic and emotional factors that impact supply and demand of property subsequently influencing the property market dynamic.

The first recorded pioneer of studying property cycles was Homer Hoyt (1895–1984) in *100 Years of Real Estate Values in Chicago* (1933, reissued by Beard Books, 2000, ISBN 1-58798-016-9). It is widely recognised that property (along with other forms of investment) follows a predictable cycle. The property cycle has four recognised recurring phases of Growth, Decline, Plateau and Recovery. It is promoted and commentated on that the cycle follows a consistent pattern which can be accurately identified (as outlined below). We believe the only consistent pattern of property is that its trend line is always up. See the graph covering the last 23 years in property movement in New Zealand.



Property cycle phases

The property cycle must operate in a 'free market environment' where property ownership is attainable by everyone without, significant government restrictions, market manipulation or Reserve Bank intervention on this ownership.

The following is a collection of some of the elements evident in each of the property cycle phases. We could have started at any one of the property cycles phases as at any given time the phase will be in one of the following areas.

Growth

When the growth phase commences most people do not accept the growth will last and think it is just a short term anomaly, believing they will wait and buy when the price drops, because they spent time understanding the property cycle and its trend in New Zealand or talked to their neighbor!

What often occurs during the Growth phase include:

- Rents rise to levels which place significant financial pressure on tenants
- The time it takes for a property to sell reduces
- Property prices rise, often significantly and into double digit percentages
- Yields fall as prices rise more than the rent rise matches
- There are fewer mortgagee/forced sales
- People feel wealthier in view of increased equity in their property and can often increase luxury spending thus driving up activity in the economy

- There are many property promotors and seminars competing for investor dollars
- Property is a hot topic in the media and the community about how this Growth phase will never end or wondering how long it can last.

Decline

The decline phase typically commences a lengthy period of time before most people realise the property market is in the decline phase, as there is a delay between the shifting trends and the impacts that are evidenced in the property market. This is also impacted on the delay from sales settled to when they get reported publicly. Market reporting on sales and prices achieved is considered slow to get to the public.

The Decline can be one of the longest phases in the property cycle when following a longer and bigger growth phase.

What is observed during the Decline phase:

- Increased number of rental properties being advertised
- Rent reductions to achieve a tenant
- Reduced cash flow for investors
- Property price growth stagnates and/or property values fall
- The length of time to sell a property increases above the average
- Increased number of mortgagee/forced sales
- Lenders tighten their criteria and thus make finance more difficult to obtain

Plateau

From time to time the market will plateau, not always present and often occurs in an environment of uncertainty, usually to do with the economy either in New Zealand or internationally.

- Rent stay static or only increase gradually
- Demand can be subdued but sufficient to underpin current activity
- The length of time sit close to historic averages

Recovery

The recovery phase can be much shorter than the slump or boom phases.

What is observed during the Recovery phase includes:

- Increased rents and cash flows
- The length of time to sell a property reduces
- Property prices begin to increase but yet to attain earlier last high point
- Much discussion in the media about whether recent property value growth is reasonable, sustainable or reach previous highs
- Many potential property purchasers delay buying because they don’t do the sums and often remain spooked by previous value falls.

David Weusten brings with him over 37 years' experience in the finance industry, both in New Zealand and overseas. He has been published in the Sunday Star Times, the New Zealand Franchise Magazine and has published 3 books. He is a budget advisor with Kingdom Resources, a Business Mentor with Business in the Community and also a Pacific Island Business Mentor regularly travelling to Papua New Guinea from 2011 to 2014 when MFAT stopped the funding.

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