

This is an original article written by Philip Loh.

Are you a flipping flipper?

Why this financial planner thinks property prices are heading 40% lower

In the wake of the worsening global financial crisis, the resurgence of the property flippers has come to an abrupt halt. Instead, many who are stuck with a condo or two are now wondering what to do next.

A good example of such a flipper is David, a young executive who believed that the property boom that started three years ago would enable him to retire young. He had forked out \$300,000 in cash and another \$110,000 from his CPF to buy three condos two years ago. All three were going to be completed by the middle of next year. He had planned to rent the condos out for rental income to cover the mortgage and then sell them for one to two million in profit in 2012, when both integrated resorts would be up and running.

When I spoke to him five months ago, he had boldly predicted that the credit crunch will soon blow over and that the Singapore property market would continue its stratospheric rise as the completion of two integrated resorts draws nearer. He mocked those who had lost money in the stock market and said that investing in property was the way to go in land-scarce Singapore. He even said that the day he cashed in on his property investments would be the day he would retire.

David's back-of-the-envelope calculation:

Total purchase prices - \$2.8 million

Down-payment - \$560,000

\$450,000 in cash (\$300,000 from savings and \$150,000 from borrowings) and \$110,000 from CPF.

Bank loan - \$2,240,000 over 25 years (estimated monthly repayment of \$14,000)

From 2009 after TOP,

Rental income - \$18,000

Net monthly positive cash flow - \$4,000 per month

After 3 years in 2012,

Earn net rental income of \$150,000 (after mortgage servicing)

Sell off all 3 condos at an estimated \$1 to 2 million in profit and retire.

Unfortunately, this was the same calculation that most American flippers made during the peak of the US property boom in 2005. And look at what happened to them in the end.

Remember those days when retirement planning meant buying the biggest house you could afford, paying off the 30-year mortgage and selling the property for 10 times what you bought it for? That idea died down for a while after the Asian currency crisis, only to be revived during the 2005-07 property boom. Many Singaporeans are

still conditioned by their childhood experience such that they have a distorted view of property investment.

In fact, I have often been asked by clients for my opinion of the property market in the next few years. My take is that buying a place called home is seldom wrong if you do not over-stretch yourself. Fulfilling your lifetime aspiration to own your dream home may be the best thing you can do for yourself. But doing it for investment purposes is an entirely different story altogether.

This is because I believe that there is a good possibility that the Singapore residential market may drop by as much as 40 percent from its peak in late 2007. This is due to the fact that the surge in property prices from 2005-07 was not a shift in the secular trend, but rather a cyclical reversal in the longer secular bear cycle that started about 11 years ago.

Now, over the years, many clients have been asking me, “Philip, what do you think is the right price for Singapore property?” After going through some published commentaries in the local papers, I find that most expert opinions of where property prices are heading are based on what we commonly called “anchoring” in psychology. The so-called “fair value” for property is based on recent price levels, rather than any methodological or analytical estimate. So I decided to embark on a journey to formulate an estimate based on comparative global statistics and household income figures in Singapore.

Based on statistical data from most developed markets gathered over the past 100 years from the US to Switzerland, the mean price for residential real estate is seldom more than three to four times that of annual household income. Applying this information to the Singapore landscape 30 years ago, I realised that is where we started out then.

At that time, based on anecdotal evidence from my mother, a five-room HDB flat cost about \$15,000 and a decent wage at that time was about \$200 a month. Assuming mum is working part-time and earning half that wage, this would give my family a household income of \$300 a month or \$3,600 per year. So the property price was about four times our annual household income. Bingo!

This back-of-the-envelope calculation may not inspire a lot of confidence especially among experienced analysts who use much more advanced analytical methods, but it nevertheless provides a sanguine view of where we started. The “number of years worked to pay off your shelter” methodology makes a lot sense to me because human expectations are not known to change very much over time, and most data from developed countries supported this thesis.

Also, we cannot limit ourselves to the historical property prices to household income ratio in Singapore. For the most part of our 40-odd years of independence, we have been more of a developing nation, rather than a developed one. I would expect this ratio to be higher when a country is growing rapidly and that it would revert to means when growth slows and flamboyant optimism is replaced with more sober realism. Hence, doing a comparative analysis with price-to-income ratio from other developed

countries with longer history makes better sense to me than using the average in Singapore over the past 40 years.

In addition, interest rates in Singapore have been on the decline over the past 30 years. This supports a higher-than-normal price-to-income ratio as Singaporeans can then pay more for a piece of property with lower financing costs. If we assume that inflation is going to be generally higher in Singapore in the next 20 years as compared to the last 20, it is arguable that interest rates are going to be comparatively higher, which will provide strong headwind for property prices.

Another factor that has contributed to a higher price-to-income ratio in Singapore is the government policy of allowing us to use our pension funds (CPF) to pay for our house. This is an outdated policy which is not in line with our developed country status. We are among the rare few countries in the world that continue to allow the use of our pension funds for our housing needs.

Realising that Singaporeans' retirement accounts are falling short, the government has made certain changes to the CPF policy, the details I do not have the space to highlight here. In summary, the changes in the CPF contribution rates and income ceiling implemented in the last few years have resulted in roughly a 35-percent drop in your CPF Ordinary Account contribution. As the Ordinary Account remains the primary financing source for our mortgages, this supposedly negative cash flow would have to be made up with more cash, which will provide further headwind.

Headwind	Consequence
Higher inflation in Singapore in the next 20 years	Higher financing costs
Lower Ordinary Account contributions	More cash needed to finance our property
Price-to-income ratio of about 8 times	Reversion to means is a strong and powerful force

Based on a rough estimate, properties in Singapore are going at over eight times our average household income. To get anywhere near four times our annual income, we need a 50-percent cut in property prices immediately. As I do not expect property correction to happen overnight, a more plausible scenario is for prices to be down 40% over the next three years. This would bring about the same impact on the price-to-income ratio as compared to an immediate 50-percent drop. We seemed to be heading that way three years back before the global asset boom pushed back the inevitable by a couple of years. I believe we are still heading there.

The adjustment process is both painful and necessary for the future of our children. The fact is property prices cannot increase faster than income forever. Reversion to means would inevitably set in one day. It is true that land may be scarce in Singapore but it is mathematically impossible for residential prices to appreciate faster than income over long periods of time. If home prices do go up more than income over a long period, nobody would be able to buy a place to live in unless they inherit one. And we certainly do not wish that for our children. Am I alone on this?