More is less! But why?

Tyron Hyde investigates why cheaper properties tend to have higher yields and often a higher depreciation ratio in relation to the purchase price

Most of us know that higher priced property tends to rent on a yield far less than lower priced property – don't we?

But why is this the case? Why doesn't a luxury house in Vaucluse rent on the same yield as a house in St Marys?

Let us first confirm this theory based on some data obtained from *Your Investment Property* February issue. (Being in Sydney, I have chosen Sydney and NSW areas.)

Area	Median price	Yield
Palm Beach	\$2.7m	1.25%
Rose Bay	\$1.7m	2.86%
Double Bay	\$2.0m	2.79%
Bellevue Hill	\$3.2m	2.32%
St Marys	\$275k	5.48%
Penrith	\$300k	5.03%
Quirindi	\$159k	6.03%
South Grafton	\$195k	6.40%

Yep – looks like the theory is correct.

So, to help me on this topic I sought the advice of experts in the field.

First, I asked RP Data to explain why higher priced property had a lower yield.

Cameron Kusher, senior research analyst at RP Data, made the following observation: "From a cash flow perspective higher priced properties used for investment purposes tend to record yields which are well below average due to the fact that the price paid for purchase is high, and although rents tend to be relatively high compared to rents of lower priced properties, relative to the purchase price the returns are not generally strong."

Yes… but why?

So I turned to Residex for further help. John Lindeman, head of research, said: "Rental at the high priced end of the market is a very discretionary affair, but demand for rented properties at the low end of the market is high and constant, because accommodation at the low end is sought by households who have no other option but to rent privately."

So, who are these tenants? Lindeman says, "New Gen Y households in WA suburbs such as East Perth, West Perth and Perth CBD are bumping up unit rental yields; in fact, these are now the highest in Australia, easily topping 8%. This is a segment who are prepared to pay high rents to enjoy the benefits of independent city living."

Lindeman says high yields can also be found in areas favoured by recent migrants, such as Berala, St Marys and Mt Druitt in Sydney; here, rental yields are over 7%. "This segment has no choice but to rent and the locations they choose are determined by work availability and good public transport."

Similarly, Chris Gray from Your Empire points out the supply and demand equation issue. "I believe it's a simple fact of supply and demand.

"At the more affordable end there are a lot of people who want to rent as they either don't have a deposit or don't want to tie themselves to a long-term commitment. With increased demand and limited supply of properties in the areas close to work and leisure, rents increase," Gray explains.

"As you get up to the more expensive end, most people can afford to buy and often want that security for their families. Therefore there's less demand and so the price drops."

I agree – the supply and demand equation is a big factor. But to properly work out why high-end property has a lower yield, I think we need to explore why demand isn't there.

Why would people pay a 7% mortgage when theoretically you could rent the same house and pay 1.5% via rent?

My next stop for further explanation was Mark Armstrong, CEO of Property Planning Australia, who said: "To understand why lower priced property has a higher rental yield we first need to look at how property is valued.

"Property can be broken up into two components – the land and building. From an investment point of view land appreciates in value and forms the capital growth component of the investment. The building, on the other hand, generates the rent and forms the income component," says Armstrong.

"Property that sits on cheap land will be lower priced. In this case, the land to asset ratio is low and the building value makes up the largest percentage of the overall asset. For example, if a property is worth \$400,000 with land value at \$100,000 and the building is worth \$300,000, then the land to asset ratio is 25%. In this case, the rental yield is likely to be high because 75% of the asset is producing income. Capital growth will be low because only 25% of the asset is appreciating.

"Property that sits on expensive land will be more expensive. In this case, the land to asset ratio is high and the land makes up the value of the overall asset. For example, if a property is worth \$700,000 – the building is worth \$300,000 and land value is \$400,000 – then land to asset ratio is now almost 60%. Only 40% of the asset is producing income so the yield will be lower. Capital growth, however, will be higher," Armstrong explains.

"The rule of thumb is: the lower the land value, the higher the yield will be. The higher the land value, the lower the yield will be."

Yes, I agree. I definitely think the ratio of land to property value has a distinct and real relationship to the yield.

I think we are inherently averse to paying someone's mortgage for land.

When we rent, we are basically looking for a roof over our head, as opposed to buying a house outright where we can add value and create.

Finally, my last port of call was Michael Yardney from Metropole Property Strategists who made the following pertinent point.

"While higher price properties may have lower yields, it does not make them poor investments. The owners will be rewarded by tax-free capital growth which they can borrow against and use the funds to purchase more properties," says Yardney.

I certainly agree with Yardney that the tax-free capital gain implications on owner-occupied housing plays an important part.

But that's a diverse range of answers to what at first seems like a pretty simple question.

So in summary, here's my take on the topic of why high-end property has a lower yield.

Supply and demand is certainly a factor. There will always be less demand for higher end property.

People are less inclined to pay rent for land, so it makes sense that properties with a higher land value as a factor of the overall property value, will, as a ratio, rent for less.

The capital gains tax-free status that we currently have is a very effective wealth creation strategy, which leads to people upgrading as opposed to jumping back into the rental market.

Australians' obsession with home ownership means we are often only willing to pay so much rent before we switch to a mortgage. At a rate of around 70%, we're up there with Canada, the UK and New Zealand as having the highest homeowner concentration in the world.

A large proportion of those wanting to live in a high-end property is the family market. The thought of moving every two years may drive that market to look for more stability.

Without a doubt some of the best tax-free money has been made on luxury houses over the last couple of decades.

But since the GFC (and with the chance of a double dip occurring), you have to ask whether these gains will continue. From a pure economics point of view I suspect you would be better off buying five investment properties valued at $400,000 each rather than one $2m owner-occupied property.

You would be able to diversify into five different states and nullify your land tax.

You would be 'in the market' so the fear of missing out would be erased.

Meanwhile, you could rent a beautiful big home for a lot less on a monthly basis than it would cost to buy.

You could even enter into a more commercial type of long-term lease with the landlord – for security and peace of mind.

And finally, lower priced property has the added advantage of more depreciation as opposed to higher priced property.

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Why less is more when it comes to depreciation

There are three main reasons why.

1. Firstly, what is known in the trade as 'wet areas', such as kitchens, bathrooms and laundries, are more expensive to build compared to bedrooms on a per square metre basis. And the greater the construction cost, the more you can depreciate.

For instance, a one-bedroom apartment still has a kitchen and bathroom.

So, as we increase the number of bedrooms (which are cheaper to build), the construction cost – as a ratio – decreases.

2. Secondly, white goods in wet areas are also depreciable at a higher rate.

Wet areas have items such as ovens, dishwashers, rangehoods and clothes dryers included within them. These items depreciate at a quicker rate than brickwork and concrete.

So, as you add more bedrooms or rumpus/other rooms to the mix, you reduce the effective life these highly depreciable items have.

Remember, it is better to have an item depreciating at 20% pa as opposed to it depreciating at the building allowance rate of 2.5% pa – because you get your deductions faster.

3. The third reason comes down to land value. As the price of the land increases, the house or construction cost decreases.

For instance, we see many house and land packages where the ratio of construction cost to purchase price is roughly 50:50.

This means if the final purchase price was $500,000, the land cost $250,000 while the construction cost the remaining $250,000.

When you start moving up the ladder to the luxury end of the market there is only so much building you can physically put on the land.

For instance, there was a recent landmark sale in Bondi where the developer paid approximately $4m for a 100m² block of land. True story!

The most the developer will be able to build on this property is a maximum of 300m² internally.

Even if the developer used gold-plated taps, I doubt he would physically be able to spend $2m on the construction of this property.

Which is far less than the 50:50 ratio that can be achieved at the lower end.

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