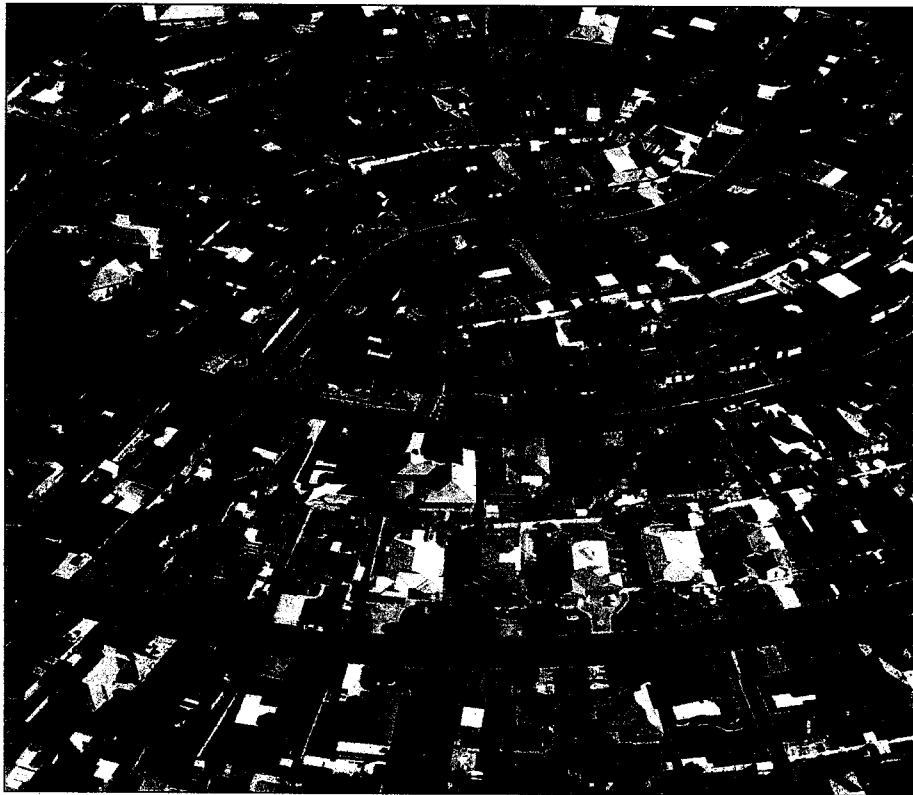


Meet the equity finance mortgage that allows investors to diffuse dollars through the housing market. **Simon Hoyle** reports.

Backing the burbs



Australia's owner-occupied residential property market is worth an estimated \$2800 billion but until now it's been an investment market all but closed to institutional investors.

If institutional investors, including superannuation funds, wanted to invest in owner-occupied residential property, they had to do it indirectly. They could assemble portfolios of residential properties and rent them out, but tenanted property is not quite the same thing as owner-occupied property.

They could lend money to people to buy a home, but mortgages are fixed-interest securities, and there's no way a mortgage lender can participate in the capital gain on an owner-occupied property.

Investing in property developers and builders is, likewise, a derivative exposure.

So investors in superannuation funds, while they might own their own homes already, have been missing out on an important source of potential capital growth and an asset class that could help diversify their retirement saving portfolios and hence reduce risk.

A solution to the problem has emerged from an unlikely quarter: the 2003 Prime Minister's Home Ownership Task Force. Christopher Joye, who led the task force and produced a 378-page report on the subject, came to the conclusion that something was needed to bridge the gap between a ready source of funds - capital markets - and home owners. But clearly, whatever structure was developed could

not increase the upfront cost of buying a home, or it would be self-defeating.

Joye believed that what was needed was a method of combining traditional debt funding (mortgages) with equity financing, which not only did not raise the upfront cost of buying a home but significantly reduced it - and which also allowed individuals to retain full control over what they did with their homes.

Joye said his objective was to "relax the all-or-nothing constraint on home ownership", whereby individuals either financed 100 per cent of the purchase price of their home, or became tenants.

The result was a product called an equity finance mortgage, or EFM. For a home buyer, an EFM is an interest-free source of funding for a property purchase, in return for forgoing a 40 per cent of any future capital gain.

"By definition, consumers or home owners own 100 per cent of their properties," Joye says. "It's not currently possible anywhere in the world for institutional investors to take large-scale equity exposures to the owner-occupied residential real estate asset class."

Joye says "housing assets are unusual, in economic terms, because they are indivisible". The sector is quite unlike shares, for example, where the ownership of a company's equity is spread across tens of thousands of individuals, who can all trade their interests in the company independently of other owners.

For investors, an EFM is a direct exposure to the owner-occupied residential real estate market, opening up this

HOW AN EFM WORKS FOR INVESTORS AND BORROWERS

	1 No change in value of home	2 Value of home decreases	3 Value of home increases
Purchase price	\$500,000	\$500,000	\$500,000
EFM	\$100,000	\$100,000	\$100,000
Sale price	\$500,000	\$450,000	\$550,000
Borrower repays	\$100,000 (principal only)	\$80,000 (principal plus 20% of \$50,000)	\$120,000 (principal plus 40% of \$50,000)
Comments	Borrower saves 20% on interest and principal payments	Investor loses on property but 20% saves 20% on interest and principal payments	Makes a profit of \$30,000 on property; saves 20% on interest and principal payments
Cashflow to ARES fund	\$100,000	\$90,000	\$120,000

SOURCE: RISMARK INTERNATIONAL

Property managers in every street, perhaps ... but under the new model investors pay no stamp duty, land tax, rates or maintenance bills. Photo: Glen McCurtayne

\$1 billion from institutional investors, which it will then package up and provide to home buyers as EFMs.

These will not be available to home buyers until the first half of 2006. They are not available to property investors.

The EFM concept is well covered by patents and other intellectual property protection mechanisms, but a simple explanation of how the product works for investors in the ARES fund is shown in Table 1. It shows how home owners fare if they use an EFM to fund the purchase of a home if that home's value remains unchanged, falls or rises. Specifically, it shows how a loss suffered on the sale of a home can be shared with the EFM provider - a sharing of risk that simply does not happen under traditional mortgage financing.

Joye says an EFM can provide up to 20 per cent of the value of a property. The other 80 per cent is financed by traditional means. It improves home affordability by Continued Page 44

vital asset class to investors such as superannuation funds for the first time.

Joye's company, Rismark International, has established a joint venture with Macquarie Bank to source funds from capital markets and package them into a product that can be sold to home buyers.

The Rismark team includes, among others, Richard Pacioni, a former executive director of Macquarie Bank, Russell

Aboud, a director of the Australian Stock Exchange and chairman of Ord Minnett, Sandra Donnarumma, previously the chief operating officer of InTech, Glen Bertram, a former UBS executive, and John McGee, a mortgage market expert.

The vehicle Rismark and Macquarie have put together is the typographically tricky ARES fund: Advanced Real Estate Solutions fund. The fund intends to raise

Back the burbs with an EFM

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reducing the required deposit and ongoing interest and principal payments by 20 per cent or more.

If the value of a property is, say, \$500,000, a home buyer may source \$100,000 as an EFM, leaving \$400,000 to be financed using a traditional mortgage. Alternatively, if the most a home buyer can afford to pay for a home is \$500,000 using traditional financing, then adding an EFM into the mix will enable them to afford a more expensive home. An EFM may also be used to unlock the existing equity in a home.

For investors in the ARES fund, there are just as many potential benefits.

Joye says institutions can avoid many of the pitfalls of traditional direct investments in residential property - namely, stamp duty, land tax, council rates and ongoing maintenance. All of these expenses are taken care of by the owner-occupiers. If ARES provides funding for, say, 15,000 homes, it has effectively also employed 15,000 property managers, at little cost.

Properly diversified, residential real estate is a relatively low risk (though by no means risk-free) asset class and is uncorrelated to other property markets and, indeed, to other investment markets.

For investors, therefore, ARES potentially provides significant diversification and reduction of risk.

And because the fund provides only 20 per cent of the value of a property, for a \$1 billion pool of EFMs, investors gain exposure to more than \$5 billion worth of property. Joye says EFMs will be available only for properties in capital cities and major metropolitan areas.

Joye expects ARES's first capital raising will be fully subscribed, and it has already struck agree-

ments with two retail home lending organisations to take EFMs to market next year.

If Rismark's medium-term plan to list ARES on the ASX comes to fruition, then individual investors will also have a chance to invest in a diversified portfolio of owner-occupied property, by buying and selling units in the fund on-market.

The investment opportunities for individuals are potentially significant, Joye says.

ARES's first capital raising is expected to be fully subscribed.

"For mums and dads it's a very interesting vehicle with which to diversify their residential real estate exposure," he says. "One of the mistakes that people make about investing in real estate is that they assume that lay consumers have the same risk and return experience as a house price index.

"You often hear commentators claim that real estate is a very safe asset class. But an owner-occupier has one house, on one street, painted one colour, pointing in one direction, with all its manifest peculiarities. Individual home owners do not have exposures to the billions of dollars worth of diversified property that underlie house price indices.

"It's analogous to putting 70 to 80 per cent of all your wealth in the world into a highly illiquid and very volatile micro-cap stock and then holding on to it for the next seven to eight years. Rismark's ARES Fund, by way of contrast, will provide both individuals and institutions with enhanced and well-diversified access to the residential real estate asset class for the first time."