NEWSLETTER

August 2021

CARE FINANCIAL SERVICES AND ACCOUNTING

It's not just about numbers

Introduction

Shares, property and interest rates. During the month of July two of these went up and one stayed low. Can you guess which is which? Read on to understand what is happening in each of these three key segments of the economy.

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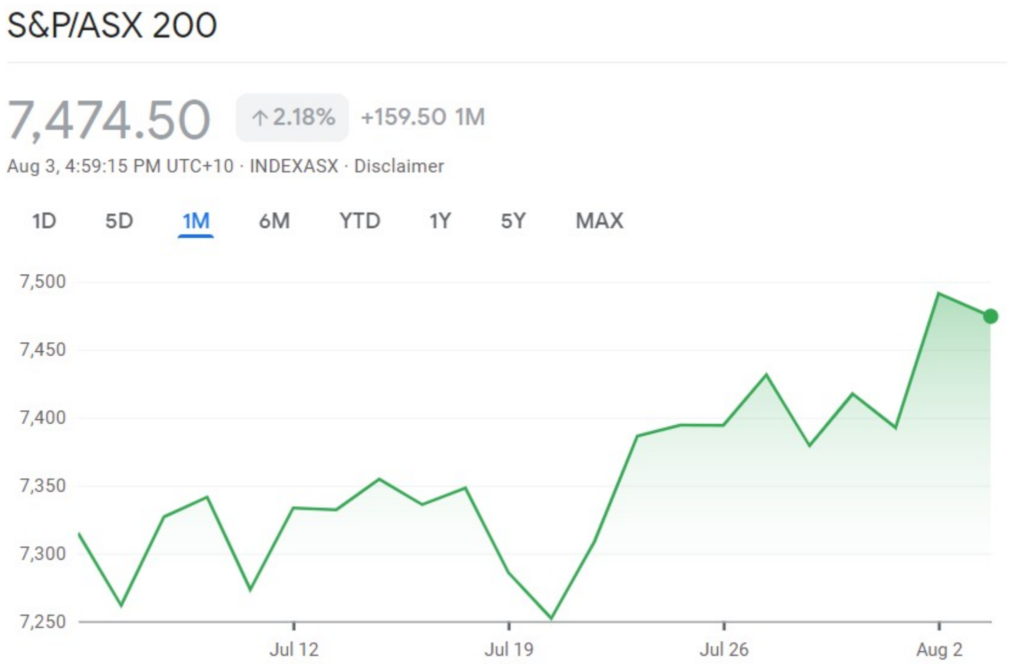
The Share Market

July was a strong month for the Australian market as measured by the ASX 200. Here is the monthly performance to the 3rd of August (at close of business), thanks to Google and the ASX:



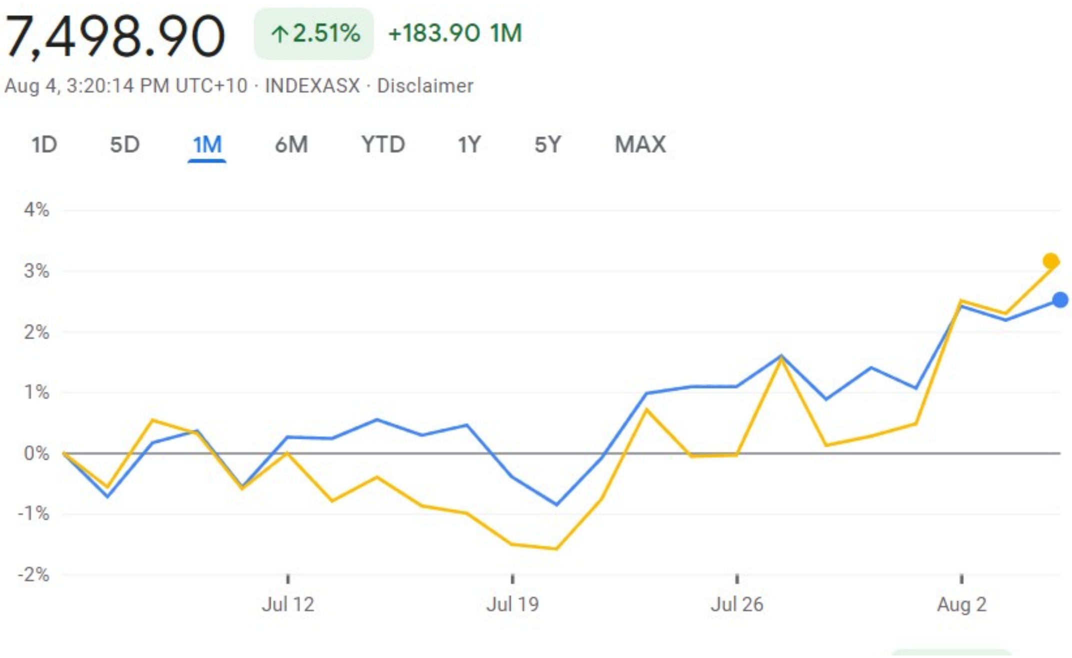
As you can see, the market rose 2.18% for the month to August 3. The steepest rise happened on July 20 and 21, when the ASX 200 rose by 1.8% across the two days. On Monday of this week (August 1), the market rose by 1.4% in just one day.

As a small aside, we thought we would mention that the rise on July 20 demonstrated that the day-to-day market really is hard to predict. At 6.45am that morning, a prominent market commentator named the Motley Fool issued its regular list of '5 things to watch on the ASX on Tuesday.' The column opened with an unfortunate prediction: "The Australian share market looks set to sink again this morning. According to the latest SPI futures, the ASX 200 is expected to open the day 70 points or 1% lower." Actually the market rose by about that much. Right number, wrong direction. Unfortunately, there are no points (or profits) for getting things half right. Daily predictions are little more than guesses.

The positive moves in prices across the month were predominantly driven by news out of the banking sector. In mid-July, the ANZ announced that it would use $1.5 billion of its cash holdings to buy shares in itself on the open market. Late last Friday (and thus just before Monday's day of trading), the NAB announced a similar buyback of $2.5 billion.

More buybacks are probably yet to come. Respected financial journalist Adele Ferguson wrote on the weekend that banks might be ready to purchase up to $30 billion worth of shares in themselves over coming months. The market liked that news. Bank prices rose and took the whole market with them.

To see just how much the ASX 200 was affected by banks during July, have a look at the following graph showing the performance of the ASX 200 compared to the price performance of our largest bank, the Commonwealth Bank. You can especially see the impact of the banking sector after July 20. The blue line is the ASX 200 and the orange line is the CBA share price:



This all might lead you to ask an obvious question: what is a share buyback? Basically, a buyback is where a company buys shares in itself and then cancels them. The buyback can either happen through the market (where the seller of the shares does not know that the specific purchaser is the company itself) or off the market in a private transaction between the company and (an) individual shareholder(s).

The ultimate effect of a buyback is that there are fewer shares on issue for that company. That means that future profits and assets of the company are shared by fewer people. Remember, a shareholder earns a return from shares in one or both of two ways. The first is via a dividend, which is a portion of a company's profits. The second is via a rise in the value of the company's shares. The value of a company's shares is influenced by all sorts of things, but the size of the dividend is an important one. The total assets of the company is another important influence. Buybacks affect both of these things.

Understanding buybacks might be easier with a simple example. Suppose the ABC Company has the following characteristics:

Total Assets	$11 million
Annual Profit	$1 million (all paid out as dividends)
Shares on issue	11 million
Current Share Price	$1 per share
PE Ratio:	11
Dividend Yield	9.09%

Of the total assets, there are $10 million of assets that are actually being used to generate profit. There is a further $1 million sitting in a bank account not earning much interest and not being used to do anything constructive for the company. It is regarded as 'excess capital.'

The PE ratio is the ratio between profits per share and the price per share. Profit per share is 9.09 cents ($1 million profit divided by 11 million shares). The price per share is $1. $1 divided by $0.0909 is 11.

The dividend yield is the dividend per share divided by the price per share. Because all profits in this example are paid out as dividends, in this case the dividend yield is 9.09%.

Rather than retain the excess $1 million in cash, the company decides to conduct a buyback of 1 million shares for $1 each. Assuming everything else stays the same, after the buyback the company looks like this:

Total Assets	$10 million
Annual Profit Next Year	$1 million (all paid out as dividends)
Shares on issue	10 million

Remember, the extra $1 million in cash was not being used to generate profit. So, using that money to buy shares back does not have any influence on profit. If we assume that the remaining assets are applied the same way, then the profit for the company will again be $1 million. Yes, this is a big assumption, but it helps us to understand the impact of the buyback.

The total profit has not changed. But other things have. The profit per share now rises to 10 cents. Because there are fewer shares on issue, the same profit *per share* must be more. The impact of this for remaining shareholders will be felt in at least a couple of ways.

Firstly, they will receive a greater dividend, because this company pays out all profits as dividends. The dividend per share will rise from 9.09 cents to 10 cents. But we would also expect this to have an impact on the market price for the shares. More profit per share would normally mean highr share prices. How high the price goes depends on many things. But the previous PE ratio can give a good indication of the likely impact on prices.

After the buyback, if the share price remained at $1 per share, then the PE ratio falls to 10. This is $1 per share divided by 10 cents per share. But if the PE ratio were to return to the previous value of 11, then the share price would need to rise to $1.10. We could then divide the profit per share of 10 cents into this figure to get the PE of 11. Before the buyback, the market thought a PE of 11 was fair. There would be no reason to think that a different PE should apply after a buyback.

So, in this simplified world where the only thing that changes about the company is the number of shares on issue, using spare cash to buy shares back would normally cause both an increased dividend per share and an increase in the share price.

The real world, of course, is not that simple! But the above example helps to show the potential impact of a share buyback. In the real world, the thing that a potential seller in a share buyback has to assess is what will happen to company profits after the buyback. If the money used to buy back the shares was being used (or could have been being used) to derive higher profits, then the company's profits may fall as a result of the share buyback. This may negate the benefit of there being fewer shares on issue: fewer shares sharing a smaller profit might actually mean less money per share. Everything depends on the relative changes.

In the case of the Big 4 banks, the market clearly expects profits to remain high. That is why the response to the announcement of the share buybacks was positive. Importantly, as Adele Ferguson makes clear in her article, the money being used for the share buybacks is considered to be 'excess capital.' It is not currently being used to make profits and the banks do not foresee that changing in the future. While the assets of the banks will be reduced by the amount of cash used to buy shares, the market does not expect profits to drop by the same proportion. If the market is right, the banks will be smaller but earning the same profits. This makes them more 'profitable,' and hence more valuable. Up go the prices.

Interest Rates

The RBA board has repeatedly stated that it expects interest rates to remain low for an extended period. So it was no surprise earlier this week that interest rates remained unchanged for the 8th month in a row. To see just how low rates are in historical terms, consider the following graph:

In the following section we detail the extraordinary growth in residential property prices over the last 12 months. There are several factors driving these increases, but record low interest rates must be one of them. Unfortunately, the RBA needs to set interest rates that address needs beyond just the property market, which is why it has been stating that rates will remain low for the foreseeable future – it wants to reassure non- property borrowers that they can borrow with confidence.

Specifically, the RBA wants to encourage businesses to borrow and expand their operations, thereby employing more people. Its stated aim is to reduce unemployment – which might be a little hard to decipher given how the RBA actually expresses itself:

> *The Board remains committed to maintaining highly accommodative monetary conditions to support a return to full employment in Australia and inflation consistent with the target.*

In theory, lower unemployment should put pressure on employers to increase the wages and salaries they pay their staff. If this happens, housing affordability may improve a little. Put simply, people are better able to buy more expensive houses if they earn more. Unfortunately, given that prices have risen on average by 16% in just the past year, wages would need to rise very strongly for the rise to be fully offset. Unfortunately, we have the same policy tool (interest rates) having two differing effects.

Residential Property

Prices in residential property continue to 'go gangbusters.' According to market analyst Corelogic, for the month of July prices in all Australian markets rose by an average of 1.6%.

That's for the month. For the 12 months to 31 July 2021, average national prices rose by 16.1%.

Within these 'macro' statistics, there was substantial variation. National house prices rose by 18.4% for the 12 months (and 1.8% for the month), whereas units 'only' rose by 8.7% for the year (and 1.2% for the month).

Unusually, in historical terms, the rise in house prices is occurring at a similar speed in both city and regional markets. Indeed, for the 12 month period, the average national regional price rise was 19.6% compared to 15.1% for the average capital city rise. Again, houses dominated with regional house prices rising by just over 20% for the 12 month period.

Individually, some of the highest rising markets were as follows:

Location	Dwelling Type	Annual Rise
Regional NSW	Houses	23.7%
Regional Tasmania	Houses	23.6%
Darwin	Houses	23.5%
Canberra	Houses	23.4%
Sydney	Houses	23.0%
Hobart	Units	23.0%
Darwin	Units	22.7%

Nationally, the lowest growth market was Melbourne units, which only rose by 5.9% for the 12 months to the end of July. The figure for units includes high-rise apartments and particularly apartments that are used as rentals for international students, which are almost all empty at present. The Corelogic data does not delineate higher-rise CBD units and student rentals from the rest of metropolitan markets, but if it did it is likely that the non-apartment market would be faring much better than the average figure.

The national median for a house is now $695,800 but there is huge variation around this figure. The median price in Sydney is $1.258 million in Sydney while it is only $284,000 in regional South Australia). Property is becoming very expensive.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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