State of the Sydney Residential Market

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The Sydney residential market is down ~15%, according to CoreLogic

Introduction

At Moelis Australia, we continuously monitor the performance of asset classes and the potential relative returns that are on offer. In May 2019, we were public in our view that the residential market was close to the bottom in Sydney after peaking nearly two years ago.

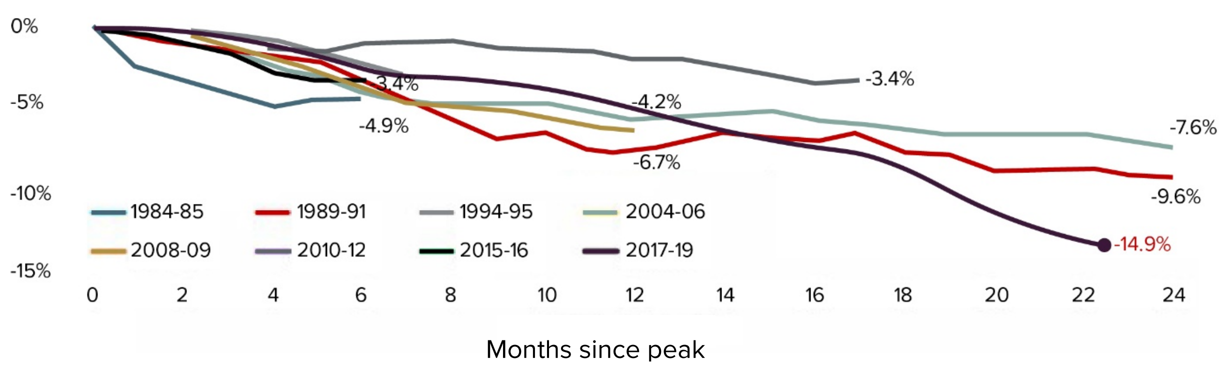
While we believe this position remains intact, we have remained cautious about the longevity and depth of the post federal election bounce and encourage investors to be judicious when considering the quality of product in which to invest.

Market Update

The Sydney residential market is down ~15% according to CoreLogic following a peak in July 2017. This represents one of the sharpest declines in Sydney's residential house prices since the early 80's.

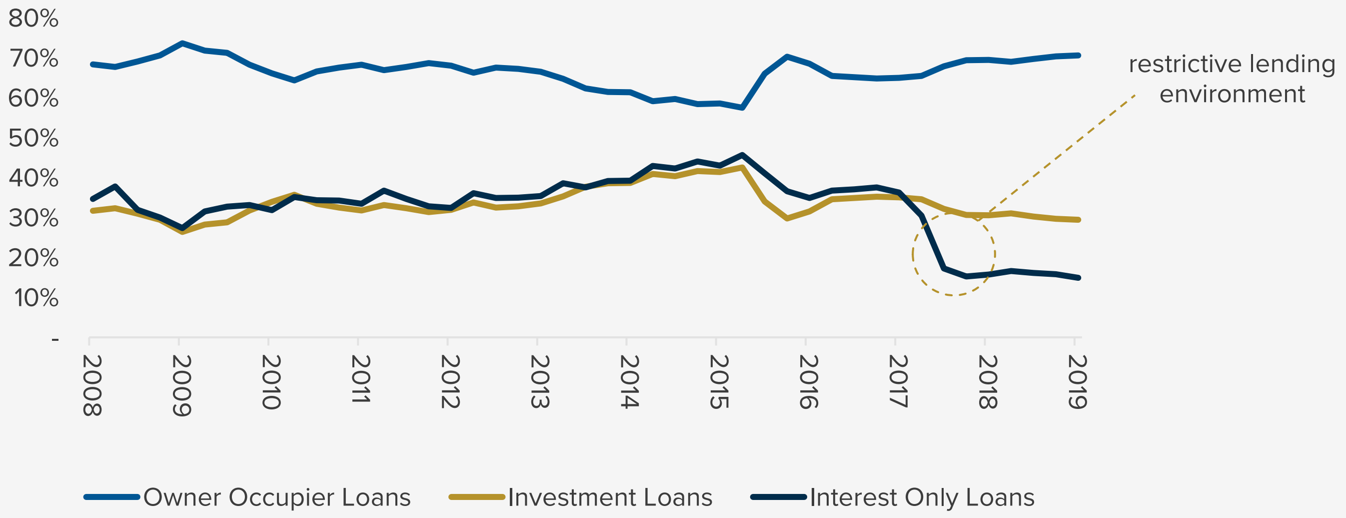
Importantly, the decline has not been driven by increasing unemployment or interest rates. Instead, the bear cycle was driven by a sharp drop in foreign buyer interest (Chinese foreign exchange control policy and finance availability), a more stringent lending environment (domestic and foreign buyers), supply of new apartments and deteriorating buyer confidence.

Sydney market - peak through troughs



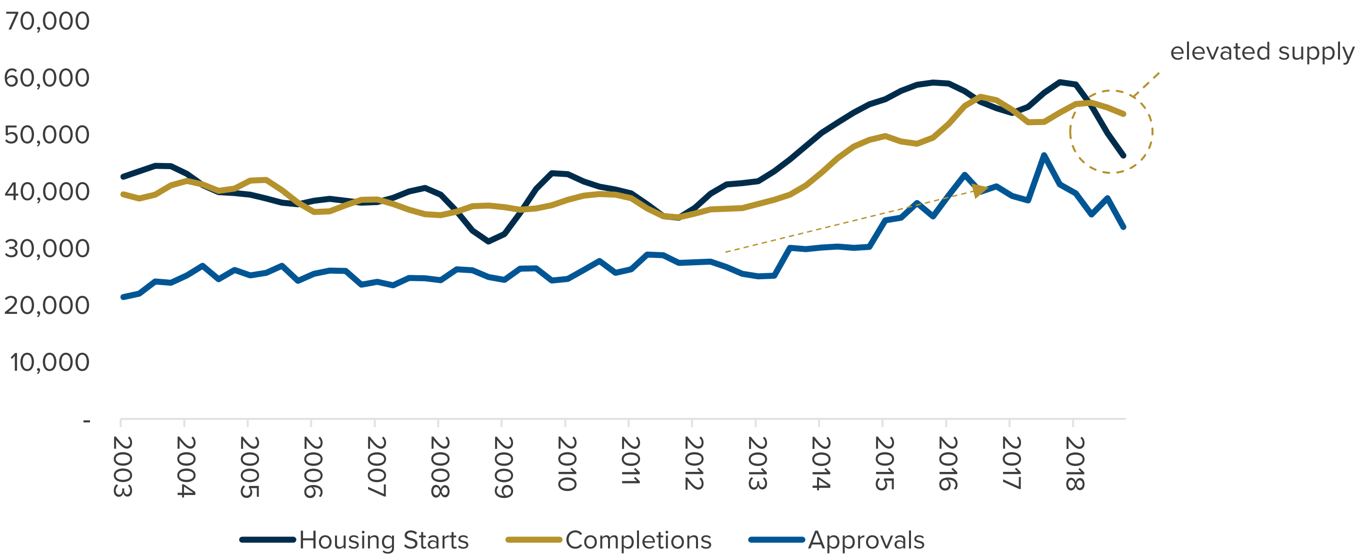
Source: ABS

ADIs – Loan types as a % of total approved



Source: ABS

Housing supply pipeline



Source: ABS

In our view, the regulator and banks will continue to look to ease lending standards for well credentialed domestic borrowers which should assist demand. This intent was apparent in APRA's recent decisions to remove the minimum theoretical interest rate of 7.0% for banks' lending standard testing, instead allowing banks to set a lower minimum interest rate floor, and ease the ability for interest only loans.

The supply equation is easier to understand as many developers will struggle to obtain financing to build new projects as pre-selling apartments has stalled. These conditions are expected to largely remain until the over-supply situation corrects and confidence improves. Given medium to high density developments take ~18-36 months to develop we are entering the final stages of the construction cycle in Sydney, which was underpinned by pre-sales in the previous upcycle.

Foreign buyers are unlikely to return in volume for some time as the availability of finance for offshore buyers remains restrictive and the respective state governments continue to impose punitive stamp duty and land tax on foreign buyers. Participants need to remember that many foreign buyers are looking globally to invest, and competition is deep for their capital.

The post federal election bounce has been positive for the residential market with an obvious improvement in market sentiment and media reporting.

The real positive of the federal election was that the impact of Labor's policies relating to residential ownership will not be tested in the near term. This was a material pivot for the market as the uncertainty was causing real concern for both investors and owner occupiers and we believe this uncertainty had already largely been priced into the market pre-election.

The anecdotal evidence from our clients is that while inquiry levels have improved, the market environment remains tough. Pre-sales velocity remains very slow, settlement risk remains a concern and financing conditions (consumer and developer) remains difficult.

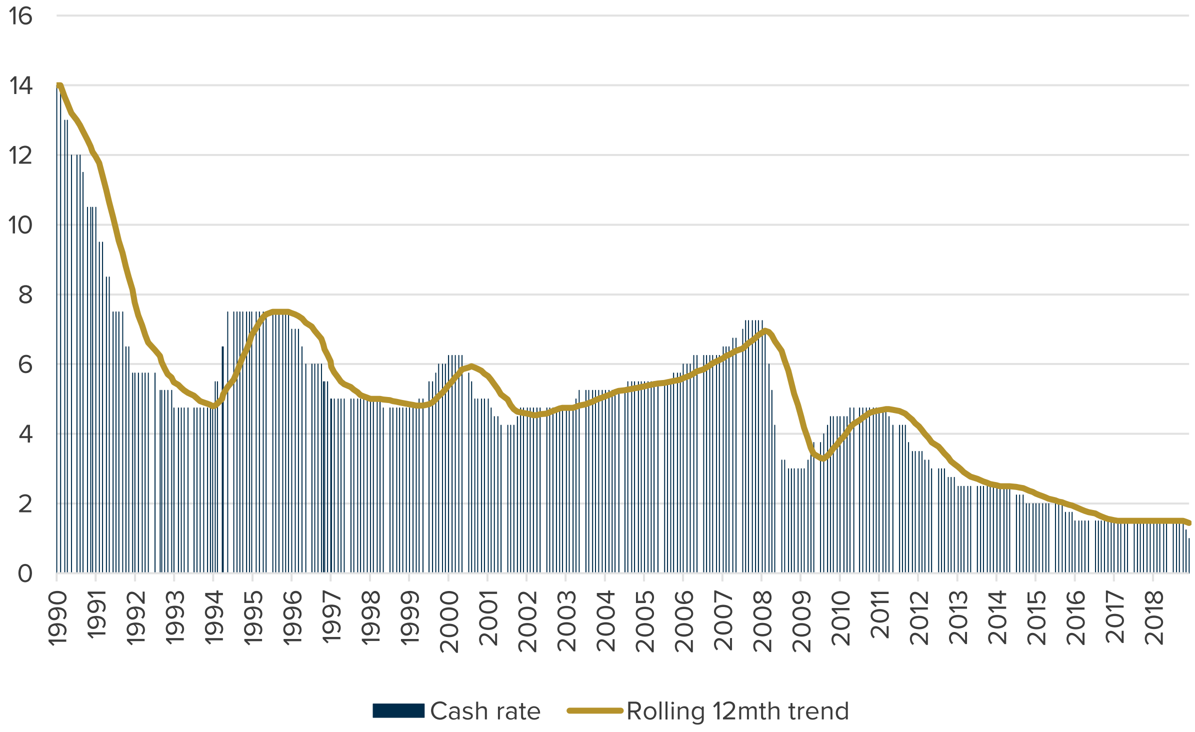
One interesting trend in the medium density apartment space is that there has been evidence of elevated demand for high quality, well located down sizer product. In our view, the ageing population and a desire for retirees to downsize their residential accommodation will continue to see strong demand for oversized, minimal maintenance well located apartments into the foreseeable future.

Arrears remain under control. Strong evidence that policies adopted by regulators have been successful in reducing the incidence of arrears to date and in the absence of a spike in unemployment are not expected to be a major issue.

The Good

- The Reserve Bank of Australia is expected to continue to decrease the cash rate over the next 12-18 months to record lows. Possibly 0.50%.
- APRA has reduced the theoretical interest rate used by banks to calculate a borrower's capacity to borrow improving availability.
- Sentiment is less cautious which has resulted in more buyers.
- Election result has removed risk of changes to negative gearing and CGT for investors.

Cash rate (%) since 1990



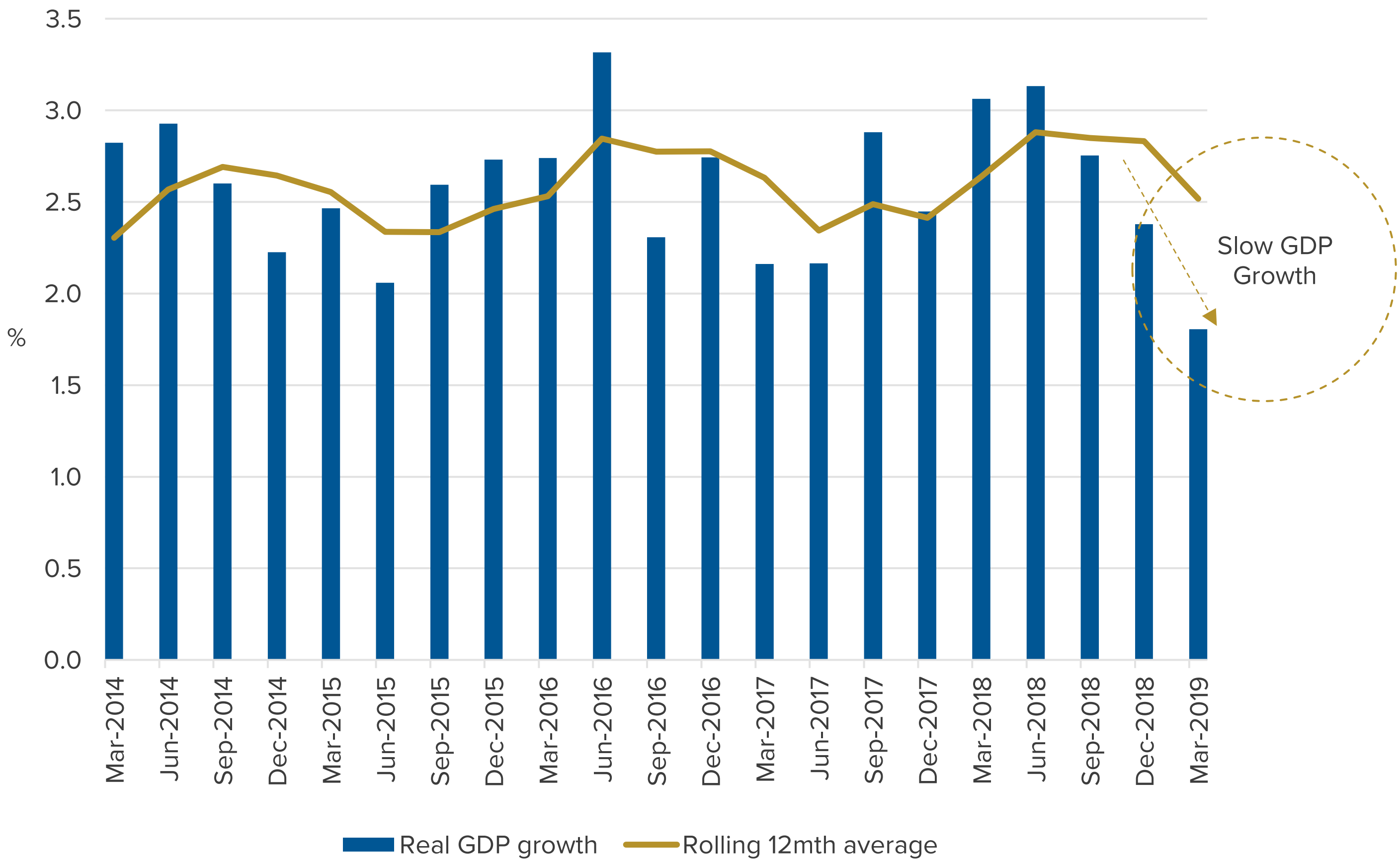
Source: ABS

Trade war tensions may slow GDP growth in China – Australia's largest trading partner

The Bad

- GDP growth is slowing, and the RBA are concerned about which industries can support GDP growth in the future.
- Trade war tensions have the potential to materially slow GDP growth in China. China represented 35% of Australian exports in 2018 with two-way trade now worth $195bn.
- The residential construction cycle is anticipated to end imminently. If this occurs, state infrastructure spend will not fully absorb any excess workforce capacity.

Quarterly GDP growth (%) – last five years

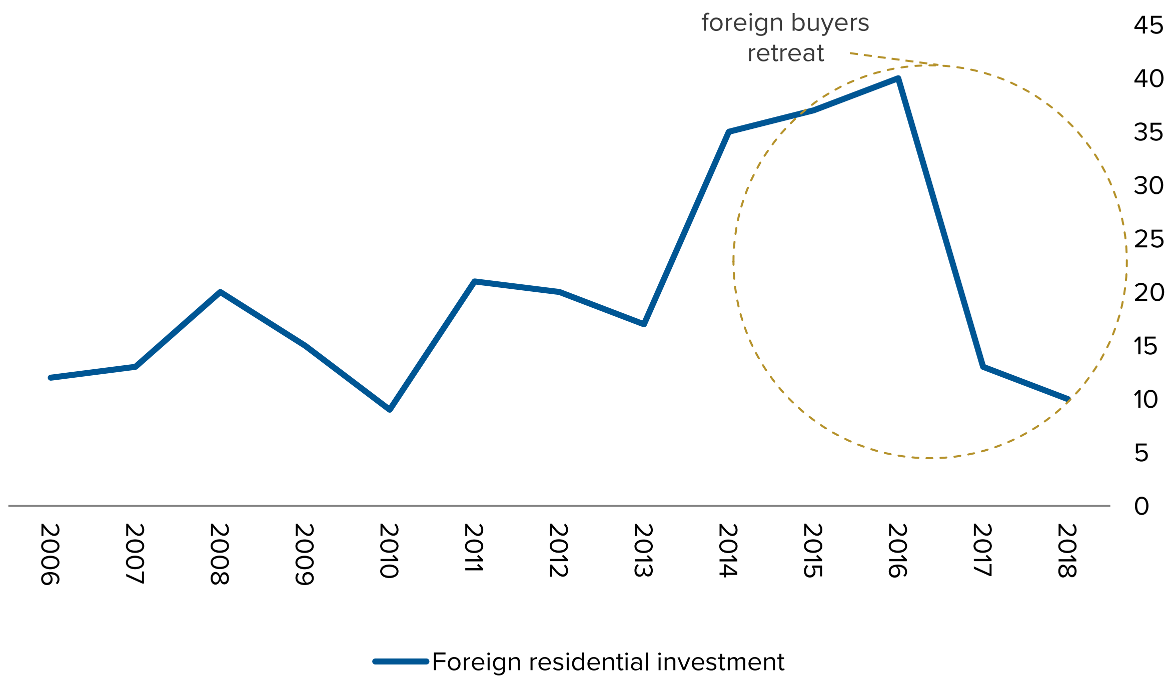


Source: RBA

The Ugly

- Supply within certain locations remains at very elevated levels and this will continue to constrain price growth for some time.
- Foreign demand for residential investment has been decimated by new taxes, Chinese restrictions on outbound investment and a restrictive lending environment for foreign domiciled borrowers.
- Building construction standards with cladding and structural issues are present will no doubt impact investor confidence and therefore demand.

Foreign residential investment ($bn)



Source: FIRB at March 2019

As foreshadowed at the Moelis Australia investor day presentation in May 2019 we believe that the Sydney residential market is close to the bottom of the current bear market.

Our house view is that Sydney residential prices will stabilise and could experience a period of moving sideways, although even within a metropolitan region market variation occurs.

Supply within certain locations remains at very elevated levels and this will continue to constrain price growth for some time in these locations. Residential investors need to remain very judicious in pin-pointing markets that have favourable supply and demand dynamics and product that suits the broadest range of end users including both investor and owner-occupiers.

Population growth in Sydney will remain positive and support a strengthening of house prices as the supply issues work through the system.

Conclusion

We believe that a low interest rate, low inflation environment is the new “normal” and will continue to support demand for defensive cash flows especially as a greater proportion of baby boomers retire.

With investors chasing yield in equities the market has nearly retraced to its previous all-time highs despite the challenges in the economy. We are generally cautious about equity valuation.

With this backdrop, we see the Sydney residential market as an interesting asset class given the recent market weakness and ability to acquire well located, high quality apartments around or below replacement cost. We feel like the risk reward dynamic is attractive versus alternative investment classes.

About Julian Biggins

Julian is a Managing Director of Moelis Australia and is Head of Real Estate Advisory.

Julian has nearly 20 years of experience providing M&A and capital markets advice to real estate and funds management companies. Recent transactional experience includes the IPO of Redcape Hotel Group ($623m), simultaneous secondary capital raisings in Centuria Metropolitan REIT and Cenutria Capital Group ($376m) and SCA Property Group's acquisition of a $631m portfolio from Vicinity.

Julian was a former senior member of JP Morgan's Asia Pacific real estate investment banking team, and prior to that was a member of UBS' Australian real estate research team.

Julian has a Bachelor of Business (Property) and a Bachelor of Business (Banking and Finance) from the University of South Australia.

About Moelis Australia

Moelis Australia is an ASX-listed financial services group offering corporate advisory, equities and asset management.

Moelis Australia has deep financial advisory and capital markets experience in real estate and REITs advising some of Australia's largest real estate companies. In 2018, we were amongst the most active real estate advisory and ECM investment banks in Australia; ranked #4 in real estate M&A advisory and #2 in real estate ECM activity.

Real estate expertise in corporate advisory compliments the expertise in asset management which manages $2.4bn in real estate assets and in our equities division which provides research on 28 listed real estate companies, of which 21 are REITs.