Residential Commentary – Sydney Apartment Market

July 2016

Executive Summary

- The Sydney apartment market is reverting back to 'normal' levels of activity, based on slowing sales volumes and rental growth. However capital value growth has surprised on the upside.
- Apartment prices in Greater Sydney are up 11.1% y-y as of 1Q16[1].
- 16,530 units are either under construction or currently marketed in Inner Sydney and are expected to complete over 2016-2021. There are further developments across various stages of planning but some may not complete in this cycle.
- Gross rental yields have tightened to 3.9% in 1Q16 in Greater Sydney, down from 4.3% in 1Q15[1].
- Rental growth has slowed. The median rental value for a 2-bed in Inner Sydney increased from $640 in 1Q15 to $660 in 1Q16 reflecting growth of 3.1% y-y[2]. This is slower than the five-year average of 4.3% y-y.
- The housing market continues to support growth in the NSW economy. Private capital investment into dwellings (new and old) grew by 17.3% y-y in 1Q16.

Sydney Apartment Market: Key Indicators

Inner Sydney			% change Y-Y
Apartment approvals 12 months to:	1Q16	9,104	3.9
Supply (2016-2021): Completed Under construction Currently marketing Plans approved Plans submitted Proposed	2Q16	 1,086 10,655 5,875 6,604 20,860 11,459	
Sales volumes* 12 months to:	1Q16	34,011	-20.1
Median unit price*	1Q16	$661,500	11.1
Median rental value 1-Bedroom 2-Bedroom	1Q16	 $520 $660	 4.0 3.1
Gross rental yield*	1Q16	3.9%	- 0.4 pps

Source: JLL Research, CoreLogic RP Data, Housing NSW, ABS

*Greater Sydney

[1] CoreLogic RPData

[2] Housing NSW

Economic Overview

Despite a recent bump in the road, the NSW economy is performing well, and is doing so at a time when the Australian economy is dealing with low inflation, high external debt and lacklustre private business investment.

In NSW State Final Demand (SFD) grew by a robust 3.5% y-y in March 2016; only Victoria recorded stronger growth at 4.0% y-y. On a quarterly basis SFD has eased, with the growth rate slowing between 4Q15 and 1Q16 from 1.4% q-q to 1.0% q-q[3]. SFD measures the domestic economy at a state level and therefore does not include imports or exports. SFD matters because the property sector in every state is far more exposed to local rather than foreign trade factors.

Growth in NSW has been supported by the residential sector. Private capital investment into dwellings (new and used) is up 17.3% y-y 1Q16. Investment in dwellings also drives household expenditure on furniture and household equipment, which is up 6.4% y-y. Overall household consumption accounted for 62.2% of SFD in the year to March 2016[3].

Employment growth has remained robust, growing by 3.2% in the year to June 2016, reflecting an additional 117,130 jobs. This brings the unemployment rate to 5.3%, down from 5.9% in June 2015.

The Sydney Metro train line and Sydney light rail will further support labour market conditions by increasing the transport capacity of Sydney CBD to sustain the workforce. Without this, the current infrastructure will reach capacity by 2026[4] and hamper business activity.

NSW is retaining more of its population than in previous cycles. The deficit on net interstate migration is just over half what it was in 2011[3]. This puts further strains on the existing infrastructure network, but is ultimately a positive because it is supportive of further housing demand.

At a federal level, possible changes to negative gearing laws were a key part of the Labor Party's election platform. However, with the Coalition staying in Government those proposals remain in abeyance. Instead the current taxation treatment of investment in residential property will remain unchanged.

Lower growth in SFD is forecast for 2016 at 2.7%, down from 3.0% in 2015[5]. Much of this is linked to a slowdown in housing investment. Rising mortgage debt driven by recent housing investment has caused household balance sheets to be stretched, and this reduces retail spending.

Beyond 2016, a more stable but lower growth environment is forecast, with SFD growth predicted to be 2.1% in 2017 and 2.3% in 2018[5].

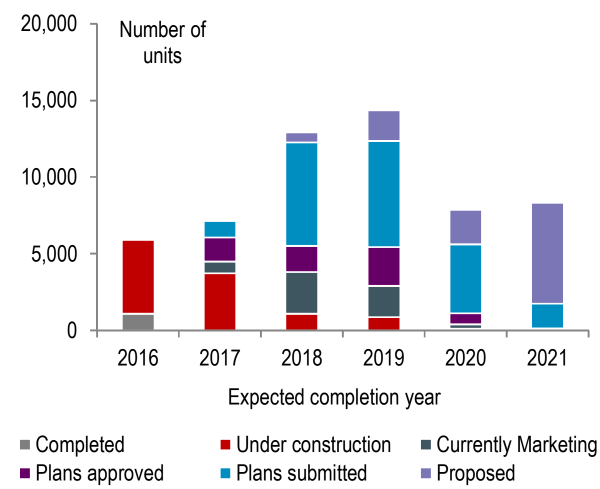
Supply

There are 16,530 units currently under construction or marketed across Inner Sydney with expected completion dates between 2016 and 2021. 1,086 units have already completed. Additionally there is a large pipeline of potential projects at various stages of the development process, however, many of these will not start construction in the current cycle.

If all recorded potential projects across Inner Sydney complete, it would represent an increase of 9.7% over six years on the current unit stock in Greater Sydney[6]. At a cumulative annual average rate of 1.6**%,** the overall quantum of supply appears reasonable.

Figure 1: New apartment supply pipeline

Inner Sydney, expected completion year and current status



Source: JLL Research

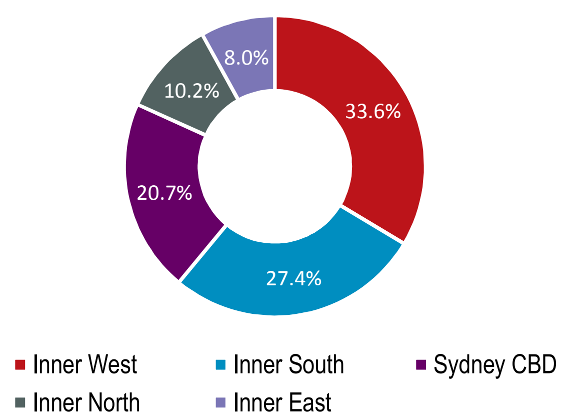
Projects with fifty units or more

Despite the attention the Inner South has received as a hotspot of supply, one third of the apartments under construction will be in the Inner West, the highest concentration of any precinct.

Unit approvals data suggests that little more is expected in the Inner West pipeline beyond those projects under construction. In the year to March 2016, Canterbury LGA was the only Inner West area featured in the top 10 LGAs by total unit approvals in Greater Sydney.

Figure 2: New apartment supply by precinct

Inner Sydney, under construction, expected completion 2016 - 2021



Source: JLL Research

Projects with fifty units or more

[3] ABS

[4] City of Sydney Council

[5] Deloitte Access Economics

[6] ABS, Department of Planning & Environment

Demand

Sales volumes have slowed with 34,011 units settled in the year to 1Q16 in Greater Sydney, which is down 20.1% from the year to 1Q15.

Pre-sale rates for off-the-plan apartments are also slowing. JLL Research has found projects brought to market between 1Q15 and 1Q16 have sold at a rate equivalent to 28 units per month on a 100 unit apartment block. This is down from the year prior (1Q14 to 1Q15), where the equivalent sale rate was 47 units per month.

Slowing sales rates are partly due to falling investor activity. Nationally owner-occupiers are becoming increasingly important, with finance commitments for owner occupiers growing 17.5% y-y while investor lending fell -5.5% y-y. Lending restrictions on investors have driven this change.

Anecdotally there is evidence that foreign buyer levels are also slowing, although little data is available to support this. Uncertainty in the UK market after Brexit and uncertainty regarding US interest rate policies may convince foreign buyers to continue investing in the more stable Australian market for the time being.

Further regulation on foreign property buyers in NSW - more signal than bite?

The NSW budget has introduced new surcharges on foreign investors, namely:

- A transfer duty surcharge of 4%.
- A land tax of 0.75% (from 2017).

This is on top of existing surcharges and costs for all buyers including:

- Stamp duty.
- Pest and building inspections.
- Agent fees.
- Legal costs.

Given the continued desire of Chinese investors to diversify their portfolios in stable economies such as Australia, demand for residential property should remain price inelastic.

Therefore the new surcharges are expected to have a limited impact. Instead, it sends a signal to the market that there will be greater transparency in monitoring foreign investor demand.

Source: JLL Research, NSW Government, Office of State Revenue, Housing NSW

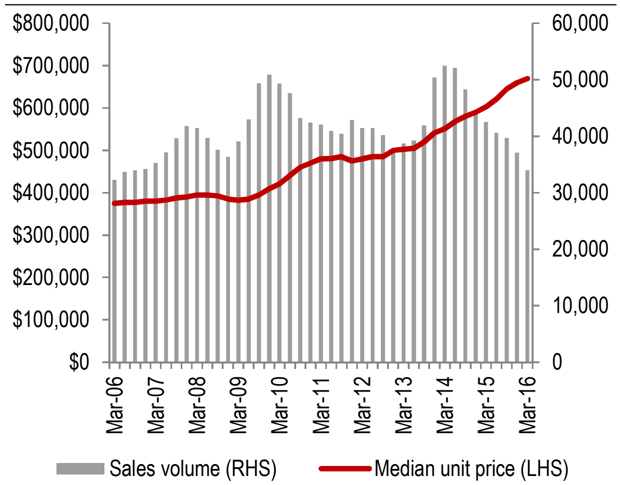
Pricing

Capital value growth surprised on the upside. Apartment prices in Greater Sydney are up 11.1% y-y as of 1Q16. This is up from 9.4% y-y as of 1Q15[7]. The strong result reflects rising prices in the back end of 2015, although there has been some price-correction early this year amidst a string of regulatory measures and concerns about supply.

While there is still sufficient demand for price growth to continue, JLL expects demand to taper-off and as a result capital value growth by year-end will be lower than in 2015. Hypothetically, if 2015 levels of capital value growth were to repeat, the median price at year-end would be $738,450. Given that as of 1Q16 the median price has only reached $670,000[7], the above scenario appears unlikely.

Figure 3: Median Unit Price and Sales Volume (Annual Data)

Greater Sydney, units, 2006 - 2016



Source: JLL Research, Corelogic RPData

In the Inner West there are suburbs where price growth in the year to March 2016 slowed to levels below the ten-year annual average price growth in that suburb.

For example Dulwich Hill (0.1% y-y), Campsie (0.4% y-y), Annandale (1.1% y-y), Enfield (1.3% y-y), Stanmore (2.8% y-y), Earlwood (2.9% y-y), Marrickville (4.9% y-y) and Petersham (6.3% y-y) all had below average growth in the year to March 2016[7]. However, growth across these suburbs remains positive.

Rental Rates

Rental growth has slowed across Greater Sydney. The median rent for 2-bed units across Inner Sydney increased from $640 in 1Q15 to $660 in 1Q16 at a rate of 3.1% y-y[8].

For investors, the Inner North LGAs of North Sydney (3.2% y-y) and Mosman (5.0% y-y) both outperformed, reflecting a smaller supply pipeline in the precinct which is supportive of higher rents.

Conversely rents fell in Leichardt (-1.6% y-y) and Botany Bay (-3.3% y-y). Botany Bay in particular is facing a large supply pipeline as it is a part of the Inner South.

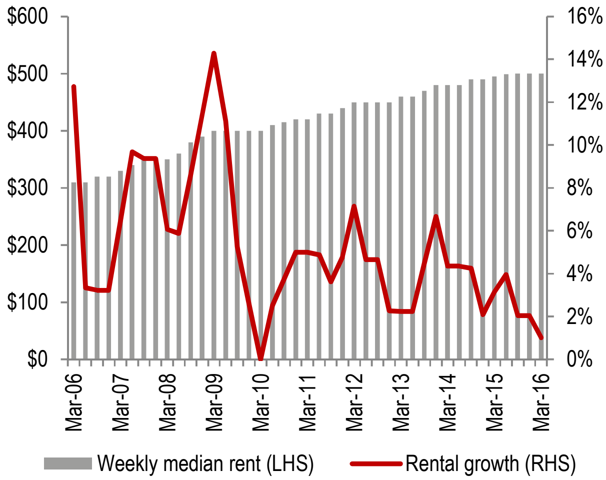
Given that JLL Research estimates that Inner Sydney supply will peak in 2018, there is potential for downward pressure on rental values in specific suburbs as the new stock is absorbed.

[7] CoreLogic RPData

[8] Housing NSW

Figure 4: Annual rental growth and median weekly rent

Greater Sydney, 2006 – 2016



Source: JLL Research, Housing NSW

Buying a new apartment off-the-plan commands a significant price premium over existing stock

JLL Research has found that new apartments off-the-plan sold for 36.7% more than older existing apartments*.

Apart from being new buildings, paying this price premium comes with a number of benefits such as:

- A long period between exchange and settlement to arrange finances.
- The 'New Home Grant' of $5,000 for off-the-plan purchases up to $650,000.
- Tax deductions based on the deprecation of your property and fittings.

Buyers will need to weigh up whether the above benefits are worth paying the 36.7% premium for, and also take risks into account such as:

- Settlement risk- lending requirements can change between exchange and settlement.
- The finished product not matching expectations.
- Delays in construction.

*Based on Inner Sydney sales in 2015.

Source: JLL Research, JLL Valuations & Advisory, Corelogic, Fair Trading NSW

Gross Rental Yields

Across Greater Sydney, gross rental yields have tightened to 3.9% in 1Q16, down from 4.3% in 1Q15[9]. JLL expects yields to tighten further in future, based on rising capital values and slowing rent growth.

Yields are an important factor for overseas buyers and therefore areas in Sydney with strong yields will be more appealing. Based on Corelogic data, the best Inner Sydney performers for yield as of 1Q16 are Sydney CBD (4.4%), Alexandria, Erskinneville and Enmore (4.3%), Surry Hills, Potts Point, Ultimo and Chippendale (4.2%).

Site Sales

Developers face a number of challenges in a market where rising development site costs and rising construction costs result in profit margins getting tighter. To add further difficulties, it is also now more difficult to source development funding, particularly if a bank has not dealt with the developer before.

As a result of this, recent site sales indicate a number of developers are foregoing opportunities to develop at this late stage of the current cycle and are instead looking at the next cycle.

In particular income generating sites such as those with current industrial or office leases in place offer a hedged opportunity for developers who are willing to take on the planning risk of buying a site without development approval.

A notable example is Chinese-backed developer Aqualand, who has already purchased a number of sites this year that fit this description:

Figure 5: Aqualand's purchase of sites with holding income

Aqualand, development site purchases, 2015 - 2016

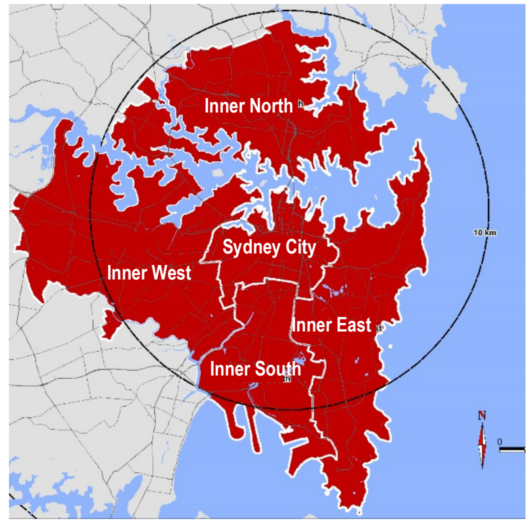
Sale Date	Address	Current Use	WALE by Area (yrs)
1Q15	168 Walker Street North Sydney	Office	31.5
1Q16	1-3 Munn Street Millers Point	Office	3.0
2Q16	40 Talavera Road North Ryde	Office/Industrial	5.1
2Q16	61 Lavender Street Milsons Point	Office	

Outlook

- The Sydney apartment market is reverting to 'normal' levels of activity.
- Price growth is likely to moderate as new supply coming on to the market is absorbed. Developers who have factored continuing price rises will have to adjust to the emerging market conditions.
- Developers will move their focus towards development sites with holding income to prepare themselves for the next cycle.
- A low interest rate environment, continued population growth and economic growth will continue to be supportive of housing investment.

[9] CoreLogic RPData

Map of Inner Sydney Apartment Market



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