Residential Commentary – Melbourne Apartment Market

July 2016

Executive Summary

- Melbourne LGA's median unit price was $501,000 in 1Q16, falling by 0.8% over the quarter and by 1.0% over the year to 1Q16.
- Apartment construction is now becoming more prevalent in areas outside of Melbourne City as developers stretch their geographic focus.
- Development site sale volumes have significantly declined, particularly in Melbourne City. This reflects increasing uncertainty regarding the recent planning changes, along with concerns regarding the level of supply in certain areas.
- Rental growth remains concentrated in those suburbs that have recorded a large volume of completions, as higher rental rates are often demanded by newly completed stock.
- The rental vacancy rate across Melbourne's inner zone (0-4km) increased to 4.3%, its highest rate since December 2014. This is the highest vacancy rate across Australian eastern seaboard capital city inner markets and a major concern for the secondary rental market.

Melbourne Apartment Market: Key Indicators

Inner Melbourne			% change Y-Y
Apartment approvals 12 months to:	1Q16	10,429	-0.1%
Supply 2016-2021:			
Completed	June 2016	2,776	
Under Construction	June 2016	21,170	
Currently Marketing	June 2016	16,707	
Plans Approved	June 2016	27,472	
Plans Submitted	June 2016	29,393	
Sales volumes 12 months to:	1Q16	6098	-8.2%
Median unit price (Melbourne LGA)	1Q16	$501,000	-1.0%
Median rental value			
1-bedroom	1Q16	$350	-1.0%
2-bedroom	1Q16	$450	0.0%
Gross rental yield			
1- bedroom	1Q16	4.9%	-0.1pps
2- bedroom	1Q16	4.1%	0.0pps

Source: JLL Research, Core Logic RP Data, REIV

[1]*Inner Melbourne*

Economic Overview

The Victorian economy has strong fundamentals recording 4.0% y-y State Final Demand (SFD) growth in 1Q16, well above the national 1.1% average. However, growth slowed with a subdued 0.1% q-q increase, reflecting falling business investment.

The RBA cut interest rates to a new historic low of 1.75% in May 2016 following weak inflation numbers. This should support a lower AUD which has helped maintain Victoria's key export industries including tourism and education. Victoria's international tourism visitors increased by 14.1% over 2015, the largest uplift of any Australian state. Victoria's service and consumer sectors remain buoyant. Retail turnover volumes grew by 5.1% y-y to 1Q16, well above 4.1% national average.

Victoria's population increased 1.7% to just under 6 million people in the 12 months to September 2015, significantly above the 1.3% national average growth. Whilst overseas migration continued to be the major component of annual growth, accounting for 54.4% 3Q15, Net Interstate Migration (NIM) has become increasingly important. As immigration underpins the majority of Victoria's population growth, visa legislation will be critical to the state's future population numbers.

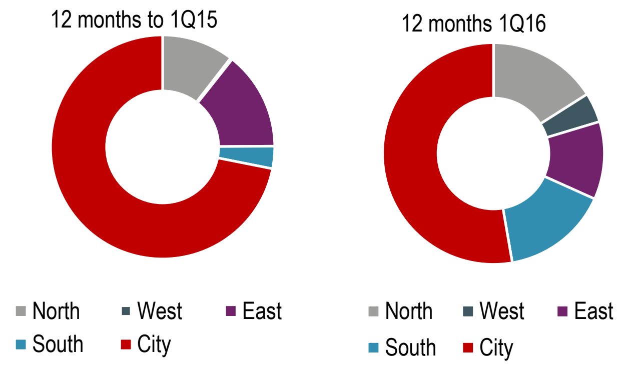
Victoria's labour market is performing well with total employment increasing by 2.2% over the year to May 2016. Additionally the unemployment rate has fallen to 5.7%, the lowest quarterly figure since March 2013. The outlook remains robust with a 35% increase in job vacancies in the year to February 2016. State Government infrastructure projects which have been identified to commence over the 2017-18 years will further support labour conditions.

The lower AUD will continue to support the state's exports whilst solid population growth is expected to continue. The outlook for the Victorian economy is for positive economic growth, albeit slightly weaker than in 2015. State Final Demand is forecast to grow by 1.5% in 2016, picking up again to 2.2% in 2017 (DAE).

Supply

10,429 apartment approvals were recorded in Inner Melbourne over the year to 1Q16, a marginal -0.1% annual decrease. Apartment approvals are becoming more evenly distributed across Inner Melbourne shifting away from the previous Melbourne City concentration. The Melbourne City recorded 53% of all apartment building approvals across Inner Melbourne in the 12 months to 1Q16, down from 72% in the previous year.

Figure 1: Inner Melbourne's distribution of apartment building approvals



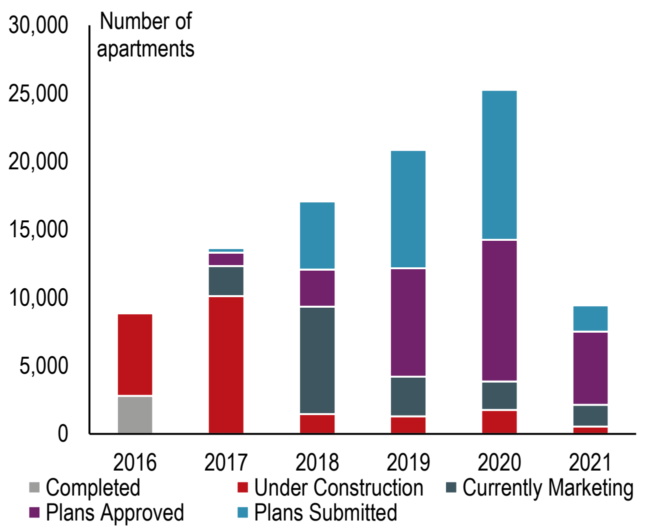
Source: ABS, JLL Research
For precincts boundaries refer to map on page 5

The transition in apartment approvals away from the inner city reflects the scarcity of development site opportunities in the city along with a widening geographic focus by developers. Inner Southern and Western precincts have both recorded rapid growth in apartment approvals.

Inner Melbourne has 21,170 apartments currently under construction, with an additional 16,707 apartments actively being marketed for completion over 2016-2021.

Inner Melbourne apartment supply pipeline is likely to peak in 2017-2018 as a large portion of the potential supply forecast in 2019-20 is unlikely to proceed this market cycle as access to development finance and pre-sale benchmarks become increasingly difficult to achieve.

Figure 2: Inner Melbourne Apartment Supply Pipeline



Source: JLL Research
Only includes developments >50 units

Another emerging trend is the orientation of both international and local developers to target the owner occupier market with smaller boutique apartment developments located in fringe suburbs. Key examples of this include Leroy Apartments in St Kilda and Rockley Gardens in South Yarra.

Amendment C270 – Melbourne's Central City Planning Changes

The Victorian Government announced in April 2016 an outline of the proposed Central City built form planning control changes; Amendment C270. In July 2016 a formal independent planning panel is expected to review the proposed provisions and all public submissions. Once finalised, Amendment C270 will be permanently gazetted into Melbourne's Planning Scheme in September 2016 coinciding with the lapse of the interim planning controls. Whilst these changes will have ramifications for existing land owners, specifically those without a planning permit, it will act to moderate the scale of development that has been witnessed over the past 24 months. However, the city will continue to see development over the proposed plot ratio thresholds as developments with permits granted prior to the interim controls proceed with construction.

Refer to JLL's Melbourne's Planning Changes Report

Demand

Increasingly tough investor borrowing criteria has reined in investor demand for Inner Melbourne's apartment market. In the 12 months to March 2016 new investor housing loan approvals decreased 25.5%, underpinning a 1.27% decline in total residential new housing loans approved for the period (RBA). This is the first negative growth figure since March 2011. Owner Occupiers are forming a larger component of buyer demand for Inner Melbourne's off-the-plan apartment market.

Offshore capital has also formed an important component of Melbourne's apartment demand, although recently introduced loan covenants for development finance limiting the percentage of FIRB allocated pre-sales may reduce these sale transactions. Increased Loan to Value (LVR) ratios and further tax provisions imposed on non-residents could also impact these investors.

Inner Melbourne's apartment market is witnessing longer marketing periods and lower transaction volumes. Across Inner Melbourne sale volumes declined by 8.2% y-y in 1Q16.

Melbourne's apartment affordability in comparison to Sydney will continue to encourage international and interstate demand.

Price

Melbourne's Local Government Area (LGA) median unit price decreased 1.0% to $501,000 in the 12 months to 1Q16; the largest annual capital decline since June 2013. This is the 4th consecutive quarter of zero or declining capital growth, suggesting supply is currently outweighing demand.

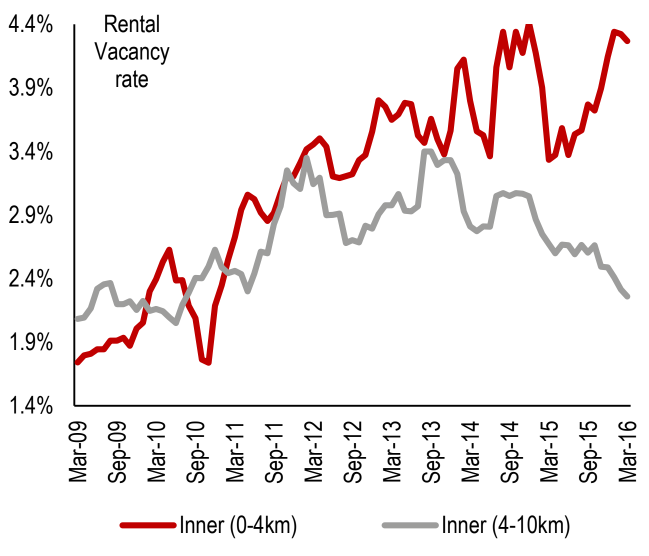
East Melbourne and Albert Park recorded the largest capital growth in Inner Melbourne over the year to March 2016 at 23.9% and 20.4% respectively. Inner Melbourne's northern precinct recorded a significant decline in median unit prices, notably Parkville and Carlton where prices fell 11.6% and 9.6% y-y in 1Q16.

Settlement risk may become more apparent as unit valuations at completion come under increasing pressure arising from the large supply.

Rental Rates

All but six suburbs in Inner Melbourne recorded positive rental growth in the 12 months to 1Q16 (average of +1%) across all unit configurations. Suburbs that experienced a large volume of apartment completions *have witnessed* the strongest rental growth, given this new stock is commanding higher rental rates. For example Carlton (8.2%) and South Yarra (4.4%) recorded the strongest rental growth across Inner Melbourne.

Figure 4: Rental Vacancy Rate, Inner Melbourne



Source: REIV, JLL Research

Rental growth was positive across Melbourne City with Docklands remaining the most expensive rental market in Inner Melbourne ($540 y-y 1Q16).

Despite the positive rental growth figures in Melbourne's inner zone (0-4km), the rental vacancy rate increased to 4.3% in March 2016 up 50 basis points from March 2015. This is the highest vacancy across all inner regions of Australia's capital city eastern seaboard markets.

Gross Rental Yields

Gross rental yields in Inner Melbourne have generally tightened in 1Q16 reflecting the robust capital growth experienced across the apartment market. However, Melbourne's city and northern precincts were an exception with both recording softer gross rental yields, notably Carlton and Parkville in north and Melbourne SA2 in the city. Inner Melbourne's eastern precinct continued to record the tightest yields in 1Q16.

The Melbourne City recorded similar trends to those witnessed in 4Q15. Docklands gross rental yield remained stable, whilst Southbank tightened slightly to 4.92% and Melbourne SA2 softened to 5.43% in 1Q16.

Site Sales

Development site sales across the Melbourne City have significantly pulled back, with few transactions recorded so far in 2016. Many international developers have delayed their investment decisions due to uncertainty regarding the proposed planning changes and concerns regarding the current supply levels in specific areas. SP Setia Pty Ltd, a Malaysian development firm has been very active early in 2016, transacting the biggest CBD sale for 2016 at 308 Exhibition Street ($101 million).

Table 1: Major development site sales YTD 2016

Street Address	Date	Approximate land rate
33 King Street	May 2016	$35,400
308 Exhibition Street	April 2016	$24,400
1-5 Queens Street	Feb 2016	$24,400

Source: JLL Research

As many developers shift away from CBD development acquisition, there is a greater distribution of site sales across Inner Melbourne in 2016. Prestigious, well serviced locations of South Melbourne, Prahran and Richmond are still receiving traction. Salta properties purchased an 800sqm site in Richmond at a land rate of $11,250 in February 2016.

Increased tax surcharges

Foreign purchasers of taxable residential property in Victoria as of 1 July 2016 will be subject to an additional **7% stamp duty surcharge** (up from 3%) of the purchase price. This surcharge is in addition to the standard stamp duty rates a local purchaser would pay. The charge is also conditioned on the transfer of vacant land with residential zoning or when there is a clear intention from the buyer for residential development.

This will impose a 12.5% stamp duty on a property exceeding $960,000 for a non-resident purchaser, compared to 5.5% for a local resident.

Additionally all investors (those not occupying the premises) on Victorian real estate titles (not just residential) will incur an increased **absentee land tax surcharge of 1.5% per annum** (lifted from 0.5%) from 1 January 2017, based on land owned on the 31st December 2016. This threefold increase comes after the recent introduction of a 0.5% absentee land tax on 1 January 2016.

Outlook

- Melbourne's median unit price will continue to come under downward pressure reflecting supply concerns. Specific suburbs with larger supply pipelines will take longer to absorb the stock.
- As redevelopment opportunities dry up across Melbourne City precinct and owner-occupiers become increasingly important, both local and international developers will continue to pursue opportunities in Melbourne's fringe markets.
- Developers are continuing to favour mixed use development, combining residential dwellings with a hotel or retail component. This gives the added advantage to developers to tap into Melbourne's growing tourism and service sector.
- Rental growth will slow as vacancy rates edge higher.

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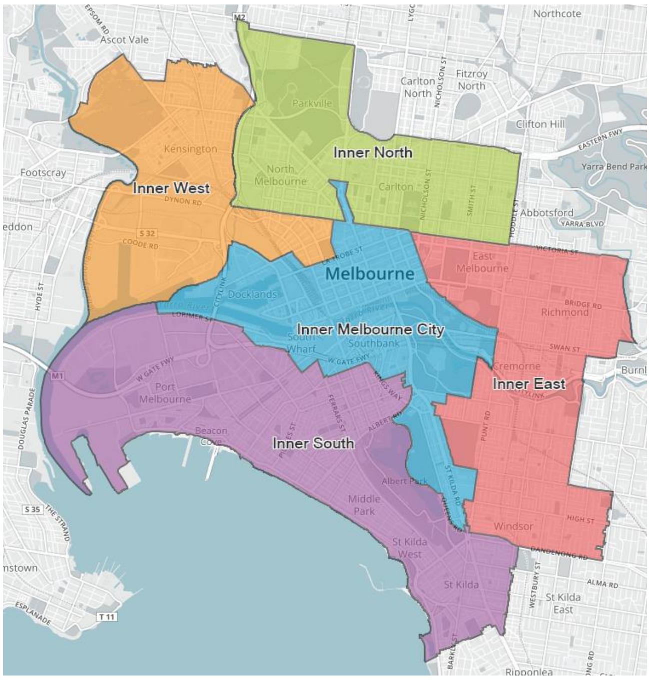

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