Land of Oz

Australia's residential market is cooling, but not crashing

by Mard Naman

In many ways, Australia remains a blessed and lucky country. This past April, Australia recorded 26 years of growth without a recession. Despite this, danger signs are ahead, especially for the residential sector.

Stoked by low interest rates and a shortage of housing, Sydney has become the world's second-most expensive property market, with Melbourne also in the top 10. In April, the median home price in Sydney reached A$1.14 million (US$854,800).

In Sydney and Melbourne, home prices rose at a torrid pace in 2016, before starting to cool over the past few months. According to Knight Frank, median home prices in Sydney jumped 9.3 percent from April 2016 to April 2017, while apartment prices increased 7.8 percent. In Melbourne, median home prices jumped 12.6 percent and apartments 8.6 percent.

Rapidly-escalating values are not new: Since 2012, home prices in Sydney and Melbourne have risen 80 percent and 60 percent, respectively. In the process, homeownership increasingly has become beyond the reach of many. At the same time, Australian homeowners are carrying record household debt. In fact, the Reserve Bank of Australia has warned Australian homeowners are overleveraged, while the use of interest-only loans remains prevalent.

Household debt is such a problem that this past June, Moody's Investors Service downgraded

12 Australian banks, including the large banks known as the "big four". Moody's indicated "elevated risks within the household sector heighten the sensitivity of Australian banks' credit profiles to an adverse shock." Although Moody's does not think a "sharp housing downturn" is a "core scenario", the ever-growing household debt, significant home-price appreciation in Sydney and Melbourne, and the extensive use of interest-only loans have caused risk levels to rise.

Others have also sounded the alarm. In June, Citigroup's global chief economist, Willem Buiter, said Australia had a "spectacular housing bubble" that had to be addressed with tougher regulatory measures. Soon thereafter, the state of New South Wales (home of Sydney) announced such a measure by doubling the tax on home purchases to 8 percent for foreign buyers. This comes on top of the normal stamp duty, which can go as high as 7 percent. The stamp duties in Australia are relatively new: In a little more than a year, all major east coast cities have introduced them.

The new duties on foreign buyers are having an immediate effect. A June KPMG report suggests demand for Australian residential property from Chinese investors has already softened because of the additional taxes, as well as from a 50 percent cap on developers selling to foreign investors and China's tightening of currency controls. Buyers from mainland China are by far the largest foreign-buyer group, and foreigners account for one-quarter of new housing sales in New South Wales, according to a Credit Suisse report. Some developers are worried, but others believe domestic sales are hardy enough to withstand the loss of foreign buyers, especially with government assistance for first-time buyers.

Will domestic demand fill the gap? For the short term, it likely will depend on the property type, observes Marc-André Flageole, portfolio manager at Presima. For detached homes, the proportion of foreign investors is typically insignificant; however, foreign investors seem more involved in the apartment market. "For apartments and condos, I'd be a bit concerned for the short term," says Flageole.

The KPMG report, *Housing Affordability: What is driving house prices in Sydney and Melbourne?,* notes making housing more affordable and putting downward pressure on rising housing costs are now ongoing government focuses. This includes, among other things, increased stamp-duty rates and vacant-property taxes for foreign buyers.

KPMG also predicts domestic investor demand will be cooled by the Australian Prudential Regulation Authority's moves to curb interest-only mortgages, and that monetary policy soon will tighten further.

Michelle Ciesielski, head of residential research for Knight Frank Australia, says a tightening domestic-lending environment has already taken some heat out of investor markets across Australia. These markets will be tested by the most recent increase in foreign investment fees and by the degree to which the Chinese government restricts capital outflow over the next year.

No dramatic drop

Despite these obstacles, uncertainties and risks, numerous analysts say a spectacular crash is highly unlikely in Australia because many factors are buffeting the market. Some say price growth will moderate, while others believe a mild correction is likely. "Sydney and Melbourne are likely to have more sustainable growth over the coming years, but demand is still too strong for there to be a drastic market correction," says Ciesielski.

The price boom resulted from strong demand and shortage of supply and, therefore, a significant fall in housing prices is unlikely, Paul Bloxham, chief economist for Australia and New Zealand at HSBC, indicated in a research note.

Considerable price growth over the past few years means investors face more risk now, but a tougher banking and regulatory environment should keep supply under control and limit any future correction, according to Steve Bulloch, head of Australia for PGIM Real Estate.

Melbourne

Presima's Flageole agrees there is little risk of a dramatic crash, given the supply/demand dynamics and expected population growth. "Long term, we are still positive on the market overall," he says. But short to mid-term, he believes a price correction could be likely at this point in the cycle. "Will it be dramatic and prices go down 30 percent? I would doubt it, just because of the chronic undersupply and long-term dynamics of the country," explains Flageole.

The KPMG report predicts the Australian housing bubble will deflate slowly over the next few years, rather than through any sharp downturn. The firm found median home prices in Sydney and Melbourne were overvalued by 14 percent and 8 percent, respectively, as at the end of fiscal year 2016. "Our forecasts show Sydney will experience a greater adjustment than Melbourne in the next few years, but this is likely to be gradual rather than a collapse in the median dwelling price," writes Brendan Rynne, chief economist for KPMG Australia, in a short piece about the report.

Oxford Economics projected real GDP growth in Australia to be 2.8 percent in 2017, but this now appears overly optimistic. First-quarter results showed growth of only 1.7 percent year-over-year, the lowest since the global financial crisis. Even if the economy rebounds some, analysts have now lowered forecasts to about 2.2 percent for the year. But longer term looks brighter: The RBA has projected growth of about 3 percent over the next two years, and Cushman & Wakefield, in its *Australia Investment Report* for 2017, projects GDP growth will be greater than in other advanced economies over the next five years.

Best and worst performers

While the residential market slows, Sydney and Melbourne continue to be the best overall performers in the country, according to Knight Frank's Ciesielski. Despite significant upward growth in capital values in both cities over the past several years, she sees capital growth likely to continue over the medium term. Flageole believes Sydney should be the market that holds up the best, going forward.

Population growth and employment remain key drivers. Population growth in Sydney and Melbourne exceeded the national average in 2016, at 1.7 percent and 2.5 percent, respectively. Ciesielski generally considers residential markets to have balanced supply and demand when vacancy reaches 3.0 percent. Sydney and Melbourne are both considered undersupplied, with Sydney's vacancy at 1.8 percent and Melbourne's at 2.2 percent as at May 2017.

At the other end of the spectrum, Darwin, capital of the Northern Territory, continues to endure a correction following the winding down of a long reliance on the resources sector. Median house values fell 2 percent over the year ended April 2017, while apartment values dropped 8.7 percent. Darwin's last recorded vacancy level in March 2017 was 7.1 percent, and the city had only 1 percent annual growth in 2016. "It's likely this market still has some time before it recovers over the longer term," says Ciesielski.

Australia's residential market is by no means homogenous, even within cities. Overall housing numbers hide the fact it is becoming more bifurcated by product type. Flageole says mostly apartments and condos, not detached homes, have been hit with price-growth moderation up to now. "Pricing dynamics in Perth, Brisbane, Sydney and Melbourne have been marginally weaker over the last few months in the condo market, and in the home or detached market, prices still seem to be holding up," he says.

Flageole likes detached homes that are at more-reasonable price points, typically farther away from the city centre. Such detached homes generally are doing well in Sydney, Brisbane and Melbourne. These mostly-suburban mid-range homes are purchased primarily by people who are going to live in them and pay for them over the next 25 years. "They're less subject to the potential volatility you see in the condo market, which seems to be transacted more by investors or speculators," adds Flageole.

Melbourne apartments, however, appear to be more oversupplied and affected by the stamp duty because of the higher percentage of foreign buyers. "We would be careful with apartments in Melbourne, meaning condos in the city centre, which are generally seeing more price pressure at the moment," notes Flageole.

Some developers in Melbourne are now offering incentives on apartments or condos, another sign of a potentially-turning market, according to Flageole. The incentives are not yet widespread, but some developers are giving rebates, paying for the stamp duty and offering rental guarantees. In this scenario, the developer tells potential buyers if they want to rent their units out, the developer will, for example, guarantee a 5 percent yield for 12 months.

In Queensland, Brisbane home prices increased 4 percent year-over-year in April 2017, but apartments, which are oversupplied, saw no growth in capital values over that time, says Ciesielski. In addition, the Queensland economy is not as strong as the economies of New South Wales and Victoria.

Nevertheless, many investors and owner-occupiers have looked to Queensland as a better value proposition. Ciesielski says some investors priced out of the heated Sydney and Melbourne markets are seeking higher gross rental yields, and once Brisbane absorbs the last wave of apartment stock over the short to medium term, more investors will return to this more-affordable market.

Other investors have been looking even farther afield for value propositions, says Ciesielski. One such destination is Hobart, the capital of the island of Tasmania, where the median home value grew 8.1 percent in 2016, while apartment values grew 7.4 percent.

A magnet for wealth

Meanwhile, the luxury segment is sailing along. "The prime markets have shown strength whilst the mainstream has cooled," says Ciesielski. Despite sky-high prices in Sydney and Melbourne for average homes, home prices are quite affordable in a global context for wealthier property buyers, Lord Andrew Hay, global head of residential for Knight Frank, told Fairfax Media back in April. Hay pointed out Sydney and Melbourne rank in the top 20 of most desirable cities for high-net-worth individuals to live and invest in. In Knight Frank's *City Wealth Index 2017,* Sydney ranked fourth in the investment category and Melbourne ranked 10th.

Demand continues to grow from the wealthy population to move money into safe-haven cities, observes Ciesielski. And Flageole believes, especially in Sydney, price might not be the first consideration in the super-luxury segment. "It appears to be more about the desirability of the city, the universities, the quality of the environment, which attract the top .01 percent," explains Flageole. "Sydney is a nice place to live."

And the shortage of supply should help sustain prices. Sydney has land constraints, and building permits are not easy to get. Development is being pushed farther from the city centre and, to be able to afford units, people often have to buy far away and have very long commutes. "For Sydney, even the stamp duties might not improve things dramatically," says Flageole. "Close to the city centre, we're not seeing a major affordability improvement on the horizon."


Brisbane

The goal of the government should be to increase supply rather than only tame demand, explains Flageole. Experience has shown in Hong Kong that restrictions can have a short-term effect, but if there is chronic undersupply of units, those measures could not work for the long run. Despite the housing shortage, the planning approval is still lengthy, according to Ciesielski.

"The way to have a more-sustainable solution down the road is to make sure developers are able to supply sufficient product to end users," says Flageole. That said, he also believes, without stamp duties, prices could have escalated pretty quickly.

Another potential challenge for future supply is escalating construction costs, mostly related to labour costs and labour shortages. Flageole says this might mean a lower margin for developers down the road, which could slow new construction starts and potentially exacerbate the chronic supply shortage.

Residential conversion continues but pace slows

One partial solution to the undersupply issue, especially in Sydney, would be to convert office or industrial units to residential. Home prices have risen so dramatically, the conversion of office properties has become a common investment strategy in many Australian cities. This strategy has been aided by changes in city planning laws.

"In many parts of the country, capital values per square metre for residential uses have exceeded that of commercial uses, making residential conversion a rational choice for many owners in order to achieve the highest and best use of the property," explains Dr Alex Pham, senior research manager for Knight Frank in Australia. Pham adds Sydney, Melbourne and many suburban hubs experiencing strong population growth provide the best investment opportunities for this strategy. Examples include the Parramatta, Chatswood, Crows Nest and St Leonards suburbs and districts in the Sydney area.

Both buyers and sellers have done well in recent years with the conversion of office properties to residential in major Australian CBD markets, according to PGIM Real Estate's Bulloch. And while strong population growth and urbanisation mean the trend will continue, Bulloch says it will be at a much slower pace going forward.

Offshore buyers, particularly those from Asia, have led this part of the market but are becoming less active. In addition, banks now have a significantly-reduced appetite for financing land and residential development. "We think this slowdown will be most evident in Brisbane and Melbourne, where the potential oversupply of inner-city residential apartments is greatest," observes Bulloch.


Perth

In Sydney, secondary office rents have strengthened considerably (in part because of stock withdrawals due to residential conversions), and this also makes residential conversion from office less compelling. But that is not the case with industrial properties. "For industrial assets, we expect to see continued conversion of well-located, inner-ring assets to residential use, due to the higher-value land use, driven by continued population growth and significant new infrastructure in these markets," concludes Bulloch.

Even with house prices moderating, Presima's Flageole believes conversion might make sense both from the perspective of providing more supply and making an investment. He says, for example, a firm could, in some cases, get greater return on equity by converting units from industrial to residential use.

Flageole believes this strategy should continue to offer opportunities for institutional investors, especially in Sydney. "It serves many purposes," he says. "It could be an efficient use of capital; it probably provides a better return, at least in the short run; and it could be helpful for the city, in that it could prevent over-conversion of farmland in the suburbs into large communities. So environmentally, it could be more efficient."

Although the strategy is also taking root in the suburbs, Flageole suggests investors could have a greater chance of success the closer the converted units are to the CBD. "If you're far away from the CBD, there's less attractiveness about moving into an old industrial site," he observes. Buyers in the suburbs are likely looking for a backyard with a lawn.

But for urban living, he thinks it is very attractive, especially in Sydney, where there is an industrial cluster in between the airport and the nearby CBD. The potential is less in Melbourne and Brisbane because there is no shortage of land in those cities.

The road ahead

Despite the new stamp duties, Flageole believes Australia remains a desirable destination for Chinese and other offshore buyers. It is a sought-after place to send kids to university, and ultimately to live and possibly immigrate to. Furthermore, it is a transparent market, where the rule of law is robust.

Underlying demand remains strong, and while apartments in Melbourne and Brisbane are experiencing temporary oversupply, an overall chronic shortage of housing persists. Population growth remains above average in Sydney and Melbourne, and Australia's GDP growth will likely exceed that of other advanced economies for the next several years.

But the risks have also increased in the residential sector. Although a steep decline in prices is unlikely, a mild correction is a distinct possibility. Foreign investors may also face additional taxes, going forward. If prices resume their upward trend after a short pause, higher stamp duties or other government policies could be enacted to cool the market. "We saw multiple rounds of anti-speculative measures in Singapore and Hong Kong, so it's definitely a possibility," says Flageole, in reference to other cities' attempts to control sky-high housing prices.

Of course, the government has the flexibility to remove or loosen such measures if necessary to provide stability to the market. But Flageole does not see that happening any time soon. There has been a lot of press about locals being priced out of the housing market, and if the government removed those measures now, it would likely face significant political backlash.

For residential investors, the margin of error can be sliver thin. While the RBA "cash rate" remains a record-low 1.5 percent, interest rates on home loans remain quite high in Australia compared with other Asia Pacific countries, according to Flageole. In Japan, for example, investors can get 30-year fixed loans at close to 0 percent to buy condos typically at a 3 percent to 4 percent yield. That spread basically is locked in for a long time. By contrast, in Australia a 4 percent to 5 percent loan would be considered low, and the rental yield — at an estimated 5 percent — would be limited. "The cost of borrowing is actually quite high, and rental yields are relatively on par and sometimes lower than what you see in other markets, so the spread is tight," concludes Flageole.

So while the future still looks bright, in the short term, investors will have to exercise caution as they navigate the bumps, twists and turns on the road home. ❖

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