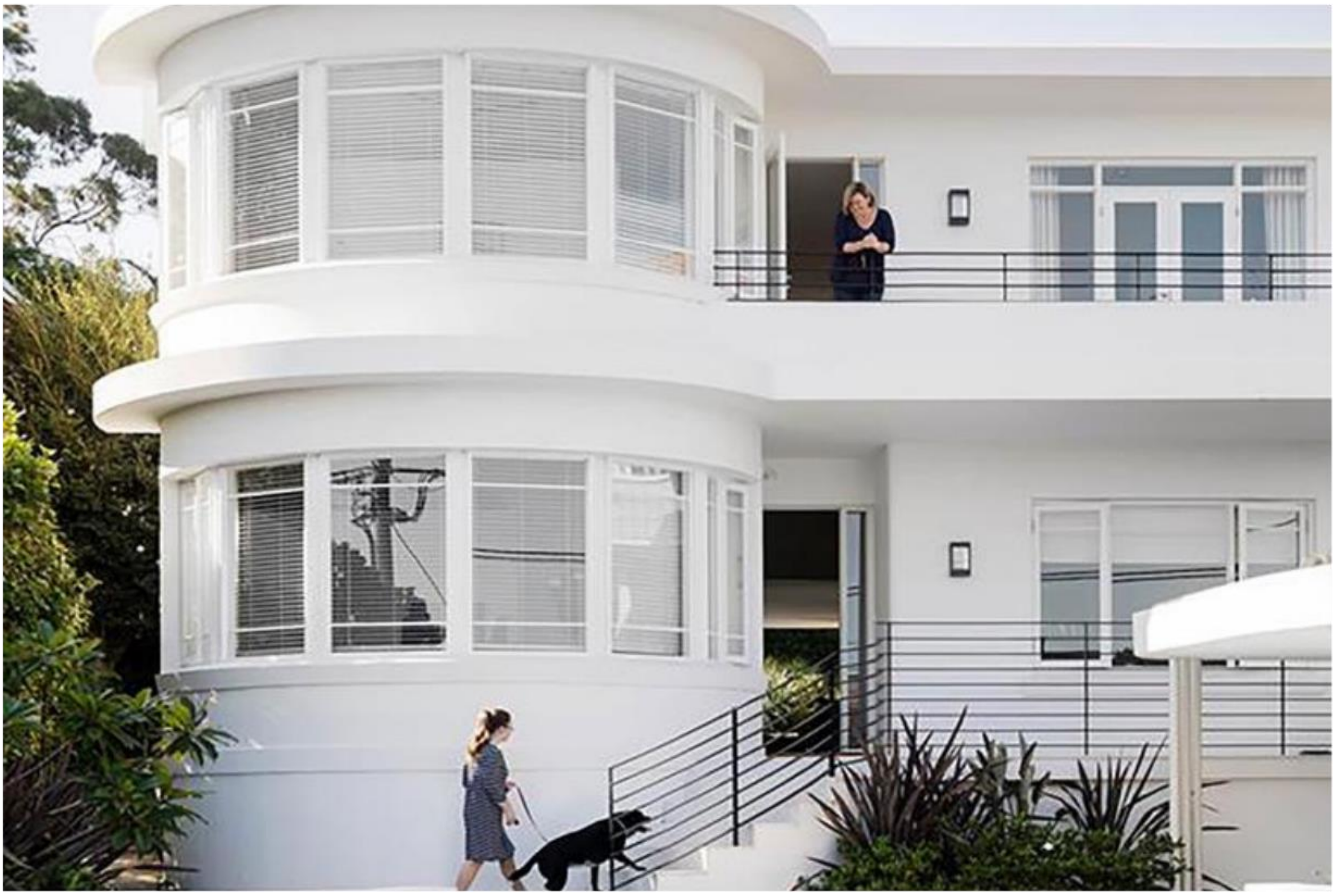
OCTOBER 2020

PERFORMANCE REVIEW OF INVESTMENT GRADE APARTMENTS



Prosolution Private Clients
Level 8, 31 Queen Street
Melbourne VIC 3000

P: 03 8624 4600
E: advice@prosolution.com.au

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1 Executive Summary

It is our observation that investment-grade apartments have under-performed (capital growth wise) compared to houses over the past 8 to 10 years. That is, apartments have generated very little capital growth (sometimes none), whereas houses have grown in value by between 5% and 8% p.a. over the same period.

This white paper considers what has caused this under-performance. Most importantly, it attempts to assess the likelihood that the investment-grade apartment sector future capital growth rate will adequately reward investors.

Our findings are summarised as follows:

- Implied land values indicate that investment-grade apartments are currently intrinsically undervalued.
- We estimate that the average capital growth rate over the next 10 years has to exceed 9.2% p.a., to make up for the past 8-10 years of under-performance. This is not unrealistic given historical growth rates over the past 40 years.
- There is strong evidence that indicates three factors are predominantly responsible for the recent under-performance, being:
    - The supply of new apartments in investment-grade locations increased substantially between 2011 and 2017. However, supply numbers have been in gradual decline since 2017.
    - Tightening in credit laws since 2009 have greatly impaired the borrowing/purchasing power of apartment buyers, which tend to have relatively weak financial positions.
    - The value of residential property purchased by foreign buyers is now one quarter of what it was 5 years ago. Previously, a substantial volume of cheap, poor-quality stock was being sold to non-residents, and this dragged the whole market down. Non-resident buyers no longer account for a substantial part of the market.
- Investment-grade houses have displayed much better capital growth rates over the past 8 to 10 years. This must be caused by appreciating land values. If we accept this as fact, then logic tells us that investment-grade apartments, which tend to have a 45% to 55% land value component, must also be worth more.
- According to the ABS, Australia is expected to experience strong population growth over the next 45 years. Melbourne's population is projected to exceed Sydney's within the next 11 to 27 years. Australia's health and economic handling of the Covid pandemic will likely result in substantially increased immigration demand from foreigners over the next few decades. This population growth will more than absorb all apartment supply that has occurred over the past 10 years.

We conclude that the very likely capital growth rate (for investment-grade apartments) over the next 10 years will substantially exceed the actual growth rate over the past 10 years. The analysis outlined in this report also suggests it's not impossible that the capital growth rate over the next 10 years will adequately compensate investors for the sectors under-performance to date.

2 Review of past investment performance

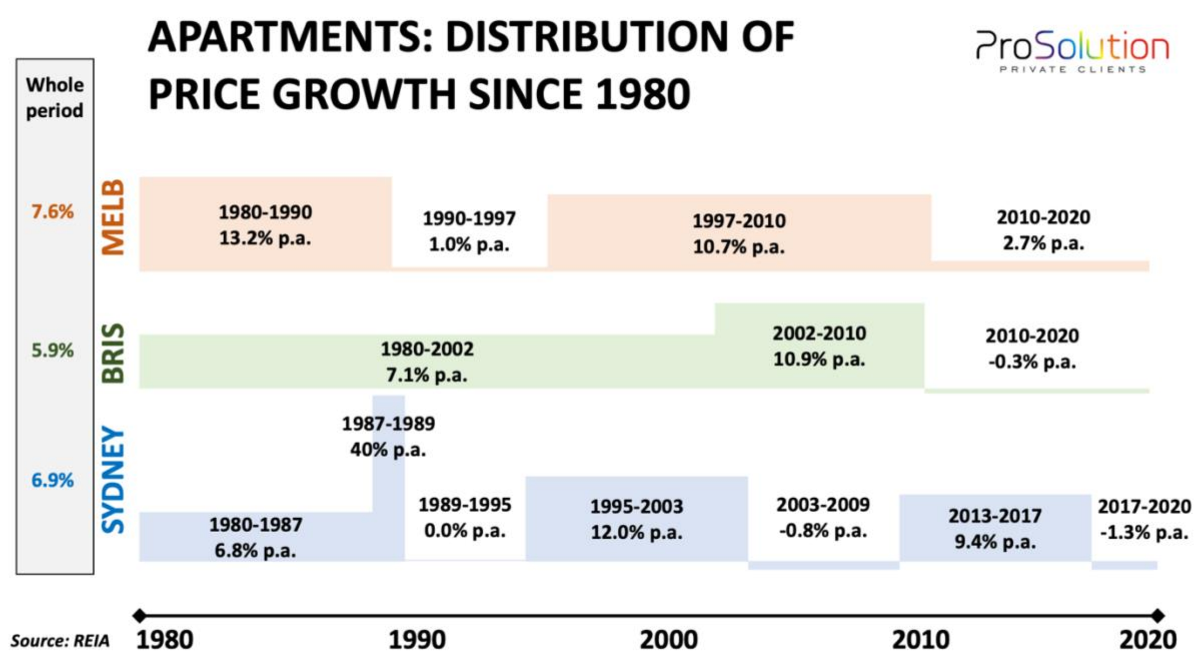
Asset class returns are more predictable over very long periods of time. That is because all markets and asset classes move in cycles which include periods of growth, contraction/correction and sideways drift (i.e. no change in value). That is why, in the short run, returns can be quite volatile. However, it has been well documented that investment returns eventually revert back to their long-term mean (or average). That is, periods of above average growth tend to be followed by periods of below average growth.

It is our observation that investment-grade apartments have under-performed (capital growth wise) compared to houses over the past 8 to 10 years. That is, apartments have generated very little capital growth (sometimes none), whereas houses have grown in value by between 5% and 8% p.a. over the same period.

The chart below sets out the distribution growth in the median price of apartments (i.e. dwellings other than houses) for Sydney, Melbourne and Brisbane over the past 40 years.

It is relatively clear that growth cycles tend to last between 5 and 10 years (although Brisbane between 1980 and 2002 is the main exception). This is in line with what we have observed for houses (as charted here).

Chart 1



Therefore, our observation that apartments have under-performed over the past 8 to 10 years seems to be supported by the above median price data.

It is the aim of this white paper to consider what has contributed to this performance and, most importantly, to ascertain the probability of apartments entering into a growth cycle.

2.1 These headline numbers may not reflect the true picture

When comparing median price growth rates between apartments and houses, there are a few important matters to take into account:

- Median house growth rates are, to some extent, impacted by capital improvements (i.e. renovations and redevelopment). An increasing number of people are choosing to renovate their home to avoid having to sell and upgrade (to avoid selling costs and paying stamp duty), particularly in blue-chip suburbs. For example, it would not be uncommon for someone to purchase a house in a blue-chip suburb for $1.2-$1.5 million and spend $600,000 on a renovation e.g. adding a 3rd bedroom. This may increase the value of the property to $2 million. If/when the owners eventually sells, this will inflate the property's nominal capital growth rate.

  Whilst it is true that owners can make capital improvements to apartments, there is far less scope to do so. For example, it is very rarely possible add a bedroom onto an existing apartment. As such, at a median data level, house growth rates will probably always exceed apartments.

  This is why it's important to not rely upon median price data to make investment decisions. Instead, comparable sale research provides more compelling and reliable data.

- The other factor to take into account is that rental yields for apartments (compared to houses) have been 1-1.5% p.a. higher over the review period. Also, on average, the cost to maintain an investment-grade house is materially higher than an investment-grade apartment.

2.2 Investment-grade apartments only

This white paper only considers the performance characteristics of investment-grade apartments. Investment-grade apartments are typically found in established, blue-chip suburbs, in small blocks of fewer than 12 apartments. They are located in quiet streets that are well-serviced by amenities such as public transport, shops and leisure and entrainment facilities. Often these blocks of apartments were constructed in the 1970-1980's, or earlier.

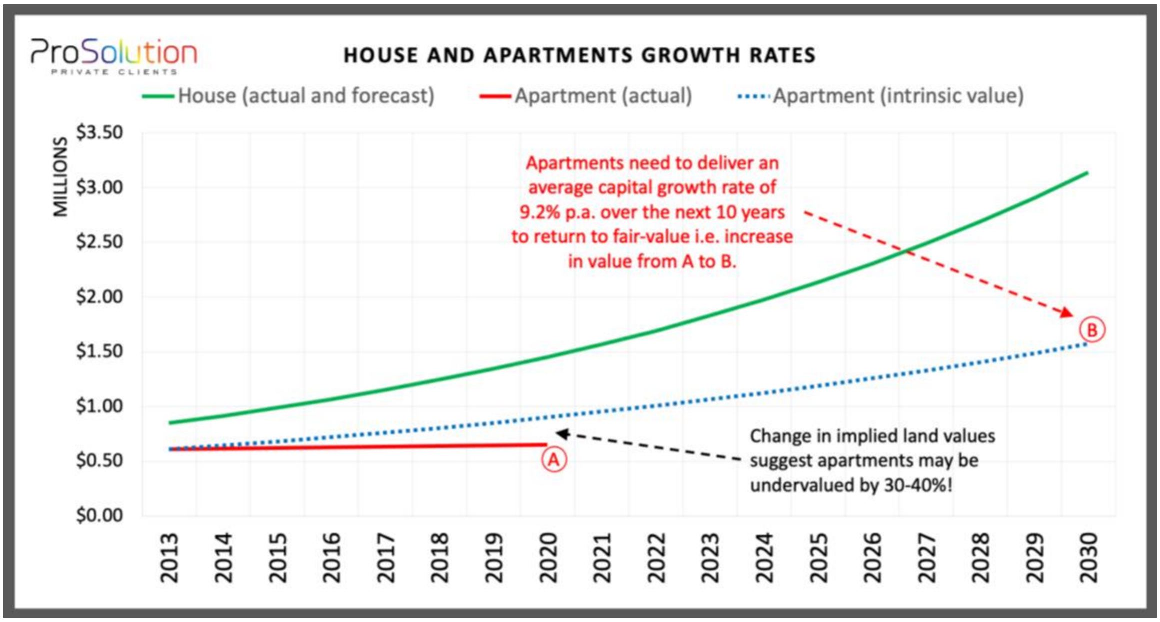
Investment-grade apartment characteristics are distinctly different to non-investment-grade apartments i.e. high-rise and/or high-density type apartments. These tend to have been constructed within the past 10 years, often are located on busy main roads and have more than 20 apartments in the block (and sometimes several hundred in the same building). The comments and analysis contained in this report do not apply to non-investment-grade apartments.

2.3 Growth rate required to normalise returns

If you purchased an apartment 7 years ago for $600,000, it may be worth $650,000 today. Most people would (and should) be disappointed with receiving only $50,000 of capital growth over 7 years. Applying the change in land values (as implied by the actual change in house prices) to apartments, one could argue that the intrinsic value of this apartment may be closer to $900,000. This intrinsic valuation is illustrated by the blue dotted line in Chart 2 below.

We calculated that this apartment would need to generate an average capital growth rate of 9.2% p.a. over the next 10 years to "make up" for its past under-performance (i.e. to grow from value A to value B). That is, the value of the apartment would need to increase from $650,000 to $1.55 million over the next 10 years. Whilst that might seem unrealistic, we note that apartments have delivered growth above 9.2% p.a. in the past, as illustrated in Chart 1.

Chart 2



2.4 Comparing apartments to houses is unfair

Comparing the performance of houses with apartments ignores that fact that the cost of an entry-level house is often more than double that of an entry level apartment. Not all investors are in a position to be able to invest in a house i.e. their financial budget doesn't extend to this level. Therefore, in order to invest in an established, blue-chip suburb, they have to invest in an apartment.

From a practical perspective, a fairer comparison is probably to compare investing in an apartment in an investment grade suburb *versus* investing in a house in a middle or outer ring location i.e. further away from the CBD.

There's a large body of evidence that demonstrates that average capital growth rates decline the further away a property is located from the CBD (e.g. this report – refer page 78 onwards). Therefore, typically, investors are better off investing in an apartment in an investment-grade suburb.

3 Contributors to supply and demand

There are two main factors that will influence the price of any asset; supply and demand.

When demand exceeds supply, prices rise. The reverse is also true. And when markets are in equilibrium, prices remain steady.

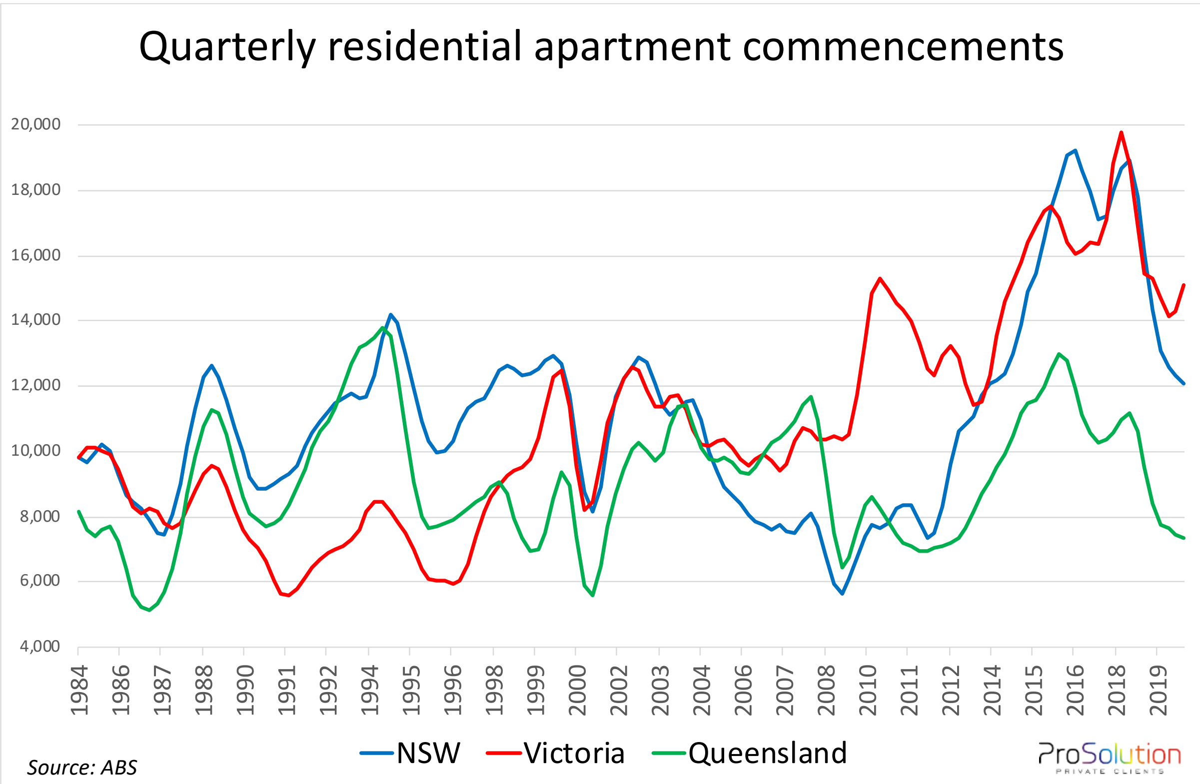
There have been a few factors that have either contributed to, or subtracted from, supply or demand for investment-grade apartments, which we discuss below (in no particular order).

3.1 Supply of new apartments

The increase in supply of new apartments is illustrated in the two charts below.

Chart 3 below sets out the number of residential unit constructions commenced per quarter. This trend data is provided by the ABS and is seasonally adjusted.

Chart 3



As you can see, supply of new apartments increased substantially from circa 2008 - 2009.

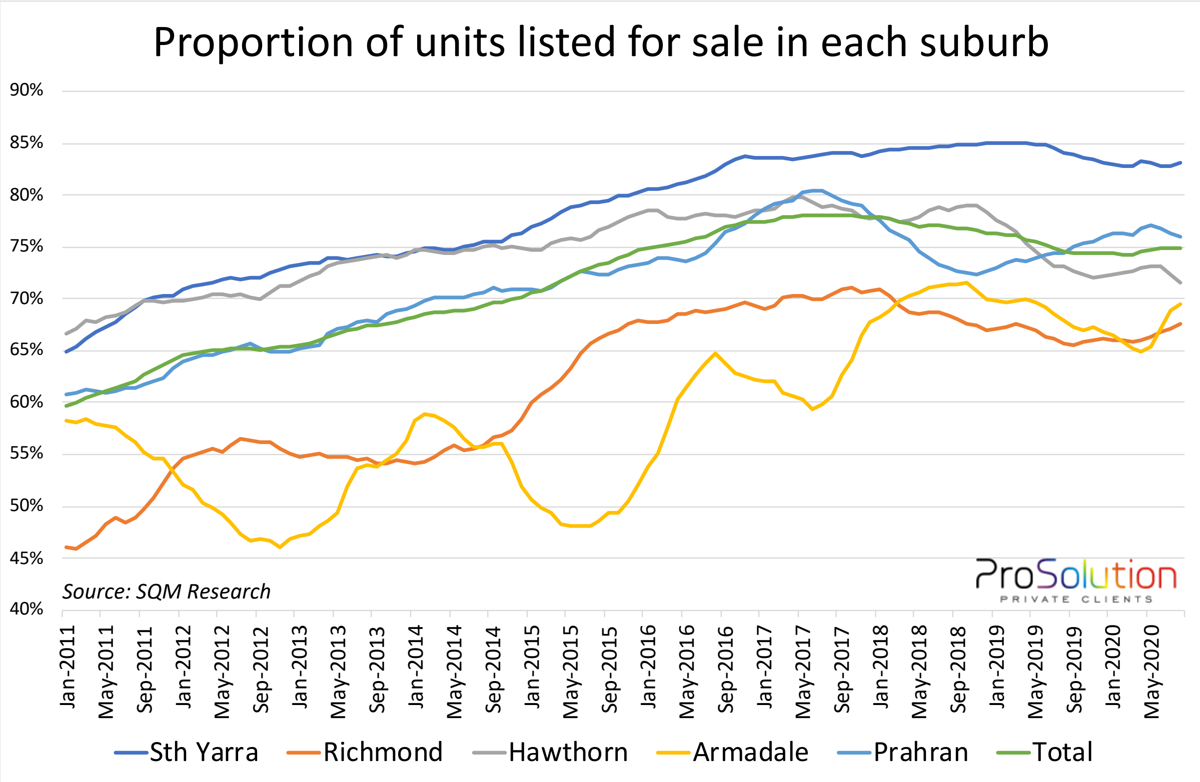
Construction commencements between 2006 and 2012 in Sydney ranged between 6,000 and 8,000 per quarter. By 2016, they had increased to over 18,000. They have since fallen significantly.

In Melbourne, between 1999 and 2009, construction commencements mostly ranged between 10,000 and 12,000 per quarter. Since 2010, the average has been 15,100 per quarter.

Brisbane underwent a construction boom between 2012 and 2016 which resulted in an over-supply of apartments. The market is still adjusting to this over-supply. It is not uncommon for owners in Brisbane to have lost $100,000 to $200,000 in value over the past 5 years.

Chart 4 sets out the proportion of apartments listed for sale compared to houses in a selection of investment-grade, blue-chip Melbourne suburbs since 2011 (when the data series began).

Chart 4



As you can see, in 2011, on average, 60% of properties listed for sale in these suburbs were apartments. By 2017, that proportion increased to 78%. Importantly, the proportion of apartments for sale is slowly trending down and is now 75%.

This data compliments the findings from Chart 3. That is, both charts suggest that investment-grade suburbs experienced a substantial supply of new apartment stock between 2011 and 2017. However, growth in the supply of apartments appears to have levelled out.

It is reasonable to assume this increase in supply of apartments has impeded price growth in the investment-grade sector.

3.2 The supply of houses cannot be changed

The supply of houses in established blue-chip suburbs cannot be changed. Supply is fixed as there is no vacant land. The only way supply of houses can be increase in established locations is through sub-division of blocks. However, sub-division is typically not economical in blue-chip suburbs (that is why sub-division activity tends to occur in secondary locations). Therefore, it is reasonable to assume the supply of housing cannot be changed. As such, investors only need to be concerned with any potential changes in demand, not supply, when contemplating future rates of capital growth.

However, as we have seen in Section 3.1 above, the supply of apartments can be increased. However, supply cannot be increased infinitely. A location will eventually become saturated.

Larger apartment developments tend to be constructed on busy main roads or behind shopping strips. Some examples in Melbourne include Chapel Street in South Yarra, Bridge Road and Swan Street in Richmond and High Street in Prahran. Larger residential unit developments are less common in quiet streets (where investment-grade apartments tend to be located). Therefore, there are a limited number of locations within any given suburb that lend themselves to high-density developments.

Given the development that has occurred over the past 10 years, there are fewer apartment development opportunities in blue-chip suburbs compared to 10 years ago. Whilst it might not yet be close to saturation levels, it is probably fair to say that a substantial number of all viable sites have already been developed.

3.3 Tightening in credit

We have written a lot about the impact of credit tightening that has occurred since 2009 when 'responsible lending' regulations were first introduced. This tightening in regulation dramatically reduced everyone's borrowing capacity. This affected first home buyers (FHB) to the greatest extent, as they tend to have relatively weak financial positions and borrowing capacities are tight.

This may have encouraged more FHB to be attracted to lower-priced, off the plan apartments – away from higher-priced, established, investment-grade apartments, thereby reducing demand for this investment-grade sector. Also, residential developers have very large marketing budgets, and this allows them to attract the attention of buyers. As such, it's not unsurprising that new apartment stock has soaked up most of the demand for apartments. Most uneducated buyers prefer a shiny and new apartment.

The Australian government has recently announced the relaxation of responsible lending rules (from 1 March 2021) which should materially improve FHB capacities.

The tightening in credit has impacted commercial finance for developers also. Banks now require a higher level of pre-sales, which can be challenging to obtain. As such, I anticipate not all approved projects will necessarily proceed to construction.

3.4 Foreign buyers used to dominate the apartment market

In the past, most residential developers targeted non-resident buyers. They would have teams of salespeople on the ground in China and other Asian countries selling Australian apartments off-the-plan. Developers constructed buildings solely to fulfil this demand.

However, in 2015, the Australian government (its *Foreign Investment Review Board* or FIRB) started tightening rules governing the circumstances in which foreigners were able to purchase property in Australia. This has led to a dramatic fall in the volume of sales to foreigners.

In the 2014/15 financial year, the FIRB approved the acquisition of over $60 billion of residential real estate. By the 2018/19 financial year, the amount of residential real estate approved for purchase by foreigners had fallen to $14.8 billion.

The foreign buyer market is now less than 25% of its previous size. In 2019, the government introduced a cap on foreign ownership of new developments. This means that developers cannot sell more than 50% of a new development to foreign buyers.

Generally, resident buyers expect a much higher level of quality (i.e. in terms of build and finish) compared to non-resident buyers. In the past, a lot of apartments were constructed specifically for the foreign buyer market and they were "cheap and nasty". However, as most developers can no longer rely on the foreign buyer market, they are forced to design developments for the resident market. This means constructing higher quality properties, which inevitably cost more. And this will push prices higher.

The volume of new apartments constructed is likely to be significantly lower over the next ten years compared to the previous ten years.

3.5 Potential shift away from "shiny and new" to "tried and tested"

Most owner-occupiers are attracted to brand new apartments because they are contemporary and in perfect condition (no wear and tear). However, new developments have lost some of their appeal in recent years due to construction issues and concerns with respect to cladding.

For example, in 2018, residents in Sydney were evacuated from the Opal Tower due to cracking and concerns about the structural integrity of the building. Not only do owners have to deal with the cost of remediation of defects, but recent reports suggest their building insurance premium will rise from $100,000 to $2 million per year!

In addition, a lot of money has had to be spent by owners to rectify apartment cladding issues in response to the Grenfell Tower fire in London in 2017.

Finally, recently constructed buildings typically include various amenities such as gyms, pools, multiple lifts and so on. As these buildings age, they will require substantial maintenances to ensure they retain their appeal. This will substantially increase Owners Corporation fees, which could negatively impact property values. Conversely, if they are not adequately maintained (which is a risk if owners vote against spending this money), they will quickly lose any appeal and value.

The upshot is that I expect apartment buyers may start preferring the safety of a well-constructed building that has stood the test of time i.e. an older-style building.

3.6 It's the land component that appreciates

The fact is that investment-grade apartments have an attributable land value.

As a basic example, a block of 8 apartments might occupy 800 sqm of very valuable land. If that parcel of land is worth say $3 million, then each apartment has a notional, attributable land value of $375,000. If each apartment is worth $650,000, then 58% of this amount is represented by land value (and the rest building value).

The fact that house prices have been rising (faster than apartments) is an indication that land values have been rising. Therefore, it stands to reason that investment-grade apartments must also be worth more (as the underlying land is worth more today than it was 10 years ago). The only way an apartment's intrinsic value could have remained unchanged over this time is if the building value had depreciated by the same amount as that the land value had appreciated. However, this is very unlikely, especially if the apartment was constructed 50+ years ago, as most of the depreciation has already occurred.

I am aware of recent sales of entire apartment blocks that provide strong evidence that underlying land values have appreciated. That is, there have been a handful of situations where 6 owners (e.g. in a block of 6 apartments) have agreed to act together and sell the whole block to a developer. In this situation, they have been able to realise the intrinsic land value of their property which has greatly improve their individual investment returns.

In short, if houses are worth more, land values must have contributed to this increase, so investment-grade apartments (which typically have a 50% land value component) must be worth more too.

3.7 Population growth and immigration

Chart 5 below has been published by the ABS.

The ABS project that Australia's population will increase from 25.6 million today to 41.6 million by 2066. Melbourne is projected to be the largest city in Australia by 2066 with a projected population between 8.6 million and 12.2 million, surpassing Sydney between 2031 and 2057.

As the chart illustrates, our population growth is highly dependent on overseas immigration. Of course, Covid has temporally reduced immigration to nil.

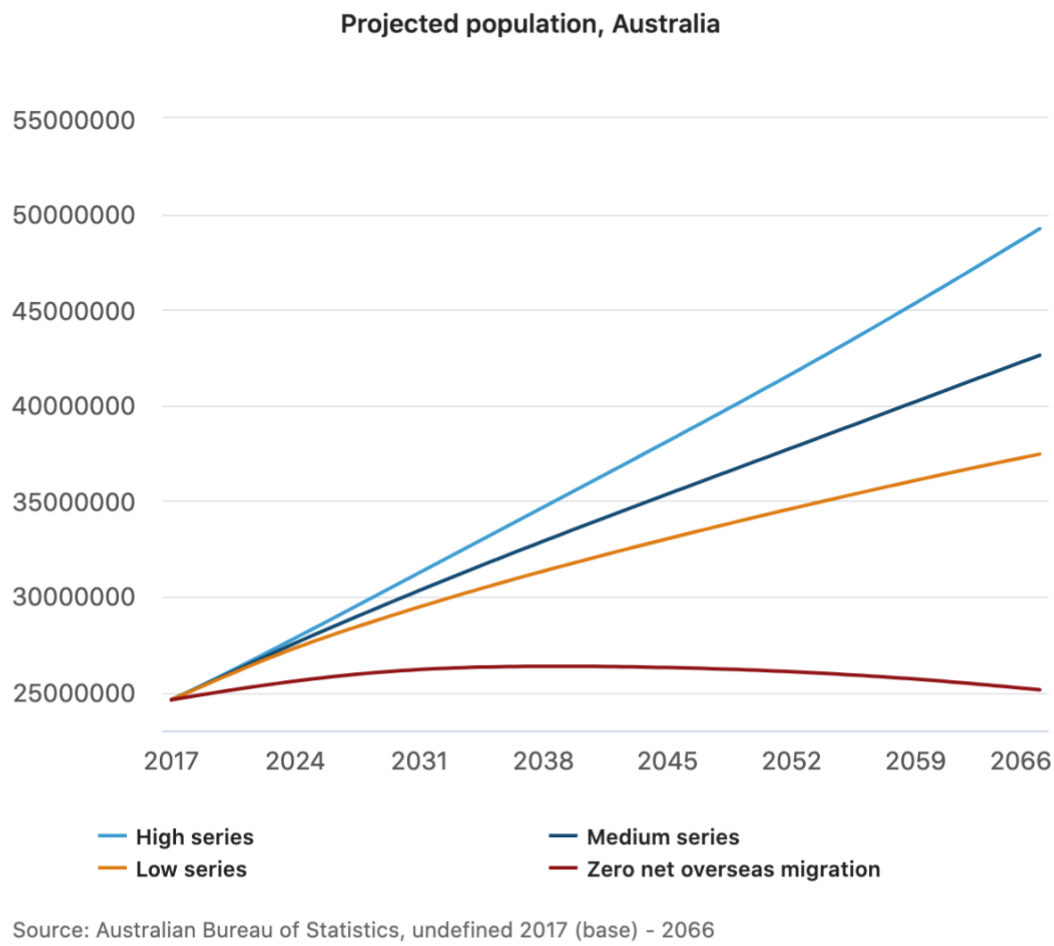
However, in the long run, we expect Australia's handling of the Covid pandemic will substantially increase demand of immigration to Australia. Compared to the USA and UK, Australia has done a substantially better job at controlling virus infection and resultant deaths. As a result, our economy and employment rate has fared better too.

This will fuel demand for immigration and underwrite our future population growth.

A strong level of population growth will eventually absorb any increases in apartment supply. Once again, demand will outstrip supply and create price growth.

Property investors must take into account these long-term trends.

Chart 5



4 What must you do to maximise your investment returns?

Apartments are not “set and forget” investments. They do require some time and attention – not a lot, but some.

It is important that an apartment building is adequately maintained and modernised where appropriate and economical. This includes maintain gardens, the external condition of the building (e.g. painting) and common areas such as lifts and lobbies. If this is not done, the apartment block will lose appeal to buyers and rent and will likely underperform from an investment perspective.

To achieve this, you need a well-functioning *Owners Corporation* (OC) that proactively maintains the building. To ensure this is the case, you should attend OC meetings as a minimum. If the OC is not functioning well, it may be necessary for you to become a member of the Committee.

In addition to common areas, it is important that you maintain the internal areas within your apartment. It is not unreasonable to expect to spend the equivalent of approximately 0.5% of your apartment’s value per year on repairs and improvements. You may not need to spend it each and every year. Instead, it may be more appropriate to complete some repairs and improvements every 5 to 10 years.

The timing, funding (e.g. loan or cash) and value of capital expenditure should be discussed with your financial and/or property advisor, tax accountant and property manager, to ensure cash flow, property value and tax benefits are maximised.

5 Conclusion

A number of factors have conspired over the past 10 years that are likely to be responsible for impairing the capital growth rate of investment-grade apartments. However, many of these factors are unlikely to reoccur, at least not to the same extent, over the next 10 years. These include:

- Supply of new apartment stock in investment-grade suburbs is likely to be proportionately lower over the next 10 years;
- The participation of foreign purchasers' is likely to be substantially lower; and
- The loosening of credit rules will likely materially increase purchasing/borrowing power.

Therefore, if you currently own an investment-grade apartment, and you are disappointed by its recent performance, we would strongly recommend you remain patient and continue to hold this asset.

For the reasons outlined in this white paper, we conclude that the likely capital growth rate over the next 10 years will substantially exceed the actual growth rate over the past 10 years. The analysis outlined in this report suggests it's not impossible that the capital growth rate over the next 10 years will adequately compensate investors for the sectors under-performance to date.

To paraphrase Warren Buffett, markets reward patient investors.

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