

# Investment-grade apartments to reward patient punters

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Older-style, investment-grade apartments have under-performed (capital growth wise) compared with 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 per cent and 8 per cent per annum over the same period.

So, what are the chances that the investment-grade apartment sector future capital growth rate will adequately reward investors?

On my numbers implied land values indicate that investment-grade apartments are currently intrinsically undervalued.

The average capital growth rate over the next 10 years has to exceed 9.2 per cent a year, to make up for the past eight to 10 years of under-performance. This is not unrealistic given historical growth rates over the past 40 years.

There is strong evidence that three factors are predominantly responsible for the recent under-performance

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 five 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 eight 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 45-55 per cent 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.

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On that basis it is 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. Indeed it's possible the capital growth rate over the next 10 years will adequately compensate investors for the sector's under-performance to date

Look at it this way: the 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 probably materially increase purchasing/borrowing power.

Therefore, if you currently own an investment-grade apartment, and you are disappointed by its - recent performance, I would recommend you remain patient and continue to hold this asset. To paraphrase Warren Buffett, markets reward patient investors.

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