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PERFORMANCE REVIEW OF INVESTMENT GRADE APARTMENTS

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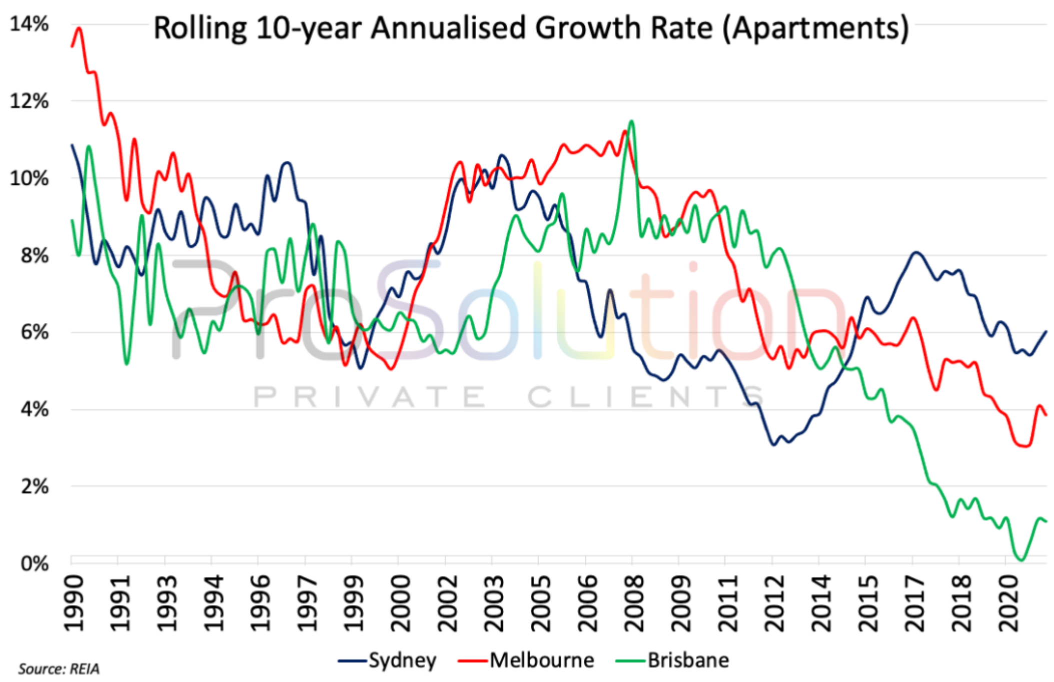
1 Addendum: Update November 2021

This report was originally published in October 2020. This addendum provides an update on how the apartment market has progressed since the end of 2020.

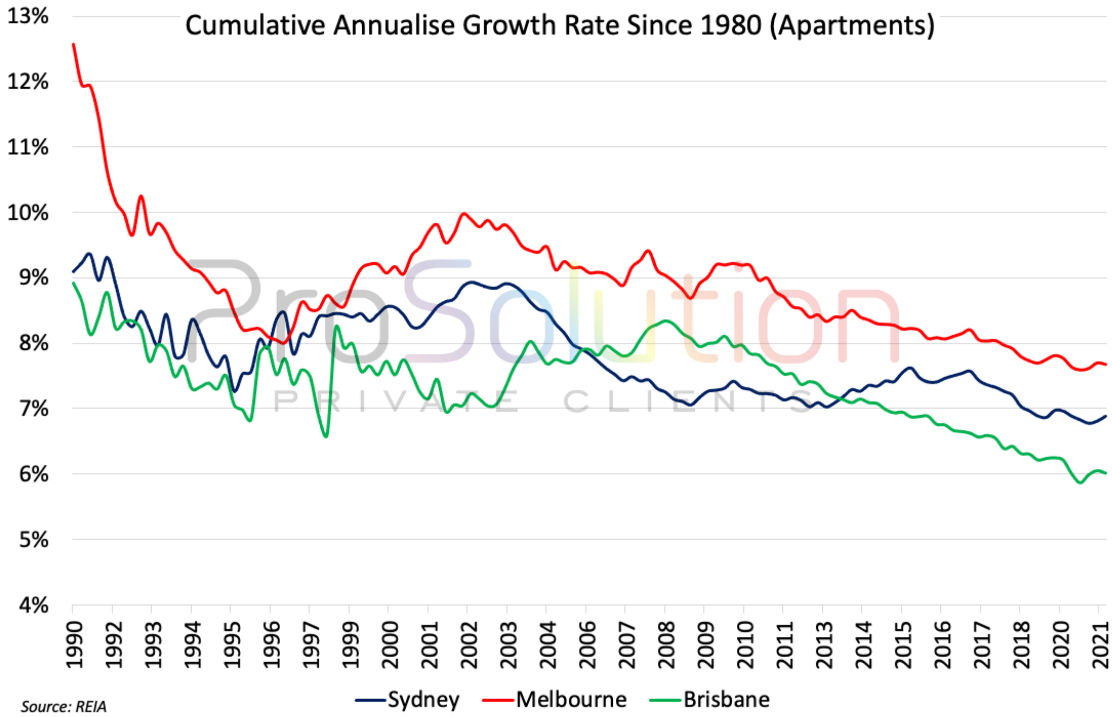
1.1 Apartment market has continued to under-perform

The chart below illustrates the rolling 10-year annualised (compounding) capital growth rate of the median price for apartments in Melbourne, Sydney and Brisbane. Brisbane has performed the worst with a growth rate close to zero. Melbourne apartments have generated growth rate of 3.7% p.a. for the 10 years ended June 2021 and Sydney 5.8% p.a.



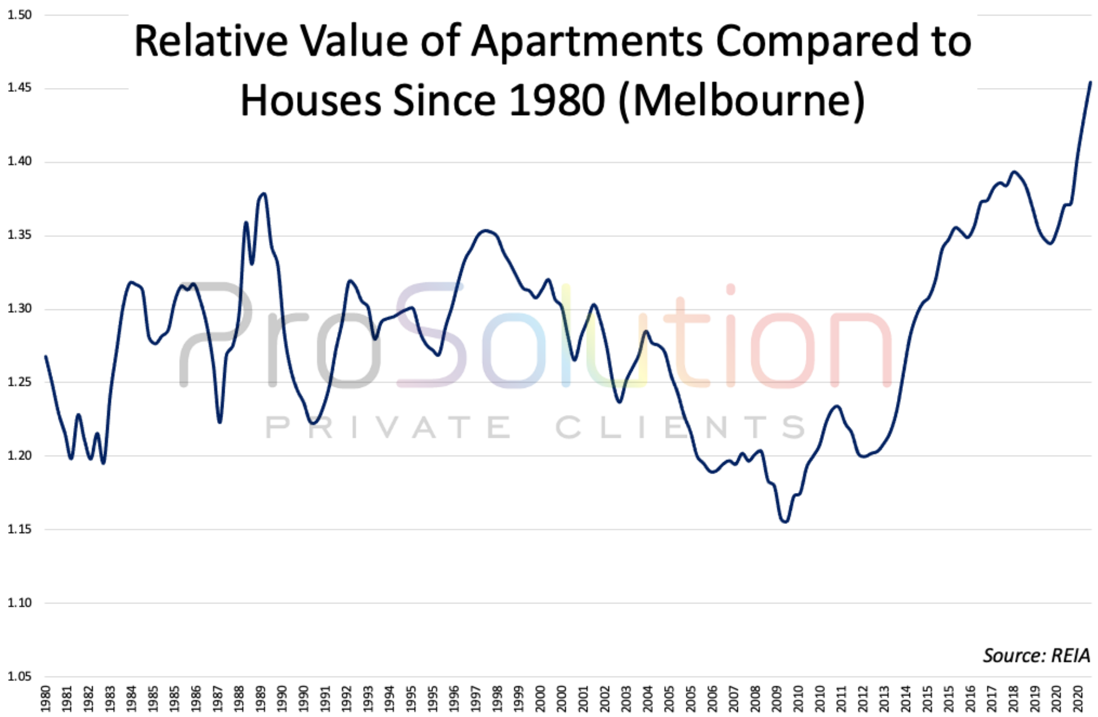
The chart below sets out cumulative returns since March 1980. Whilst growth over past decade has been poor for apartments in Melbourne and Brisbane, the annualised compounding returns between 1980 and 2011 (i.e. 10 years ago) were 7.2% p.a. for Sydney, 9.0% for Melbourne and 7.7% p.a. for Brisbane. This demonstrates two important observations:

1. That apartments do have the capacity to generate meaningful returns over long periods of time – dispelling the notation that apartments are not good investments; and
2. The last 10 years could be described as "the missing decade" in that returns have been well below their long-term average. As I discuss in Section 3 below, it is an irrefutable fact that all established investment markets experience the reoccurring trend of mean reversion. That is, returns will eventually revert to their mean (average) over long periods of time. That means a period of below-average growth is typically followed by a period of above-average growth. A typical property cycle lasts 7 to 10 years. We have already experienced 10 years of very low growth. Therefore, as each year passes, the probability that the Melbourne apartment market will begin its next growth cycle becomes substantially higher.



1.2 Maybe apartments were intrinsically over-valued 10 years ago?

Let's look closer at the Melbourne market. The chart below compares median house price relative to median apartment price in Melbourne since 1980.



Between 1980 and 2005, median house price was on average 1.3 times higher than median apartment price. The relative value of houses dropped to an average of 1.2 times during 2005 and

2013, mainly driven by the relative strength in apartment prices. The median house price is now 1.45 times the median apartment price in Melbourne, the highest point on record since 1980. This has been mainly driven by relative strength of houses prices and at the same time, weakness in apartment prices over the past decade.

It is possible that capital growth returns in the apartment market over the past decade in Melbourne have been impaired because apartments were intrinsically overvalued 10 years ago. I acknowledge that it is difficult to draw this assumption with a high level of confidence because to do so we must assume median house prices were fairly valued 10 years ago.

Let us consider whether relative value is a good predictor of future returns. In early 1989, the median value of houses was almost 1.38 times median apartment prices, which is the previously highest point. Median apartment prices only grew by 3% p.a. over the subsequent 5 years (1989-1994) which is well below average growth (houses grew by 2.3% p.a. over the same period). This analysis suggests that relative value of apartments versus houses isn't necessarily a good predictor of future returns, although this performance was almost certainly impacted by the recession that occurred in the early 1990's.

In early 1998, the median houses price was equal to 1.35 times the median value of apartments. In the subsequent 5 years, the median apartment value appreciated by 14.9% p.a. (1998-2003). This suggest that relative value could be a useful indicator of future returns. It stands to reason that relative value is a reliable indicator because:

1. As described in Section 1.1 above, *mean reversion* confirms that the best time to invest in an investment-grade asset class is after a period of below average returns; and
2. As the price of houses rise, fewer people will be able to afford them. As such, potential buyers will be forced to either purchase an apartment or move to a suburb further away from the CBD to be able to afford a house.

1.3 Covid adversely impacted apartments to a much greater extent

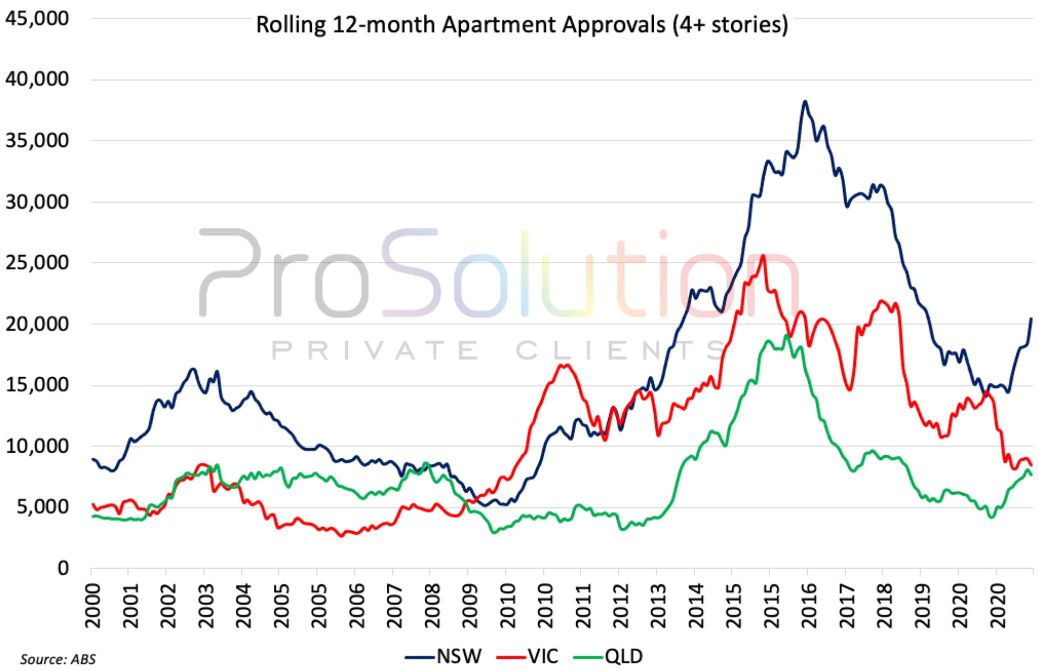
It has been well documented that Covid has impacted lower income earners to a disproportionate degree, as they tend to work in industries that have been locked down and their jobs do not lend themselves to working from home. Conversely, higher income earners, in the main, have avoided any adverse financial implications from Covid.

During the pandemic, investors were asked to provide rental reductions to tenants. As such, many investors received less income from apartment investments and/or had to reduce asking rent levels when reletting their property.

Since the price-point for apartments is lower than houses, they tend to appeal to buyers that cannot afford a house in the same location e.g. first home buyers. It is this cohort that have been adversely impacted by Covid, so buyer demand has been lower throughout 2020 and 2021 thereby not contributing to price growth.

1.4 Supply of new apartments is falling in Melbourne

Apartment approvals have rebounded in NSW and Queensland to a lesser extent but continue to decline in Victoria. In Melbourne, apartment approvals during 2021 have averaged 8,700 p.a. which is a level not seen since 2010. Furthermore, Melbourne population has increased by over 1,000,000 people since 2010. Therefore, on a per capita basis, apartment approvals are almost at a record lows.



This contraction of supply of apartments in Melbourne will assist in creating price appreciation, given that there is likely to be a shortage of apartments, as fewer people can afford houses without compromising on location.

1.5 Additional evidence of intrinsic value

A client of mine purchased an apartment in Toorak, Melbourne for $560,000 in April 2017. It is one of 12 units in the block. Recently, all the owners have agreed to sell their apartments as one parcel and it is expected that they will receive approximately $1 million each. That equates to a compound annual growth rate of 13.5% p.a. There have been similar sales of blocks of units in investment-grade locations at levels that confirm this is not a once-off event.

Of course, the value of a whole block of units is almost always going to be greater than the aggregate value of the individual units, because the owner controls a larger parcel of land which they can develop. However, sales like this do confirm that the intrinsic value of investment-grade apartments is higher than their recent (individual) sale values. That is because the underlying land has become more valuable over the past 10 years, as I discuss in Section 4.6 below.

1.6 Indicative budgets

If your investment budget is in the range of $500,000 and $700,000 then I would typically recommend buying an investment-grade one-bedroom apartment. If your budget is in the range of $700,000 and $900,000, then you can target a two-bedroom apartment.

1.7 Conclusion

An overwhelming body of evidence suggests that investment-grade apartments in Melbourne represent excellent value and arguable exhibit the best future growth prospects over the next 5 to 10 years, and beyond. The irrefutable law of *mean reversion* tells us that the probability of a period of above average growth occurring becomes higher as each year passes. When it will begin is uncertain, but it’s likely to be within the next few years.

Section 2 and onwards were written in October 2020 and discuss many important additional considerations.

2 Executive Summary (October 2020)

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 must 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.

3 Review of past investment performance

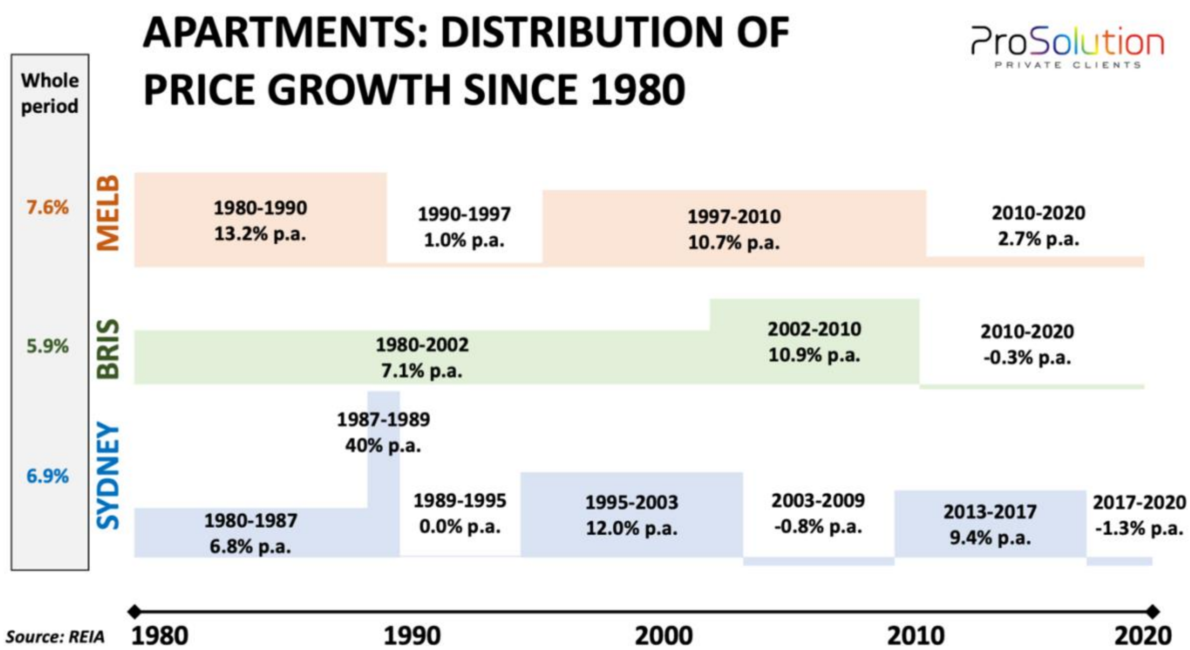
Asset class returns are more predictable over very long periods of time. That is because all markets and asset classes move in cycles which include periods of growth, contraction/correction and sideways drift (i.e. no change in value). That is why, in the short run, returns can be quite volatile. However, it has been well documented that investment returns eventually revert 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 a growth cycle.

3.1 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 consider:

- 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 sell, 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.

  Therefore 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 consider 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.

3.2 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 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.

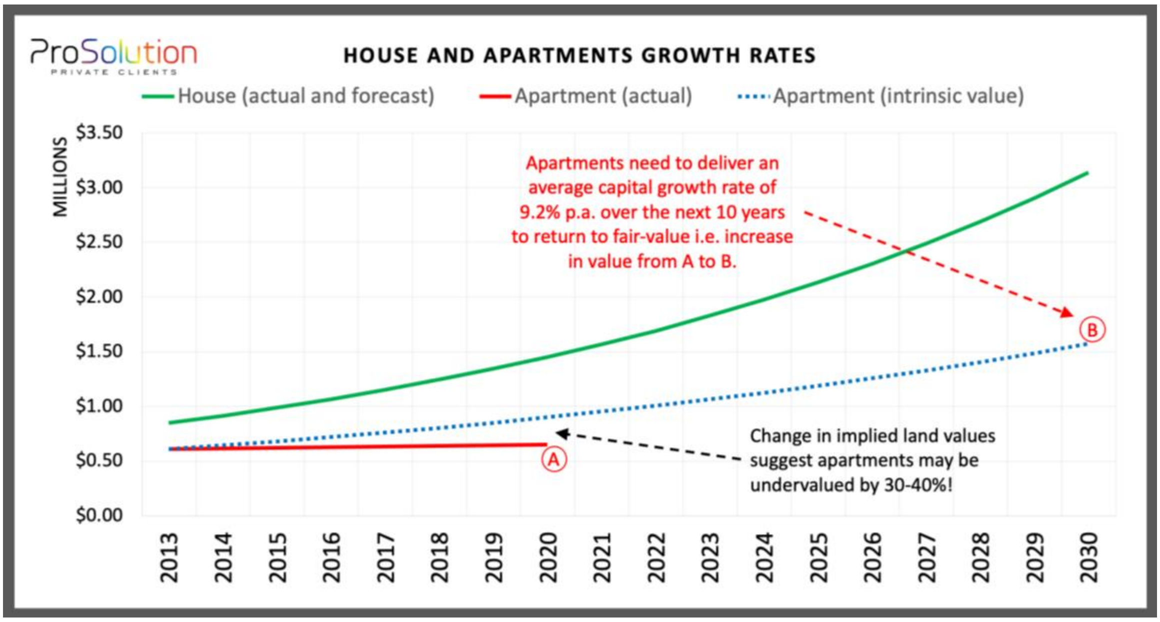
Investment-grade apartment characteristics are distinctly different to non-investment-grade apartments i.e. high-rise and/or high-density type apartments. These tend to have been constructed within the past 10 years, often are located on busy main roads and have more than 20 apartments in the block (and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

3.3 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



3.4 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 able to be able to invest in a house i.e. their financial budget doesn't extend to this level. Therefore, to invest in an established, blue-chip suburb, they must 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.

4 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.

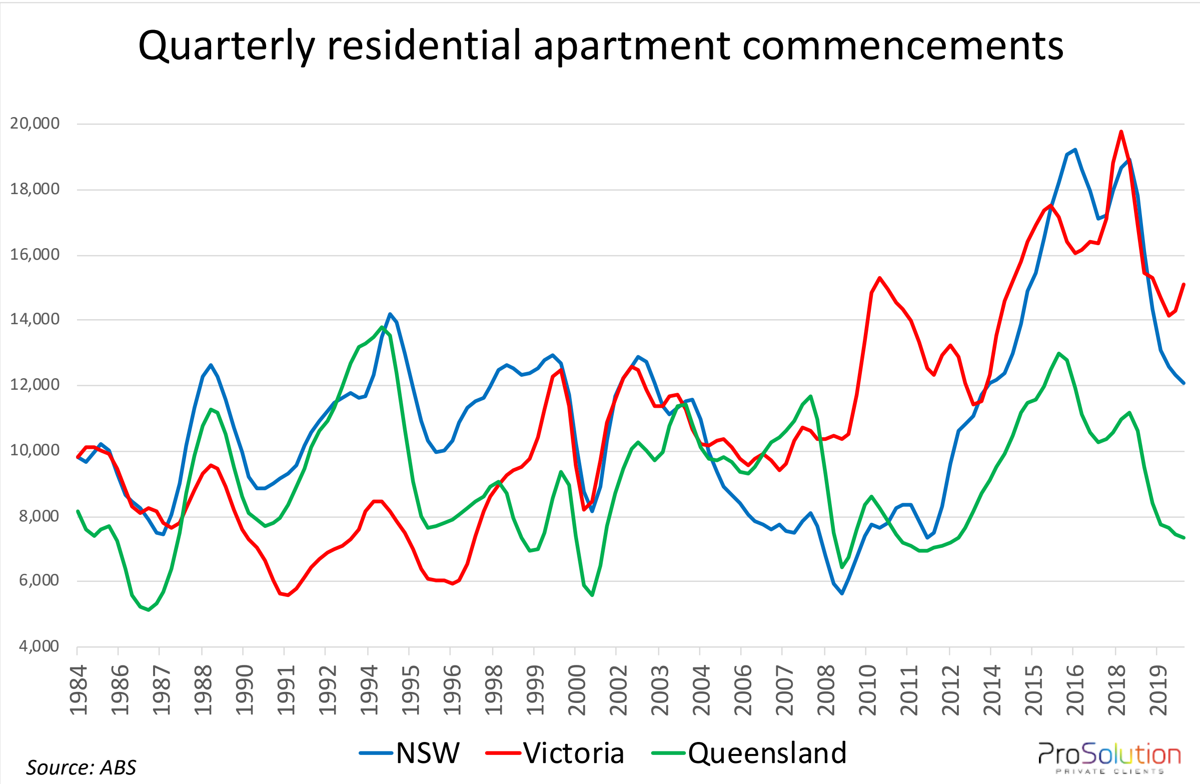
There have been a few factors that have either contributed to, or subtracted from, supply or demand for investment-grade apartments, which we discuss below (in no particular order).

4.1 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.

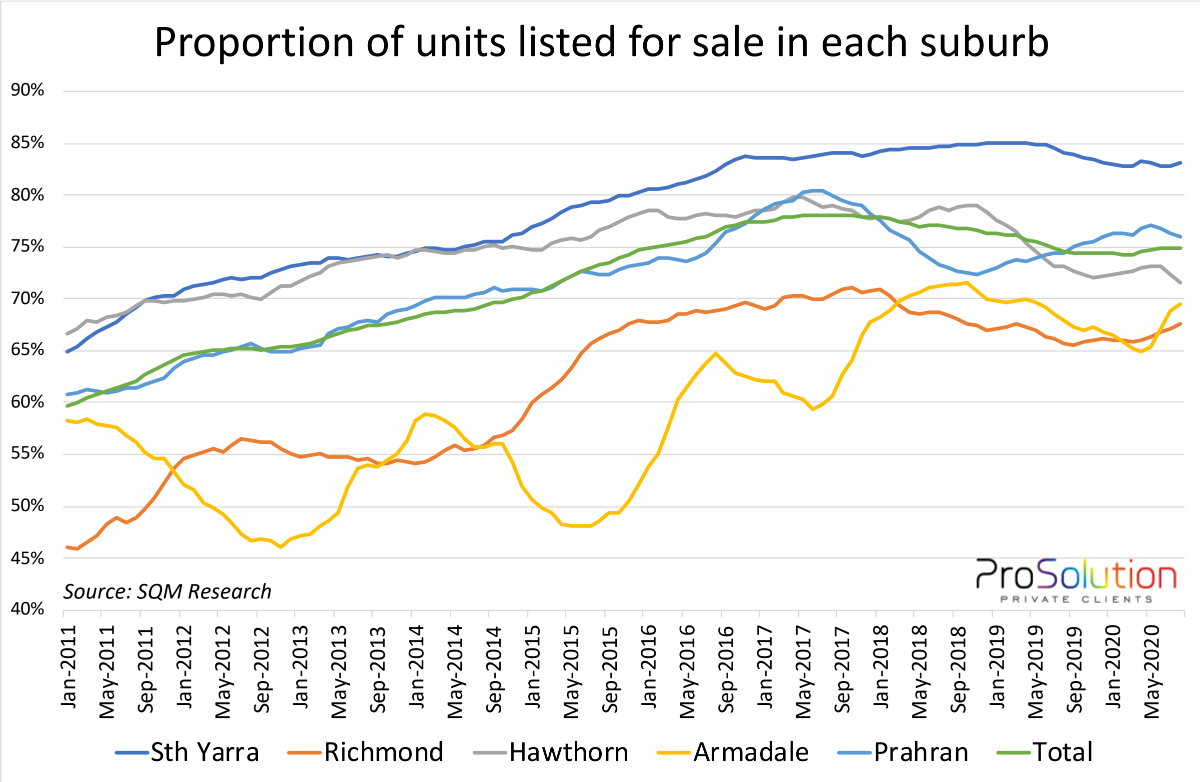
Construction commencements between 2006 and 2012 in Sydney ranged between 6,000 and 8,000 per quarter. By 2016, they had increased to over 18,000. They have since fallen significantly.

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.

4.2 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.

4.3 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.

4.4 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.

4.5 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.

4.6 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.

4.7 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.

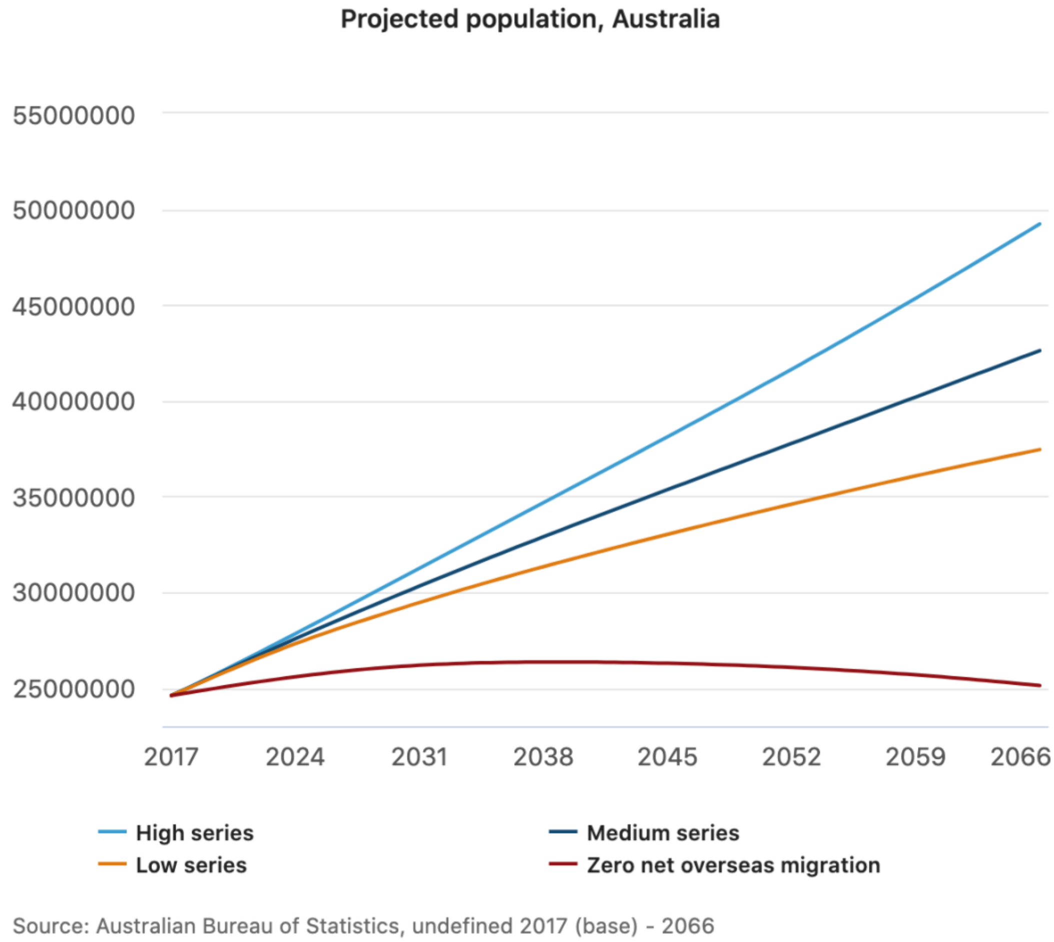
However, in the long run, we expect Australia's handling of the Covid pandemic will substantially increase demand of immigration to Australia. Compared to the USA and UK, Australia has done a substantially better job at controlling virus infection and resultant deaths. As a result, our economy and employment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

Chart 5



5 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 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.

6 Conclusion

Several 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 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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