WargentAdvisory

The Long & Short Report

SAMPLE ONLY

Brisbane Property Market 2017-18.

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PURPOSE OF REPORT

Presented below is detailed analysis of the Brisbane property market and the outlook for 2017 and beyond.

The report considers both the opportunities and the risks and threats in the current market, as well as our consideration of expected future trends.

The report does not contain price growth forecasts.

The report does identify suburbs and property types which we expect to outperform and underperform over time.

Please note that market conditions, and therefore views, are subject to change at any time.

The report considers both demand factors (including the Brisbane economy, employment trends, and population projections) and supply factors (including dwelling approvals, commencements, and completions, as well as projections and consideration of future supply trends).

WargentAdvisory also provides detailed consideration of market risks and potential triggers for a correction.

We have used the timeliest available data for all market analysis, and where appropriate, the sources of data are referenced or stated.

All dollar amounts are quoted in Australian Dollars (AUD) unless otherwise stated.

Please note that we are unable to discuss specific securities in this report.

For matters not covered in this report please consider engaging ***WargentAdvisory*** consultancy services.

REPORT CONTENTS

REPORT CONTENTS (CONTINUED)

EXECUTIVE SUMMARY

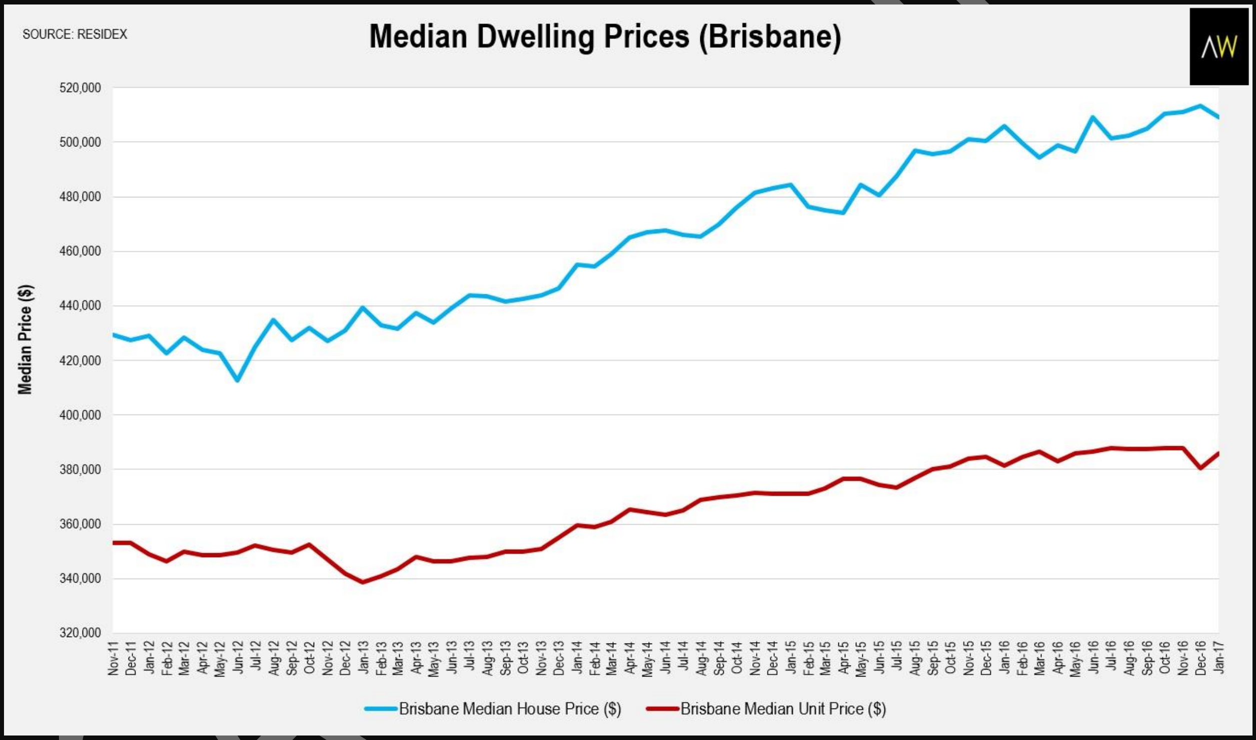
Brisbane apartments under pressure

Brisbane has recorded house price growth in many of its desirable suburbs, but apartment prices in the inner city are increasingly coming under pressure as a record glut of supply comes online.

WargentAdvisory expects this divergence in performance to continue through 2017 and beyond, due to the extensive over-building of inner city apartment stock.

Since July 2012 the median Brisbane house price has increased steadily by **19 per cent** or $81,500 to $511,000, according to the *Residex* repeat sales index.

Brisbane unit prices have increased by only a moderate **9 per cent** over the same period or $33,000 to $386,000, with prices having flattened lately, and in many cases beginning to fall.



Certain sectors of inner Brisbane's housing market are set to be swamped with an oversupply of dwellings, particularly high-rise apartments, resulting in rising vacancy rates and declining rents and prices.

Combined with tighter restrictions imposed by the banks related to lending to non-resident buyers, there is likely to be some fallout in the new apartment sector, including settlement defaults.

While mortgage rates could become tighter in 2017 and beyond, overall mortgage rates remain relatively stimulatory, certain sub-markets may continue to experienced price growth in 2017, particularly in the middle ring suburbs.

Much of this report will be focused on the risks facing the Brisbane market, and the possible causes, timing, and magnitude of the next cyclical correction.

EXECUTIVE SUMMARY (CONTINUED)

Risk 1 - Oversupply

Unlike in Sydney and Melbourne where there remain undersupplied sectors of the market, Brisbane's looming apartment oversupply is fully apparent and not in dispute.

Previously a high percentage of new builds were sold offshore to mainland Chinese buyers, but now local banks have largely ceased lending to offshore buyers, fearing investigation into lending practices in the form of a Royal Commission.

Local buyers are generally not keen on paying the high price premium that tends to be associated with new property, although some buyers are lured into buying in their SMSF (self-managed pension funds) by commission-driven salesmen acting as pseudo advisers, while other investors have also been encouraged to buy new high-rise apartments by 'white knight' seminar groups.

With the Chinese bid for new property declining in 2017, apartment approvals in Brisbane have crashed from several thousand per month at the peak to just a few hundred per month.

Mirroring trends seen in some overseas markets this crash in apartment approvals foreshadows a sharp correction in this sector of the market, in concert with falling rents due to the oversupply.

Risk 2 – Rising mortgage rates

While mortgage rates could become somewhat tighter in 2017, overall mortgage rates remain relatively stimulatory for now, and Brisbane's inner suburban detached housing market is likely to see some price growth in 2017 in the inner ring suburbs.

Although a hike in the official cash rate is considered unlikely until H2 2018, mortgage rates are already rising, and there may be further increases to come if bank funding costs rise.

If mortgage rates revert towards a historical mean the impact on dwelling prices would be negative for Brisbane, where the local economy is not strong.

Risk 3 – Interest-only loans & lending standards

The share of the mortgage market accounted for by interest-only loans in Australia increased consistently from 27 per cent in early 2009 to a peak of **more than 45 per cent** in Q3 2015.

Following the implementation of macroprudential measures to curb investor lending, the share of interest-only loans then fell to below 35 per cent, but was seen to be rising sharply again by Q4 2016, resulting in a new interest-only lending cap being introduced by APRA on 31 March 2017.

These trends partly reflected the extraordinarily high number of investors in the market in 2015, with around two in every three investor loans being interest-only.

While it may be rational for investors to use interest-only loans with interest payments being fully tax deductible in Australia, even homebuyers (about 1 in 4 loans in 2016) and some first homebuyers have used interest-only loans, reflecting the speculative nature of some markets.

Interest-only loans typically have a 5-year interest-only period in Australia, at which point the loan must be refinanced into a new interest-only product or it is switched to a principal-and-interest loan with a considerably higher repayment.

EXECUTIVE SUMMARY (CONTINUED)

In the past, it has been assumed by borrowers that the loan will automatically be refinanced at the end of the interest-only period.

While some lenders (such as Commonwealth Bank and Westpac) have been rolling over loans almost automatically, others (such as Suncorp) now require a new application to be made.

There is a clear risk that if banks become unwilling or unable due to ongoing regulatory changes to continue rolling interest-only loans then borrowers could become exposed by the significantly higher repayments.

If the above scenario was to be combined with mortgage rates reverting higher than the market impact would be severe.

Risk 4 - Brisbane's economy & the impact of the construction downturn

The Queensland economy went through a very significant downturn in 2014 and 2015 as the resources construction boom transitioned to the production or export phase.

A ramp up in liquefied natural gas (LNG) and coal exports has seen the state economy recording trade surpluses in 2017.

The main risks to the Brisbane economy include the imminent downturn in the apartment construction sector, as well as exogenous factors including a material slowdown in China's economy and a potentially sharp decline in coal and LNG prices.

With the property markets of Melbourne and particularly Sydney recording strong gains since 2012, interstate migration to south east Queensland is now increasing solidly again.

However, if the local economy is not creating jobs, historical trends suggest that migration from interstate will not be sustained, and at around 75,000 per annum Queensland's population growth remains well below the levels seen during the resources construction boom years.

Some demographic factors are changing the dynamics of the capital city markets in Australia, including the ongoing ageing of the population, the casualisation of the workforce, and the shift toward permanent settlers and temporary migrants of Asian origin.

Many first homebuyers are now turning to investment property as a first step on to the housing ladder, although this trend is less prevalent in Brisbane than in Sydney or Melbourne.

Household debt levels have increased sharply further since the financial crisis in Australia, and therefore the housing market is likely to be more sensitive to upwards changes in interest rates.

Conclusion

WargentAdvisory believes that all of Australia's capital city markets are due for a correction, with prices in Perth and Darwin already in decline.

We believe that Sydney's market median price may continue to rise in 2017. However, apartment approvals are already in a very sharp decline in Brisbane, which we believe foreshadows an imminent correction to prices, with rising vacancy rates, and falling rents.

When mortgage rates rise, there is the potential for further downside to the housing market.

PART 4 – THE SHORT REPORT (SAMPLE)

Risk areas

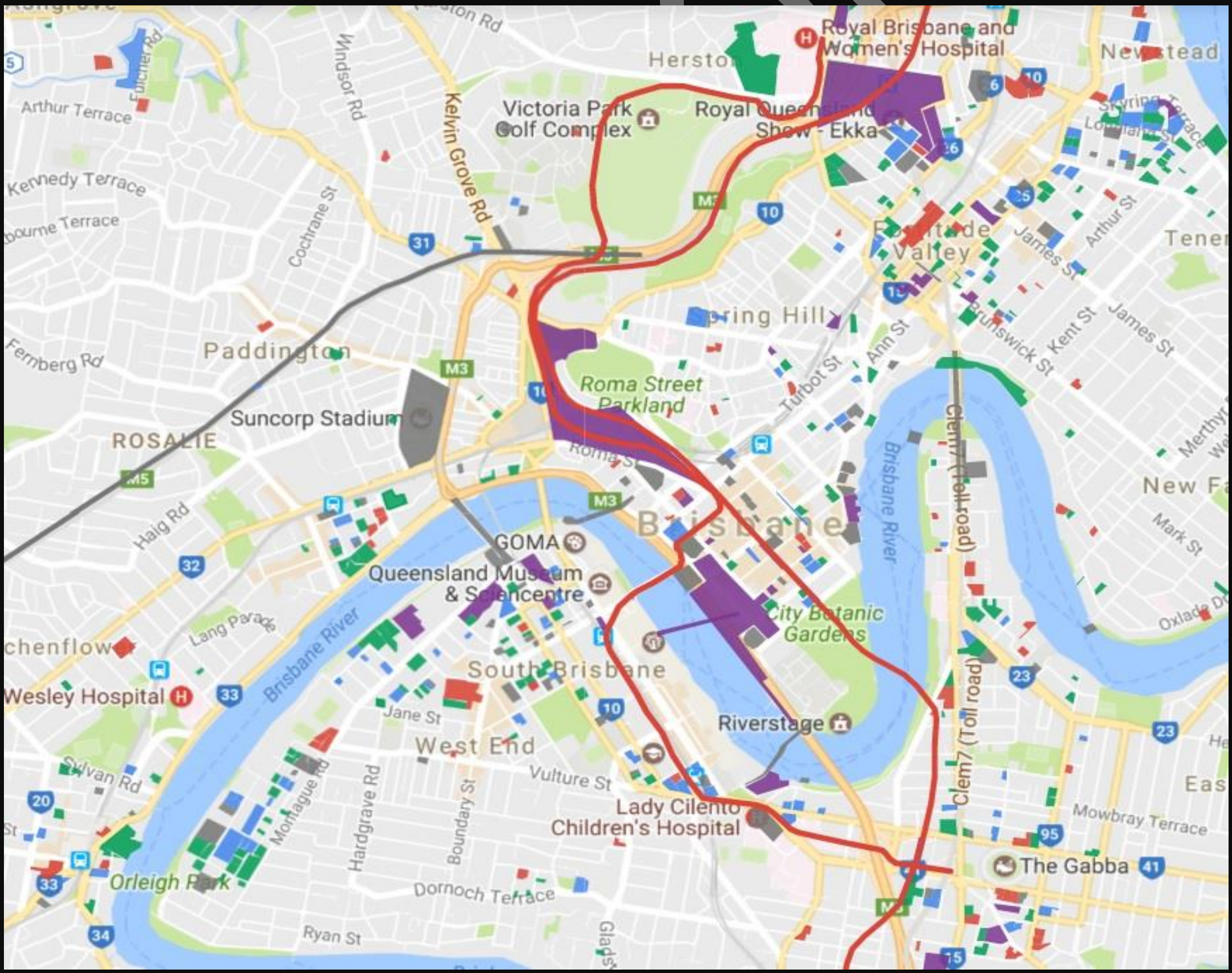
In this section of the report we discuss the most fragile sectors of the Brisbane housing market, the associated risks, and what might happen to dwelling prices as a result of the coming downturn.

(a) New apartments & the emerging risks

One of the emerging risks at this stage in the cycle is the supply response to rising prices from developers.

As previously noted there is a **severe concentration risk** in Brisbane related to the over-building apartments, particularly high-rise apartments. Annual approvals for multi-unit dwellings in Brisbane rose to record highs in 2016, peaking at more than 21,680, which is way above the long run average.

As highlighted in the map below, the inner city of Brisbane has a huge number of proposed (red), approved (green), under construction (blue), and completed (grey) projects, as well as master plan projects (purple).



Source: Brisbane Development

WargentAdvisory suburb level analysis has shown that approvals figures are lumpy and change by the month, with the most accurate indicators of supply often being derived simply from regular suburb visits and trends in vacancy rates.

Glut of supply

Over the final quarter of 2016 more than 8,000 apartments were launched, with Fortitude Valley and Newstead leading the way, accounting for nearly 3,000 new apartments.

The vast *The Gregory* (686 apartments) and 100 Barry Parade (590 apartments) projects were two examples of the main contributors.

While the local area is gentrifying, it will necessarily take the market a long period of time to adjust to such huge levels of supply.

Despite the looming glut of new supply, to date any downward impact on prices has been relatively moderate, and sales volumes held up well with relatively few defaults reported, at least by listed developers.

Apartment approvals were already well into a downtrend in 2016, and will almost certainly continue to fall through 2017, with the proportion of established sales gradually set to account for a greater share of the market once the pipeline is fully absorbed.

According to *Urbis* a further 19 inner Brisbane projects are expected to launch between October 2016 and June 2017, bringing a further 3,600 apartments for the inner Brisbane market[8].

These figures already represent a material downward revision from nearly 4,900 apartments only a quarter previously, suggesting that the appetite for this type of development is waning[9].

It is worth noting that nearly 4 in 10 inner Brisbane apartment sales have been 1-bedroom apartments, and about 45 per cent have been two bedroom apartments.

This means that despite the high absolute number of apartments, the number of persons housed per dwelling will be lower than in previous cycles, especially given the apparently significant number of apartments left vacant.

Having spiked massively in the second quarter of 2015 at more than 2,250, off-the-plan apartment sales for inner Brisbane have stabilised back at around a more sustainable 800 per quarter[10].

However, the damage has already been done by the huge number of completions, representing an unprecedented uplift in the attached dwelling stock.

Suburb level

When drilling down to the suburb and street level, it is clear that the highest risk areas include Newstead and Fortitude Valley, South Brisbane and West End, and the Central Business District itself (where the dramatic SkyTower is presently under construction).

From on-the-ground observations, ***WargentAdvisory*** believes there is an inherent risk at this stage of the construction cycle that vacancy rates may be understated by the official figures.

In part, this is due to offshore investors leaving units vacant, although this has little detrimental impact on rents since the property is effectively never brought to the rental market.

March 2017 photo – SkyTower will be 274 metres high and deliver 1,138 new city apartments

Furthermore, upon the completion of larger multi-unit projects, property managers may be incentivised to advertise only a sample of 1-, 2- and 3-bedroom apartments rather than duplicating advertisements.

Where many properties are advertised for rent in the same multi-unit project, the perception of an oversupply can be reinforced, leading prospective renters to be more inclined to negotiate harder on the rental price.

Oversupply pockets

While the Brisbane CBD itself is clearly a market at risk of oversupply, with the potential for towers to be built up to 274 metres in height, there is potentially an even greater risk in certain surrounding inner city suburbs, where former industrial and commercial sites have been rezoned for residential apartment projects.

WargentAdvisory on-the-ground research shows that several other parts of Brisbane have a relatively high volume of approvals and/or completions, and as such represent a relatively elevated risk.

These areas include, but are not limited to, the following suburbs:

- West End and South Brisbane (vacancy rate of 4.6 per cent)
- Hamilton (vacancy rate of 9 per cent)
- Newstead (vacancy rate of 4 per cent)
- Fortitude Valley (vacancy rate of 4 per cent)
- The Brisbane Central Business District (vacancy rate of 5 per cent)

Other suburbs which are presently seen to be at somewhat lower risk level, but may see an apartment oversupply include, but are not limited to:

- Toowong (vacancy rate of 4.9 per cent)
- Coorparoo (vacancy rate of 3.1 per cent)
- Milton (vacancy rate of 5.3 per cent)
- Indooroopilly (vacancy rate of 5 per cent – seasonally higher over Christmas due to fewer students)

Newstead apartment projects under construction in 2016

(b) The apartment oversupply hotspots

Rising inner city vacancy rates & declining rents

The Brisbane Central Business District (CBD) has seen the construction of significant apartment projects.

This has resulted in elevated vacancy rates, and asking rents have declined moderately over the past three years.

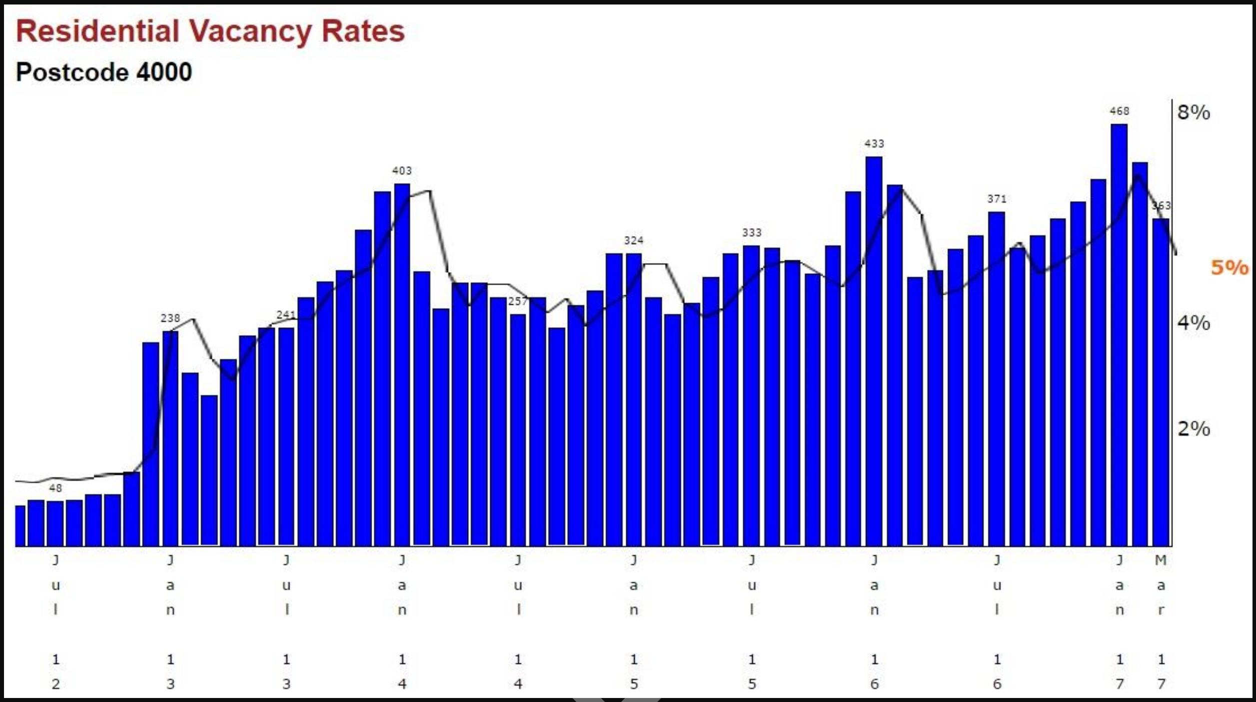
The CBD area is an artificial market, with many dwellings used as weekenders, 'crash pads', let on a short-term basis, or as furnished lets.

WargentAdvisory research suggests that this market is likely to weaken further before it stabilises.

The 90-storey SkyTower under construction at Margaret Street will be Brisbane's tallest building at 274 metres, and will add another 1,138 apartments to the existing CBD stock.

90-storey Sky Tower at 222 Margaret Street under construction, comprising 1,138 new apartments by 2018-19.

Although off-the-plan sales have reportedly been recorded to both domestic and offshore investors, this will result in supply getting well ahead of demand and put further downward pressure on apartment rents in the city.

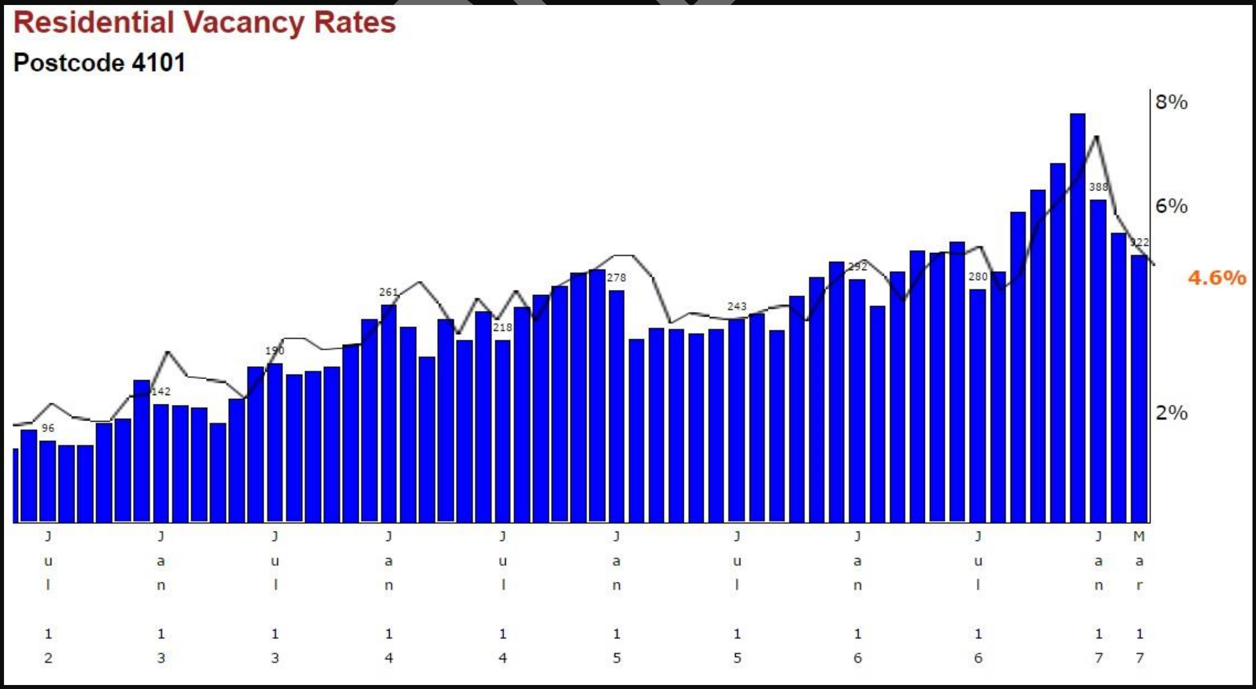


Rising CBD vacancy rates (Source: SQM Research, sqmresearch.com.au)

The oversupply issue is by no means limited to the Central Business District. For example, thousands of new apartments have either been completed or are under construction to the south of the river in the post code comprising the suburbs of South Brisbane and West End.

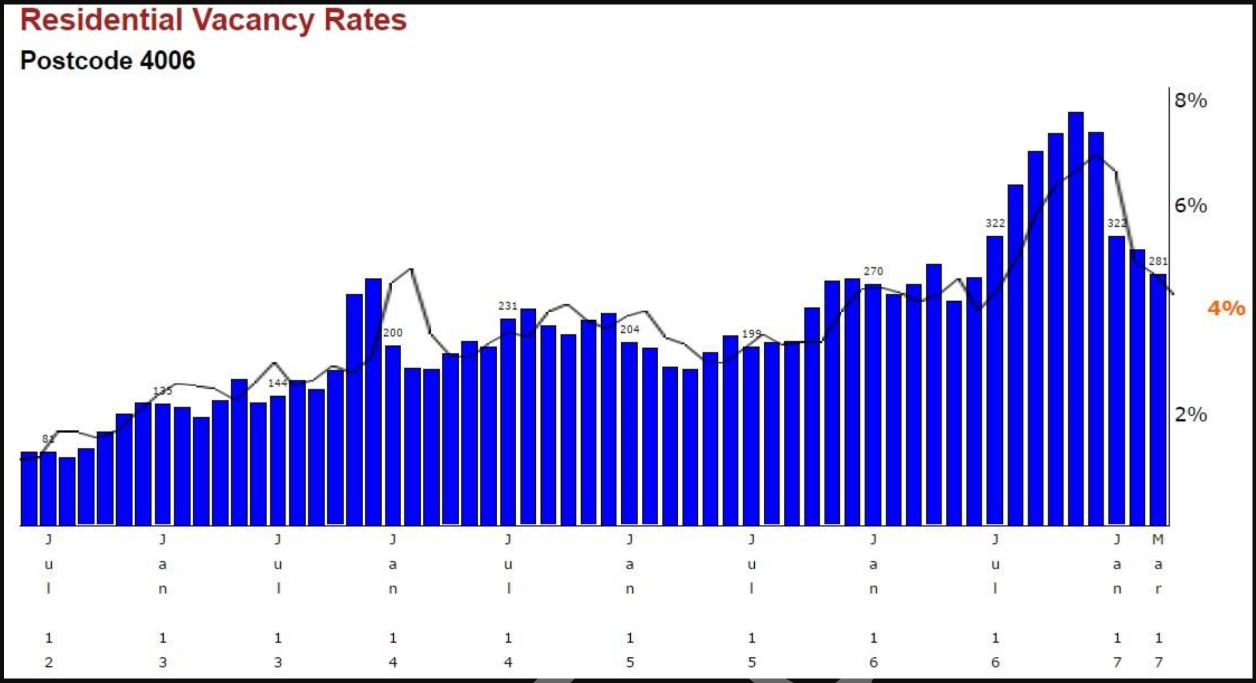
Cranes and apartments under construction at West End in 2016

Vacancy rates in the post code increased very sharply in 2016, and by the end of the calendar year it was clear that rents were falling.



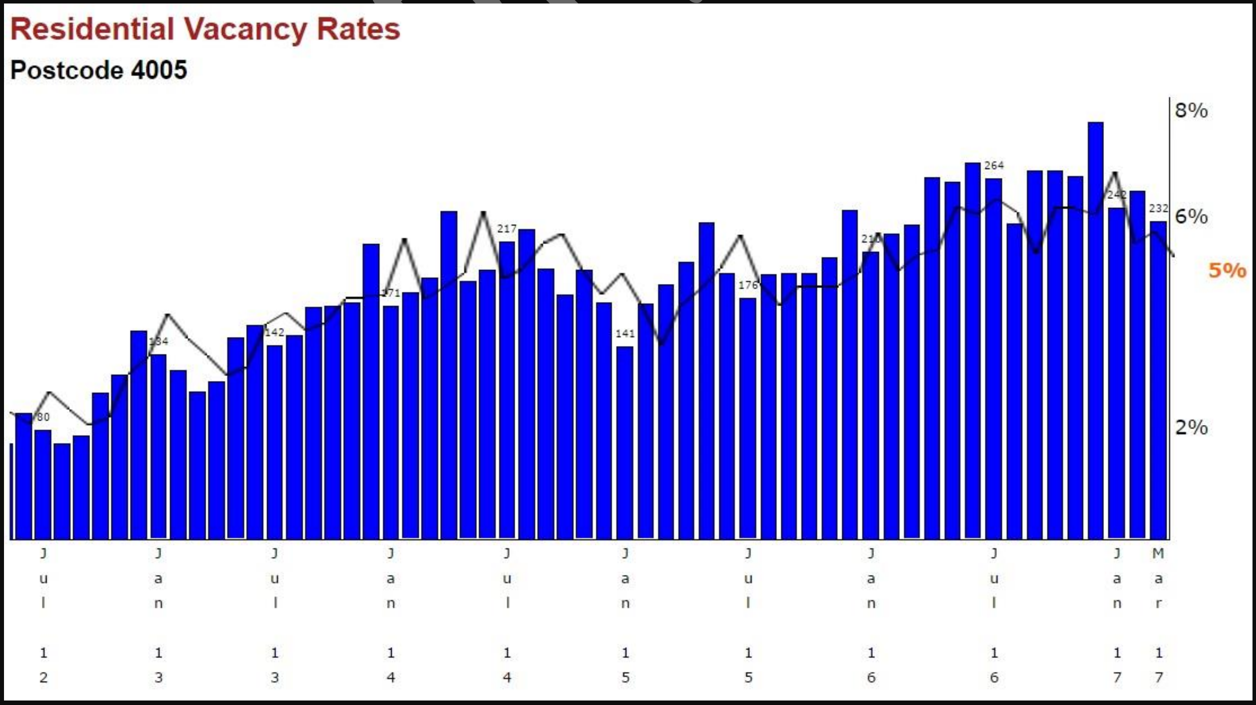
Vacancy rates in South Brisbane/West End (Source: SQM Research, sqmresearch.com.au)

Another area formerly dominated by industrial and commercial premises that is now being overbuilt is Fortitude Valley and Newstead (post code) 4006, and rents were in decline here too.



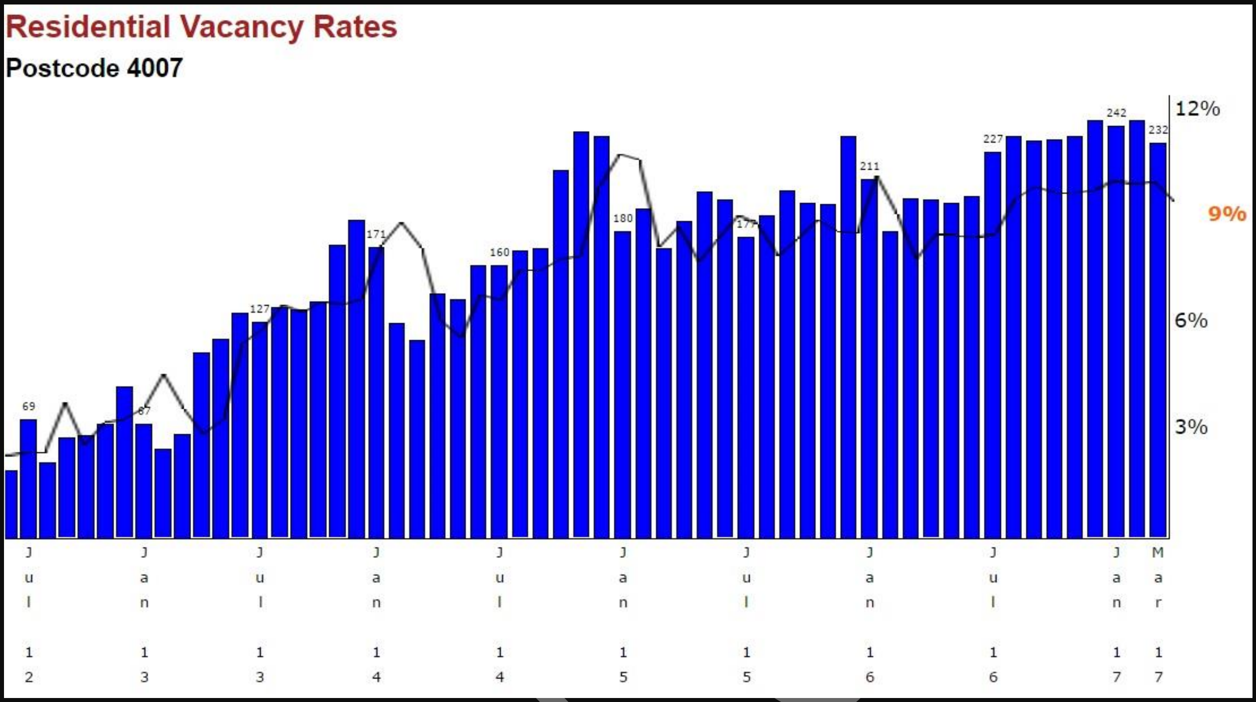
Increasing Fortitude Valley/Newstead vacancies (Source: SQM Research, sqmesearch.com.au)

There is evidence that the oversupply has adversely impacted inner suburbs which don't have high levels of construction, such as New Farm, implying potential contagion.



Vacancy rates in New Farm (Source: SQM Research, sqmresearch.com.au)

The new supply has also impacted blue chip or upmarket areas, including Hamilton, which is located on the Brisbane River. Despite the higher quality of the new stock, rents were in decline.



Vacancy rates in Hamilton (Source: SQM Research, sqmresearch.com.au)

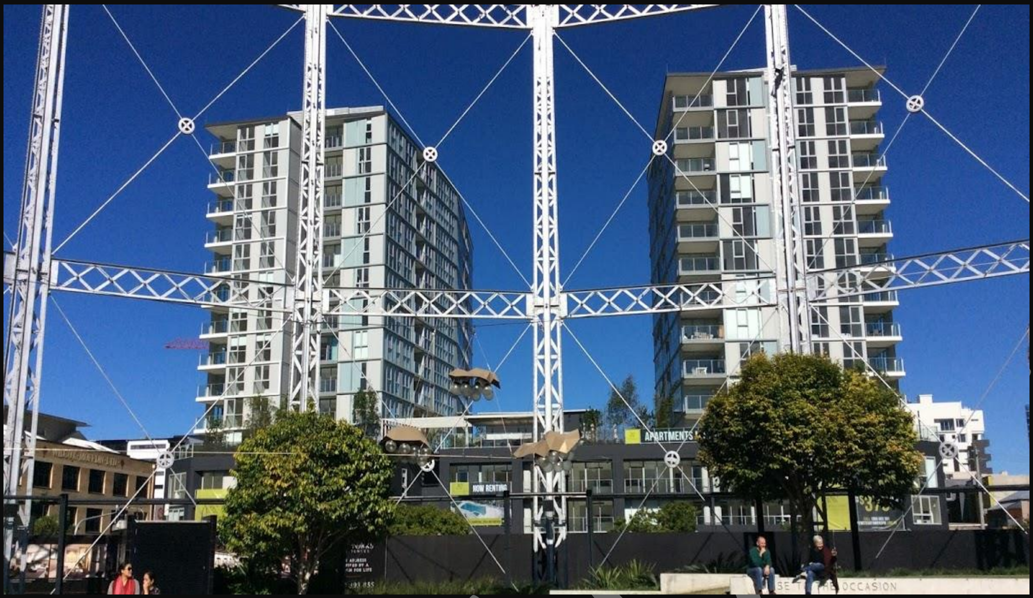
Case study: Newstead

In this section of the report we take a more detailed look at the suburb of Newstead, which we have identified as one of the high-risk sectors of the new apartment market.

With many projects reaching completion at a similar time, there are now visibly many vacant apartments in the suburb, and median apartment rents have declined over the past three years.

Newstead apartments approaching completion in 2016

In March 2017 there were 70 apartments listed as available for rent in Newstead, and more than 160 apartments and townhouses available for rent in adjoining Fortitude Valley, 151 in New Farm, 172 in Hamilton, and a further 282 in the Central Business District.



New apartment towers at Newstead Gasworks

WargentAdvisory's on-the-ground observations suggest that there are many more vacant apartments, but for various reasons many are not yet listed online as available for rent.

This may in part be due to the high share of apartments bought by Asian investors, particularly from mainland China, many of which appear to be never brought to market.

Other apartments may be advertised and rented directly by landlords via the internet, including websites such as Airbnb.com.

New development next to Newstead Gasworks (new coffee shop and commercial premises are to the left of shot, already well frequented)

WargentAdvisory has identified examples of apartments being relisted at lower rental prices, as well as advertisements offering incentives to prospective renters, including initial weeks being offered for free, and open offers to negotiate.

These all represent typical indicators of an oversupplied market, and we expect that rents will decline accordingly.

WargentAdvisory has observed that the new commercial and shopping facilities at Newstead Gasworks are relatively well used by students, young professionals, and families. This may bode well for the future popularity of the suburb, despite the looming apartment glut.

However two prominent and established retail stores in the precinct had closed by early 2017.

Cranes in the suburb of Newstead in 2016

The suburb is located only 3 kilometres or less than two miles from the Central Business District.

Formerly known for its timber yards and woolstores, the suburb remains somewhat austere in parts, but being located so close to the city employment hub it is expected to become a more popular location over time.

Although some self-managed superannuation or pension funds (SMSFs) purchase new apartments in Australia, generally domestic investors have been wary of buying new apartments in due to the oversupply risks in this sector and high prices.

With new 2-bedroom apartments often priced at $550,000 to $800,000 and sometimes higher, the price premium makes new property relatively less attractive than buying established dwellings, even after accounting for the generous depreciation benefits available to investors on new builds.

This is one of the reasons that foreign investors are generally restricted to the purchase of new properties, as it encourages construction and adds to the dwelling stock.

To combat this, developers often pay commissions to salesmen or ‘middlemen’ of up to 6 per cent of the purchase price to sell their new apartments, as well as offering rental guarantees for 2 or more years.

WargentAdvisory has obtained example documentation from seminar promoters and salesmen recommending the purchase of new apartments in Newstead (often to unsuspecting investors interstate), claiming that new supply in the area was “restricted” in nature despite record levels of new construction.

While such middlemen may appear to unsuspecting consumers to be acting as pseudo-financial advisers or apparent ‘white knights’, their substantial sales commissions are hidden away in contractual small print and represent a clear conflict of interest.

Unfortunately, this practice is common in Australia, particularly in developments that are proving difficult to sell to domestic investors.

The same type of promoters were heavily involved in the promotion of off-the-plan purchases in mining towns and cities before the resources boom peaked, leaving investors wearing enormous losses often exceeding 50 per cent of the purchase price in regions and cities such as the Pilbara, Gladstone, and regional Queensland mining towns.

We often received invitations to sell new projects for a 5 to 7 per cent commission. An example email is copied below.

I would like to open my exclusive stock to you. I would love for you to be a part of our referral program. Check out my exclusive stock here.

We can offer you 5% commission. We accept all FIRB deals.

When is a good time this week to meet up for a coffee or a Skype call?

Here is my availability.

Our stock includes:

- House and Land
- Apartments with 5 year, 5% rental guarantees
- 10% rental guarantee for 2 years
- 95% LVR for finance loans

I have attached our referral agreement to you, Please sign and send back if you're ready to sell with us. - I will then add your details to our portal.

Thank you,

Note that an “FIRB deal” refers to a foreign investment purchase.

Mirvac development under construction

Mirvac's Waterfront masterplan is to be made up of seven precincts forming a high street connecting Breakfast Creek Road to Skyring Terrace.

A thoroughfare from the water will lead to cafes, restaurants, and shopping facilities.

Combined these developments will lead to a very substantial percentage increase in the inner city dwelling stock, introducing a significant concentration risk.

Investors of Asian heritage inspecting Newstead Gasworks apartment projects

There is little transparency at the suburb and project level surrounding how many apartments are sold to offshore investors, although independent studies have shown a high proportion of properties are often bought buy buyers with Chinese surnames.

What we do know at the state and city level is that the proportion of offshore buyers was very high at least until the second half of the 2015 calendar year, although there was a slowdown through 2016 as lending criteria were tightened suddenly and dramatically.

WargentAdvisory site visits to inspect projects have shown there to be a great deal of interest from Asian investors, many of whom were not English speakers (suggesting that funds may be sourced from offshore, even when the properties are bought by Australian citizens).

The impact of the boom in non-resident investors has been to encourage development of smaller apartments targeted specifically at the investor market rather than owner-occupiers.

Furthermore, partly for cultural reasons, some Chinese investors choose to leave their new apartments vacant, believing that used or second hand apartments lose some of their appeal.

Others have bought apartments with a view to their children using them in the future should they come to study in Australia.

NEWSTEAD CONSTRUCTION – APRIL 2017

In April 2017, it is clear from ***WargentAdvisory*** suburb visits that a glut of apartment completions is now coming online.

'For rent' billboards advertising the new supply are commonplace.

Vacancy rates in these locations are clearly higher than implied by official data.

NEWSTEAD CONSTRUCTION – APRIL 2017

Mirvac's Unison Development, April 2017

Despite the evidence of oversupply issues, there remain thousands of apartments under construction in April 2017.

NEWSTEAD CONSTRUCTION – APRIL 2017

The Mirvac Waterfront development has hundreds of high-rise apartments due to complete in 2017.

NEWSTEAD CONSTRUCTION – APRIL 2017

Mirvac's Newstead development still has phases that have not been constructed.

WEST END/SOUTH BRISBANE SNAPSHOT

The new dwelling sector in West End and South Brisbane is another market which we see at risk of a material correction in 2017 and beyond. These two suburbs are located close to the South Bank of the Brisbane River, and are covered by one post code.

Many new developments are coming onstream.

South Brisbane and West End demonstrate many of similar characteristics to Fortitude Valley and Newstead. Being so close to Brisbane's South Bank and the south bank campus of Griffith University, these are tremendously well located suburbs, which ***WargentAdvisory*** expects to be hugely popular with new settlers of Asian heritage in future.

Here too, however, supply is set to move well ahead of demand, and vacancy rates have followed a very similar upwards trajectory to date, particularly for apartments.

Over a long-term horizon, the risks here may be lower given that demand is all but certain to rise strongly over time. However, new apartments are priced high in this sector of the market, and the risk of loss on resale of new units is accordingly high.

Developers often advertise new apartments for sale with a guaranteed rental return for the early years of ownership. This is often successful in attracting non-resident buyers, although domestic buyers often see a guaranteed rental return as a potential red flag.

Summary of apartment risks

While most Australian cities are seeing an uplift in apartment construction, none compares to Greater Brisbane which could see an unprecedented 25 per cent uplift in the total stock of units within the space of two years. Whatever, the longer-term outlook, it is difficult to see how this can lead to anything but declining rents and prices.

WEST END/SOUTH BRISBANE – APRIL 2017

During visits to the postcode in April 2017 it was clear that vacancy rates are higher than reported by the official data, with many balconies empty and lights off in the evenings.

Newly completed blocks of units have ‘for rent’ signs draped across them.

Despite the evidence of oversupply, thousands of units remain under construction as at April 2017 in these suburbs too.

(c) Development on the suburban fringe

Fueled by record low interest rates, there has been a very significant increase in household debt (now approaching 190 per cent of household disposable income) and the average mortgage size in Australia, continuing a trend that has been ongoing for more than two decades.

Property markets are more sensitive to interest rates than has been the case historically, particularly in markets in which most homes are reliant on a single salary earner, with risks abounding when interest rates are eventually tightened. Market data showed that yields on Australian bonds likely bottomed out in the third quarter of 2016, despite a recent decline.

There could be further cuts in the cash rate in this cycle, although this outcome is not priced in by futures markets. However, the risk is clearly that mortgage rates revert higher at some point.

When it happens, this will result in mortgage stress for many single-income households, particularly in some of the lower socio-demographic areas. To date, upwards movements in mortgage rates have been relatively moderate, but we have seen the first signs of both fixed and variable rates moving higher.

While the apartment markets around Newstead and South Brisbane are two of the sectors of the market which present a high risk of correction, not all the market risks relate to new apartments.

In some of the outer Brisbane suburbs, fueled by low interest rates and yield-starved investors, house prices may have stretched beyond the capacity of average families to service the required mortgage debt should interest rates rise.

WargentAdvisory has held discussions with developers in 2016 during which they indicated an increasing reluctance to develop sites in new greenfield fringe locations.

Developers noted that valuations on completion in new streets and estates had frequently come in below expectations. This can occur as valuers have few readily comparable established sales against which they can benchmark, and therefore can be inclined towards conservative valuations.

When valuations are coming in below sales price, this can indicate a sector of the market at a risk of correction. While ***WargentAdvisory*** did not witness any apparently significant drop in demand for detached housing in 2016, it is noted that should interest rates begin to rise later in 2017 there may be an elevated risk in this sector.

In outer suburban markets where there is a high volume of generic new housing, the inherent lack of scarcity and land value can lead to a risk of market correction as new developments become established.

Implications for the economy

Residential construction is known to have a very strong multiplier in Australia, so when construction activity growth reverses there will be an adverse knock-on effect to employment and economic growth.

As mortgage arrears and defaults rise (this was already in evidence in 2016 in Western Australia and regional Queensland) there will be declines in bank profits and a decline in company profits and taxes, with banking being a huge sector of in Australia's economy.

Note that some smaller lenders have heavy exposure to regional Queensland's housing market.

Any deleveraging in Australia's mortgage debt could therefore be reflected in an increase in government debt as stimulatory spending is required and as tax receipts decline.

In such scenarios, the Australian dollar could weaken significantly from its present level of around 80 US cents.

Although a serious market correction could lead to liquidity challenges for the banks, insolvency is not considered likely by regulators, in part due a Committed Liquidity Facility (CLF) provided by the RBA as part of Australia's implementation of the Basel III liquidity standards from 1 January 2015, to the value of $245 billion in 2016.

PART 5 – TRIGGERS & MARKET RISKS

In this section of the report we consider some of the property market risks in Brisbane, and the potential triggers for a downturn.

(a) Lending standards & practices

Lending standards have tightened considerably since before the financial crisis, when 100 per cent LVR loans were routinely available for employees with provable salary income at high multiples of their salary, and 'low doc' self-certified income loans were also commonplace.

Serviceability criteria are tougher today, and it is harder for individuals to take on very high levels of debt, despite lower mortgage rates, with new borrowers typically stress-tested at mortgage rates of 7 per cent over the last two years.

Although it is more difficult to obtain mortgages than it was, the incentives structure is broadly unchanged.

Which is to say, banks are still motivated to write loans, and mortgage brokers are still incentivised to help their clients secure mortgage finance.

While mortgage fraud is a hot topic in Australia, specific cases are difficult to prove, although the major lenders are clearly concerned about the prospect of a Royal Commission into lending practices.

This was reflected in the cessation of most mortgage products available to foreign or non-resident borrowers in 2016, due to the looming prospect of investigations.

With a high proportion of new dwellings sold to offshore buyers, this led to a higher risk of settlement defaults from non-resident buyers.

Although listed developers reported a rise in settlement defaults on new apartments in 2016, the numbers were not unduly out of line with historical averages, although some reported that settlements had been delayed while buyers sought new avenues for securing finance.

There is very little clarity surrounding the classification of outstanding loans between investors and owner-occupiers in Australia, with some buyers securing mortgages notionally as homebuyers then subsequently switching the purpose of the asset to become a rental property (there is no accurate data matching between the lenders and the Australian Taxation Office).

To cool speculation in the market in late 2014, the market regulator the Australian Prudential Regulation Authority (APRA) imposed an arbitrary 10 per cent cap on investor credit growth in the mortgage books of lenders.

Very quickly the Reserve Bank of Australia's (RBA) Financial Aggregates figures showed investor credit growth slowing, but owner-occupier growth immediately increasing sharply to plug the gap.

While the share of the market between owner-occupiers and investors shifted, total housing credit growth was all but unchanged.

This reinforced the view already held by ***WargentAdvisory*** that the lines between investor and owner-occupier lending were blurred.

Analysis of geographical market share and the investor loans books by lender falls outside of the scope of this report. Please refer to *WargentAdvisory* consultancy services for discussion of specific securities.

(b) Investing & yields

With interest rates having fallen since 2011, dwelling prices nationally have outpaced the growth in rental prices, resulting in significant yield compression, with gross yields at record lows.

The impact has been felt most keenly by investors in Sydney and Melbourne, but has impacted most capital city housing markets to some extent.

With relatively lower entry prices into the Brisbane market for investors, rental yields are more attractive in the Queensland capital, which tends to attract investors from interstate and overseas.

Gross yields in Brisbane vary depending upon the sector of the market. For apartments, gross yields of at least 5pc have not been difficult to find, though investors should be wary of the risk of vacancy periods or rents declining in the years ahead.

For the detached housing market, it is still easily possible to find gross yields of above 5pc, though not in the inner ring suburbs. With mortgage rates generally available from around 4pc to 4.5pc in 2017, such investments can produce an even cash flow, provide that repairs costs are not too high.

However, the higher yielding properties are typically located further from the city, and the higher rental yield can sometimes come at the expense of capital growth (and due to the combination of leverage and the compounding growth effect, it is investors that attain the highest prices growth

Election manifesto changes

In Australia on 2017, net rental losses after attributable costs and depreciation charges can be offset against salary income.

Therefore, property investments that generate a net rental loss can still be popular, particularly with higher income earners otherwise due to pay income tax at the highest marginal rate.

During the last election campaign the incumbent Coalition (Liberal) party retained the existing 'negative gearing' rules, that have been a feature of tax legislation aside from a brief quarantining between 1985 and 1987.

The opposition Australian Labor Party (ALP) proposed restricting negative gearing benefits to new dwellings prospectively, and scrapping the existing 50 per cent capital gains tax discount for assets owned for longer than a year.

Should the ALP be successful at the next election, therefore, there is a possibility of tax legislation becoming considerably less favourable to new property investors, although the change in ruling will not be applied retrospectively.

In early 2017, most opinion polls were fairly evenly divided between Australia's two main political parties.

Paradoxically, the ALP proposals have led to a rise in investor activity, and landlords aim to maximise their market exposure while the existing negative gearing tax legislation is in place.

(c) The short side & timing the next downturn

It has always been difficult to time property market downturns accurately.

However, from international experience we know that a downturn in building approvals can foreshadow a correction in market sentiment and prices, being an indicator that developers have become less confident of completing projects profitably.

In this context, the downturn in unit and apartment approvals in Brisbane in 2016 suggests that a correction will play out in the attached dwelling markets in 2017.

Lenders also became extremely wary of lending to non-resident investors in 2016.

This may lead to an increased risk of settlement defaults.

By the end of 2016, listed developers reported that defaults remained relatively contained, and within normally acceptable ranges, although some reported that settlement dates had been moved out to accommodate buyers with difficulties securing mortgage financing.

By 2017 some media reports suggested that defaults were becoming more common. This trend will be one to watch in 2017.

The 90+ day mortgage arrears for the third quarter of 2016 remained relatively low in aggregate, but had spiked hard in Queensland's resources regions and jumped by 24 basis points in Australia[18].

This suggests that the resources downturn is likely to lead to a cascade of mortgage defaults in 2017 in the regional resources markets, a dynamic that ***WargentAdvisory*** has been aware of for some time.

Sydney's preceding housing boom was brought sharply to an end by twin interest rate hikes in November and December 2003, and with household debt ratios having risen to record highs there is good reason to believe that rising mortgage rates could result in financial distress in many of Australia's housing markets.

This time around, futures markets are pricing a first hike in the cycle by the end of 2018 or early 2019.

The worst-case scenarios see the oversupply in the apartment sector and falling rents spread into the established detached housing and owner-occupier markets.

In this scenario, there will be a sharp downturn in residential construction and housing finance, putting banks, developers, mortgage insurers, and suppliers of building materials under significant pressure.

This is to some extent reflected by short sell reports, which show that some of the listed companies in these sectors have a higher than average percentage of its stock being sold short.

Sectors to come under pressure

The downturn in apartment construction and prices will have implications for listed securities, including some of those in the following sectors:

- Retail
- Shopping centres
- Hardware
- Developers
- Mortgage insurance
- Real estate agents
- REITS
- Mortgage brokers
- Banks
- Non-bank lenders
- Materials

Analysis of specific banks, mortgage insurers, and other listed companies falls outside the scope of this report. Please refer to *WargentAdvisory* consultancy services for discussion of specific securities.

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