WargentAdvisory

# The Long & Short Report

# SAMPLE ONLY

Sydney Property Market 2017-18.



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## PURPOSE OF REPORT

Presented below is detailed analysis of the Sydney 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 consideration of expected future trends.

This market report does not contain price forecasts.

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

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

The report considers both demand factors (including the Sydney economy, employment trends, and population projections) and supply factors (including dwelling approvals, commencements, and net 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 this 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 such matters not covered in this report please consider engaging ***WargentAdvisory*** consultancy services.



## FULL REPORT CONTENTS



**REPORT CONTENTS (CONTINUED)**

## EXECUTIVE SUMMARY (SAMPLE ONLY)

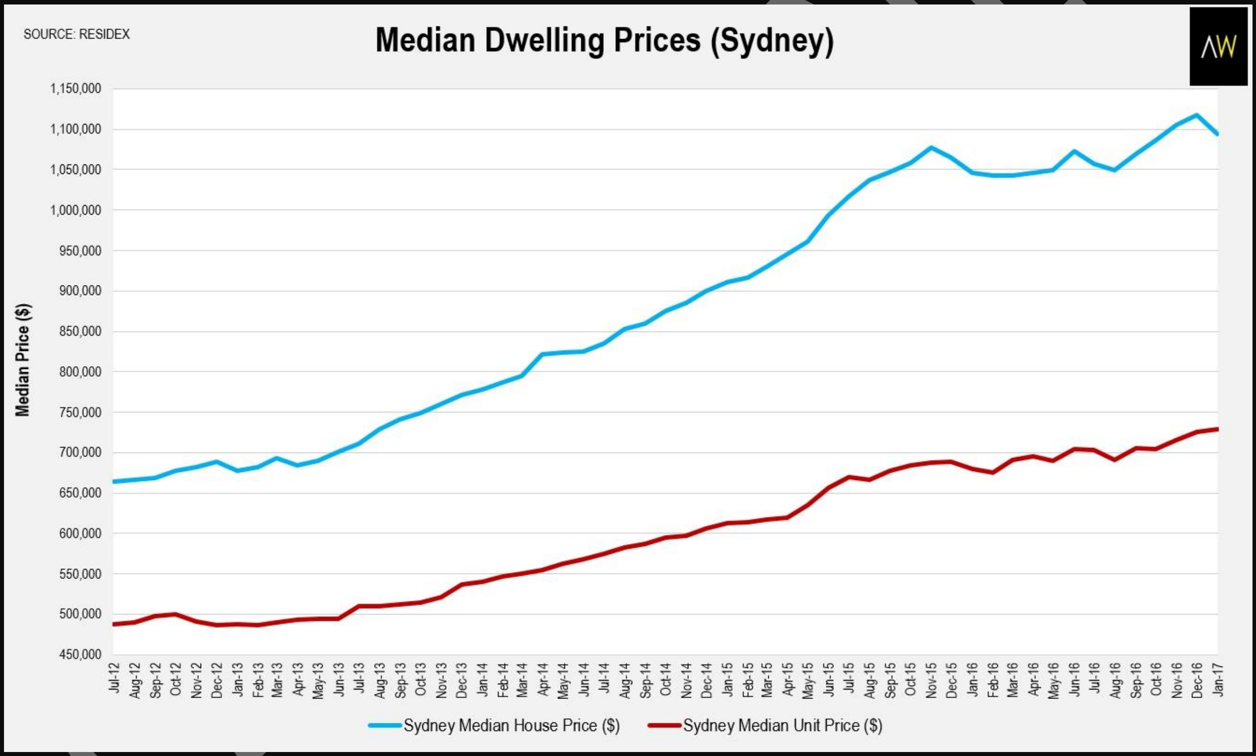
### Sydney prices have soared

Sydney has recorded very strong growth in both houses prices and attached dwelling prices since the middle of 2012, from a high base.

Since July 2012 house prices have increased by $430,000 or **65 per cent** to a median of $1,094,000, according to the *Residex* repeat sales index.

The median Sydney unit price has also increased by $240,500 or **49 per cent** over that time to $728,500.

The repeat sales index is not seasonally adjusted and therefore the early 2017 declines will likely prove to be seasonal, and other indices have implied considerably stronger year-on-year growth than this index.




Up until June 2017, there were few signs of the Sydney housing market having slowed significantly.

Record prices are being paid across many market sub-regions with exuberant market sentiment having been reignited by two interest rate cuts in May and August 2016 respectively, which took the official cash rate to a new low of 1.50 per cent.

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

## EXECUTIVE SUMMARY (CONTINUED)

### Risk 1 - Oversupply

Sydney entered the current cycle with an infrastructure and a dwelling deficit, with dwelling commencements having fallen to a 56-year low in 2009.

After five years of house and apartment price growth, a record supply response is now in full swing, particularly in the new apartments sector.

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

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

Despite this, with a Greater Sydney population passing 5 million in FY2016, overbuilding of apartments alone will not be a sufficient trigger for a market downturn.

As the research in this report shows, the government has increased the issuance of temporary visas to nearly 2 million, particularly to international students since 2013, which has to some extent helped to absorb the new supply of apartments in Sydney and Melbourne.

Moreover, Sydney does not suffer from the same levels of concentration risk as Melbourne and Brisbane, with the new construction spread more widely across the Greater Sydney area.

However, from observing previous cycles it can be said that the true extent of any market oversupply does not become apparent until there is a downturn in sentiment and prices, as recently evidenced in Perth, the capital city of Western Australia.

As such, a dramatic increase in new supply may exacerbate the downturn such as was the case in Sydney in 2004, or more recently in Perth from 2014 onwards.

### Risk 2 – Rising mortgage rates

In some of the poorest neighbourhoods in Western Sydney there has been explosive price growth since 2012, leading poor quality housing stock in many suburbs to become severely overpriced.

As we will show through analysis prices in some areas of Sydney have moved beyond the capacity of new homeowners to service mortgages if mortgage rates rise.

While mortgage rates could become somewhat tighter in 2017, overall mortgage rates remain relatively stimulatory for now, some sub-markets are likely to continue experiencing price growth for some time to come, particularly in the supply-constrained eastern suburbs, inner west, lower north shore, and in the northern beaches region of Sydney.

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

In the event that mortgage rates revert towards a historical mean the impact on dwelling prices in Western Sydney would be cataclysmic. Implied yields on the cash rate futures yield curve are pricing the first rate hike by late 2018.

## EXECUTIVE SUMMARY (CONTINUED)

### 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. This partly reflected the extraordinarily high number of investors in the market in 2015, with around two in every three investor loans being interest-only at that time.

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 every 4 loans in 2016) and some first homebuyers have been using interest-only loans, reflecting the speculative nature of some Australian housing 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 automatically switched to a principal-and-interest loan with a considerably higher repayment.

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

While some lenders (such as Westpac and Commonwealth) have rolled over interest-only loans almost automatically upon request, others (such as Suncorp) have required a new application to be made.  There is a clear risk that if banks become unwilling or unable due to regulatory changes to continue rolling interest-only loans then borrowers could become exposed by higher repayments (APRA announced a new cap on interest-only lending on March 31, 2017).

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

### Risk 4 – Sydney's economy & the impact of the construction downturn

Although challenged by Melbourne in 2017, Sydney's economy was the strongest in the nation through until 2017 – partly due to the construction boom underway - so combined with very strong population growth, demand for housing in the inner ring suburbs is expected to remain high.

The main risks to the Sydney economy include the eventual downturn in the residential construction sector, as well as exogenous factors including a material slowdown in China's economy.

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

Many first homebuyers are now turning to investment property as a first step on to the housing ladder. At the peak, excluding refinancing more than 55 per cent of mortgages written across the entire state were investment loans, before cooling measures were implemented by the market regulator APRA.

## EXECUTIVE SUMMARY (CONTINUED)

Construction employs more than 1.1 million Australians from a workforce of around 12.2 million – the highest ever sectoral share - and the multiplier effect of the residential construction boom has been vastly beneficial.

The flip-side to this is that as the residential construction cycle passes its peak, employment prospects are likely to dwindle and demand for Sydney housing may follow.

### CONCLUSION

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

Sydney now faces the prospect of record dwelling supply combined with potentially slowing population growth as residents migrate interstate to cheaper and less crowded locations, mainly in south-east Queensland.

***WargentAdvisory*** believes that sectors of all of Australia's capital city markets are ultimately due for a correction, with prices in Perth and Darwin already in decline since 2014.

Apartment approvals or permits are in a trend decline in Melbourne, and in a very sharp decline in Brisbane, which we believe foreshadows an imminent correction in these markets, particularly in the oversupplied inner city locations.

Meanwhile, in regional Queensland and Western Australia mortgage delinquencies are rising sharply as the resources construction downturn continues to bite hard.

However, as Australia's most populous and popular capital city we believe that Sydney's market median price may continue to rise in the first half of 2017 as the supply response is still underway and demand from investors and owner-occupiers continues to be very strong, reflecting an ongoing fear of missing out.

Rather than an oversupply, the likely trigger for Sydney's downturn is as likely to be a change in sentiment, with prospective buyers aware of how high prices have been pushed by ferocious bidding over recent years.

When the Australian Prudential Regulation Authority (APRA) introduced tougher macroprudential measures to cool the housing markets in 2014 and 2015, Sydney's auction clearance rates rapidly fell from record levels of above 90 per cent to the 50 to 60 per cent range by the end of the calendar year, buyer confidence in the market only being restored by interest rate cuts in May and August 2016.

Further regulatory measures were announced at the end of March 2017, as further detailed in the body of this report.

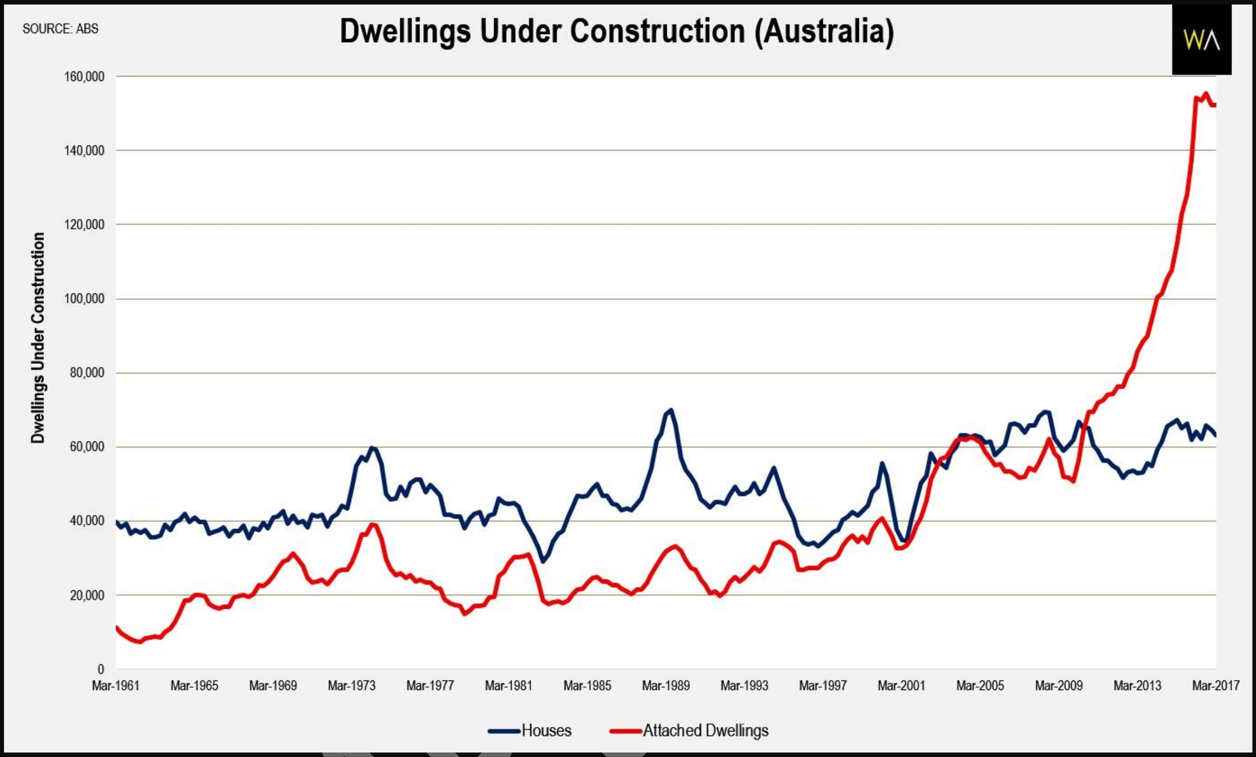
With mortgage rates now inching higher, any further hit to market confidence will eventually catalyse falling prices, in turn reinforcing the end of the construction boom.

Australia's banks and economy are highly leveraged to housing, so the impact of falling prices will magnify any economic downturn.

## PART 4 – THE SHORT REPORT (SAMPLE)

### Risk areas

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

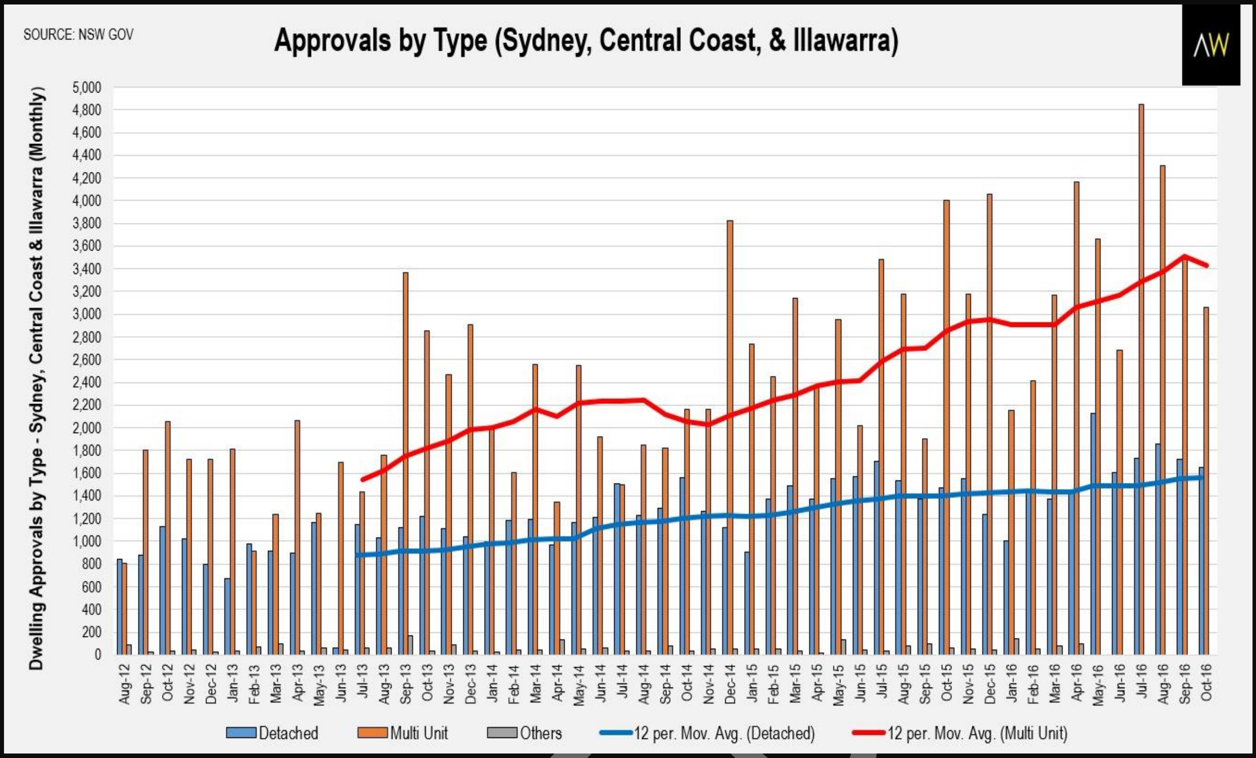



#### (a) New apartments & the emerging risks

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

Sydney last experienced a significant oversupply from late 2003, whereafter Western Sydney saw reported vacancy rates rise to well above 5 per cent[5], resulting in declining rents and dwelling prices.

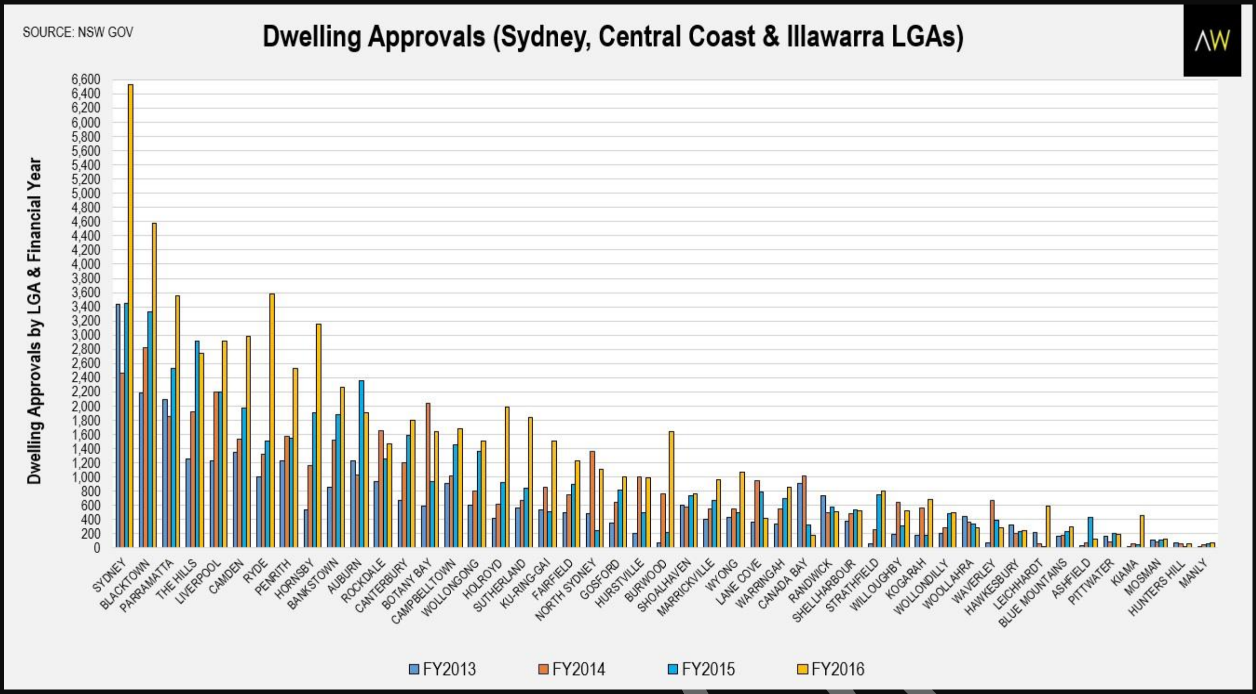
As previously noted there is a market risk in Sydney related to the over-building of apartments, particularly high-rise apartments. Annual approvals for multi-unit dwellings rose to record highs in 2016, apparently peaking in the month of September.



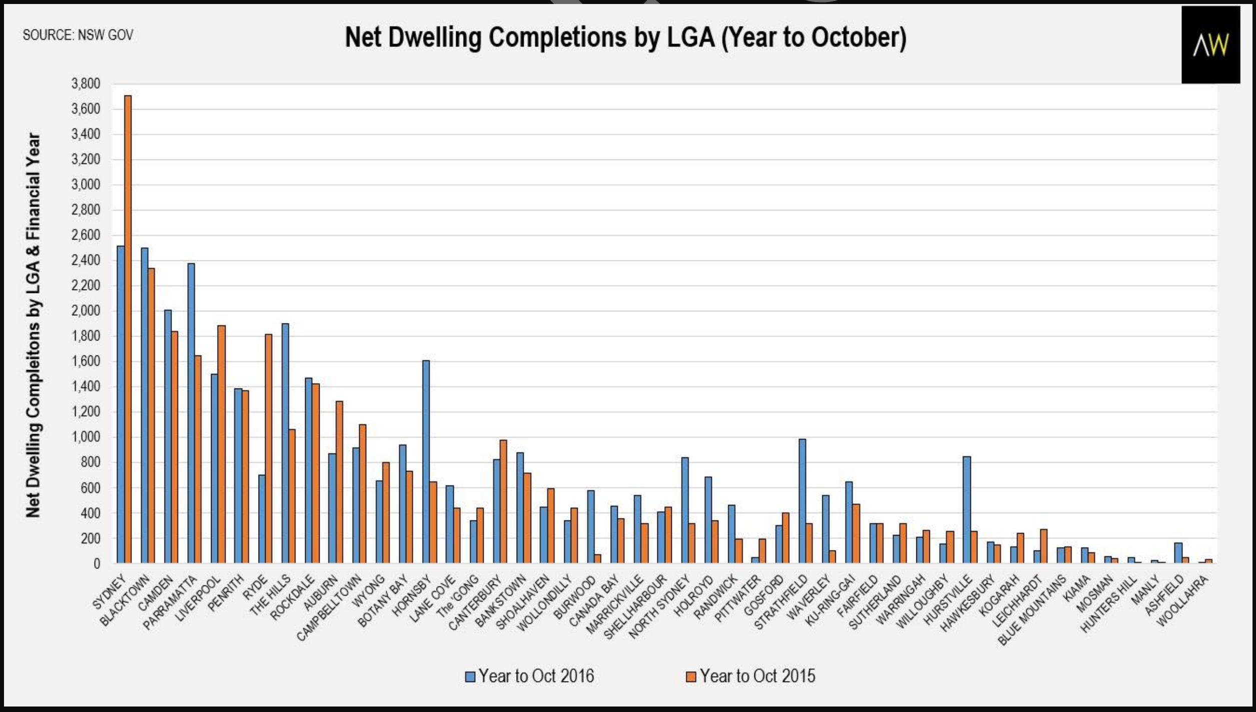

Unlike in Melbourne and Brisbane where the apartment supply response has been heavily concentrated on a few construction hotspots, as a more mature city with fewer prime location development sites available, Sydney has seen its apartment construction spread across a wide geographical area.

Despite this there are still gentrified blue chip areas where very few building permits have been granted, while in other areas huge numbers of dwellings have been waved through for approval.

Drilling down to the LGA level, it becomes clear that the highest risk areas include secondary locations such as Parramatta and Blacktown, where building approvals have been granted in their thousands over the last few years. Over the combined financial years of 2015 and 2016, both Parramatta (6,100) and Blacktown (7,900) saw record numbers of multi-units approved.




By late 2016, net dwelling completions in Parramatta in particular were beginning to rise significantly, with a looming oversupply and falling rents the inevitable result.




By February 2017, reported vacancy rates in Parramatta had already increased to around 3 per cent appeared to be trending higher[6].

In Blacktown, the vacancy rate had also risen to around per cent and the trend was also climbing[7].

Parramatta and Blacktown case studies are looked at in further detail in ***Section 4(c)*** of this report.

As noted, ***WargentAdvisory*** believes that there is a risk at this stage of the construction cycle that vacancy rates can be understated by the officially reported 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.

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 projects, the perception of an oversupply can be reinforced, leading prospective renters to be more inclined to negotiate harder on the rental price.

During site visits, we have observed that many more apartments appear to be vacant than reported, with a lack of furnishings often a key indicator.

**Oversupply hotspots**

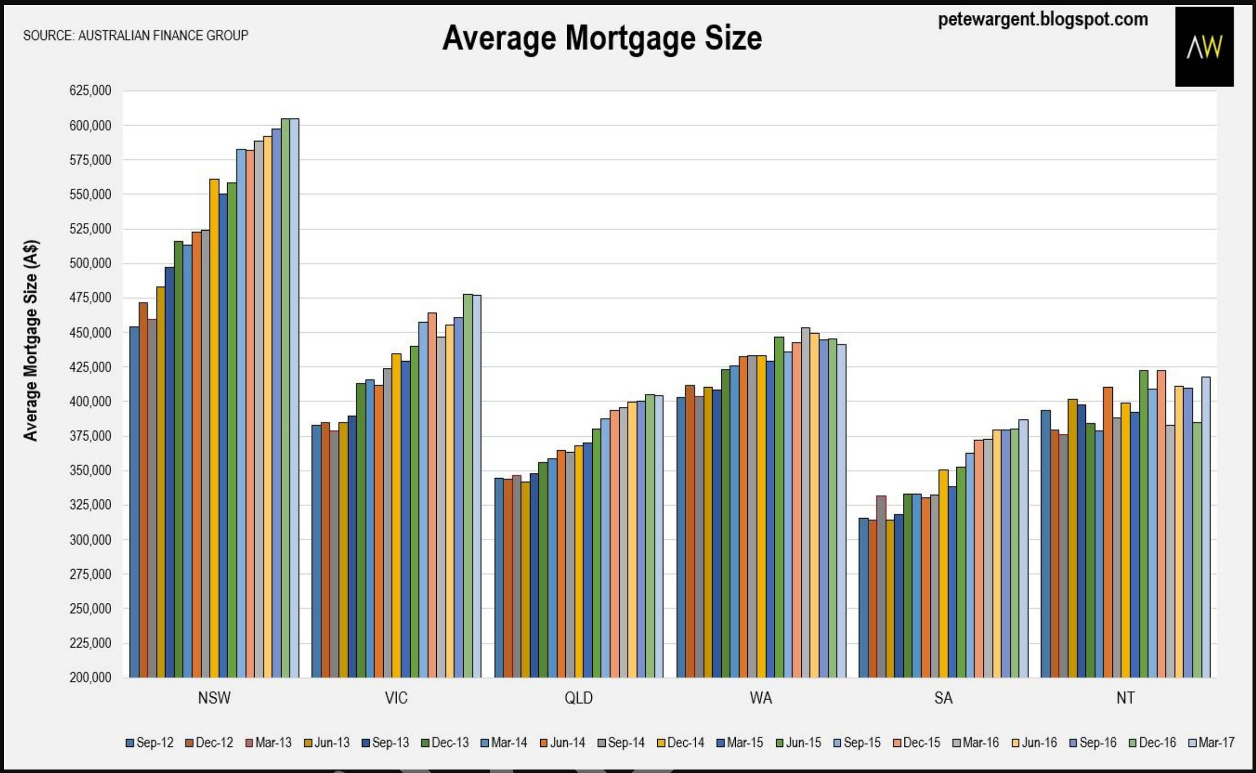
While the LGA of Sydney itself has also seen an increase in the construction of apartments, the LGA covers a very large area, and any oversupply is likely to be relatively isolated to parts of the inner south region of the Sydney (City) LGA.

***WargentAdvisory*** research shows that several other parts of Greater Sydney 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:

- Mascot (close to the airport)
- Green Square (“)
- Zetland (“)
- The Hills District
- Liverpool
- Camden
- Hornsby
- Homebush
- Wentworth Point

## (b) Western Sydney exuberance

Fueled by record low interest rates, there has been a very significant increase in household debt in Australia, now rising to around 190 per cent of household disposable income and continuing a trend that has been ongoing for more than two decades.




Australia's property markets have in turn become far more sensitive to interest rate hikes than has been the case historically.

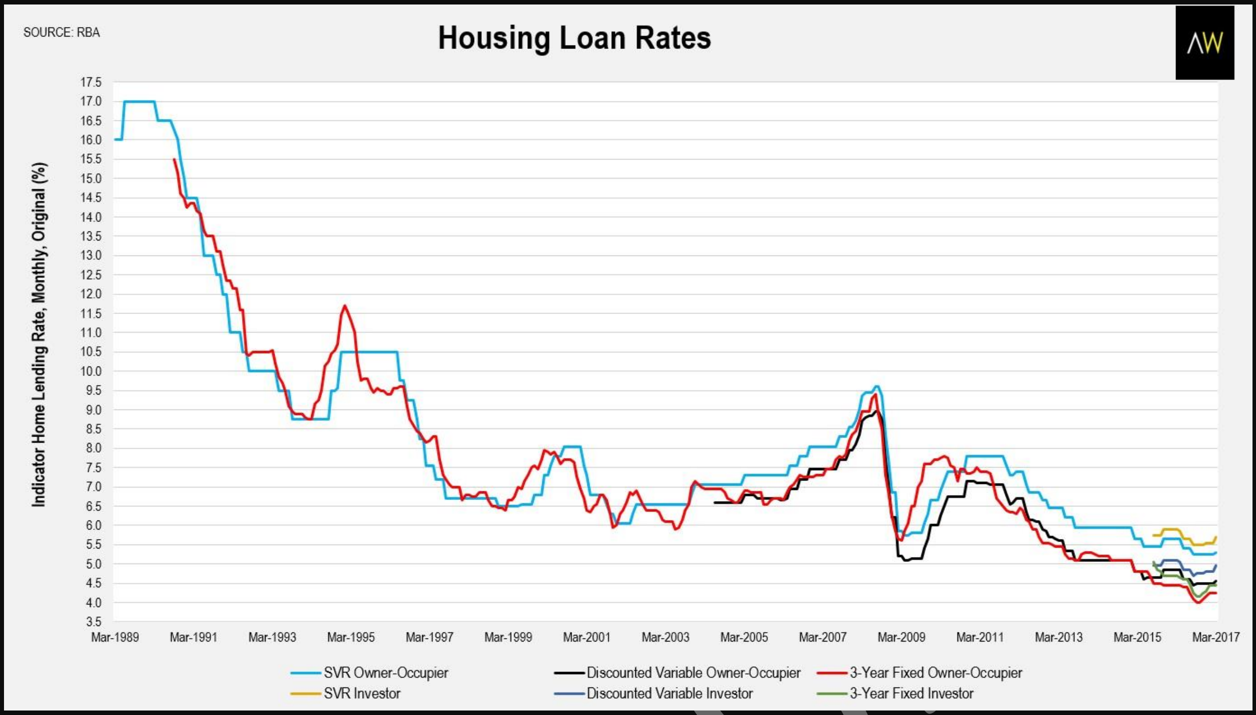
This is particularly the case in markets in which most homes are reliant on a single salary earner, with risks abounding when interest rates are tightened.

Yields on Australian bonds bottomed out around the third quarter of 2016 and began to rise following the US election result.

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 this occurs, this will result in mortgage stress for many single-income households, and acutely so in many of the lower socio-demographic areas.

To date, movements in mortgage rates have been relatively moderate, but we have already seen the first indications of fixed rates moving higher, as well as mortgage rates for investors.




Some of the greatest gains in house prices in Sydney over the past five years have often been seen suburbs in the inner west, including in Homebush, Lilyfield, and Strathfield, where median prices have more than doubled.

The apartment markets surrounding Parramatta and Homebush is one of the sectors of the market which present a very high risk of correction.

Not all of the market risks relate to new apartments, however.

**As a rule, the further west one travels from the centre of Sydney, the more irrationally exuberant the market appears to be.**

In some of the outer-western Sydney suburbs, fueled by low interest rates, yield-starved investors, and buyers simply desperate to gain a foothold on a rapidly rising market, house prices have stretched well beyond the capacity of average families to service the required mortgage debt on new purchases.

We consider several of the highest risk Western Sydney suburbs below, although we note that the risks are by no means limited to these examples.

## WESTERN SYDNEY SNAPSHPOT

### Mount Druitt, NSW 2770 – Suburb snapshot



Mount Druitt is a low socio-demographic suburb with most households reliant on moderately paid single-income salary earners. The median household income is under $55,000 per annum.

The suburb was recent portrayed in a severely negative light by the television series *Struggle Street*, which focused on the deprivation, poverty, unemployment and addiction in parts of the suburb. The suburb is located 43 kilometres to the west of Sydney Central Business District.

Like-for-like sales show incredibly strong price growth has taken place, particularly since 2012, driven by a surge in speculation from investors seeking houses with lower entry prices and relatively higher gross yields.

House prices are now extremely high compared to moderate incomes in the suburb, even though relatively little gentrification has taken place. As such, even a moderate increase in mortgage rates is likely to lead to mortgage arears, defaults, and sharp declines in prices.

A sample of property resales is provided below, showing dramatic price growth since 2012. Even by early 2017 three-year price growth in asking prices was still tracking at **above 50 per cent** in Mount Druitt, yet median asking rents were in decline.

### Sample of example resales, Mount Druitt

| Street Name | Block | Type | | | Sold Date | Sold Price | Sold Date | Sold Price | Price Gain | CAGR |
|---|---|---|---|---|---|---|---|---|---|---|
| AUSTRAL | 450sqm | 4 | 2 | 2 | 4/11/16 | $630,000 | 26/02/02 | $263,000 | 140pc | 6pc |
| DIXON | 1012sqm | 3 | 1 | 1 | 1/11/16 | $865,000 | 10/09/09 | $430,000 | 115pc | 10pc |
| FRANK | 989sqm | 4 | 1 | 2 | 12/10/16 | $750,000 | 14/2/15 | $585,000 | 28pc | 13pc |
| FRANK | 1012sqm | 4 | 2 | 2 | 10/09/16 | $682,000 | 26/11/11 | $375,000 | 82pc | 13pc |
| PALMERSTON | 639sqm | 3 | 1 | 2 | 7/06/16 | $560,000 | 11/05/10 | $325,000 | 72pc | 10pc |
| CHESTER | 556sqm | 3 | 1 | 2 | 2/12/16 | $650,000 | 21/12/11 | $280,000 | 132pc | 18pc |
| FULLER | 463sqm | 3 | 4 | 1 | 30/1/17 | $575,000 | 16/6/13 | $334,000 | 72pc | 18pc |

## Rooty Hill, NSW 2766 – Suburb snapshot

***WargentAdvisory*** observed during recent visits that there has been a good deal of development of older style housing into modern brick builds and townhouses, which has skewed median price growth higher in Rooty Hill.

Nevertheless, analysis of like-for-like sales shows that there have been very substantial gains in this suburb too since 2012, in part driven by investors chasing yields and lower entry prices.

Rooty Hill is another low socio-demographic suburb with low median household incomes - although household incomes are somewhat higher at around $75,000 per annum - and is located 42 kilometres to the west of the Sydney Central Business District.

The quality of the established housing stock is typically poor, and often very poor.

House prices are now extremely high compared to moderate incomes in the suburb. As such, even a moderate increase in mortgage rates is likely to lead to mortgage arears, defaults, and sharp declines in prices. By early 2017 three-year median asking price growth for houses was still **above 45 per cent** but vacancy rates were trending higher.



### Sample of example resales, Rooty Hill

| Street Name | Block | Type | | | Sold Date | Sold Price | Sold Date | Sold Price | Price Gain | CAGR |
|---|---|---|---|---|---|---|---|---|---|---|
| VICTORIA | 483sqm | 5 | 2 | 2 | 25/11/16 | $897,000 | 25/11/08 | $480,000 | 87pc | 8pc |
| BAINBRIDGE | 450sqm | 4 | 2 | 2 | 12/9/16 | $823,000 | 22/10/10 | $525,000 | 58pc | 8pc |
| LISTER PL | 425sqm | 3 | 1 | 1 | 28/11/16 | $605,000 | 10/03/11 | $329,000 | 84pc | 11pc |
| ALICE | 557sqm | 3 | 1 | 1 | 23/12/16 | $650,000 | 12/8/11 | $325,000 | 100pc | 14pc |
| HELEN PL | 601sqm | 4 | 3 | 3 | 11/10/16 | $635,000 | 26/08/13 | $436,500 | 45pc | 13pc |
| GARDNER | 573sqm | 3 | 1 | 2 | 06/12/16 | $685,000 | 16/09/13 | $414,000 | 65pc | 18pc |
| HARTINGTON | 685sqm | 4 | 2 | 2 | 11/3/17 | $840,000 | 27/10/14 | $613,000 | 37pc | 16pc |

## St Marys, NSW 2760 – Suburb snapshot

St Marys is another low socio-demographic suburb with a moderate median household income of under $55,000 per annum, and is located 45 kilometres to the west of the Sydney Central Business District.

Analysis of like-for-like sales shows that there have been substantial gains in this suburb too since 2011, as well as some development of older homes into more modern types of dwelling.

In March 2012, the suburb saw a house on a 1,267 square metre Adelaide Street block sell for a suburb record $1.23 million, which was extraordinary for such a low socio-demographic area. The house had been bought in 2000 for only $280,000, reflecting the massive and unsustainable magnitude of price inflation in the suburb.

By early 2017 the three-year median house price growth was still tracking at around **45 to 50 per cent**, but vacancy rates were rising sharply higher, in part reflective of the new development in this suburb.



### Sample of example resales, St Marys

| Street Name | Block | Type | | | Sold Date | Sold Price | Sold Date | Sold Price | Price Gain | CAGR |
|---|---|---|---|---|---|---|---|---|---|---|
| KING | 885sqm | 4 | 1 | 2 | 23/6/16 | $750,000 | 11/3/09 | $456,000 | 64pc | 7pc |
| COLLINS | 715sqm | 7 | 2 | 3 | 23/11/16 | $725,000 | 4/6/05 | $282,000 | 157pc | 9pc |
| ADELAIDE | 1267sqm | 5 | 2 | 1 | 07/07/16 | $1,230,000 | 20/11/00 | $280,000 | 339pc | 10pc |
| MARGARET | 607sqm | 2 | 1 | 1 | 18/7/16 | $665,000 | 22/9/09 | $275,000 | 142pc | 14pc |
| VINCENT | 870sqm | 4 | 1 | 3 | 19/12/16 | $659,111 | 14/9/12 | $355,000 | 86pc | 16pc |
| MARSDEN | 1104sqm | 2 | 1 | 1 | 18/7/16 | $618,888 | 19/7/14 | $447,000 | 38pc | 18pc |

## Summary of Western Sydney market risks

Although we have presented a snapshot of some of Western Sydney's suburbs above, it is only through visiting these areas in person that a true appreciation of the market risks become apparent.

The quality of the houses being purchased is often exceptionally poor, there is much deprivation and poverty, and median household incomes are amongst the lowest in the city.

Yet house prices have risen at a rate of **15 to 20 per cent per annum** in many cases for several years, outperforming almost all asset classes.

Dwelling price-to-income levels have run extraordinarily high, and compounding the issue there is still much further development taking place, in turn making much of the established stock appear even less attractive than it already is.

Price gains locally have been largely driven by speculation and investors, with more than 55 per cent of mortgages in the entire state of New South Wales being written to investors and the peak of investor activity, and at the peak more than 45 per cent of new loans nationally being interest-only products.

As investors look to lock in substantial gains by selling, a hole is likely to be left in the market given that homebuyers in these poor areas (which also have a good deal of poverty and unemployment) are unable to pay the current market prices.

Note that until 2016 there have been many examples of Chinese buyers purchasing properties, often reflected by purchase prices ending in '888', and the expected pullback from this sector of the market could add further to the risks.

Rescued by two interest rate cuts in 2016, early signs of declines in prices had been halted in these markets, but cracks were clearly beginning to show in declining rents or rising vacancy rates, or in some cases both.

When the Sydney market experienced its last significant downturn from 2004, the Western Sydney market was the first to decline, with vacancy rates rising significantly to well above 5 per cent, before price declines subsequently spread across the city.

## 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.

Australia's four largest companies by market capitalisation are Commonwealth Bank ($146 billion), Westpac Banking Corporation ($115 billion), ANZ Bank ($92 billion), and National Australia Bank ($87 billion).

Only the market capitalisation of BHP Billiton Limited comes close to these companies in size in Australia.

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.

### (c) The apartment oversupply hotspots

**PARRAMATTA SNAPSHOT**

The new apartment sector in Parramatta is another market which we see at risk of a material correction in 2017 and beyond.

Although ***WargentAdvisory*** has never purchased property in the Parramatta market, in part of work undertaken with hedge funds in 2016 we undertook numerous site visits and inspections.

On each visit the proliferation of cranes and projects under construction was very notable.

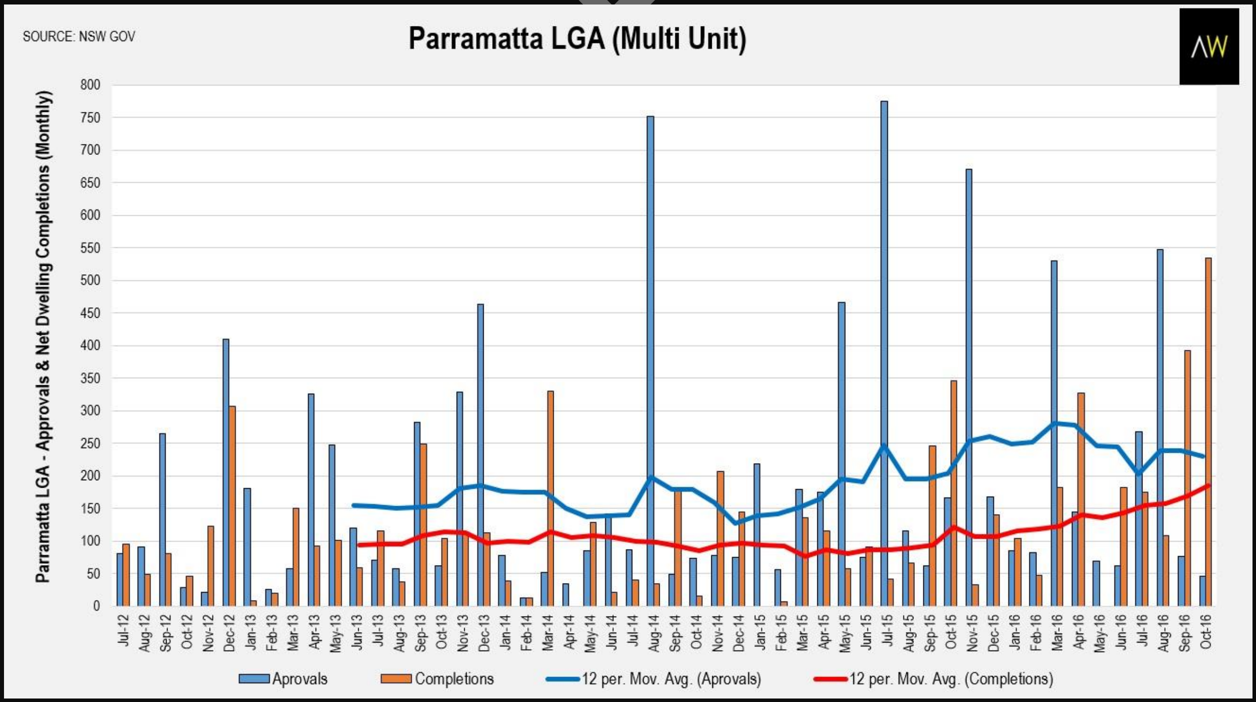
By the end of 2016 we had begun to see falls in median asking rents for apartments located within the suburb.

Vacancy rates had also begun to rise relatively sharply in Parramatta, up to above 3 per cent.

Capital city reported vacancy rates are typically relatively low in Australia due to the prevailing methodology, and this reading compares unfavourably to reported vacancy rates of under 1 per cent in several of Sydney's popular inner ring suburbs.

Net dwelling completions in the suburb had increased to 1,650 in financial year 2015, and increased again to 2,400 in financial year 2016.

The annualised figures show how net dwelling completions have been trending up strongly since the first quarter of 2015 in Parramatta.




With some 3,560 dwellings also approved in financial year 2016, it is all but inevitable that Parramatta apartment rents and prices will decline as the new supply reaches the completion stage.

Figures derived from the labour force survey show that new workers are moving to Parramatta, and therefore the new supply will eventually be absorbed.

However, the statistics show that the supply of high-rise apartments is set to move well ahead of demand in 2017, resulting in a weakening market.

*Parramatta skyline*

***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 offers to negotiate om rental prices.



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

***WargentAdvisory***'s on the ground observations suggest that there are many more vacant apartments than reported, 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, or via websites such as Airbnb.com.

## BLACKTOWN SNAPSHOT

The new dwelling sector in Blacktown is another market which we see at risk of a material correction in 2017 and beyond.

Although ***WargentAdvisory*** does not buy property in the Blacktown market being a secondary and partly lower socio-demographic location, as part of work undertaken with hedge funds in 2016 we undertook several site visits and inspections.

On each visit the number of cranes and projects under construction was very notable in this region too, and by the end of 2016 we had begun to see a significant fall in median asking rents for the suburb.

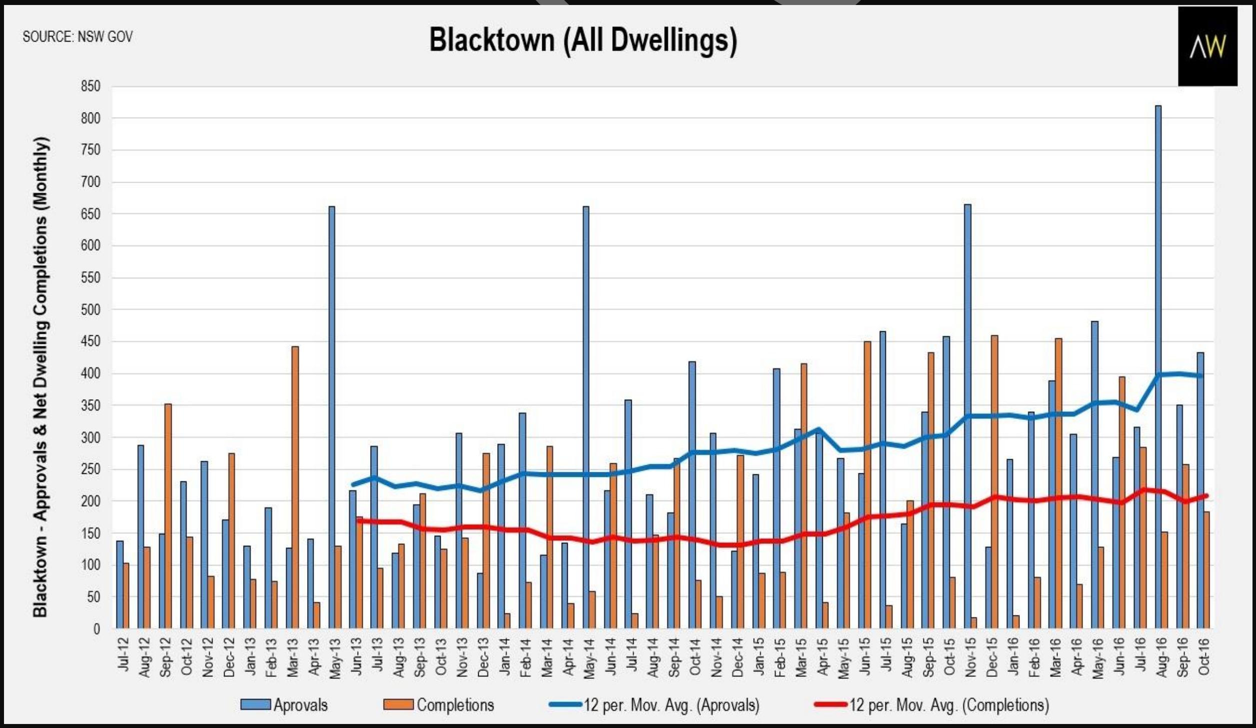
Vacancy rates had also begun to rise in Blacktown, rising to above 3 per cent in early 2017.

Net dwelling completions in the suburb increased to 2,340 in financial year 2015, and increased slightly again to 2,500 in financial year 2016.

The annualised figures show how net dwelling completions have been trending upwards relatively steadily in Blacktown since 2013.

Although there is a somewhat more diversified range of new property types in Blacktown split between detached housing and multi-unit construction, the sheer volume of approvals and construction work in the pipeline is almost certain to weigh heavily on the market going forward.






With an extraordinary 4,760 dwellings also approved for Blacktown over the year to October 2016, it is all but inevitable that rents and prices will decline as the new supply reaches the completion stage.

Blacktown has been a somewhat popular market with first homebuyers or young ‘rent-vestors’ due to its transport links and relative affordability, although the suburb has visible indications of poverty and drug abuse. The statistics show that the supply of new dwellings, while not dramatic to date, will eventually move well ahead of demand by 2017, resulting in a significantly weakening market.

*Blacktown – planned new Meriton project*

By 2036, the population of Blacktown is officially projected to increase by 200,000 persons from 340,000 to 540,000. ***WargentAdvisory*** believes that there is an inherent risk of apartment overbuilding in the LGA of Blacktown.

*Source: Blacktown Local Environment Plan (LEP)*

## PART 5 – TRIGGERS & MARKET RISKS (SAMPLE)

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

### (a) Household debt & underwriting standards

### Interest only loans & investor credit

Australia's Prudential regulator (APRA) reported that by Q3 2016 the quarterly share of interest only loans written had declined to 36.7 per cent from a record 45.8 per cent in June 2015.

These extremely high figures reflect the high degree of speculation that was taking place by landlords, which ultimately led to the implementation of new macroprudential tools, including an arbitrary cap for lenders on the growth of the investor mortgage books at an annualised pace of 10 per cent, imposed from late 2014.

The intervention was notionally successful in that the pace of investor credit growth slowed markedly, although by the end of the calendar year 2016 the pace was picking up again as lenders had brought the annual rate of growth well below the arbitrary ceiling.

Underwriting standards in Australia have improved since before the financial crisis, with tougher serviceability criteria (designed to test that new borrowers can service mortgage rates of 7 per cent) and restrictions on the total value of mortgages extended based upon income.

'Low-doc' loans now represent only a very small share of the market since the financial crisis.

That said, a great many existing property owners have been able to refinance equity from dwellings that they already own to use as a deposit for further purchases, effectively closing the door on many new entrants to the market, who have found saving the deposit and stamp duty costs very challenging in Sydney.

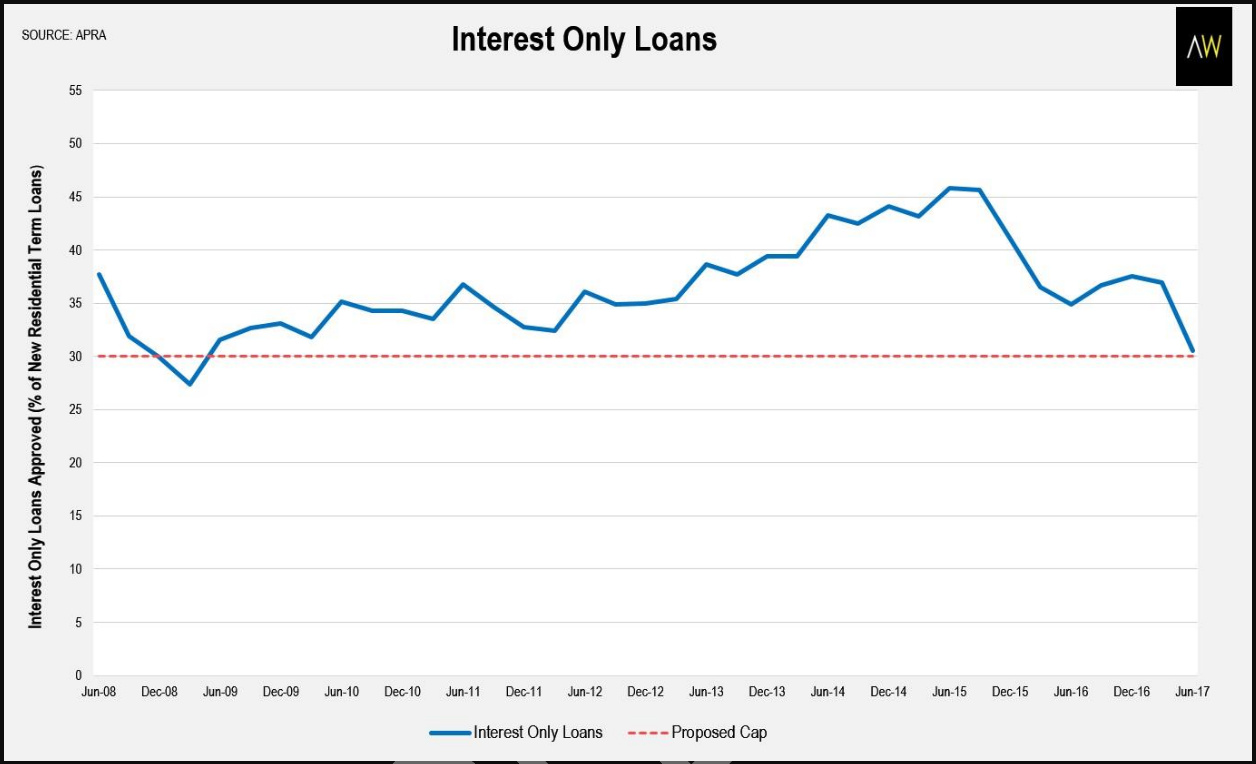
The quality of lending standards in Australia has been called into question by recent matters that have come to light, including reckless lending in resources regions and instances of reported mortgage fraud.

Ultimately banks are incentivised to write loans, and brokers are incentivised to assist borrowers in getting their applications approved.

For this reason, there is an inherent risk in the system of higher risk loans being approved despite regulatory changes having been pushed through.

## Further APRA measures March 2017

On 31 March 2017 APRA announced a new cap on new interest-only loans at 30 per cent of new mortgages, well below the current level.




There will also be more scrutiny of high LVR lending, particularly in respect of interest-only loans.

Some of the impacts of these latest measures will include:

- Banks such as Commonwealth Bank of Australia and Westpac which were previously rolling interest-only loans at the end of their IO period easily will likely now require a formal assessment to be made
- Higher mortgage rates on investor loans
- A shift in market share towards private financiers and non-banks
- A crackdown on interest-only lending to owner-occupiers and aged borrowers
- **Mortgage stress for investors that had intended to rely upon rolling interest-only loans in perpetuity**

## Foreign investment in Australia

There has been a high degree of non-resident buying in Sydney per figures released quarterly by National Australia Bank (NAB) from its Residential Property Survey[8].

Typically, non-resident buyers are restricted from buying established property in Australia, unless buying for development purposes, in which case the Foreign Investment Review Board (FIRB) may grant approval to buy.

However, multiple pathways exist for foreign investors to transfer money to Australia, and without a doubt this has had an impact on stretching valuations in Sydney. Moreover, new properties are overwhelmingly targeted at non-resident investors, particularly those from mainland China.

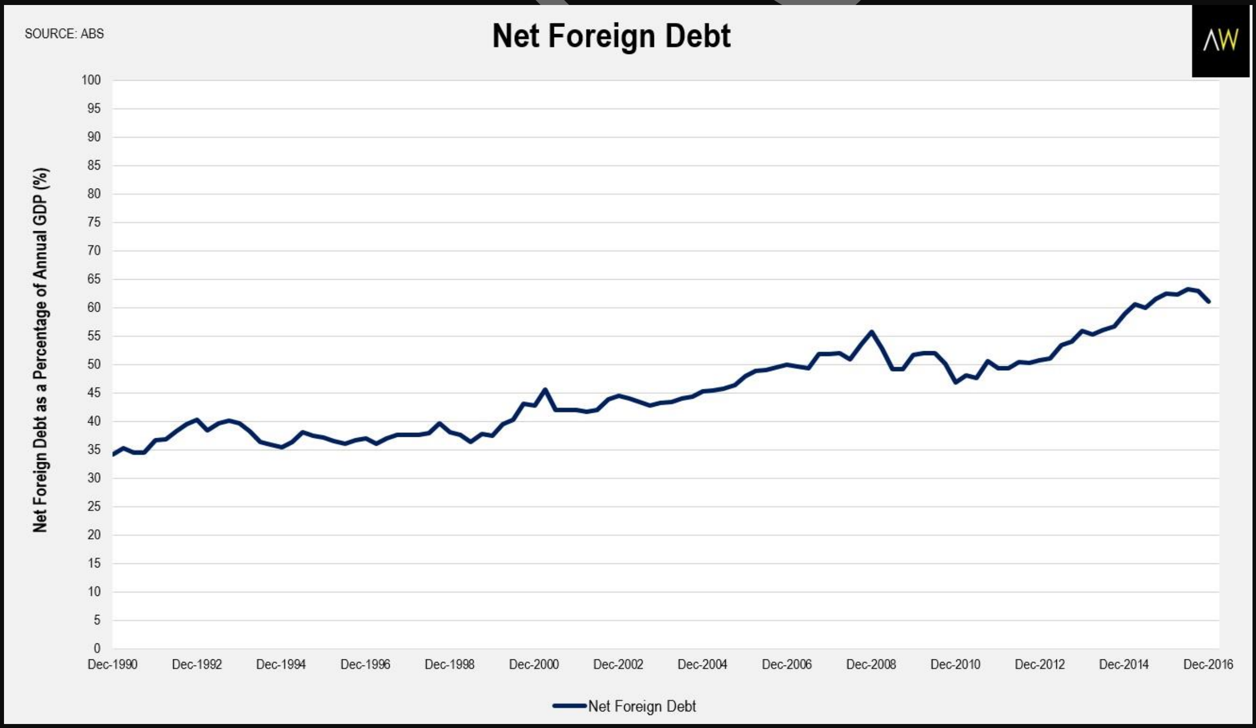
To date, demand from China has not only remained strong, it has positively mushroomed as capital flight takes hold, as reported in the annual figures from the FIRB[9].

The FIRB's 2016 Annual Report showed that total real estate approvals for non-residents had tripled in only two years, suggesting an apparently insatiable demand for investing in Australia[10].

Concerned at the prospect of a Royal Commission into lending practices, domestic lending to non-resident buyers was all but halted in 2016.

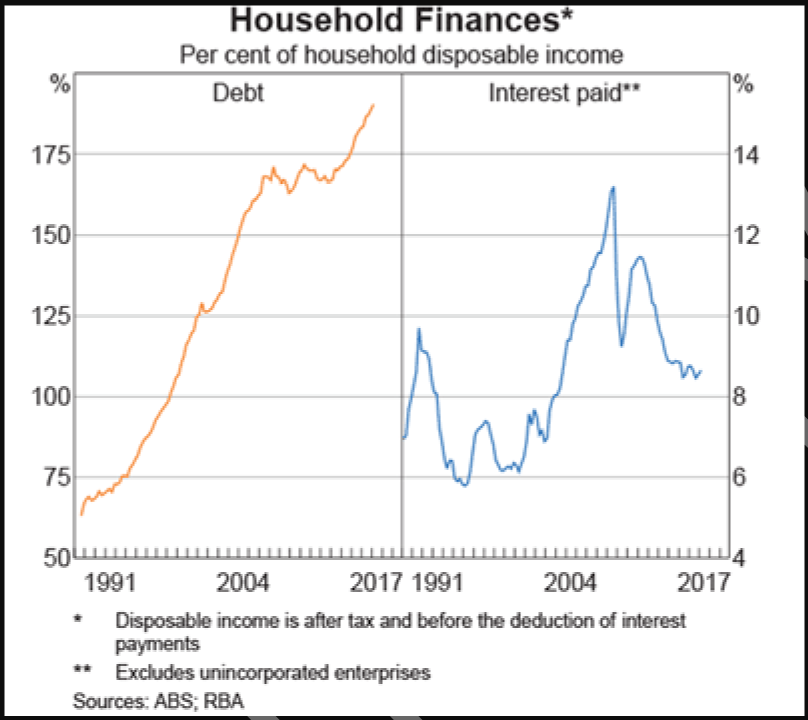
Australia's foreign debt to GDP ratio rose again to a record high 63.8 per cent in Q3 2016, before declining slightly, implying a risk that funds from overseas institutions are no longer extended.





## Household debt levels stretched

Household debt levels reached a record high in early 2017, now approaching 190 per cent of household disposable income, amongst the highest ratios in the world.




However, aggregate mortgage buffers in offset and redraw facilities have also increased to a record 17 per cent of all outstanding loans, the equivalent of well over 2.5 years of scheduled repayments at current interest rates[11].

Analysis by the Reserve Bank of Australia (RBA) has suggested that lower income earners may not have such strong buffers[12].

We believe this analysis support's ***WargentAdvisory***'s assertion that rising mortgage rates could result in sharp corrections in some lower socio-demographic markets where prices have become over-cooked.

Triggers which could result in a market downturn include, but are not limited to the following:

- A slowdown in China's economy or a global recession could slow demand for Australia's iron ore and coal, leading to a slowdown in national income and wider budget deficits (or simply a glut of iron ore on the market, already reflected in record high stockpiles)
- The ensuing loss of AAA-rating would result in higher borrowing rates
- A tightening of capital controls in China may restrict capital flight and in turn mainland Chinese demand for Australian property
- Rising interest rates could put pressure on mortgagees and slow the lending market

- Foreign institutions may become reluctant to continue rolling their wholesale funding for Australia's major lenders, banks, and other financial institutions

- APRA may impose further tighter restrictions on lending

- With hundreds of billions of dollars in interest-only loans gradually reaching the end of their interest-only period, higher mortgage repayments could cripple over-leverage borrowers resulting in mortgage delinquencies or a fire sale in investment properties

- Rising vacancy rates and declining rents in some sectors of the market could lead to an investor exodus, reinforcing any market downturn

The RBA has indicated an unwillingness to see dwelling prices fall while resources construction continues and total capex continues to decline.

The latest figures for engineering construction activity and private new capex show that declines are continuing due to the completion of major construction in Western Australia, but the nadir is expected to be reached within 12 months.

As such hikes to the official cash rate are a realistic possibility by H2 2018.

Implied yields on cash rate future markets are presently pricing rate hikes potentially commencing in late 2018 or early 2019.

### (b) Consequences of the apartment oversupply issue

When demand for slow properties as supply peaks, rents can fall, as has been experienced in Perth and Darwin since 2014.

Although rental growth has softened in some of Australia's capital cities as the new supply comes online, rental price growth continued to outpace inflation in Sydney through 2016, albeit moderately.

Although this is clearly positive news for the landlord sector of the market, rental price growth of 18 per cent over the last five years has failed to keep pace with price growth, leading to significant yield compression.

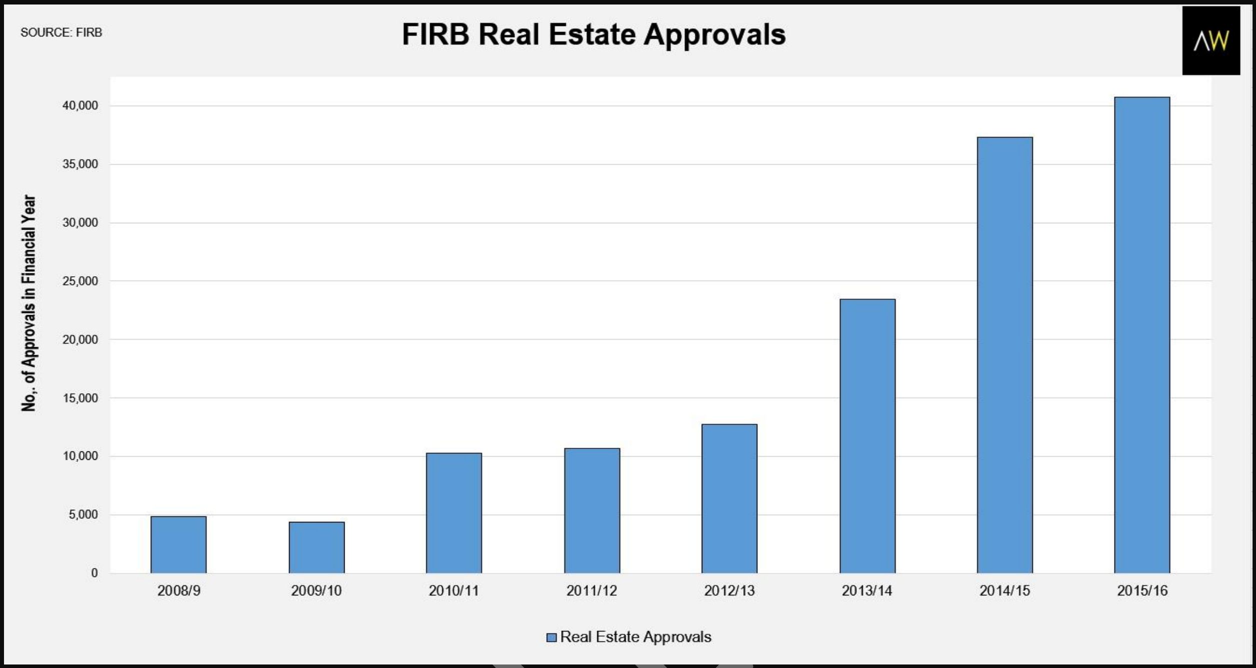
If there was a genuine dwelling shortage, as has often been reported in Australia, we would expect to see the rate of rental growth strengthening, but the opposite is now occurring in all capital cities.

As the new supply of apartments reaches completion in 2017, it is expected that rental price growth in the new apartment sector will slow or in many cases turn negative, and this could also have a detrimental effect on rents and vacancy rates in the wider Sydney market.

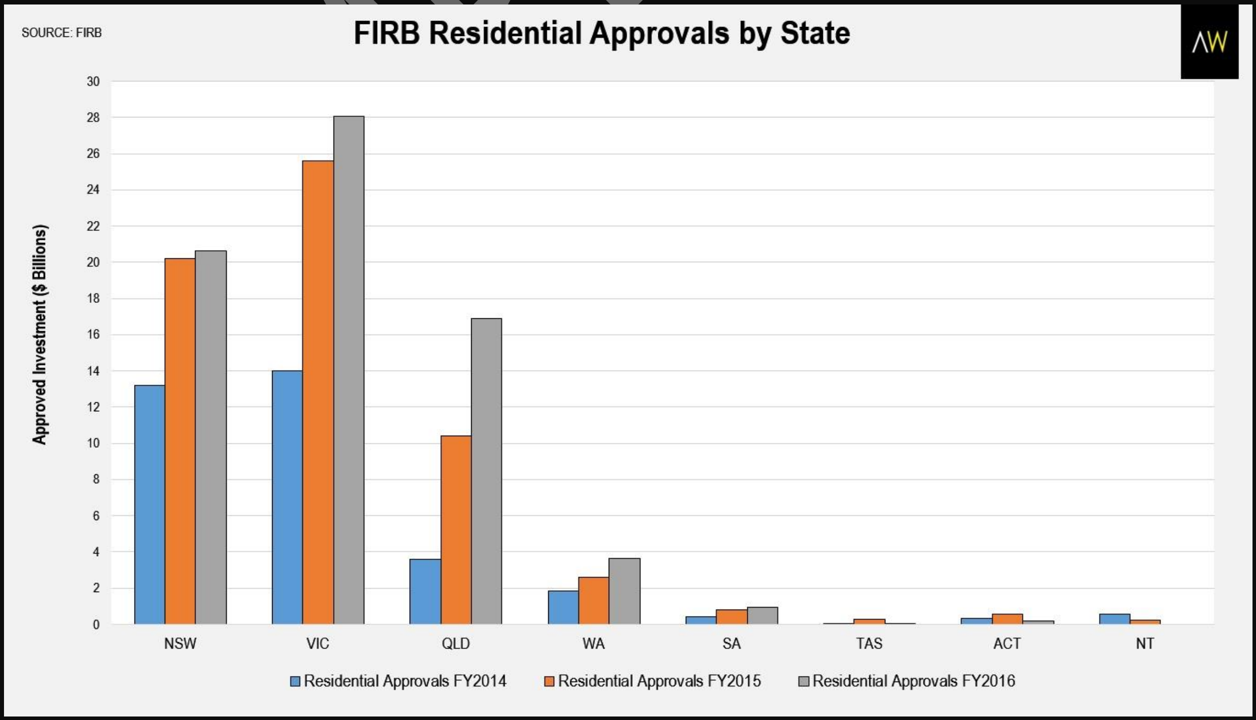
Offsetting this to date, population growth in Sydney has remained strong, with a surge in international students from Asia resulting from a lower dollar and a streamlining of visa rules adding to the demand for rental housing.

### (c) Foreign investors

The National Australia Bank (NAB) Residential Property Surveys in 2016 showed that close to a fifth of new and established properties in New South Wales were bought by foreign buyers, concentrated in inner Sydney[13]. The FIRB Annual Report showed that total real estate approvals for foreign buyers have tripled in the past two years[14].

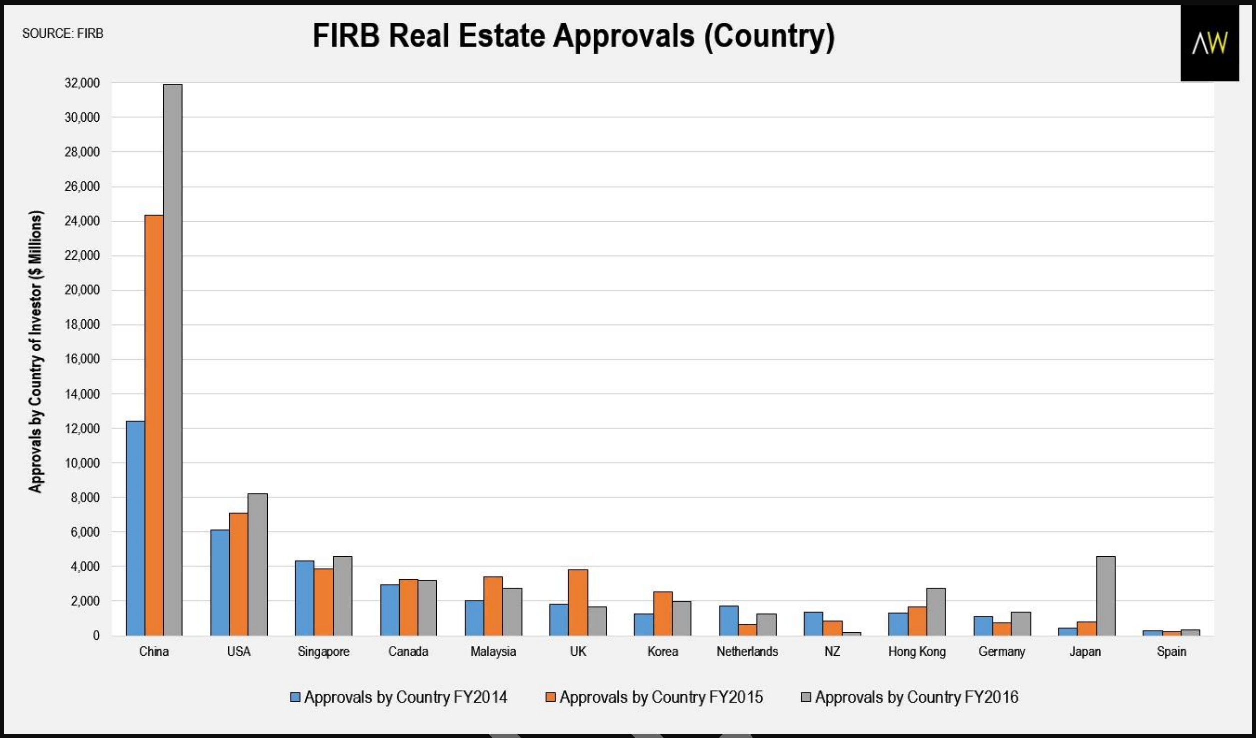



Melbourne is the most popular destination for foreign capital, but demand has been increasing strongly in Sydney too.



This trend represents both an opportunity and a threat to the Sydney market.

It has been estimated that Chinese investors plan to pump $60 billion into Australian housing markets over the next five years[15].




The main risk for the Sydney market is that China imposes stricter regulations on capital flight, stemming the flow of funds into Australian real estate.

Meanwhile nervous local lenders have stopped extending loans to offshore buyers, which has disrupted the flow of capital and may result in settlement defaults on new apartments.

### (d) Resources downturn

Australia's resources construction boom peaked in 2012, with construction activity declining ever since.

While this poses a significant threat to the economies of Queensland and particularly Western Australia, paradoxically Sydney's housing market benefitted from the resultant record low interest rates and low inflation readings at the national level.

Indeed, private business investment is rising in New South Wales, against the national downtrend.

The downturn in resources construction is expected by the RBA to reach a nadir by 2018, and therefore rate hikes have finally become a realistic proposition by the end of 2018.

In Sydney's case, also of significance will be the potential for a downturn in residential construction activity, and whether this can be offset by the increase in infrastructure projects and commercial construction.

### (e) Lending standards & practices

Lending standards have tightened 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 became tougher from late 2016 forth, and today 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 and new serviceability tests applied to total mortgage debt.

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 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 have clearly been 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 an increased 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 has been 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 remained strong over the year to July 2017.

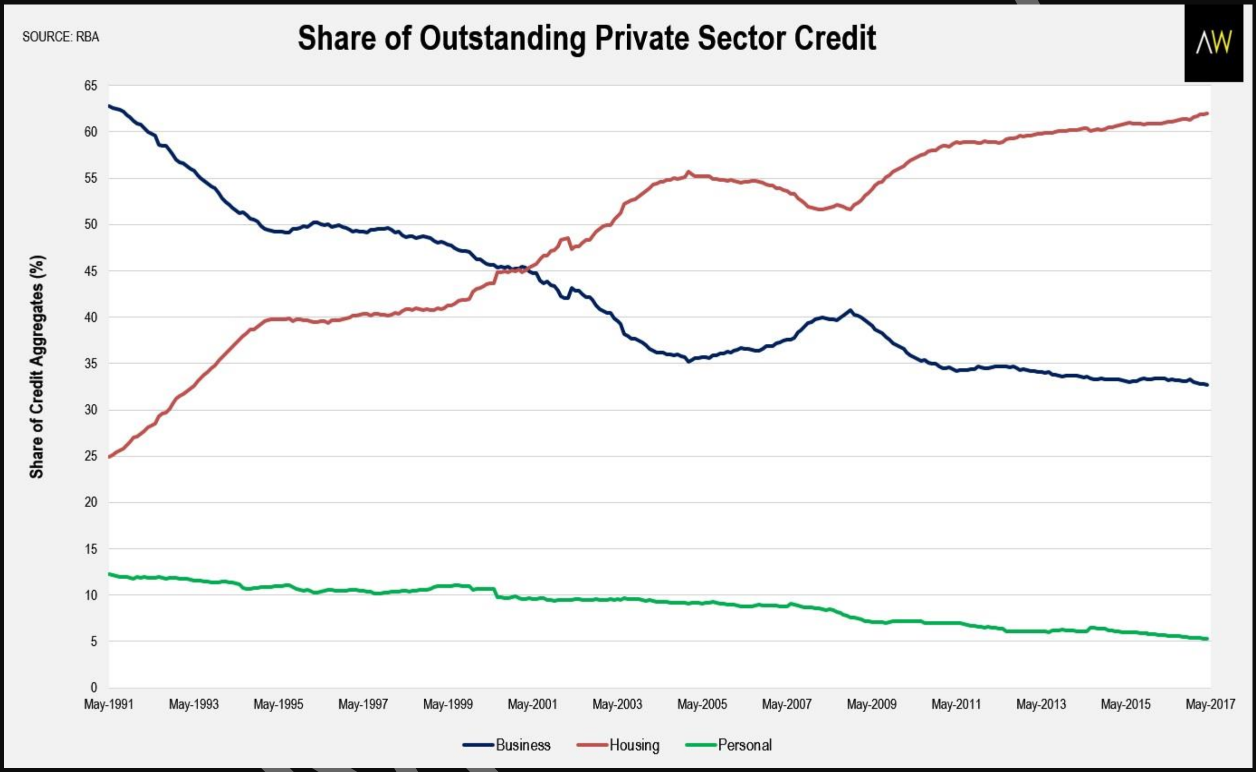
This reinforced the view already held by ***WargentAdvisory*** that the lines between investor and owner-occupier lending have become very blurred.

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

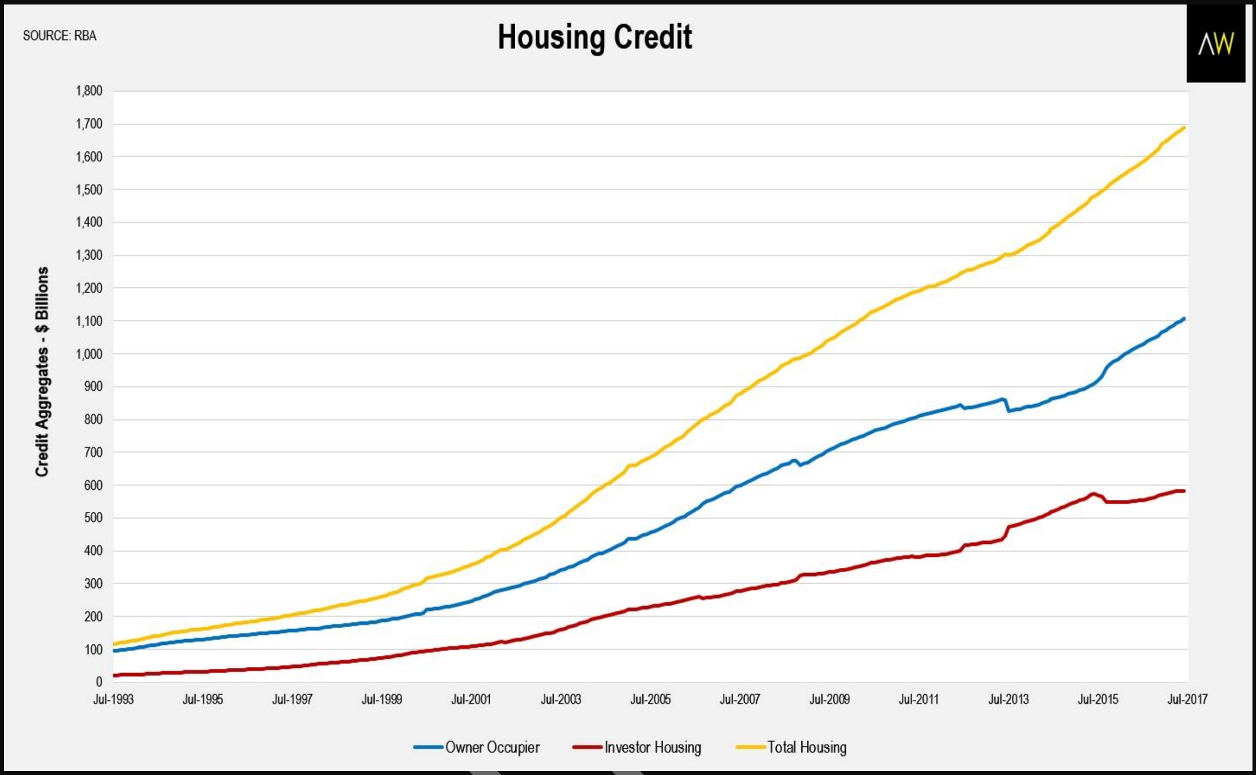
Following the introduction of an interest rate differential between housing loans to investors and owner-occupiers in the middle of calendar year 2015, some borrowers ‘changed the purpose’ of their existing loans.

The net value of ‘switching’ of loan purpose from investors to owner-occupiers was estimated by the RBA to have been $50 billion (refer to the charts below).

The RBA Financial Aggregates figures also show that housing credit growth has been outpacing the growth in business credit for the past quarter of a century, to the extent that housing loans now account for a record high 62 per cent of outstanding credit.



There is perhaps a lack of clarity surrounding outstanding credit too, with lines of credit used for small business or personal use likely to be secured against housing.




However, the trend is clearly for housing to take up a record share of loan activity.

Indeed, when reading macroeconomic analysis in Australia, from retail trade to motor vehicles sales to employment growth, most commentary seems to feed back to housing in some way relatively quickly.

The use of mortgage brokers has become increasingly common in Australia in recent years.

The recently listed Australian Finance Group (AFG) is thought to be Australia's largest mortgage aggregator, with more than 2,800 mortgage brokers across Australia who have access to more than 1,450 home loan products from over 45 of Australia's lenders.

AFG's mortgage index, which is not seasonally adjusted, shows that the group now writes more than $15 billion in new mortgage volume per quarter, about 32 per cent of which is to investors (down from 40 per cent in 2015).

Periodically lenders release lists of mortgage 'blackspots', being riskier postcodes which require higher deposits.

Recently many postcodes with high volumes of apartment construction have featured prominently.

However, the apparent willingness of lenders to write very high loans even into high-risk markets was arguably typified by lending activity in the mining towns and regions up until 2012.

For example, the house pictured below on a 1,831sqm block of land with subdivision potential – rented for $1,000 per week at the peak of the mining boom and its associated local dwelling shortage – was sold for $864,000 in December 2011.

Similar dwellings were reselling for between $100,000 and $200,000 by early 2017, assuming any willing buyers could be found.

The house in question is just of many such examples located in the small coal-mining town of Moranbah in regional Queensland.

***WargentAdvisory*** research found more than 100 examples of houses selling for between $800,000 and $990,000 in Moranbah in calendar years 2011 and 2012.

Similar stories were mirrored in many locations which saw the construction of resources projects, including Gladstone and Dysart (Queensland), or Port Hedland and Karratha (Western Australia).

*Moranbah, mining town homes sold for bubble prices in 2012*

Real estate seminar groups and mentoring programs enthusiastically promoted the mining town locations as superior investments due to the extraordinarily high rents of up to $2,500 per week paid by mining companies and their FIFO workers at the peak of the dwelling shortage.

As developers moved in and the resources projects transitioned to the less labour-intensive production phase, losses on resale of 50 to 90 per cent have been common.

Most Australians believe that similar outcomes cannot be experienced in the capital cities since the greatest losses were seen in small mining towns, although the city of Gladstone has a population of more than 65,000.

***WargentAdvisory*** met with the winner of the '2012 investor of the year', an award presented by one of several property investment magazines in Australia*, who had used $5.8 million of mainly interest-only mortgage debt to invest in mining towns such as Moranbah.

The interest-only debt had been easy to source at that time for the couple in question, although they have now defaulted on the loans and been declared bankrupt due to both rents and dwelling prices having crashed dramatically.

Because prices rose so fast during the boom, fueled by investor credit extended by lenders – and because today the market is so illiquid – the median price data for the town almost certainly understates the extent of the mining town boom and bust.

Very similar price trends can be found in several other mining towns around Australia, with the market peaking in 2012 as the resources construction phase of the mining boom reached its peak.

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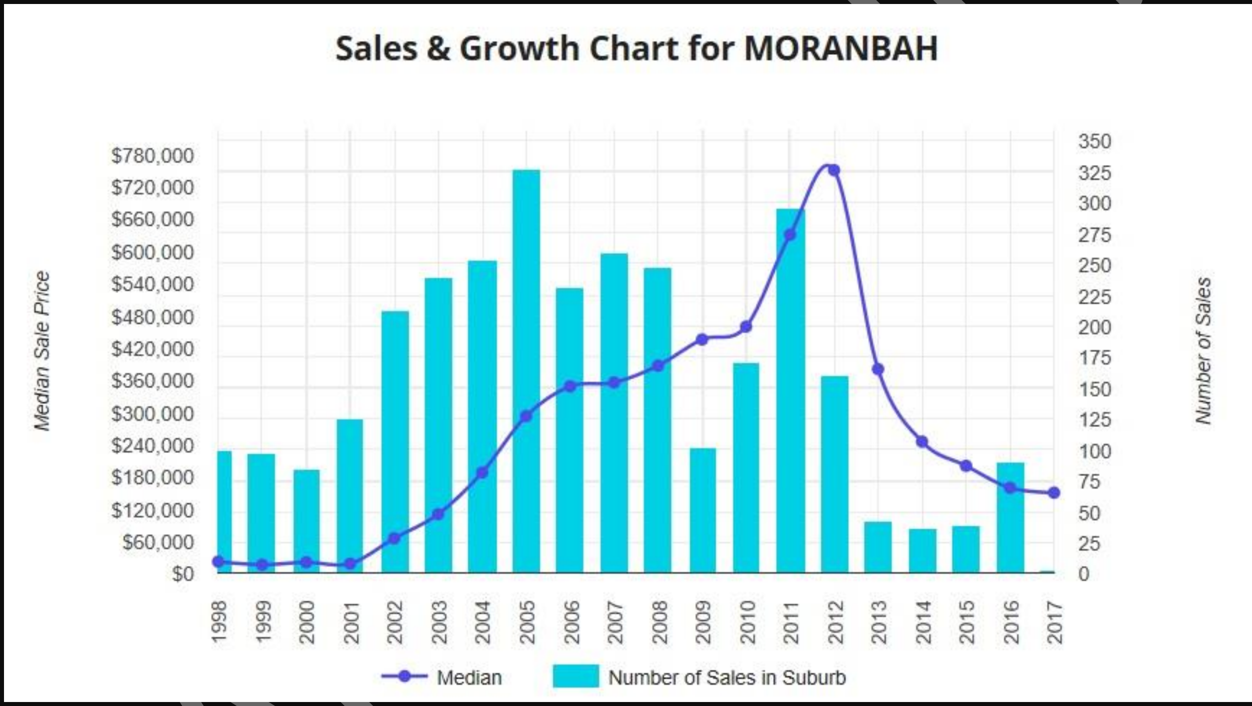
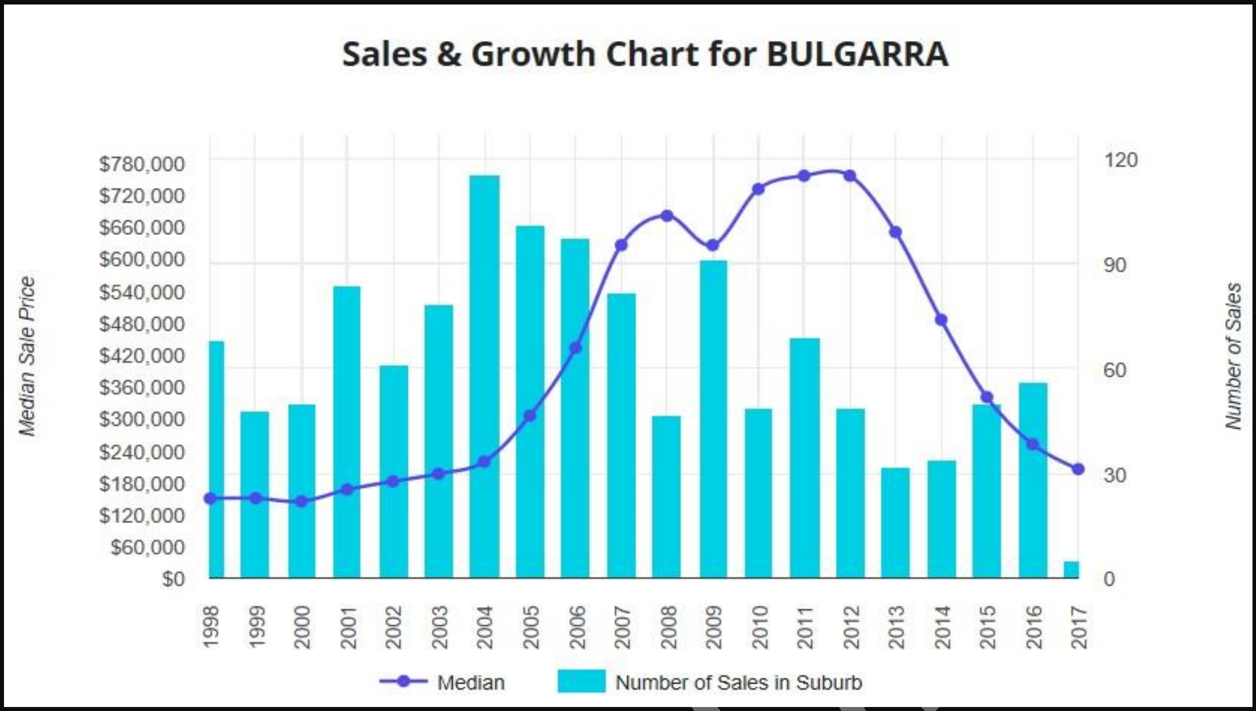
*Your Investment Property (YIP) magazine. Australian Property Investor (API) magazine ceased trading in December 2016, after nearly 20 years of publishing.




*Median sales price and market liquidity in Moranbah*

The same dynamic has played out in many Queensland mining towns.

In Western Australia, similar trends have played out, including in the resources regions of the Pilbara.




*Median sales price and market liquidity in Karratha region*

### (a) Investors facing erosion of yields

With interest rates having declined since 2011, dwelling prices nationally have significantly outpaced the growth in rental prices, resulting in yield compression.

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

Gross yields in Sydney vary depending upon the sector of the market.

For apartments, gross yields of 4 to 5pc are not 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 possible to find gross yields of above 4pc as one travels further away from the Central Business District.

With mortgage rates generally still available from around 4.5pc in April 2017, such investments can still produce a moderately negative rental return, if repairs costs are not too high.

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

Detached houses closer to the city are often likely to command the greatest capital growth over the long term due to their inherent scarcity, but typically gross yields are now very low.

In Australia in 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.

**Election manifesto changes**

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

**In February 2016, 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.**

The election result was very close, with housing affordability an increasingly key election campaigning issue in Sydney and Melbourne.

Should the ALP be successful at the next election, therefore, potentially in 2019, 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 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.

**(b) The short side & timing the next downturn**

It is perennially difficult to time property market downturns accurately.

However, a downturn in building approvals can foreshadow a correction in market 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 Australia outside Sydney in 2016 suggests that a correction will play out in some markets 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 2017 reporting season, 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. 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 very hard in Queensland’s resources regions and jumped by 24 basis points in Australia[16].

This suggests that the resources downturn is likely to lead to a cascade of mortgage defaults in H2 2017 in the regional resources markets, a dynamic that ***WargentAdvisory*** has been aware of for some time.

By February 2017 new apartment approvals were still tracking at historically very high levels in Sydney, suggesting that buyer and developer confidence in the sector remained relatively upbeat.

Sydney's preceding housing boom was brought sharply to an end by twin interest rate hikes in November and December 2003.

This time around, futures markets are presently pricing a first hike by late 2018, but mortgage rates are already drifting higher independently of the official cash rate, particularly on investor loans.

Should a sharp downturn begin to play out in approvals this may be an indicator that prices are set to decline in some pockets.

In inner city Melbourne and particularly inner-city Brisbane, ***WargentAdvisory*** believes that apartment prices will decline in H2 2017.

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

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

This is to some extent reflected by market 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 agencies
- REITs
- Mortgage broking
- 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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