MaxCap
Investment Management

MAXCAP AUSTRALIAN RESIDENTIAL MARKET UPDATE

NOVEMBER 2020

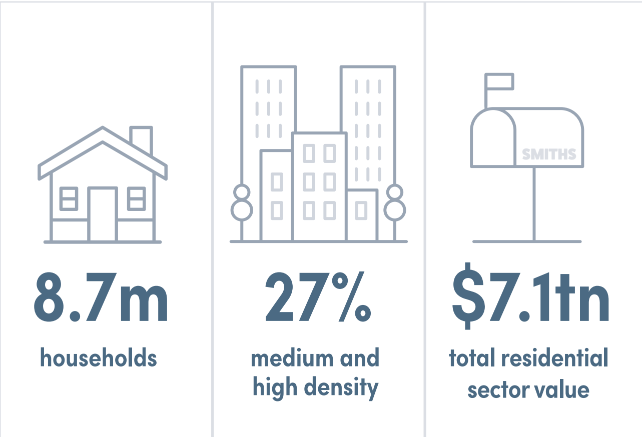
AUSTRALIAN RESIDENTIAL UPDATE 2020

OVERVIEW

- COVID-19 has had a negative impact on the sector, but several capital cities and sub-markets have already stabilized or shown early signs of recovery. The sector benefits from inherent diversity in prices, ownership and geography; with further upside from recent reductions in borrowing costs and fiscal support from State and Federal Governments.
- We see modest price declines of up to 5% in most major capital cities through to June 2021. Thereafter, consistent with the latest forecasts from the major domestic banks, we expect sustained growth in prices to 2023 driven by low borrowing costs and resumption of net inbound migration.
- We expect Brisbane, Perth and Sydney to perform most strongly, and see continued demand for well-located and well-designed medium- and (to a lesser extent) high-density developments.

MARKET COMPOSITION

The most recent ABS Census in 2016 showed the Australian resident population at 23.4m people in 8.7m households (Table 1).[1]



The total value of residential assets was $7.1tn as of June 2020, approximately 3.5x the total market capitalisation of the Australian Securities Exchange or 2.5x total Australian pension fund (superannuation) assets.[2, 3, 4]

Approximately 200,000 dwellings are added annually (2019: 202,289 dwellings representing approximately $160bn in total value).[5]

TABLE 1: 2016 CENSUS HOUSEHOLD TENURE AND TYPE (REPORTED)

(MILLIONS)	OWN, OUTRIGHT	OWN, DEBT	RENTING	TOTAL
Separate house	2.2	2.4	1.3	**5.9** (74%)
Medium density	0.3	0.3	0.8	**1.4** (18%)
High density	0.1	0.1	0.5	**0.7** (9%)
Total	**2.6** (32%)	**2.8** (35%)	**2.6** (33%)	**8.0** (100%)

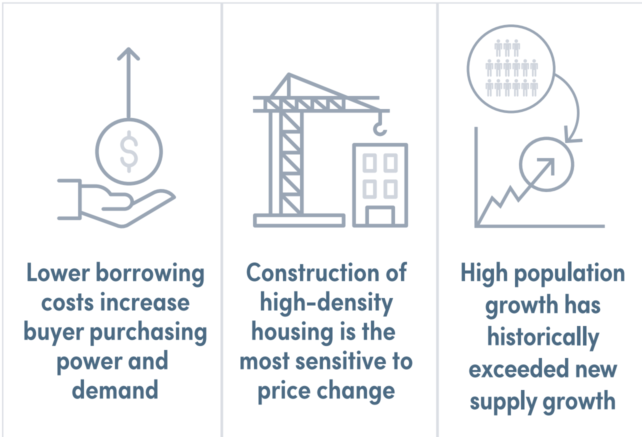
Where household tenure was known (8.0m households):

- 67% were homeowners (32% without a mortgage, 35% with a mortgage) and 33% were renters.
- Renting was more common in high-density dwellings (71%) than in detached housing (22%).

The residential market displays significant divergence among different capital cities, which are influenced by both common national macro-economic trends (such as interest rates) as well as localised state or city-specific factors (such as international student migration in Sydney and Melbourne, or resources activity in Perth).

The majority of housing stock is held privately, though we are aware of an emerging build-to-rent market from the commercial sector (which is currently vastly underdeveloped in Australia compared to similar advanced economies such as the US and Europe).

DEMAND AND SUPPLY DYNAMICS



Interest rates

Over the longer-term, changes in mortgage interest rates are a key driver of house prices and construction activity.

Research from the Reserve Bank of Australia (RBA) finds that "a percentage point drop in the expected real mortgage rate [from early-2019 levels] would boost housing prices by 28 per cent in the long run".[6]

All else being equal, a lower interest rate means that for a given level of income a borrower can service a larger mortgage, putting upward pressure on borrowing power and therefore house prices. As interest rates approach the lower bounds (as they are now) the effect becomes more pronounced (i.e., at lower interest rates, each percentage point shift is proportionally larger and therefore has a greater effect on house prices).

The Australian residential market in particular is highly rate elastic, being almost entirely comprised of variable-rate or short-term fixed rate loans. In contrast, the US and European markets are dominated by long- and medium-term fixed rate loans of up to 30 years, reducing the impact of monetary policy on house prices.[7]

Lower rates also increase the attractiveness of property as an investment class, improving the spread of rental yields over bank deposit rates and bonds.

Population growth

Prior to the onset of COVID-19, Australia's rate of population growth was among the highest in the Organisation for Economic Co-operation and Development (OECD) (and the highest for comparable economies).8

Total population growth in 2019 was 364,782 people, creating underlying dwelling demand of approximately 182,000 dwellings.9

Approximately two-thirds (61%) of total population growth was a result of net overseas migration, mainly originating from India and China (together accounting for approximately 41% of total net migration into Australia).10

Broadly, net overseas migration population growth tends to reduce rental vacancies, boost rents and increase housing prices.

The high levels of population growth over the past decade has also exceeded supply of new dwellings (Graph 1), creating a period of sustained housing undersupply. This effect is widely attributed as being the predominant source of upward pressure on house prices over the recent period, particularly in major destination cities such as Melbourne and Sydney.

Construction activity

In turn, construction activity is highly responsive to changes in real housing prices (Graph 1): when the price of established housing increases relative to the cost of new housing, the incentive to build increases. Existence of this effect is consistent with a cross-section of industry and academic studies.[6]

GRAPH 1: INDEX OF CHANGES IN BUILDING APPROVALS AND REAL HOUSE PRICES (MARCH 2010 = 100)

Source: Australian Bureau of Statistics, MaxCap Research

Of total residential construction, high-density construction is generally more sensitive to change than other dwelling investment (Graph 3). This effect is typically attributed to the changes in the price of existing dwellings largely reflecting land prices: when land prices increase (a function of the naturally limited supply of land close to cities), higher-density housing becomes more attractive. This effect is likely more pronounced given Australia's relatively low proportion of high-density housing relative to comparable advanced economies.

The greater flexibility to construct infill-style high-density construction (relative to the large-scale land releases and planning required for detached housing) may also be a factor.

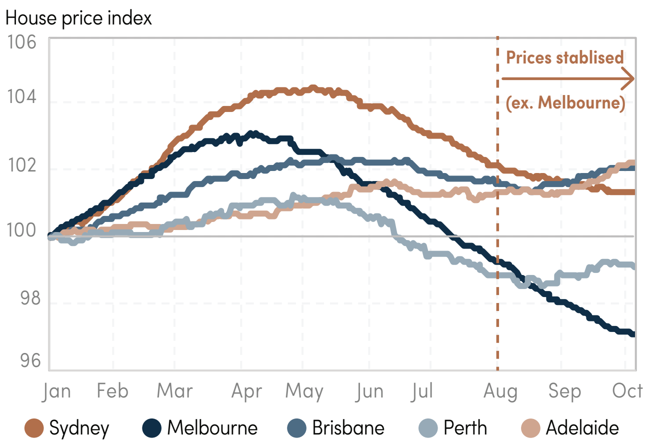
CURRENT TRENDS

Prices and construction

Residential housing prices have outperformed expectations at the start of COVID-19, correcting approximately 3% from peak as at April 2020.

The latest CoreLogic indices show prices stabilising or starting to rise in Sydney, Adelaide, Brisbane and Perth (Graph 2). Melbourne remains the exception due to the 'second wave' of infections and subsequent lockdowns.

GRAPH 2: HOUSE PRICE INDEX AS AT OCTOBER 2020 (JANUARY 2020 = 100)



Source: CoreLogic, MaxCap Research

We attribute the resilience in housing prices to several fundamental factors:

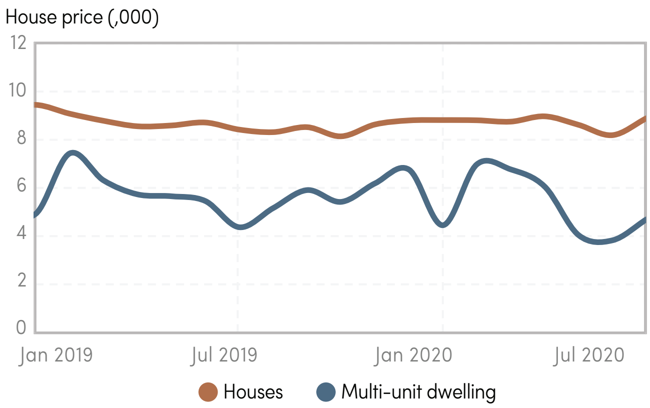
1. **Historical price correction:** following the widely reported growth in house prices over the five years from 2012 to 2017, Australian house prices have not experienced any recent appreciation and remain below the peak experienced in early-2017.
2. **Structural Undersupply:** the undersupply gap has been narrowing over the past four to five years as high-density construction has increased, but we estimate remains in undersupply of approximately 80,000 dwellings as of June 2019.
3. **Record-low Interest rates**: absent the constraining effects of COVID-19, modelling from the RBA suggests the recent rate cuts (totalling more than 100 basis points since early-2019) would generate house price appreciation of more than 20%, reflecting Australia's highly rate-elastic (i.e., predominantly variable rate or short-term fixed) mortgage market.

Price disruption from distressed sales also remains limited due to a combination of increased affordability of debt servicing and bank policies allowing repayment deferrals (which currently apply to approximately 11% of loans).

These factors are expected to underpin recovery in prices and market activity once the current health crisis is controlled.

Consistent with our thesis of the link between house prices and construction activity, building approvals (the best forward-looking indicator for residential construction) also remain relatively resilient (Graph 3). We attribute the recent uplift in approvals occurring circa Jun-20 in part to Federal Government stimulus measures to boost construction activity, together with a partial easing of the recently introduced constraints in lending to multi-unit dwellings which were a result of the Royal Commission into banking, FIRB taxes and 'Responsible Lending' Federal legislation.

GRAPH 3: MONTHLY DWELLING APPROVALS TO JULY 2020 (PRIVATE SECTOR), SEASONALLY ADJUSTED



Source: Australian Bureau of Statistics, MaxCap Research

Government stimulus

Supporting the indirect effect of monetary policy on prices, the Australian Federal and State Governments have implemented extensive discretionary policies to stimulate building activity.

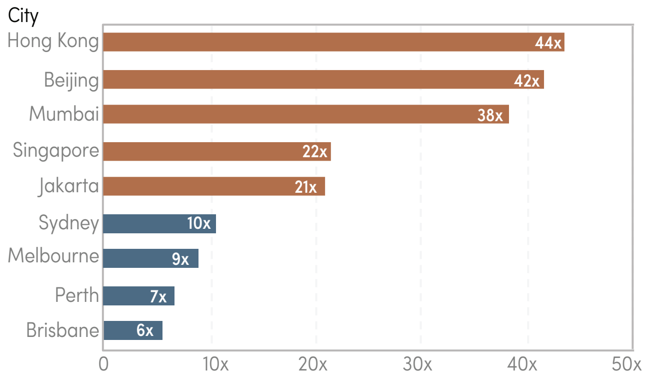
Measures include a $25,000 Federal homebuilder grant (available nationally), and further first homeowner grants of $10,000 in NSW and Victoria (and similar programs in other states).[11]

Affordability

As a comparison of median price to median levels of disposable income, apartments in Australian capital cities remain affordable relative to other major cities in the APAC region (Graph 4).

The relative affordability of apartments, the increasing preferences of State and Local Governments for densification (in favour of expanding urban sprawl) and shifting generational preferences continue to favour increased activity in multi-unit construction.

GRAPH 4: MEDIAN APARTMENT PRICES TO MEDIAN FAMILY DISPOSABLE INCOME, SELECTED CITIES, ASIA AND OCEANIA



Source: Numbeo, Citi Research, MaxCap Research

OUTLOOK

Long-term, low borrowing costs see price growth of 10-20%

Modest near-term oversupply, reaching broad equilibrium with demand by 2023

The extent of price growth and activity varies between capital cities

Interest rates

We expect interest rates to remain low for the foreseeable future as monetary policy remains focused on wage growth and inflation (the RBA has indicated it does not expect to increase rates until at least 2024).[12] These objectives will likely eclipse traditional concerns about the indirect impact of low interest rates on dwelling prices and credit demand.

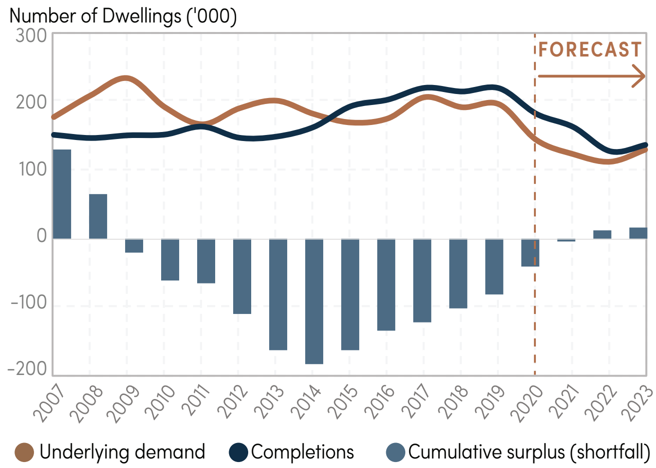
The low borrowing cost environment provides favourable conditions for dwelling price growth and construction activity, although this will likely be moderated in the near-term by lower migration.

Housing balance

Immigration restrictions imposed in response to COVID-19 are widely expected to reduce net overseas migration to Australia, and in turn accelerate a narrowing of the existing undersupply gap.

Our base case forecasts (integrating the median Federal Government net migration estimates) see modest oversupply in the near-term, peaking at approximately 30,000 dwellings before reaching a broad equilibrium in supply and demand in 2022-23 (Graph 5).[13, 14]

GRAPH 5: HOUSING BALANCE



Source: Australia Bureau of Statistics, National Housing Financing and Investment Corporation, MaxCap Research

Changes in migration represent the most significant upside swing factor in our forecasts. The re-commencement of migration is subject to the widespread availability and efficacy of a vaccine. In particular, international students, which account for 50% of net overseas migration may return sooner than expected given Australia's favourable handling of the COVID-19 pandemic, attractiveness as an island nation, and weak A$. There is further potential upside if the Federal Government is successful in new initiatives designed to attract overseas talent.

Unwinding of loan deferrals

Current estimates as at September 2020 are that approximately 11% of housing loans are deferred, valued at approximately $192bn. Banks (with the support of regulators) have extended the maximum deferred payment period to March 2021.[15]

We see limited downside risk of distressed sales. Domestic banks are heavily exposed to the housing market through both mortgages and secured small business loans, and we anticipate that the volume and timing of distressed sales will be minimized and carefully managed to avoid widespread price disruption. We expect continued support from the regulator for this approach as a means to insulate the economy from a collapsing housing market.

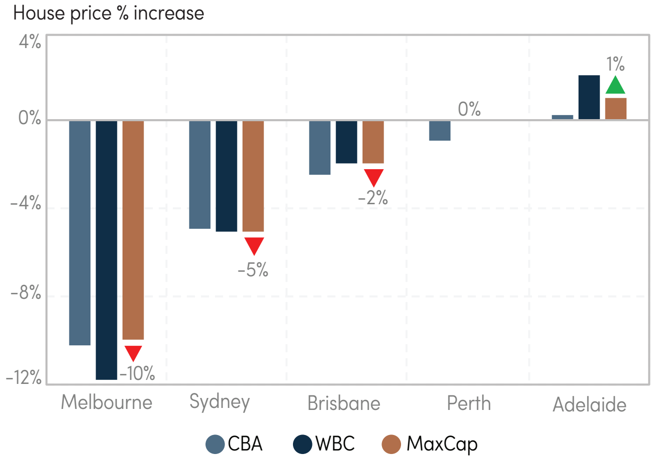
Price outlook

Over the near term to June 2021, we maintain our forecasts for a generalised price correction in most major capital cities of up to -5% (Melbourne up to -10%).

This outlook is consistent with the revised September 2020 outlook from both CBA (the nation's largest mortgage lender) and Westpac (the second largest mortgage lender) (Graph 6). [16, 17, 18]

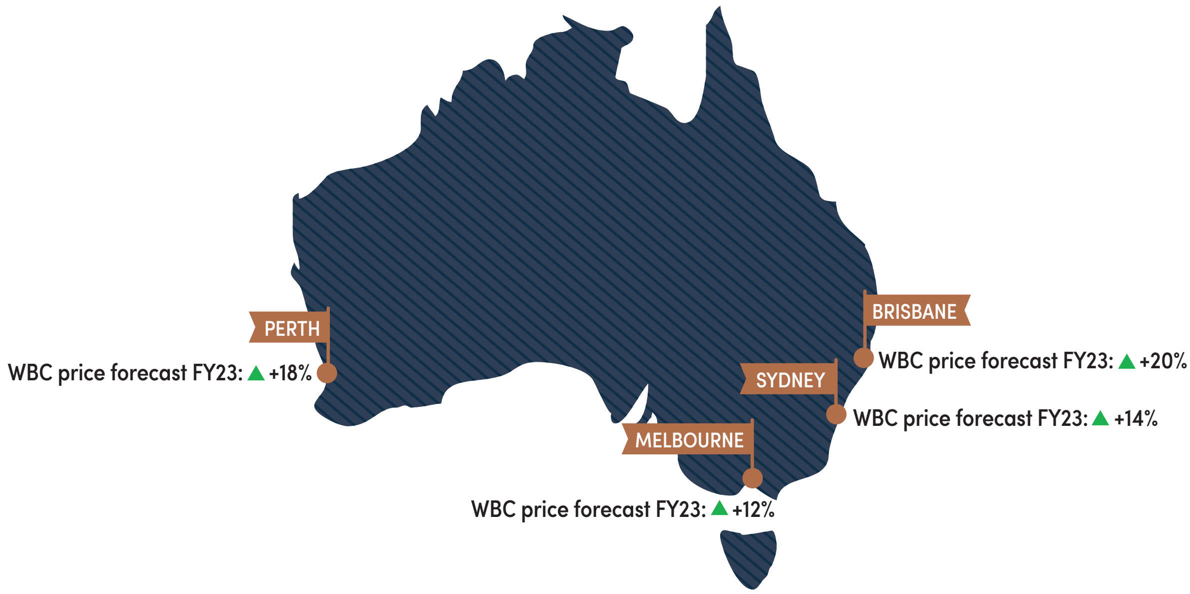
Thereafter Westpac forecast a strong recovery in prices of up to 10-20% by June 2023, supported by record-low borrowing costs, affordability and regulatory and fiscal support.[18]

GRAPH 6: HOUSE PRICE FORECASTS TO JUNE 2021 BY MAJOR CAPITAL CITIES



Source: Commonwealth Bank of Australia (CBA), Westpac banking Corporation (WBC), MaxCap Research

FORECASTS BY MAJOR CAPITAL



PERTH

Overview: support for commodity prices positions the resources-led State economy for a strong recovery.

Supply: new apartment approvals remain concentrated in the CBD, though an increase in affluent near-city precincts is evident.

Demand: strong economic recovery, good affordability and large incentives see increased demand.

Price outlook: change in prices over the near-term are modest, helped by strong affordability and low reliance on migration, with good longer-term upside.

BRISBANE

Overview: medium-term recovery supported by strong economic outlook and low levels of construction.

Supply: outer rings represent majority of new supply, with the greatest declines in inner-Brisbane.

Demand: ABS data shows housing finance rose in Jun-20 for both owner-occupiers (+19%) and investors (15%), with further upside expected from HomeBuilder commencing Aug-20.

Pri**ce outlook:** limited near term impact supported by strong demand and providing strong long-term upside.

MELBOURNE

Overview: stretched affordability pre-COVID, prolonged disruption from 'second wave' and higher reliance on net migration will see longer-lasting effects.

Supply: fast-tracked major approvals to sustain construction has supported dwelling approvals.

Demand: demand from foreign and domestic investors is likely to remain subdued.

Price outlook: change in prices over the near-term are significant, though longer-term remains positive.

SYDNEY

Overview: fast tracked infrastructure projects should dampen the short-term impacts of lower migration.

Supply: falls in completions over next 3 years increases likelihood of under-supply once demand recovers.

Demand: long-term recovery in demand is tied to unemployment and population growth (skewed to net overseas migration), dampened by low affordability.

Price outlook: near-term forecasts see moderate drops, with attractive longer-term upside given strong fundamentals as the largest and deepest market.

INVESTMENT OPPORTUNITIES

Fundamentals remain attractive as a deep non-discretionary real estate sector

Carefully selected, experienced sponsors continue to perform

MaxCap continues to apply strong and prudent credit risk controls

Demand for residential CRE debt

We have seen consistent demand for residential commercial real estate (CRE) debt throughout the pandemic, with the impact of COVID-19 magnifying the already significant credit dislocation of the Australian banking market.

Within our broader portfolios, residential construction loans are emerging as one the most robust investment strategies, particularly for low and medium-density boutique offerings targeted at local owner-occupiers.

We have also noted no deterioration to credit risk due diligence or controls over this period, reflecting the favourable asset characteristics from the diversified purchaser base and self-liquidating nature of projects in the case of residential construction.

Notwithstanding these results, given the broader global economic context, we are very focused on the valuation of the underlying asset; the quality of pre-sales achieved; the project's feasibility and construction program; and the builder's balance sheet, capability and workload.

Key risks and mitigates

Construction risk

The impact on MaxCap's current construction portfolio has been well managed.

Occurring early in the crisis, supply chain constraints related to the bottleneck of building materials sourced from China (in particular joinery, glazing and cladding These delays and challenges have now subsided. Output is trending back to full capacity. Similarly, subsequent labour supply constraints as a result of social distancing measures no longer represent a material risk.

Projects approaching completion have been impacted more materially, being at the stage at which the number of contractors on site reaches its peak. This was particularly challenging given health and safety measures including staggered shifts and social distancing measures on site. Construction activity is now normalising.

As a prudent lender, we incorporate significant time buffers to project delivery timeframes, which provide protection against the possible impacts of unforeseen conditions.

Market risk

We expect price pressure on the residential construction sector to be largely eased over the medium-term.

Market risk can be further mitigated by determining appropriate levels of pre-sale requirements with regard to specific project characteristics. In all cases the key focus is that the project benefits from a diverse buyer base supported by appropriate deposits. These pre-sales not only represent a large sample of market data (demonstrating market acceptance of product), but also provide contractually binding sale contracts contributing directly to the assessment of a "gross realisation" valuation of the project.

Settlement risk

We are observing early positive signs for projects in our broader portfolio with settlements due.

Settlement rates have remained very high across both our low-density and high-density markets with minimal rescissions. Of 1,165 recent settlements, we observed 28 rescissions (approximately 2%), consistent with historical averages in our loan book.

The relatively low rescission rates throughout and despite the COVID-19 pandemic period reflects the binding nature of the pre-sales contracts, and the well diversified buyer base inherent in medium- to large-scale residential projects (with contracts underpinned by a 10% deposit and personal recourse to the purchaser).

Our prudent lending parameters for maximum loan to value also provide significant equity buffer to absorb downside risks and protect investor capital.

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