Maraboo Island by Megara

Going Up: The Outlook for Australian Residential

MaxCap Group Research - July 2023

The outlook for Australian residential

It's like watching a rerun. Amid the long-standing calls for a big housing market correction, residential returns to recovery. Prices are rising broadly again, while rents are surging ahead. This cycle is being turbocharged by undeniable demographic drivers, specifically robust population growth.

Curb your enthusiasm. What is unusual this cycle, is the aggressive and persistent uplift in mortgage rates. Historically, rate cuts precede the turnaround in prices. This time, the strength of housing demand is generally outweighing the adverse drag of higher funding costs.

Full house versus empty nest. Without a doubt, the strength in housing demand is structural in nature. On the one hand, strong migration inflows and population growth – quite unlike many parts of the world – are driving urgent housing needs. On the other, personal living preferences (with more singletons and couples) are also adding to that housing requirement.

Arrested development. This demand uplift is occurring alongside a faltering supply pipeline, waylaid by higher input costs, higher funding costs and unseasonably wet weather. While feasibility is challenging, the sale opportunity is looking firmer upon completion.

Growing pains. With surging demand and lagging supply, we are looking at a sustained undersupply for much of this decade, notably concentrated in the major cities and more skewed towards higher-density apartments, which offer more affordable entry price points.

Home improvement. For investors, there is a sizeable and durable opportunity ahead in Australian residential, to address the urgent need for private and public housing, to enable the rapidly emerging multifamily rental sector, and to fund the diverse equity and debt capital needs of this substantial, multi-year home-building cycle.

Going up again

Over numerous decades, the **Australian housing market** has seen predictable, regular and muted pricing cycles. In many respects, this current cycle follows a very familiar pattern – like a rerun of previous cycles – as muted price falls of -7% in capital cities over 9 months in 2022 progressively gives way to an emerging pricing recovery in 2023.

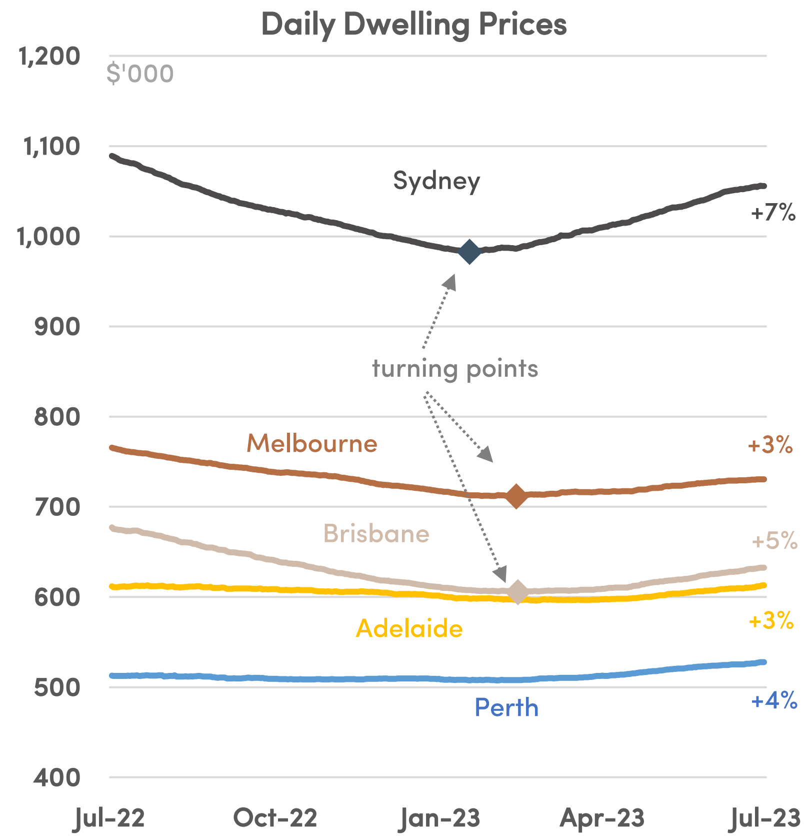
What is somewhat unusual in this cycle, is the aggressive and persistent uplift in **mortgage interest rates** as the central bank moves urgently to curb consumer price inflation. In previous cycles, interest rate cuts precede the turnaround in prices by several months. This time, the turnaround in prices is running slightly ahead of that monetary policy easing cycle, with prices rebounding even as the Reserve Bank of Australia apply the latter stages of their rate tightening cycle.

There are several clearly-identifiable factors for this **pricing recovery**, despite the cooling effects of higher mortgage rates.

- **Robust housing demand.** With reopened borders, Australia is seeing resurgent migrant inflows, all of whom require housing upon arrival. Moreover, the return of foreign students and the return to work are notably concentrating this housing demand in the larger capital cities.
- **Lagging housing supply.** A perfect storm of higher building costs, higher funding costs and unseasonably wet weather are seriously disrupting housing construction, at a time of buoyant demand. In other words, the cure of additional supply will take several years to realise.
- **Persistent undersupply.** The mismatch between robust demand and lagging supply puts Australia in a long phase of undersupply for much of the 2020s, which provides enduring opportunities for equity and debt capital to deliver on this urgent government policy priority.

Altogether, this demand-supply imbalance is driving the **earlier and stronger rebound**, outweighing the adverse drag of higher funding costs.

Australian housing prices are seeing a familiar pattern of adjustment and recovery. The mild downturn of 2022 is already giving way to a firming recovery in 2023.



Source: Corelogic, MaxCap Group (July 2023)

Full house versus empty nest

The standout driver of the Australian economy relates to the robust pace of **population growth**, which is looking quite firm in Australia (2023-27: +1.4% p.a.) and stands in stark contrast to many other developed economies, particularly in Europe (+0.1% p.a.) and East Asia (-0.2% p.a.).

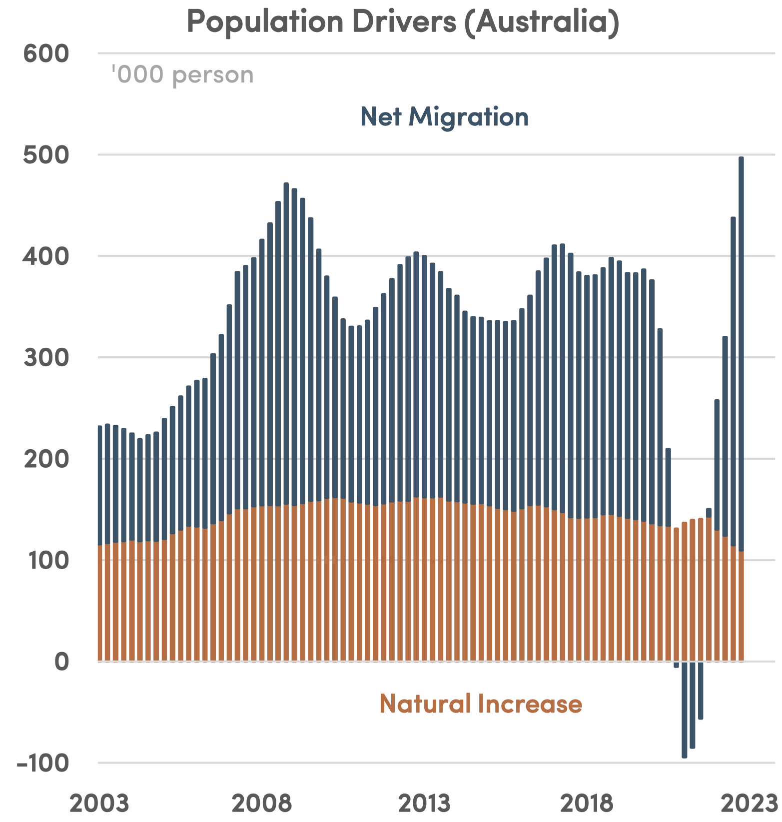
Certainly, the uplift in **inbound migration** is the dominant driver of this population surge. While the movement of people was seriously curtailed by COVID lockdowns, the subsequent border reopening has spurred a massive rebound in migration, which is tracking close to 400,000 people a year. Unlike other types of population growth (like newborn babies), migrant arrivals will add immediately to housing demand.

Additionally, there is a marked shift to **smaller household sizes**. With increased demand for socially-distanced personal space and the demographic shift to smaller single- and couple-based households, Australia is seeing an accelerating shift to smaller households, from 2.9 people per home in the 1980s, to below 2.5 people in 2023. Indeed, the seemingly modest shift of 0.05 since the 2020 pandemic itself has lifted housing demand by 85,000 dwellings (or 9 months of construction).

Meanwhile, there are considerable shifts to **housing demand patterns**.

- **Treks and the city.** The increasingly strident employer-led push to return to the office in 2023 is partially unwinding the sea change / tree change moves from 2020. Commuting times is becoming a factor again in home locational choice, adding to the weight of housing demand in more affordable inner- and mid-ring suburban locations.
- **Going up.** On a related note, there is increasingly greater appetite for higher-density apartment living, partly related to personal preferences (as migrants arrive from denser cities abroad) and partly related to relative affordability (with apartments tracking at a sizeable 39% discount to houses in Sydney and a 33% discount in Melbourne).

Post COVID lockdown, the reopening of Australian borders is driving a massive rebound in population growth, mainly through net overseas migration



Source: Australian Bureau of Statistics, International Monetary Fund, MaxCap Group (July 2023)

Arrested development

At a time of surging population and strengthening housing demand, there is a more urgent requirement to deliver on the **supply pipeline**. However, that pipeline is clearly faltering in 2023.

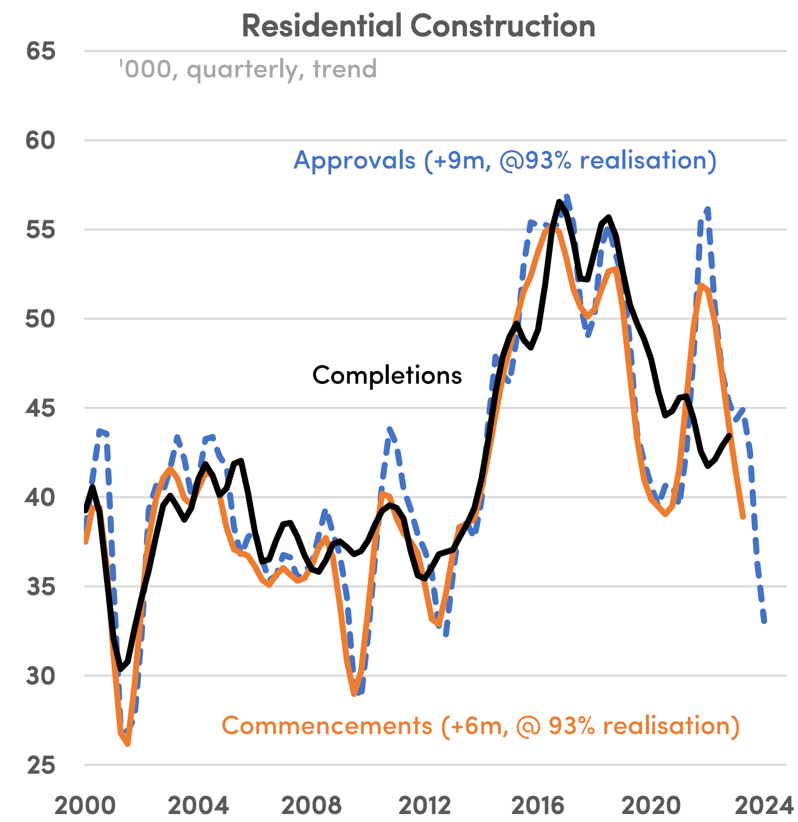
There are **fewer projects** in the development pipeline, taking **longer to complete**. Already, residential building approvals are tracking to their lowest levels in nearly 12 years. What was a 9-month timeframe from approvals to completions has blown out considerably to two years plus.

In our view, there are many diverse reasons for this slower pipeline.

- **More expensive inputs.** Building input costs have surged 32% in the three years to early 2023, and most dramatically in fuel, timber, tiles, sand and steel, adding considerable uncertainty to contract pricing. Timely delivery is also a concern, given lingering supply chain delays.
- **Fewer available workers.** Buoyant employment growth (May: +3.1% p.a.) and a rock-bottom unemployment rate (May: 3.6%) speak to the extremely tight labour market in Australia and the escalating challenge of finding and keeping skilled construction workers on the building site.
- **Wet weather.** Cooler Pacific Ocean temperatures since 2020 (known as La Niña) have produced increased rainfall in Eastern Australia. In turn, construction days lost to rain have risen noticeably, sufficient to drive increased contract allowances for inclement weather.
- **Higher funding costs.** The aggressive hikes in interest rates are impacting consumers and builders in equal measure. Development project feasibilities need to clear higher funding cost hurdles, often with more stringent cost management, increased equity and lower leverage.

Notably, there are slow but encouraging **signs of a turnaround** for some drivers. Fuel and steel prices have peaked, with some moderation since. Rising immigration is adding to the pool of workers. Meteorologists report an emerging El Niño pattern and much dryer weather conditions in 2024.

The residential construction pipeline is being deeply curtailed by high material costs, high interest rates and wet weather. Completions are set to weaken into 2024.



Source: Australian Bureau of Statistics, MaxCap Group (July 2023)

Growing pains

Given the robust pace of **housing demand** from inbound migration and shifting occupier preferences, and the lagging pace of **housing supply** with higher materials and borrowing costs, there is a clear, inevitable and likely persistent trajectory for the Australian housing market ahead.

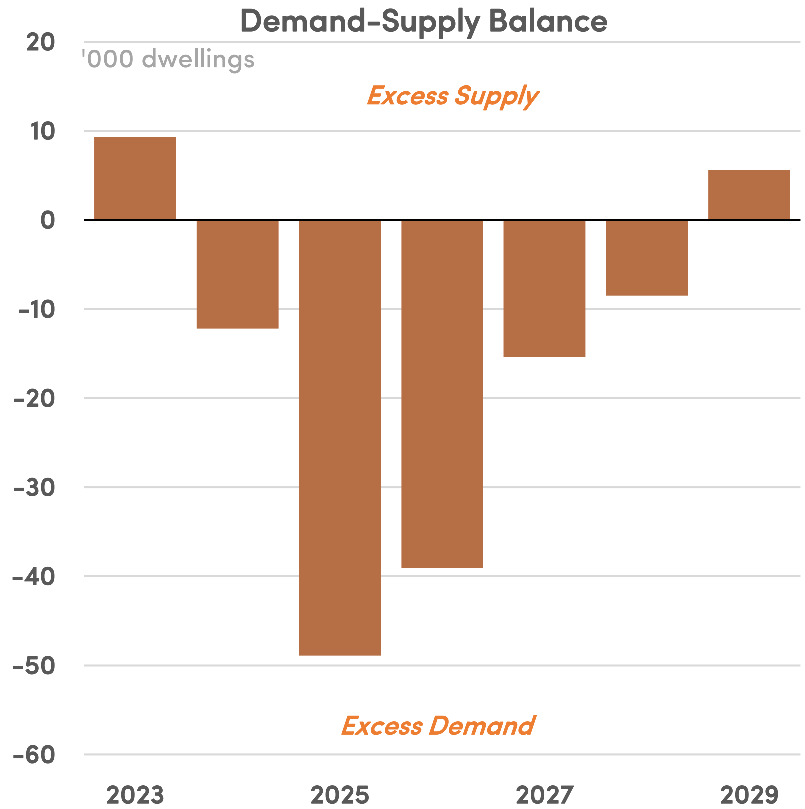
We are looking at **a substantial undersupply** of residential housing, both right now and for much of this decade to come. On government estimates, this tallies to a shortfall of 125,000 dwellings over the next five years, mostly concentrated in the bigger capital cities of Melbourne and Sydney, and relatively skewed towards medium- and higher-density housing.

Already, there are strongly apparent signs of this housing shortfall today, reflected in the tight state of the rental market.

- **Fully occupied.** Vacancy rates are tracking around 1% or lower for major capital cities in 2023, which is effectively a fully-occupied rental housing market. This is clearly evidenced by the long and frantic queues outside each Saturday rental inspection seen this year.
- **Surging rents.** As the pool of available rental stock dwindles nationwide, there is already a fervent response in rents. For the larger capital cities, the rental uplift is still strengthening in 2023, with few signs of moderation, despite more concerns about rental affordability.
- **Rising distress.** The higher costs of housing and deteriorating affordability carry serious social impacts. Many households, particularly in the lower income cohorts, are showing increasing signs of financial strain and calling for urgent policy support for low-income renters.

Out of this, we see deep and enduring **investment opportunities** ahead. Simply, there is a fundamental need for more housing over a long timeframe, particularly in the capital cities, increasingly skewed towards denser developments. At the same time, there is a more urgent policy need to improve affordability especially for low-income households.

The combination of buoyant housing demand and lagging housing supply will likely drive a persistent state of housing undersupply over much of this decade.



Source: National Housing Finance and Investment Corporation, MaxCap Group (July 2023)

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