AUSTRALIAN PROPERTY RESEARCH

'GROWING PAINS' FOR INNER-MELBOURNE APARTMENT MARKET

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MAIN POINTS

- The inner-Melbourne residential building boom threatens to persist into the medium-term. The 'Field of Dreams' quote: 'build it and they will come' is very much in play and about to be tested for the second time in two decades. At face value, the unprecedented supply pipeline suggests a potentially destabilising influence on market outcomes. However, expected re-assessment of project viability by key stakeholders should act as a key lever, re-callibrating the supply-side to minimise market fallout.
- 2013 is presenting as the most vulnerable period with peak volumes of around 5000 to 7000 apartments[1]. Further, the product-mix in 2013 shifts predominantly towards the "sky-scraper" form. Absorption of this 'very high rise' stock at the scale in prospect presents a major challenge for the sector.
- Achieving adequate levels of stock absorption does not require housing demand to rise beyond plausible historical benchmarks. Various supply/demand scenarios are presented to assess potential imbalances.
- Inner-Melbourne prices can be expected to show considerable volatility. Such volatility is 'par for the course' in this market. A 9% collapse in prices in late-2010 has been partially regained in the early months of 2011 (up 5% through the April quarter 2011).
- Rising vacancies will constantly test market resolve over the coming development cycle, particularly as new 'lumpy' stock is introduced to the occupancy market. Importantly, broader demand/supply analysis suggests that higher average vacancies are likely to reflect 'frictional' rather than longer-term structural vacancies.
- The sentiment-driven 'correction' currently underway is critical to minimising the potentially disruptive influence of the forthcoming boom in inner-Melbourne construction. It is the most powerful mechanism to enable supply to self-regulate. It also allows price points for purchasers to be reset at more sustainable levels.
- If the supply-side takes heed of market signals early, the inner-Melbourne residential market should rise beyond its adolescent years into adulthood with a minimum of pain.

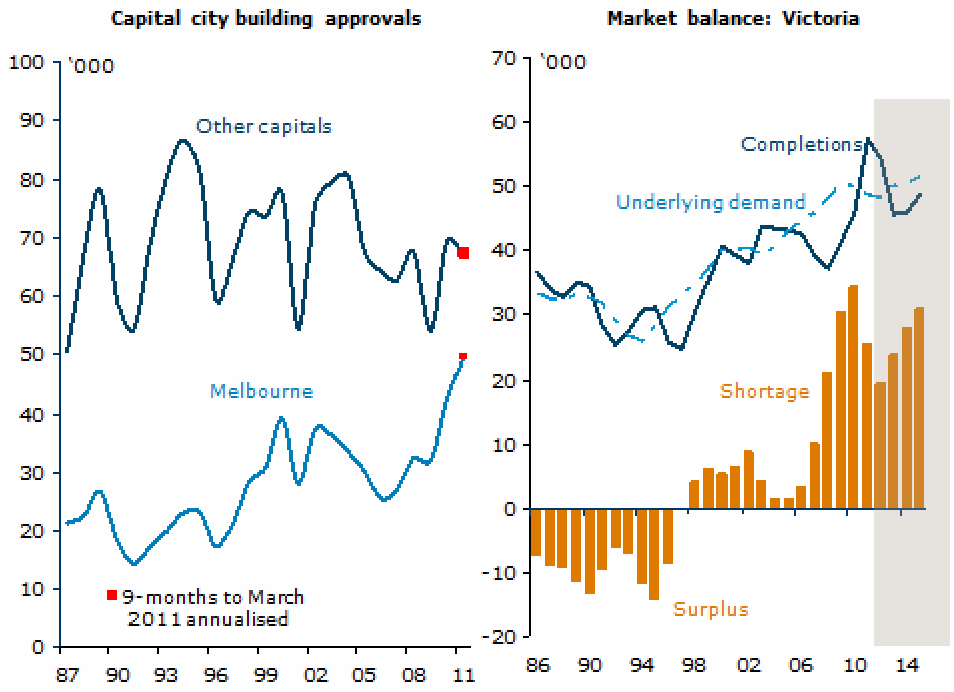
[1] Based on December 2010 data sourced from Charter Keck Cramer

MELBOURNE BUILDING BOOMS

Melbourne building approvals have breached historical peaks, in stark contrast to other capital cities which have generally held within their 'two-decade' range. Victorian dwelling completions are set to run higher than underlying requirements in 2011 and 2012 for the first time in several years. At face value, such strength suggests a degree of overshoot and unsustainability. Healthy employment growth and sustained strength in underlying housing market fundamentals have to date provided foundations for this solid out-performance in building levels. While population growth has slowed markedly in line with national trends, a period of under-building (2007-09) suggests some pent-up demand exists. The current boom therefore reflects elements of 'catch-up' and should not alone raise undue concern about potential market fallout.

Whilst lower construction levels are likely in Melbourne over the medium-term, most short-term leading indicators suggest continued strength for 2011/12. For inner-Melbourne, however, the building boom still has a way to run. We examine the broad parameters likely to play out on both sides of the market over the medium-term to assess performance.

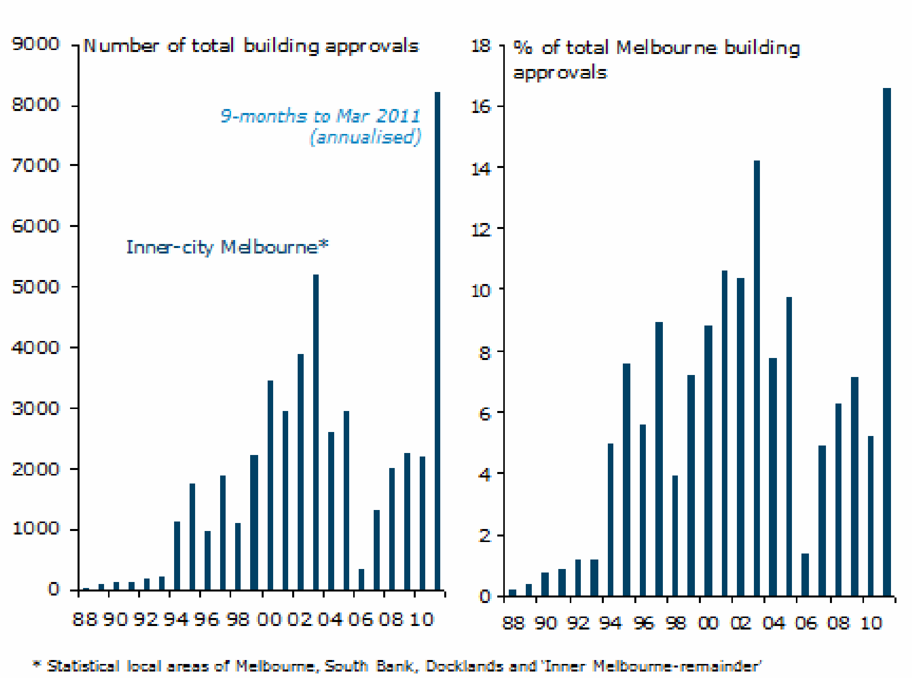
FIGURE 1. MELBOURNE BUILDING BOOMS BUT… IT IS PARTLY 'CATCH-UP'



Sources: ABS, ANZ

The **Inner-Melbourne** precinct has been a key feature of the most recent wave of building. Whereas the previous decade-long boom was triggered by low commercial property returns and a political desire to develop the 'docks', the current boom takes the 'residensification' of inner-Melbourne to the next, untested level. Even as Melbourne metropolitan building activity booms, the inner-Melbourne *share* of this is at record highs with approvals running 4-fold higher in the nine months to March 2011 compared to trend levels in recent years.

FIGURE 2. INNER-MELBOURNE BUILDING APPROVALS LIFT FOUR-FOLD



Sources: ABS, ANZ

DEMAND SIDE TEST – A "FIELD OF DREAMS"?

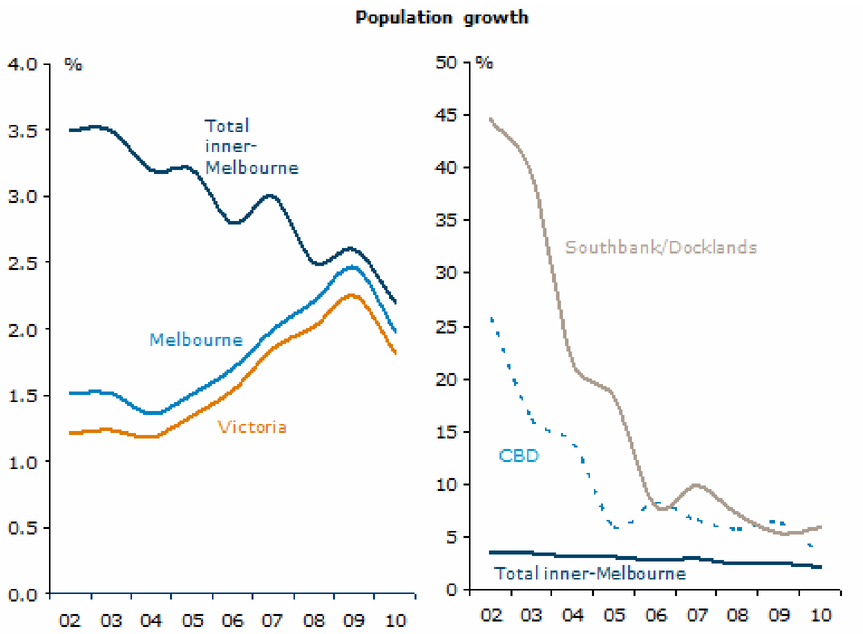
Population growth is central to sustaining housing demand and validating the current building boom. There has been a notable convergence in the inner-Melbourne population growth rate towards the broader-Melbourne average over the past decade. It is natural for 'maturing' precincts to slow as they develop, but still relatively low population density in key central districts (e.g. The Docklands at well under 4,000 persons per sq. km.) suggests this is an unlikely constraint at this stage and is supported by relative resilience in this precinct's population growth. The structural shift appears to be continuing, albeit at slower rate. How much further such a shift has to run can only be tested once stock is presented and digested by the market. The observed slowing in inner-Melbourne population in recent years is likely to reflect the natural flow-on effects of weaker development. This is supported by continued tightening in inner-Melbourne rental vacancies.

In such circumstances, new supply is a pre-condition to support ongoing population growth but it is not a sufficient condition going forward. With the unprecedented levels of new stock in prospect, the 'Field of Dreams' quote 'build it and they will come' is very much in play and about to be tested for the second time in two decades. On this score, the trend in vacancy rates remains the critical signal.

As new supply is presented, population trends in inner-Melbourne could reasonably restore to a growth premium above the metro-average. Naturally, the quality and size-mix of new supply (studio, luxury, mega-high-rise, lower rise etc.) will also be critical to absorption rates and the ultimate size of this growth premium. A case in point is the student accommodation market which is undergoing some adjustment. Miscalculations of prospective demand have direct implications for relative price outcomes for stock that is exclusively created for this market. The demand/supply mismatch generally can reflect more subtle nuances such as location, number of floors in building, size and quality of dwellings etc.

Subject to getting the supply mix roughly aligned to demand preferences, the still fledgling 'residensification' of the Docklands/Southbank precinct (an area 2.5X Melbourne's CBD) suggests inner-Melbourne could easily accommodate much higher levels of population than it has ever before without breaching historical population density limits.

FIGURE 3. 'COMING OF AGE' FOR INNER-MELBOURNE... NOT FAR AWAY



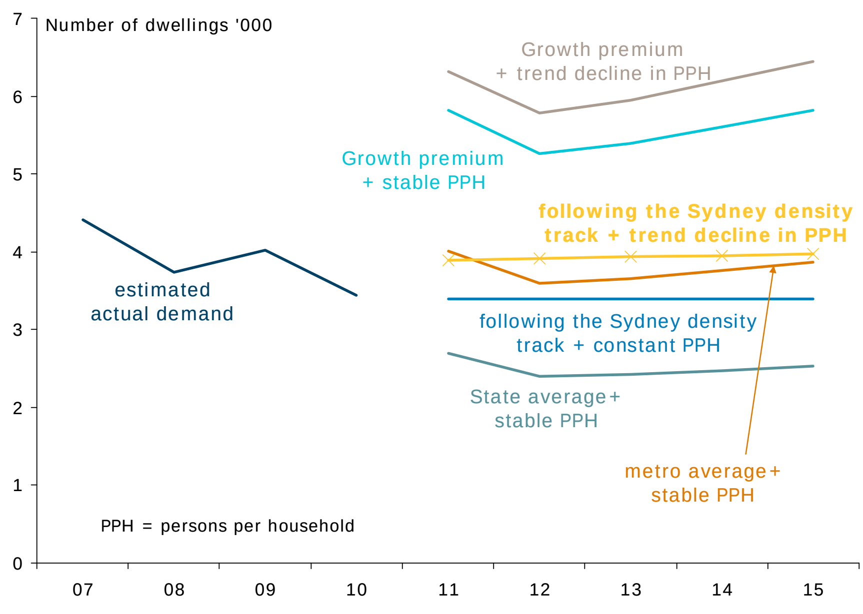
Source: ABS

Given the inherent uncertainty in predicting dwelling demand, particularly in sub-markets such as an inner-city precinct, assessment of the sustainability of supply must rely on applying plausibility tests. The scenarios offer a descriptive context for allowing judgements to be made about relative plausibility. The series of 'demand for dwellings' scenarios based on a set of assumptions (ranked from strong growth to low growth) are presented in chart below.

The strongest demand scenario assumes a continuation of a population growth *premium* (inner-Melbourne population growth over the state-average population growth) *and* a trend decline in 'persons per household' (resulting in dwelling demand of around 6000 per annum over the 4 years to 2015). At the other extreme, it is assumed inner-Melbourne population growth merely tracks the state average *and* no further reduction in 'persons per household' occurs (translating into dwelling demand of just over 2000 per annum over the same period). A series of intervening scenarios is also presented.

In light of relatively low population densities in inner-Melbourne, cultural adaptation to inner-city living and official support for more 'efficient' use of urban land, the demand scenarios towards the higher end represent more plausible outcomes than the weaker scenarios presented.

FIGURE 4. DWELLING DEMAND SCENARIOS FOR INNER-MELBOURNE



Sources: ABS, ANZ

THE SUPPLY SIDE

The volume of activity that is 'under construction and marketed' in the "50+ apartments" sector appears healthy and out of the historical range recorded over the preceding decade. As always, uncertainty relates to both the likelihood and the time-line for projects still in planning stage. This uncertainty is causing concern in some quarters. Specifically, a historically high volume of 'planned' and 'mooted' projects (a further 26,000 dwellings *not* included in the bars in the chart below) suggests at face value a potentially destabilising influence on market outcomes in the years ahead. Critically however, the transfer rate from 'plan' to 'marketing' to 'construction' can act as a very powerful market stabiliser.

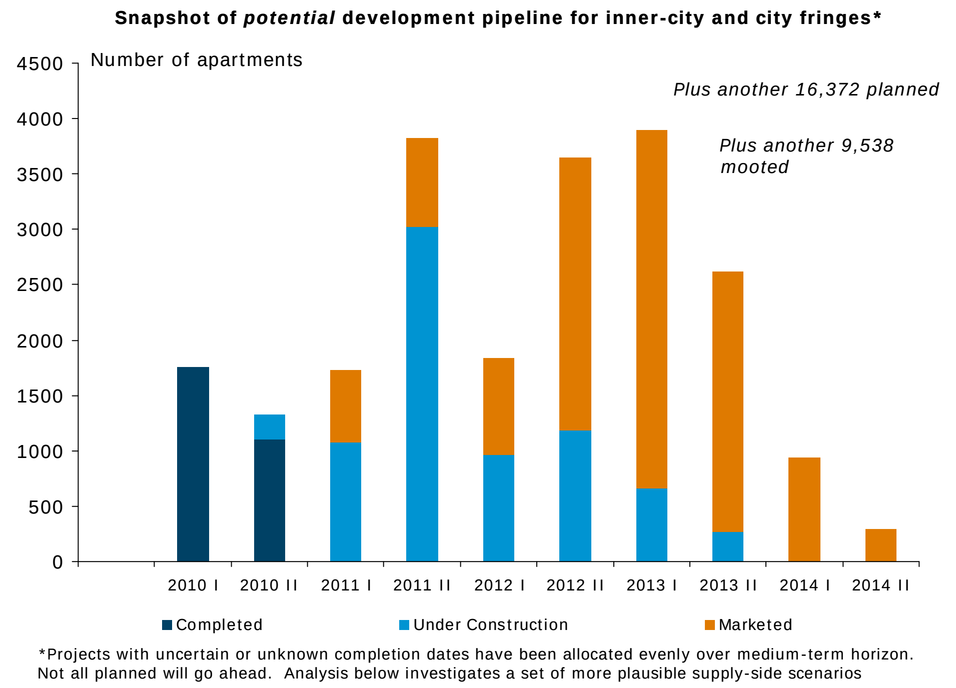
We have constructed three supply-side scenarios under various 'transfer rate' assumptions. The '*optimistic*' case assumes half of planned developments go ahead, the '*fair*' case assumes 25% of planned developments go ahead and the '*low*' case assumes only includes projects that are 'under construction and financed' go ahead. In an easier credit environment, 50% flow-through would be deemed plausible but under today's more restricted credit conditions, is deemed optimistic. The low case effectively assumes that no additional projects in planning stage will go ahead in the time horizon being investigated. This is an overly pessimistic scenario for supply, understating the likely outcome. The 'fair' case can be characterised as a realistic outcome even in a cautious credit environment.

Despite being a very powerful lever, the transfer rate from 'plan to construction' will reflect a combination highly uncoordinated micro-decisions across key stakeholders (e.g. financiers, developers and local governments). Continual monitoring of absorption and vacancy rates will provide hints of potential market imbalances. To the extent that marketed stock runs ahead of trading demand, some 'indigestion' will occur.

The upshot though is that trading market vulnerabilities should (1) prove temporary if the fundamentals remain intact (i.e. population growth supports the supply side) and (2) signal to planned and mooted projects that some shelving of projects is warranted. While this adjustment is potentially an unruly process, the market mechanism should work to re-callibrate the supply side in order to minimise any sustained market fallout.

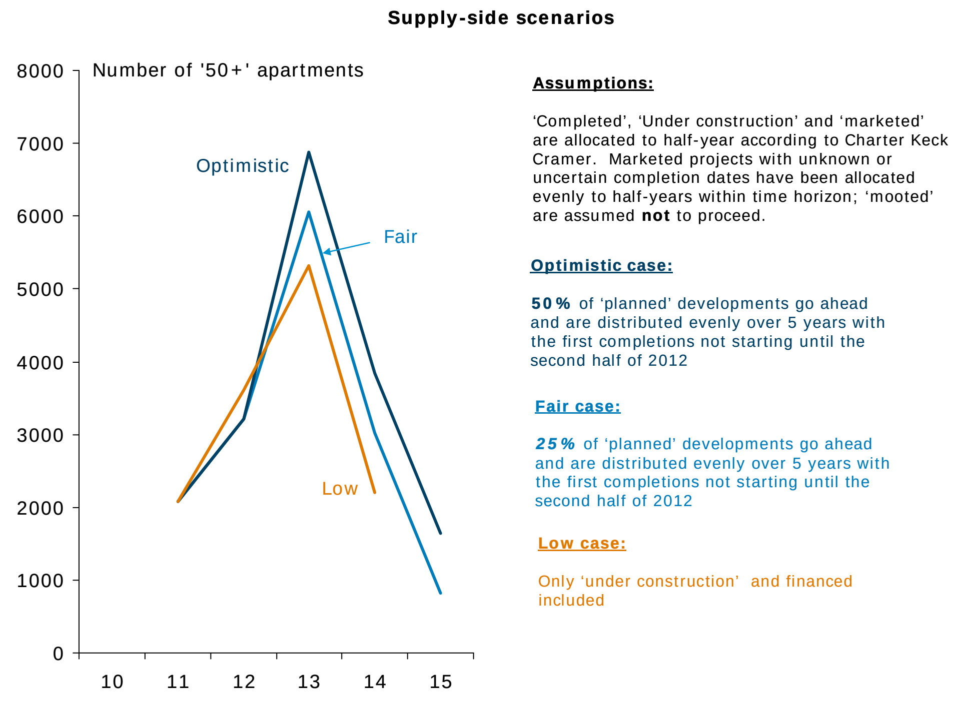
2013 is presenting as the most vulnerable period for inner-Melbourne with the flow of new apartments ranging from around 5000 to 7000 units in that year (low to optimistic scenarios).

FIGURE 5. INDUSTRY DATA SUGGESTS MEDIUM-TERM PIPELINE IS HUGE



Sources: Charter Keck Cramer, December 2010 data, ANZ

FIGURE 6. THE SUPPLY-SIDE IS NOT SET IN CONCRETE



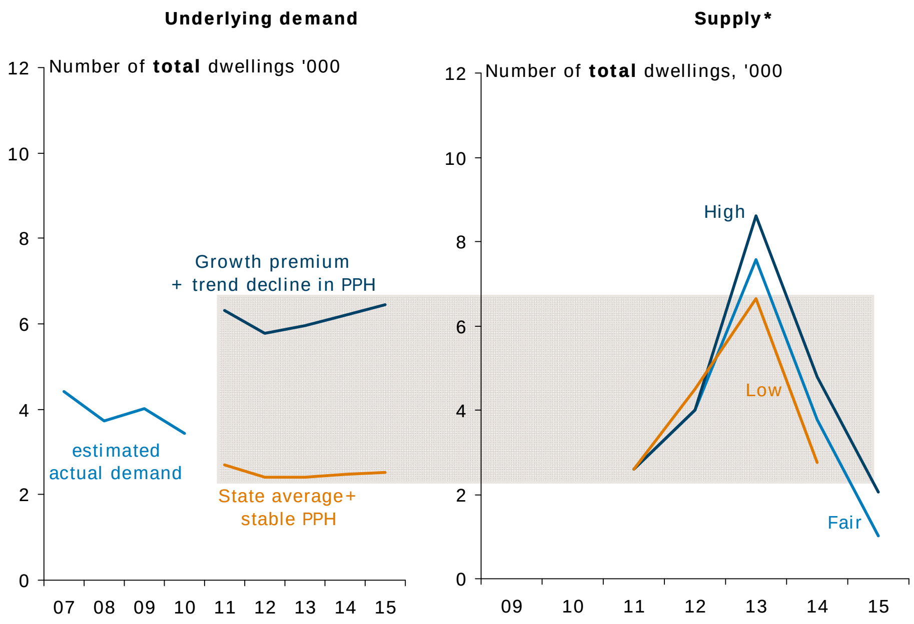
Sources: Charter Keck Cramer, December 2010 data, ANZ

MARKET BALANCE

In order to absorb the estimated supply pipeline, demand needs to grow at a healthy but not unprecedented rate for this precinct. In assessing what is achievable, it is important to recognise that observed growth in population is generally constrained by supply-side availability *and* by the extent to which the quality of supply aligns with demand side preferences (location, size, tenant mix, floor level etc.). Upper limits on population growth will therefore be set not only by the broad parameters but the 'texture and smell' of the stock. Inappropriate mix of quality (e.g. too many 'one bedders') will reflect in sluggish take-up, higher vacancies, slower population growth, weaker rentals and weaker prices in that market. A mix of stock that is better aligned with demand preferences will raise the bar on what population growth is achievable.

At the broadest level, the supply of apartments in prospect over the next few years is not out of a plausible demand range, even when comparing one year at a time. However, given the flow of trading demand (desire to own) can decouple from fundamental demand (desire to have shelter), fundamental balance is more fairly presented by looking through the cycle and in average annual terms. It is the market's ability to find occupants within a reasonable time frame that will drive market performance over the medium-term.

FIGURE 7. ENCOURAGINGLY, BOTH SIDES OF MARKET IN SAME 'BALL-PARK'



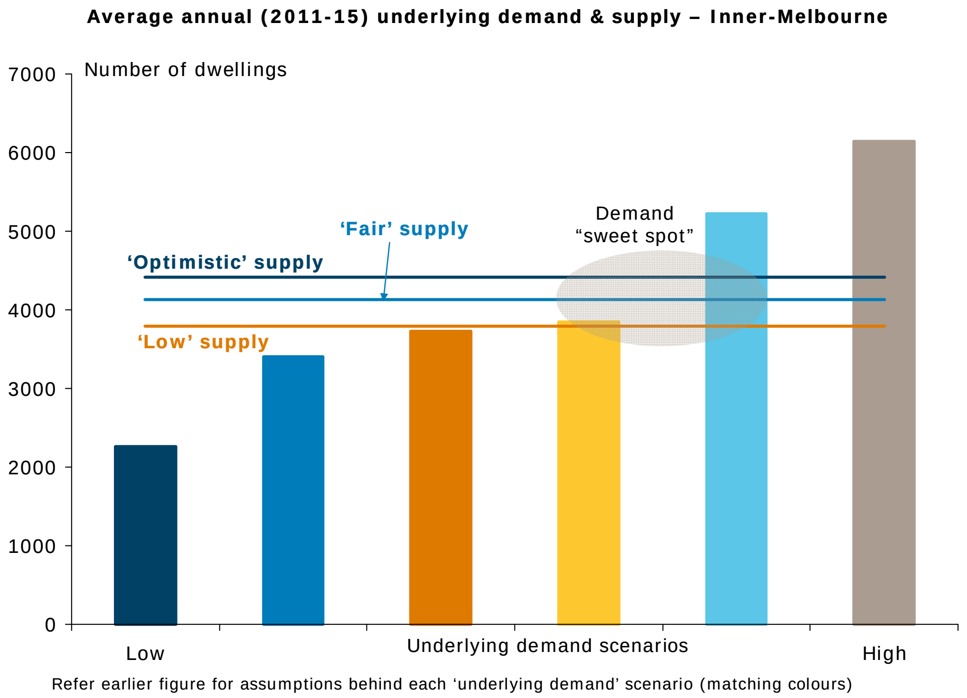
* Uplift factor of 25% to account for extra 'non-apartment' supply to achieve count on a **total dwelling** basis.

PPH is 'persons per household'

Sources: Charter Keck Cramer, December 2010 data, ABS, ANZ

In order to absorb the 'fair' supply scenario, inner-Melbourne population needs to grow at the premium above the state-average or to follow a population density track similar to that achieved in Sydney over the previous decade. These are the two scenarios that align closely with the 'sweet spot' in the chart below. While they have been presented at the high end of potential demand outcomes, neither of these scenarios is particularly challenging in light of historical experience and the strategic re-rating of inner-cities in the past decade. Furthermore, given NSW's economic and demographic underperformance over the past-decade, using the inner-Sydney population density track as a benchmark is a fairly conservative one.

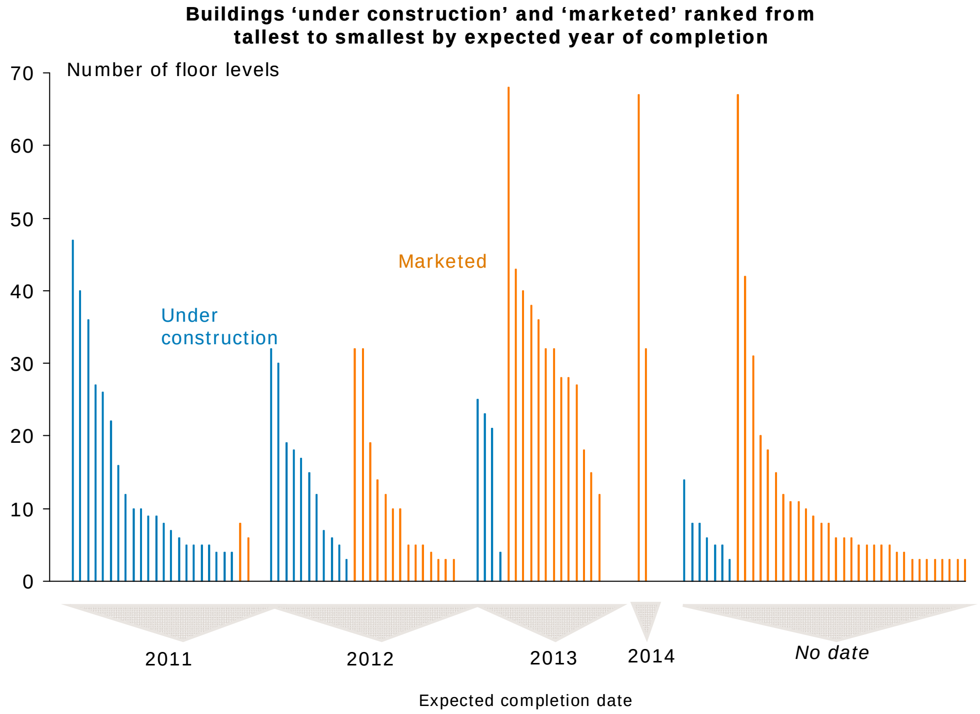
FIGURE 8. HISTORY SHOWS DEMAND CAN BE ENOUGH TO ABSORB SUPPLY



Sources: Charter Keck Cramer, December 2010 data, ABS, ANZ

At issue though is the shift in product mix ahead. While there appears to be a reasonable balance of supply (on height criteria) in 2011 and 2012, the mix of projects in 2013 clearly shifts towards the "sky-scraper" form. While only a handful of these is 'under construction', the bulk of 'marketed' projects in that year consists of buildings over 25-storeys. The lower rise product might appear, prima facie, to be intrinsically more palatable to most occupiers but the higher level stock is largely untested in such quantities. Absorption of this 'very high rise' stock presents as a major challenge for the sector in the next few years.

FIGURE 9. MINE'S BIGGER THAN YOURS



Sources: Compiled by ANZ using Charter Keck Cramer December 2010 data

Supply-side responsiveness to early evidence of weakening fundamentals or even slower economic growth is critical to achieving a non-disruptive trading cycle over the forthcoming development phase. Assuming current economic and population prospects pan out as expected and 'mooted' and 'planned' developments are subjected to critical market-testing (by all stakeholders) over the coming year, fundamentals should remain sound. Heightened foreign equity interest in development projects introduces an additional dimension. To the extent such development is outside the traditional finance 'ring' and hence less sensitive to local constraints or vulnerabilities, the burden of any supply adjustment will have to fall upon the balance of the domestic development sector.

VALUES VULNERABLE

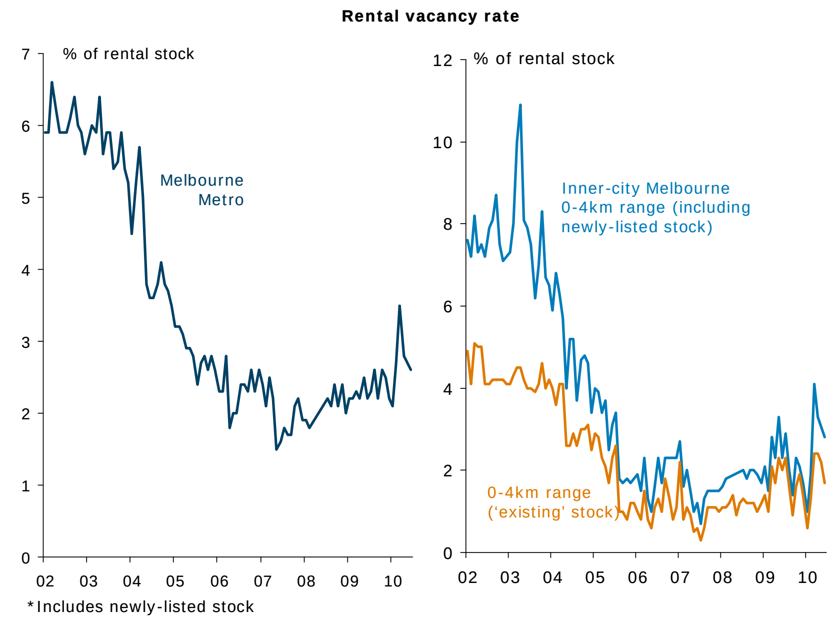
Inner-Melbourne prices will continue to have strong underlying support over the medium-term but as the precinct is less mature than the broader market, 'normal' range shifts in demand and (particularly) supply will generate relatively greater volatility in price outcomes. Inner-Melbourne prices fell around 14% over 2003 and 2004, a period that coincided with high rental vacancies and a flattening in broader metro-Melbourne prices. Over 2007 and immediately post-GFC, inner-Melbourne prices again fell around 7% but recovered with considerable momentum to new highs. More recently, inner-Melbourne prices collapsed 9% in late 2010 but have regained some of this lost ground in early 2011, lifting 5% since the January 2011. Such volatility is 'par for the course' in this market.

The hint of rising frictional vacancies already evident in the past couple of months suggests the market will be continually tested over the coming development cycle. Looking ahead, though we expect greater volatility in vacancies as the weight of new stock is introduced onto the rental roll. Importantly, the broader demand/supply analysis above suggests that higher average vacancies over the next couple of years are likely to reflect frictional (therefore short-term) rather than longer-term structural vacancies. Persistently higher vacancies due to inelastic supply or a disappointing population feed, will naturally undermine confidence in the marketplace, until fundamentals are restored.

An extended period of price flatness, but more precisely, continued restoration in relative prices (inner versus metro) over the next year towards levels experienced earlier in the decade should provide healthy and pre-emptive reinforcement ahead of the unprecedented supply flow that is expected. Front-loading the 'correction' is critical to minimising the potentially disruptive influence of the forthcoming boom in inner-Melbourne construction. Not only does it send a clear signal to developers to reassess viability of planned and mooted projects (by implication reducing the pipeline), it also allows price points for purchasers to be reset ahead of a lion's share of marketed projects. This will minimise the prospect of re-sale value 'disappointments' and minimise the potential disruption to market conditions.

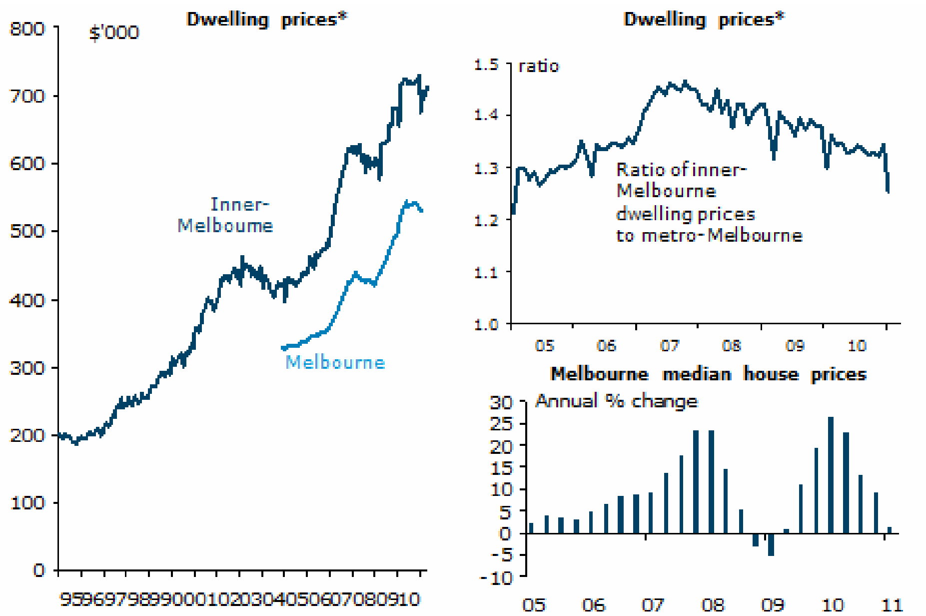
General headwinds arising from higher interest rates and more subdued housing market sentiment will impact on the inner-Melbourne market performance in the years ahead. How rough the ride might be for this segment depends critically on the rate of project 'shelving'. If the supply-side heeds market signals early, the inner-Melbourne residential market should rise beyond its adolescent years into adulthood with a minimum of pain.

FIGURE 10. INNER-MELBOURNE VACANCIES STAYING TIGHT FOR TIME BEING



Source: REIV

FIGURE 11. INNER-MELBOURNE PRICES MORE VOLATILE



* RP data uses a hedonic-regression, a method that attempts to overcome issue of compositional bias associated with median price measures. By decomposing the sample of houses into their various structural and location attributes, the differences in these qualitative factors across houses can be controlled. The resultant price series will therefore closely align with a 'pure' price.

Sources: RP Data, ABS

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