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The positive signs of Sydney's residential market upturn

Key Points

- The Sydney residential market is in the midst of an upturn. Rising demand from prospective home-owners and investors, including many offshore-investors, is colliding with a long-term under-supply of accommodation, to drive up dwelling prices and, lift auction clearance rates to the highest level recorded in a decade last year.

- Sydney's housing recovery follows a long period of under-performance. Matching the slow growth of the New South Wales (NSW) economy, Sydney established house prices rose by 19% between 2006 and 2011, compared with the national average of 30%. Since December 2011, however, Sydney house prices are up 9% compared with 6% nationally, and the pace of activity seems to be accelerating.

- As a further stimulus to demand, home mortgage rates are at multi-decade lows. Buyers in the Sydney housing market are interest rate sensitive because Sydney is still the most expensive residential market in Australia despite a decade of under-performance, and therefore home mortgages tend to be large. The recovery in the share market has further bolstered household balance sheets, encouraging Australians to revisit residential property as an investment option.

- Sydney has always been a magnet for international migration. Net overseas migration has been a key contributor to population growth over the past two years, accounting for almost 70% of net population growth. There has also been a substantial growth in overseas students completing qualifications in Australia, with strong projected increase in the next 20 years. As a result, the two residential sub-markets likely to show most activity over the next few years are the Outer Fringes, where house-and-land packages make entry to Sydney's housing market relatively affordable, and inner Sydney, where the young demographic tend to congregate.

- The Sydney residential market is under-supplied and construction activity is finally starting to pick up. In the past five financial years, private sector dwelling completions in Greater Sydney have totaled 79,500, well below estimated underlying demand of 122,900 dwellings, a shortfall of 43,400 dwellings.

- The 'grey' cohort (people aged 65 years and over) has grown at almost twice the rate of the overall population in Sydney over the past decade. This trend is expected to continue over the next decade as the population ages, driving demand for housing in locations with good access to retail and medical amenities, along with transport infrastructure.

- Forward looking indicators are encouraging. The NSW economy is expected to accelerate through 2014 and 2015, with potential positive impact on housing sector. Labour market conditions are an important driver of demand and have been relatively strong in Sydney in relation to the rest of the State. Retail spending also started to show improvement late 2013.

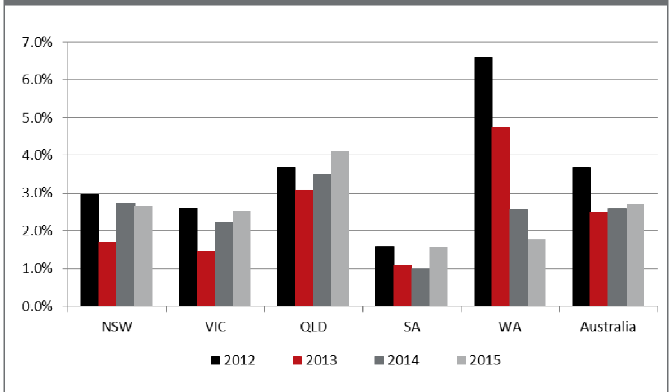
Stronger economic conditions over short term

Lacking such external drivers as commodity prices (Western Australia) and a strong international tourist magnet (such as the Gold Coast in Queensland), the state of NSW and the capital city of Sydney, are heavily dependent on a rebound in the residential construction sector. Historically a housing recovery has been a lead indicator for a cyclical upturn in the broader NSW economy.

Global economic conditions are improving and Australia's GDP growth is also forecast to pick up over the next two years, particularly in the eastern seaboard states of Queensland (QLD), Victoria (VIC) and New South Wales (NSW). QLD and NSW are the only two states that are forecast to grow at or above the Australian GDP growth rate of 2.7% per annum in the next two years (QLD – 3.8% per annum and NSW – 2.9% per annum over 2014-2015, shown in Figure 1).

Growth in retail spending in NSW started strongly in 2013, slowed mid-year, but has increased again over recent months. Growth of 2.1% over the three months to December has lifted year-ended growth to 7.2%, which is slightly above the 5.7% growth recorded nationally. The rise in retail spending is an indication of stronger housing market conditions.

Figure 1: Economic growth by Australian state (annual % change)



Source: Jones Lang LaSalle, Deloitte Access Economics

Consumer sentiment in NSW has been strong relative to other states over most of 2013. However it started weakening at the end of last year, reflecting robust price growth. According to the Westpac - Melbourne Institute, the 'Time to Buy a Dwelling' index in NSW dropped 13% in December, down by 22% from its September peak, while the State's measure of housing price expectations is 6% above the national level.

The NSW labour market performed very strongly through 2012 and 2013, with robust employment growth and an unemployment rate below the national average. Nevertheless, total employment in the state peaked in April 2013 and since then almost 50,000 jobs have been lost across the state. Unemployment rose from 5.1% at the start of 2013 to 5.8% in December. NSW employment growth has now fallen to 0.1% over the year to December, slightly below national growth of 0.5%. Sydney's unemployment rate is below that in most of the other major capital cities (with the exception of Perth) and Australia as a whole. The rate of unemployment has also stayed below the last 2009 peak.

Employment growth in Australia is going to continue at the same pace over the next two years but there will be differences across the Australian states. According to Deloitte Access Economics, average annual employment growth of 1.1% per annum is forecast across Australia over the next two years (2014-2015 calendar years), a continuation of the 1.1% increase per annum between 2012 and 2013. Weaker employment growth is forecast in NSW over 2014-2015 compared with 2013, however, Sydney is projected to see stronger demand for office space across the white and blue collar sectors over the next two calendar years.

The Australian unemployment rate is expected to rise from an average of 5.4% over the 2012-2013 period, up to 6.1% over the 2014-2015 periods. The average annual rate of unemployment in NSW and VIC will be in line with the overall country. Western Australia (WA) and QLD will be the only two states with a lower unemployment rate compared with overall Australia during the next two calendar years, according to Deloitte Access Economics forecasts.

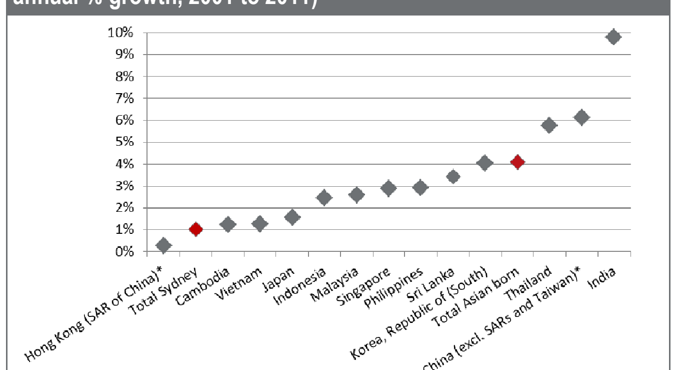
Net overseas migration driving demand

Greater Sydney's population of 4.7 million accounts for almost 65% of the State of NSW's population and over 20% of Australia's population. The city's population has risen at a rate of 1.2% per annum over the past decade, with relatively strong growth in the City and Inner South; Blacktown and Parramatta broader SA4 geographical areas.

Net migration, which includes net overseas and interstate migration, has been the key contributor to population growth in metropolitan Sydney and the broader State of NSW over the past two years. Despite losing people to the other states (primarily QLD and WA), NSW has benefited from a pick-up in birth rate (natural increase) and strong net overseas migration since 2010. For example, net overseas migration contributed to 66% of the population growth in the State in FY2013, natural increase made up another 49% of the annual increment, while net interstate migration led to a 15% drop in the State's annual increase in population.

Metropolitan Sydney attracts a large share of the State's overseas migrants. The number of Asian-born people resident in Sydney rose by 4% per annum between 2001 and 2011. The Thai, Mainland Chinese and Indian populations have been increasing at more than 1.5 times this rate, with the latter two groups largely arriving through skilled migration schemes. The share of the Asian born population has gone up to 13% of the overall Australian population in 2011, from 10% a decade ago. Offshore developers from the Asia-Pacific region, including China, have arrived and are looking to cater to local and offshore demand for new apartments.

Figure 2: Growth in Asian born population in Sydney (average annual % growth, 2001 to 2011)



Source: Jones Lang LaSalle, Australian Bureau of Statistics

* Special Administrative Regions (SARs) comprise 'Hong Kong (SAR of China)' and 'Macau (SAR of China)'.

According to the Australian Bureau of Statistics' medium growth scenario, Sydney's population of 4.7 million is expected to grow at an average annual rate of 1.5% per annum over the next two decades and reach 6.3 million by 2032. The 'grey' cohort (people aged 65 years and over) is forecast to grow at 2.9% per annum during this period, almost twice the rate of overall population growth. This will have implications for changes in location, type and design of housing stock over the long term. Buyers in this age cohort are likely to seek independent living units / retirement living / aged care accommodation in locations offering proximity to public transport, health and retail amenities.

The NSW Department of Planning and Infrastructure's population projections by Sydney Local Government Area (LGA) indicate that the Sydney City will be the second fastest growing LGA in Sydney, with a projected population growth rate of 2.3% between 2011 and 2031. Within the LGA, Sydney City Council data shows particularly strong projected population growth in the Green Square, City South and Redfern areas in the next five years. In order to satisfy the potential demand for housing in these locations, we expected the continued conversion of sites for residential development in the medium term.

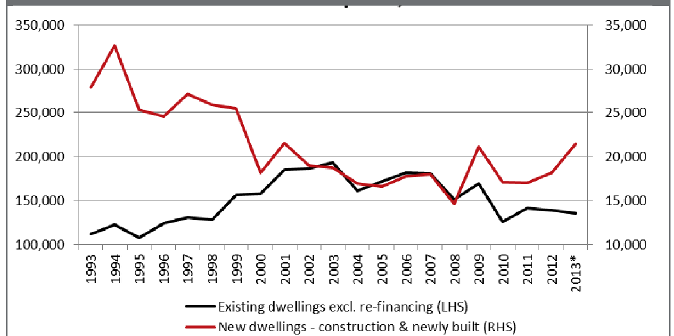
The outer North West and South West regions of Sydney will also be future growth corridors, with Camden, Liverpool and The Hills Shire LGAs projected to see population growth above that across Sydney. As a result, the State Government's infrastructure investment is focused in these areas, with two major pieces of transport infrastructure to be built. The South West Rail Link, scheduled to complete in 2015, is a new twin track passenger rail line from Glenfield to Leppington via Edmondson Park. The $8.3 billion North West Rail Link is Australia's largest public transport infrastructure project currently under construction and due to complete in 2019. It will deliver eight new railway stations, connecting Chatswood to Rouse Hill in the outer North Western region of Sydney.

Strong demand for new residential product

The Reserve Bank of Australia believes that supporting domestic growth is appropriate given low inflationary pressures. The official Cash Rate is at an all-time low at 2.50 per cent. Housing lending rates started declining in May 2012, with the bank standard variable rate at 5.95% in December 2013 (5.1% discounted and 5.3% three year fixed). This is well below the 10-year historical average standard variable rate of 7.3% (discounted 6.7%). The standard bank variable mortgage rate is expected to fall further in 2014 before rising in 2015, according to Deloitte Access Economics forecasts.

Falling interest rates are flowing through to owner-occupier demand, especially in the new segment of the residential market, which is linked to the recent increase in the supply pipeline in Sydney. For example, the number of owner-occupier housing finance commitments was up by 6.2% across NSW in the year to November 2013 compared with the previous corresponding period (pcp) in 2012. Finance commitments for newly completed dwellings rose by 48% in the year to November 2013 compared with the pcp in 2012, and commitments to build new dwellings increased by 14 per cent. Lending for new housing made up almost 14% of all finance commitments. In NSW, buyers of new homes up to the value of $550,000 and land up to the value of $350,000 are exempt from paying stamp duty, with part concessions offered for homes up to the value of $650,000 and land up to the value of $450,000.

Figure 2: Number of Owner-Occupier Housing Finance Commitments in NSW*



Source: Jones Lang LaSalle, *Australian Bureau of Statistics – as at November 2013

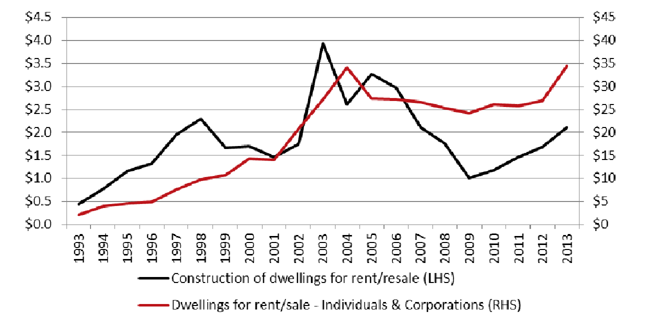
Owner-occupier commitments to purchase established dwellings make up the bulk of all housing finance commitments, at over 85% of all commitments in the year to November 2013 (excluding re-financing of established dwellings). However there was a nominal 2.3% increase in commitments to purchase existing dwellings compared to the corresponding period in 2012. The Australian Government's removal of the $7,000 first home owner grant for the purchase of established housing and an improving supply pipeline could be explanatory factors.

There has been an increase in housing loans to non-first home buyers, who made up 93% of all housing finance commitments over year to November 2013, compared with 10-year average of 82%. This suggests property upgraders and downsizers have recently dominated the market rather than first home buyers (FHBs).

FHB activity is weak, with a 51% drop in commitments by this buyer type between the year to November 2012 and 2013. As a result, FHB loans only accounted for 7% of all loans in NSW during this period compared with a ten year average of 18%. Despite the low interest rate environment and a doubling of the FHB grant for the purchase of new housing up to the value of $650,000 in mid-2012 (from $7,000 to $15,000), caution among FHBs can be explained by the significant price growth in certain areas of Sydney over the past year, along with the recent subdued labour market conditions.

On the investor side, both the new and existing residential segments of the market have recorded solid growth in the year to November 2013 compared to the pcp in 2012. In NSW, the value of construction of dwellings by investors rose by 21% to $2.4 billion and investment in established dwellings for rent / resale increased by 33% to $39.7 billion (shown in Figure 3).

Figure 3: Value of finance commitments for investment housing in NSW ($ billion, year to June)



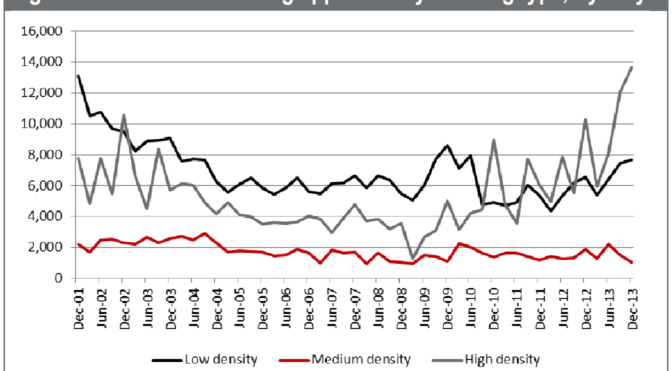
Source: Jones Lang LaSalle, Australian Bureau of Statistics

Demand and supply imbalance

The Sydney residential market is under-supplied. In the past five financial years, private sector dwelling completions in Greater Sydney have totaled 79,500, well below estimated underlying demand of 122,900 dwellings, a shortfall of 43,400 dwellings. The net underlying demand for dwellings is the annual change in total new stock required by the population and takes into account the changing household size.

Building approvals data are a good forward indicator of supply and have increased at a rate of 12% per annum over the past five years in Sydney, compared with high density approvals growing at a rate of 26% per annum, buoyed by the stronger price growth recorded in 2013. Apartments made up 55% of all dwelling approvals in 2013, well above the long term trend. Houses and medium density housing made up a lower share of total approvals (37% and 8% respectively).

Figure 4: Number of dwelling approvals by dwelling type, Sydney



Source: Jones Lang LaSalle, Australian Bureau of Statistics (excludes Central Coast)

A breakdown of approvals for high density residential development by region in Sydney shows the concentration of future building activity in the inner city areas, with a significant rise of apartment development in these areas over the past five years, and solid interest in the acquisition of residential development sites. This is a function of changes to planning policy, conversion of commercial / industrial property to residential uses, population growth and a structural change in buyer preferences toward higher density living which includes flats / units / apartments.

A planning response to increase housing supply and jobs has been the NSW Department of Planning and Infrastructure's announcement of the first eight Urban Activation Precincts (UAPs) across Sydney in March 2013. These UAPs include the North Ryde Station Precinct, Epping Town Centre, Herring Road in Macquarie Park, Randwick, Anzac Parade South, Carter Street in Lidcombe, Wentworth Point and the Mascot Station precinct. Since this announcement, there has been significant interest in these locations from investors / developers looking to acquire sites for future residential development. Examples of significant site sales transactions in 2013 include Meriton's purchase of British American Tobacco's site in Pagewood ($140 million, 1,625 equivalent unit yield) and 19-33 Kent Road, Mascot ($100 million, 980 equivalent unit yield); Bridgehill Investments' purchase of the Waverley Council Depot site in Zetland ($82 million, 750 equivalent unit yield); and Toplace Pty Ltd's acquisition of a site on Epsom Road / Dalmeny Avenue, Rosebery ($75 million, 699 equivalent unit yield).

A shortage of large scale developments, dysfunctional planning rules and increasing demand from developers has resulted in strong prices for approved development sites. Given the challenges and time taken to gain approval for raw sites, it is likely that prices for these sites will continue to rise, driving down developer profit margins. A number of new overseas entrants, who see the Australian residential market as low risk, are prepared to pay a premium as the returns are relatively healthy and market conditions favourable. As a result, local developers are tending to use their expertise in site amalgamation and planning to deliver approved sites to the market for these international buyers to develop.

Overseas developers and investors more prominent

The NAB Residential Property Survey Q3/2013 indicated a pickup in foreign investor activity in NSW (16%), particularly demand for new apartments in the CBD and inner city houses over the quarter. Foreign investment proposals to acquire residential real estate for development have dominated in the past few years. In FY2012, $59.1 billion worth of foreign investment into Australian real estate was approved by the Foreign Investment Review Board (FIRB), with over 25% of this proposed investment being in the residential sector. Of the $19.7 billion approved investment in residential real estate, almost 80% was for new development, with foreign parties seeking to sell Australian apartments 'off the plan' in the Asia Pacific region. The approved investment proposals for residential development were largely in NSW and Victoria.

Figure 5: Foreign investment proposals for residential real estate development in Australia ($ billion)

Source: Jones Lang LaSalle, Australian Foreign Investment Review Board (FIRB)

'Cooling' housing policy measures were introduced in China, Hong Kong and Singapore between 2010 and 2013, in order to slow down sales activity, price growth and lower household debt levels in these markets. The measures have included the Home Purchase Restriction (HPR) and a new capital gains tax in China; higher stamp duties in Hong Kong and Singapore; and tighter regulations on bank credit in Singapore. Australia has been a beneficiary, with investors who would have purchased in their domestic market now acquiring property in offshore markets.

The Australian Government's introduction of a new Significant Investor Stream Visa in November 2012, has further spurred overseas migration into the country and real estate investment in the domestic market. The visa requires an investment of at least AUD$5 million into complying investments and approved applicants to spend a minimum of 40 days a year in Australia over the four-year visa period. The visa has no upper age limit, does not require to have English proficiency, which is part of the skilled migration check list, and the main applicant does not have to meet the business points test.

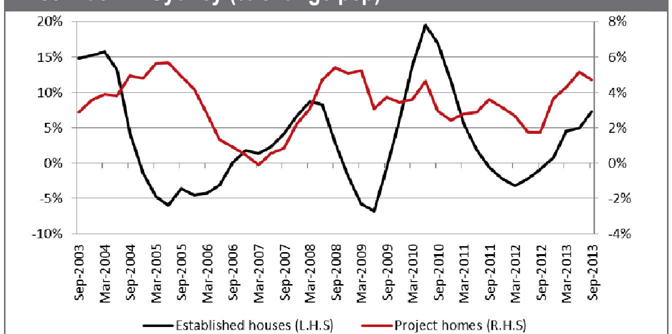
Local and offshore residential developers and investors are also keen to capitalise on the growth in overseas students in Australia over the past decade. According to the Australian Government - Australian Education International data, course completions by overseas students increased at an average annual rate of 6.1% between 2003 and 2012, compared with 3.4% per annum growth in overall course completions. Demand for Australian education is dominated by students from Asian countries (particularly China and India) and the NSW usually attracts the largest share of these students. The Organisation for Economic Cooperation and Development (OECD) Education at a Glance 2012 report showed that Australia was the third most popular destination for international students in the world in 2010, behind the United States and the United Kingdom. The solid historical and projected growth in international students will flow through to demand for specialist student accommodation, the private rental and/or buyer markets.

Solid price and returns growth

The residential property price cycle last bottomed out in 2012, following the 2007-2008 global financial crisis, despite the Australian economy faring relatively well in relation to most other developed economies. Since then most capital city markets have seen recovery in price growth. Capital value growth is outstripping rental growth, eroding rental yields but having a positive impact on residential property returns.

Dwelling prices in Sydney were subdued over the past three years, but values for established and new houses have been rising faster than inflation over the past year, following a recovery in demand indicators such as high auction clearance rates, high sales volumes, reduced selling periods and lower price discounting. The Australian Bureau of Statistics recorded an 11.4% rise in Sydney established house prices over the year to September 2013 – the highest rate of growth of all the capital cities and above the five year average annual growth of 3.4%.

Figure 6: Annual Movement in the Established and New Home Price Index in Sydney (% change pcp)

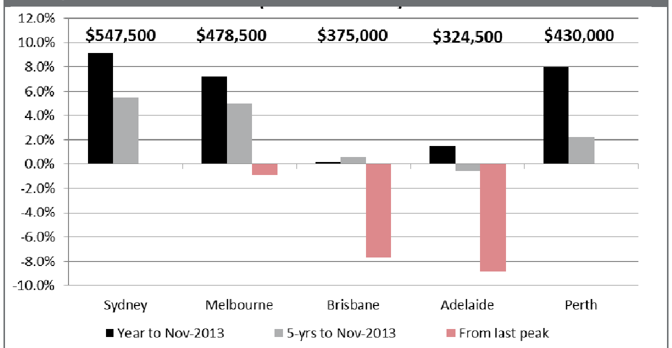


Source: Jones Lang LaSalle, Australian Bureau of Statistics

Prices for new project homes in Sydney have increased more rapidly in Sydney (5.0% between Q3/2012 and Q3/2013) than in other capital cities and faster than the five year average (3.6%). Further evidence of positive demand in the new dwelling segment of the market is the previously mentioned rise in new housing finance commitments over the year to September 2013 quarter.

In the apartment market, RPData – Rismark reported a 21% rise in unit sales volumes in Sydney over the three months to September 2013 compared with the same period in 2012. A 9.2% increase in values was recorded over the year to November 2013, above the 5.5% five year average (see Figure 7). In the past six months, strong sales rates have been recorded in apartment projects being sold off the plan in Sydney's CBD, the city's Inner South, North and West. Projects located close to public transport, education, health and retail amenities, are being highly sought after by local and offshore buyers. Potential local and offshore buyers are invited to submit expressions of interest, including a refundable deposit amount, which has ensure good sales rates on the official day of project release.

Figure 7: Residential Unit Price Growth by Capital City(Median Price), as at November 2013



Source: Jones Lang LaSalle, RPData-Rismark

Conclusion

The key question is how long will the market upturn last in Sydney?

The short term outlook for the Sydney residential market is favourable.

- NSW economic growth is projected to improve over the 2014-2015 period and interest rates should remain low this year, both being positive cyclical drivers of residential demand.

- Underlying demand will remain strong, given solid population growth projections in Greater Sydney, particularly in Inner Sydney, Outer North and Outer South Western Sydney locations. Net overseas migration will continue to be a key driver of population growth in the city. This has already been the case since introduction of the Significant Investor Stream Visa in 2012, cooling housing policy measures in select Asian countries such as China, Hong Kong and Singapore.

- Housing construction has been particularly low in NSW over the past decade and is likely to be a key driver of economic growth in the state over the next few years. As a result, the supply-demand imbalance should improve, as completions pick up over the 2014-2015 period, particularly in the apartment segment of the market.

- A potential area to watch is the sustainability of price growth, that is, prices being paid for the acquisition of residential development sites and also the developed end product. Development margins have started declining, with the potential to constrain the projected supply pipeline.

- Another cautionary factor is the labour market, which is yet to demonstrate sustainable improvement. Jobs growth was weak in 2013 and the NSW unemployment rate increased from 5.3% in April to 5.9% in October. However, employment forecasts suggest that the NSW labour market will be stronger than most other states over the medium term.

Sydney residential market indicators

Indicator	Level as at November 2013	Annual Change
Median price		
House	$749,995	13.3%
Unit	$547,500	9.2%
Median weekly rent		
House	$581	4.5%
Unit	$509	4.1%
Gross rental yield		
House	3.9%	
Unit	4.7%	
Overall vacancy rate*	2.1%	-0.8%
Annual return*	14.5%	
10-yr average annual return*	7.2%	

Source: Jones Lang LaSalle, RPData-Rismark; *Real Estate Institute of Australia – REIA (data as at Q3/2013 and change is between Q3/2012 and Q3/2013). REIA's annual and average returns incorporate the growth in overall median prices (capital growth) together with the percentage returns derived from net rental income.

Rupa Ganguli
Director, Residential Research – Australia
Jones Lang LaSalle
tel: +61 2 9220 8496
rupa.ganguli@ap.jll.com

David Rees
Head of Research & Consulting, Australia
Jones Lang LaSalle
tel: +61 2 9220 8514
david.rees@ap.jll.com

Real value in a changing world

Jones Lang LaSalle offices

Adelaide
Level 22, Grenfell Centre
25 Grenfell Street
Adelaide SA 5000
tel +61 8 8233 8888

Brisbane
Level 33, Central Plaza One
345 Queen Street
Brisbane QLD 4000
tel +61 7 3231 1311

Canberra
Level 7, 121 Marcus Clarke Street
Canberra, ACT, 2601
tel +61 2 6274 9888

Glen Waverley
Building 2
540 Springvale Road
Glen Waverley VIC 3150
tel +61 3 9565 6666

Mascot
Level 3, Sydney Airport Centre
15 Bourke Road
Mascot, NSW, 2020
tel +61 2 9693 9800

Melbourne
Level 21, Bourke Place
600 Bourke Street
Melbourne VIC 3000
tel +61 3 9672 6666

North Sydney
Level 27, North Point
100 Miller Street
North Sydney NSW 2060
tel +61 2 9936 5888

Parramatta
Level 8, 79 George Street
Parramatta NSW 2150
tel +61 2 9806 2800

Perth
Level 29, Central Park
152-158 St George's Terrace
Perth WA 6000
tel +61 8 9322 5111

Sydney
Level 25, 420 George Street
Sydney NSW 2000
tel +61 2 9220 8500

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