Operational Capital Markets | Q1 2023

SPOTLIGHT

Savills Research

Australian Multifamily Report

Realm Caulfield

MULTIFAMILY REMAINS ATTRACTIVE IN THE CURRENT CLIMATE

Despite current macroeconomic challenges, Multifamily is highly attractive given its inflation-matching characteristics and structural tailwinds, including increased occupier demand, a continuing supply shortfall, rising migration and challenges to home ownership.

Yields have also proven resilient relative to other real estate asset classes, supported by rental growth.

Forward funding developments will become the primary route to market and low-geared investors can take advantage of the current challenges in the debt market.

With the private for-sale market weakening in terms of forthcoming supply (and prices), Multifamily can look to increase its share of construction starts and further support housing delivery nationwide.

"Investor appetite for Multifamily continues to be resilient with a staggering $15.85 billion of investment earmarked to the sector."

SUSTAINED DEMAND FOR MULTIFAMILY INVESTMENT IN 2023

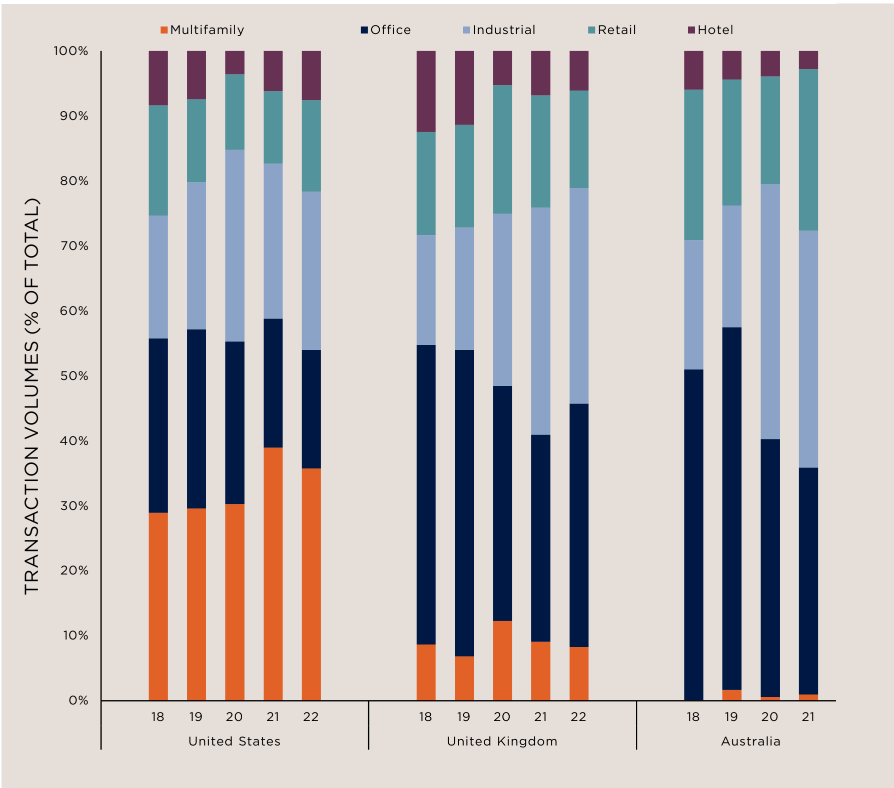
Multifamily continues to be one of the most in-demand real estate sectors globally, and in Australia. In Savills' Q3 2022 Investor Sentiment Survey, two thirds of European investors said they were likely to invest in Multifamily (across Europe and the Middle East) in the next 12 months. This follows a prolonged period of growing investor demand. These funds are now looking at their next steps and broadening their investment horizon to expand into Australia.

Our analysis shows that the number of funds targeting Australian residential investment strategies has grown exponentially over the past 18 months, with the amount of institutional capital already raised, allocated or in process of being raised for Multifamily far exceeding $15.85 billion.

This shows the growing weight of capital looking to invest in the sector and the dry powder that has been raised but is yet to deploy.

Although significant funds have been allocated for Australian Multifamily, the sector still only accounts for less than 2% of the national investment universe. Multifamily in Australia remains an extremely nascent sector in comparison to the United States, where capital has diversified to the living sectors, and where it is considered a core mainstream asset class, averaging 35% of all transactional volume over the past three years, out spending the office sector by 76%.

Opportunity for the Nascent Multifamily Sector to Surge as Capital Looks for Portfolio Diversification



Source Savills Research/RCA (*Multifamily excludes student, age-restricted and subsidised housing)

WIDESPREAD SUPPLY SHORTAGES HIGHLIGHT THE NEED FOR MULTIFAMILY INVESTMENT

The supply-demand imbalance in the rental sector shows no signs of abating, making the need for Multifamily expansion stronger than ever.

Stock in the rental market remains in very short supply – in December 2022, the number of properties available to rent nationally was down 38% annually, and the lowest level on record for December.

The Housing Industry Association is forecasting that the number of dwellings starting construction is set to decline further this year and in 2024 to its lowest level since 2012 – pointing to further weakness in residential construction which flows through to rental stock.

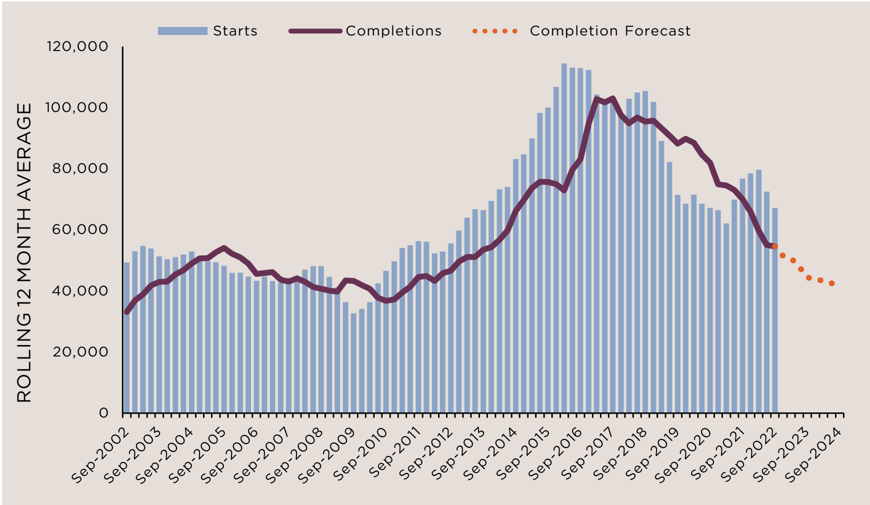
Additionally, "mum and dad" investors continue to withdraw from the rental sector – with the value of new investor loans (excluding refinancing) declining 35% annually to the end of January 2023, due to higher financing costs, changes to tenancy laws and lack of consideration for landlords' rights.

There are more than two million property investors in Australia, which is about 8% of the population, according to the Australian Taxation Office. Approximately 70% of investors own a single property.

Landlords coming to the end of their fixed-rate mortgages are now refinancing at rates much higher than they would have expected when taking out their initial mortgage. If landlords are unable to pass the added costs on to their tenants through higher rental payments, this could result in significant loss-making investments, particularly for the most leveraged investors or portfolios.

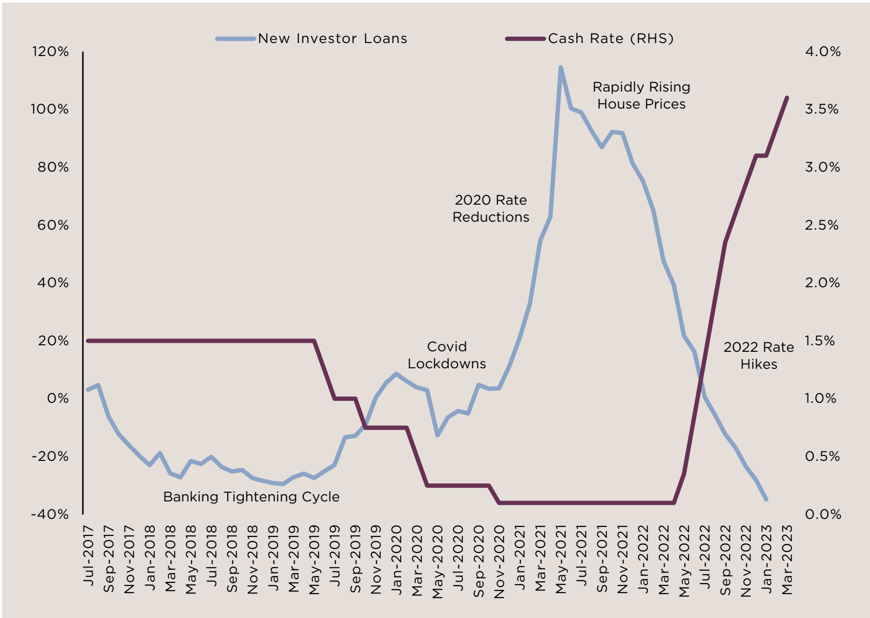
Markets have already responded to rising costs, with the number of investment properties for sale increasing from 20-25% of the monthly total to more than 30%, according to CoreLogic.

Apartment Starts and Completions Dwindling Post Pandemic



Source Savills Research /ABS

Rising Rates Impacting on Investment into Rental Accommodation



Source Savills Research /ABS/RBA


Kinleaf Element 27 - Phase 1


Kinleaf Element 27 - Phase 2


Kinleaf The Briscoe

"Assuming the $15.85 billion of capital raised, allocated or in process of being raised for Multifamily is leveraged with debt, this could be able to support the delivery of 52,800 new homes over the next five years. This would play an integral part in the government's targets for housing delivery and assist in providing much needed rental housing to Australian cities. However, much more investment from both global and domestic capital is needed to really make a difference to housing supply. Tackling the inefficiency of taxes and planning would go some way to amplifying the investment thesis of Australian Multifamily."

Home Richmond

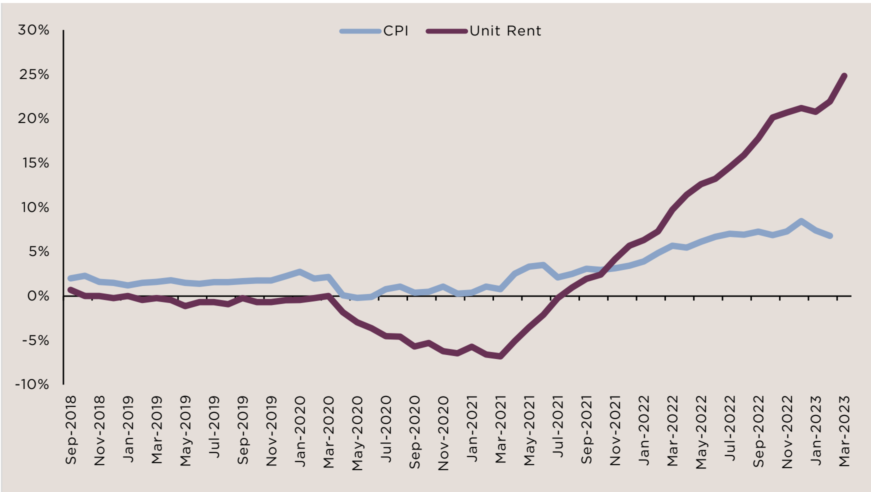
MULTIFAMILY HAS PROVEN ITSELF AS AN INFLATION HEDGE

One of the main attractions of Multifamily in the current economic climate is its inflation-matching characteristic. The rate of annual CPI reached a peak of 8.4% in December, compared to a 21% growth in apartment rents over the same period. The natural churn of tenants means investors can regularly rebase rents in line with the market.

How renters respond to rapidly increasing rents remains to be seen. There could be a shift back towards households with a larger number of people, reversing the trend seen during the Covid pandemic. Either way, the return of skilled migrants and international students, coupled with the lack of additional rental supply will put further upward pressure on rents.

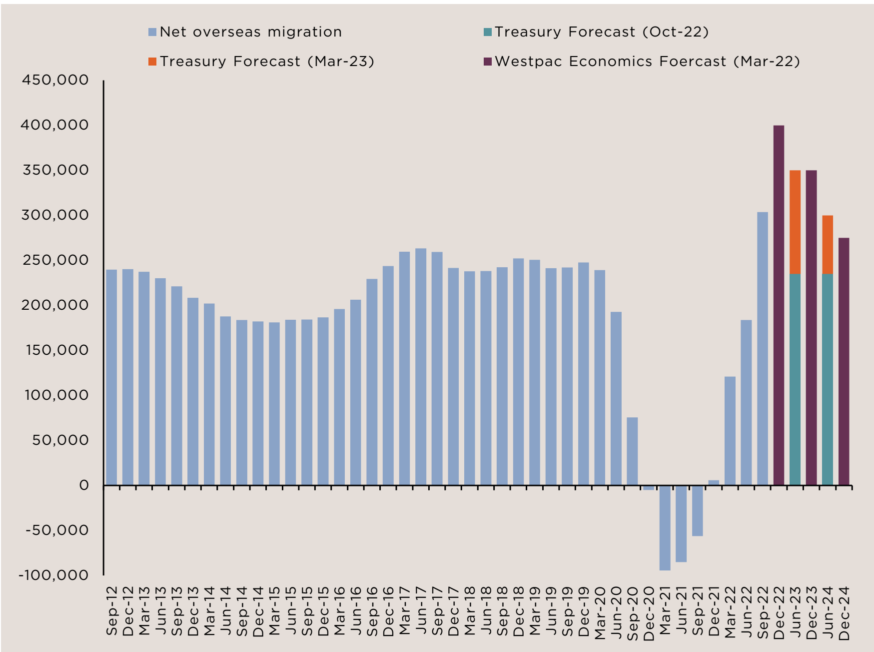
Those who were already invested in Multifamily during this period have enjoyed rising rents, high occupancy and record lease-up rates, which has more than compensated for higher operational costs across their businesses. The Australian rental market is currently characterised by strong rental growth, underpinned by a shortage of rental homes relative to demand. This mismatch has applied upward pressure on rents that is far in excess of initial underwriting assumptions.

Oversized Rental Growth, Hedge Against Inflation



Source Savills Research /RBA/SQM Research (Capital City Average)

Population Growth Surging on the Back of Government Policies



Source Savills Research/ABS/Westpac Economics

UNCERTAIN ENVIRONMENT, BUT STRONG RENTAL GROWTH

The current economic uncertainty has resulted in a more cautious approach from investors across all real estate sectors. In Multifamily, a lack of operational assets which have traded has made it challenging for investors to assess where pricing sits. As we move through 2023 and into 2024, investors are looking to see increased liquidity in the market, which will help them firm up fair market pricing.

Investors will be keeping an eye on rental growth and what is happening to the long-term risk-free rate over the coming months. Our expectation is that oversized rental growth will continue – with Westpac forecasting 11.5% rental growth in 2023 – which will result in rising investor confidence.

STRUCTURAL TAILWINDS WILL CONTINUE TO KEEP DEMAND FOR RENTAL PROPERTIES HIGH

Whilst rental market supply is heavily constrained, demand for rental properties remains elevated. This is likely to continue, as higher mortgage rates are causing an acute affordability squeeze in the sales market. Would-be first-time buyers are being kept in the private rental sector for longer, driving greater demand over the medium term.

Particularly important for longer-term demand is that international migration has returned. The year to 30 September 2022 saw net overseas migration increase to 303,700, the highest annual figure since March 2009, with total population increasing by 418,500.

The October 2022 budget forecast net overseas migration rising by 235,000 both in 2022-23 and 2023-24 financial years. By March 2023 this forecast had increased to 350,000 and 300,000 respectively. However, data still suggests that what Treasury are assuming net migration to be, is significantly underestimated, with Australia poised for a net migration of 400,000 individuals this year, and a further 350,000 in 2024.

MULTIFAMILY INCREASING ITS SHARE OF CONSTRUCTION STARTS

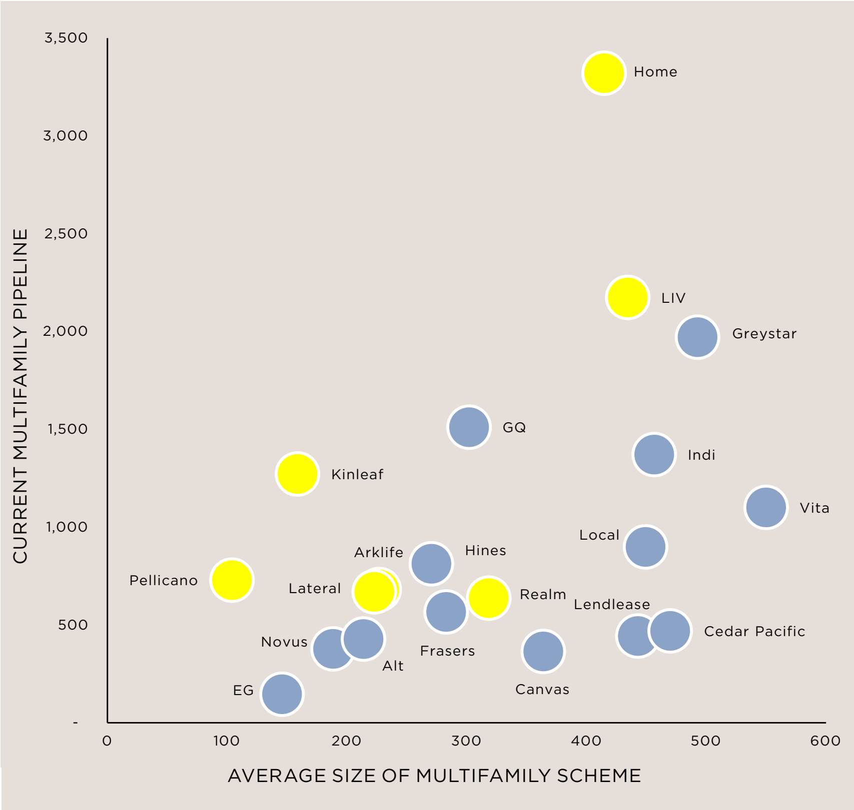
We can expect Multifamily schemes to make up a greater share of housing moving forward, given that traditional 'build-to-sell' residential developers are now looking at alternative exit strategies to de-risk their pipelines. With rental demand forecast to remain more robust than off-the-plan sales demand, we are likely to see this share increase.

Australia's institutional Multifamily stock now stands at 5,475 completed apartments, with 8,400 apartments under construction. The future pipeline currently stands at 26,350 apartments, including those in the pre-application stage. This brings the total size of the sector to 40,100 apartments completed or in the potential pipeline.

The market is evolving, a year ago, Melbourne accounted for over 60% of all Multifamily apartments either operational or in planning. At Q1 2023 that is now down to 53%.

With the announcement of the Olympics, significant public infrastructure spend, a fast growing population and a diminishing residential pipeline, Brisbane has become a key focus of most investors, increasing its share of total completed apartments and pipeline to 20%. Sydney remains the hardest city to navigate, as land values remain elevated, impacting on feasibility.

Volume of Operational Multifamily Stock Becoming Greater



Source Savills Research (yellow circle indicates those with operational assets, proposed and reported projects)

FORWARD FUNDING WILL BECOME THE PRIMARY ROUTE TO MARKET

Forward funding will become increasingly popular over the coming years, despite a much-changed macroeconomic outlook.

As a benchmark for the Australian market, forward funding has been an integral part of Multifamily expansion in the UK, with 75% of investment in the past five years coming via this route. Circa £1bn was deployed to forward fund developments in Q4 2022 alone.

Homes delivered through forward fundings add to the rental stock and are vital for the continued growth of the sector, as well as helping address the widespread shortage of housing.

One of the main attractions of forward funding for investors has been the opportunity to drive value during construction. This is even more important now the spread between Multifamily yields and the risk-free rate has narrowed. The yield on an Australian five-year Government bond has risen to 3.5%, having been at 1.8% just 12 months ago.

This places greater emphasis on value growth. A typical Multifamily block will take between three and five years to build and stabilise. Rental growth in the wider market during this period means that the NOI can be higher than projected, driving up the yield on cost (YOC) and widening the premium over the risk-free rate. Given this, forward funds will become an attractive route to market.

INVESTOR-DEVELOPER PARTNERSHIPS LIKELY TO RISE

For developers, the wider economic context has made partnering with an investor more attractive. Firstly, using forward funding arrangements to access development funding avoids the use of expensive debt to finance projects. Forward funding can make projects viable where debt is no longer accretive. And secondly, the weakening sales market should increase the value of certainty. Multifamily investors can offer developers a guaranteed exit on completion, at a price which is agreed before construction begins.

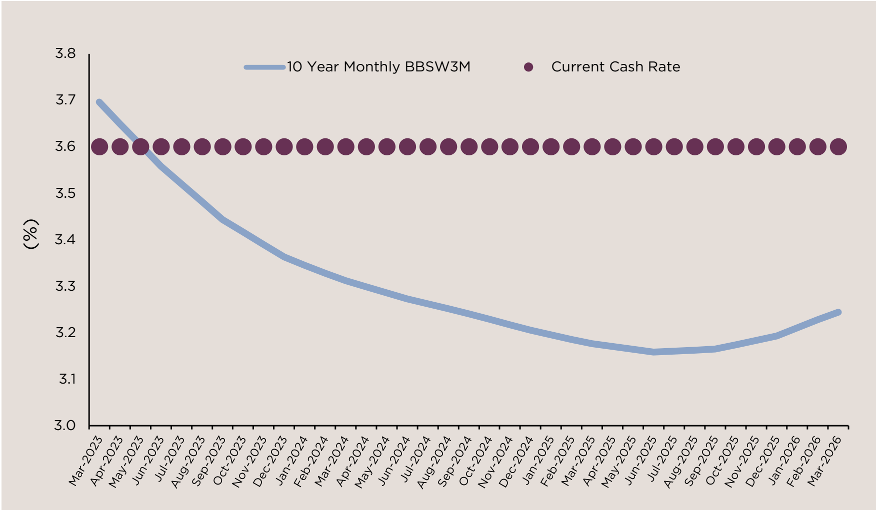
The appetite of developers to take on Multifamily projects is likely to increase, given the security of partnering with an investor and the lack of alternative development opportunities. Multifamily investors should therefore gain access to a wider choice of development partners. Investor-developer partnerships will allow both parties to secure their development pipeline over the next couple of years.

UNGEARED INVESTORS CAN CAPITALISE ON CHALLENGES IN THE DEBT MARKET

The elevated cost of debt remains a challenge for investors. Relative to a year ago, the all-in cost of debt (risk-free rate + lender margin) has risen sharply – on a typical five-year horizon, it has nearly tripled. This means highly leveraged investors are unlikely to be able to generate the same cash-on-cash returns as a year ago, with some parties temporarily pausing acquisition activity, or becoming less competitive as a result. This presents opportunities for less-geared investors to take advantage of reduced competition and secure the highest quality sites, and assets if operational stock were to come to market.

The latest ABS data suggests that inflation peaked in December 2022 and will continue to slow over the course of 2023 following falls in January and February. On 7 March, the Reserve Bank of Australia voted to raise the base rate by 25 bps to 3.6%, the 10th meeting in a row that rates have been increased. The Monetary Policy Committee's key message was that rates are now close to their peak.

Futures Pricing Beginning to Stabilise, Improving Investor Confidence



Source Savills Research/Chatham

Most banks expected a further 50 bps rise by mid-year, followed by a pause in rate hikes, and potential fall in 2024. However, this consensus has dramatically shifted since the collapse of SVB and Credit Suisse, which has globally reset expectations to lower interest rates.

This slowing or stalling of the cash rate upward cycle will reduce the upward pressure on the cost of debt. The 3-month BBSW forward curve (as of 24 March) suggests it has already peaked. From this point, as the cost of debt comes down, we can expect to see transactional activity levels pick up, as investor confidence regains, and as more stock completes and stabilises.

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