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Fast & Furious – Residential Development in South Sydney

August 2013

Highlights

- **Growing real estate investment is reflective of international and domestic demand.**
  Both domestic and foreign investment in Australian real estate has grown exponentially in recent years. AREITs and real estate giants, such as Meriton, are making large purchases hiking up their inventory of residential development sites while on the international front countries such as the US have doubled their real estate investment in Australia in recent years.

- **Chinese demand welcomed with open arms.**
  While Beijing has put restrictions on property ownership in China, the Australian government has introduced the 'Significant Investment Visa' offering permanent residency to those investing a minimum of AUD$5m over 4 years, which will undoubtedly lead to further Chinese investment, already strong in the real estate sector.

- **South Sydney is experiencing strong interest.**
  With average apartment values being approximately 25% less per square meter compared to Surry Hills, South Sydney is increasingly attractive to young professionals, families, and investors.

- **Developers face hurdles, but remain intent.**
  Despite drawbacks such as section 94 contributions, potential environmental hazards, and traffic congestion, developers see South Sydney as an enticing prospect.

- **Industrial businesses are relocating.**
  Industrial businesses, historically dominant in South Sydney, are under pressure from increased competition from low cost countries, high wages and declining productivity compounded by the strong Aussie dollar. This has led many manufacturers to relocate to more affordable areas in West Sydney, providing residential developers with the appealing prospect of large, undivided plots to develop.

- **Government is pushing high-density residential.**
  Movement at Green Square Town Centre and public funding for infrastructure and community facilities together with the rezoning impact of the Sydney LEP 2012 has led to increased interest from a range of developers.

- **Residential development will continue to thrive.**
  Trident Real Estate Capital is bullish on apartments in the South Sydney area and predicts that prices will continue their upward trajectory underpinned by low mortgage rates on the one hand and population growth on the other.

Introduction

Inner South Sydney encompasses some of Sydney's most culturally and economically diverse communities. Alexandria, Waterloo, Rosebery, Beaconsfield and Zetland, collectively South Sydney, are buzzing art-deco districts in the mists of a wave of new developments. In this research paper, Trident Real Estate Capital analyses the recent and rapid appearance of high rise apartment buildings in these suburbs. The paper considers the causes, potential hazards, and the future outlook of the growth in residential development in South Sydney.

Growing Demand

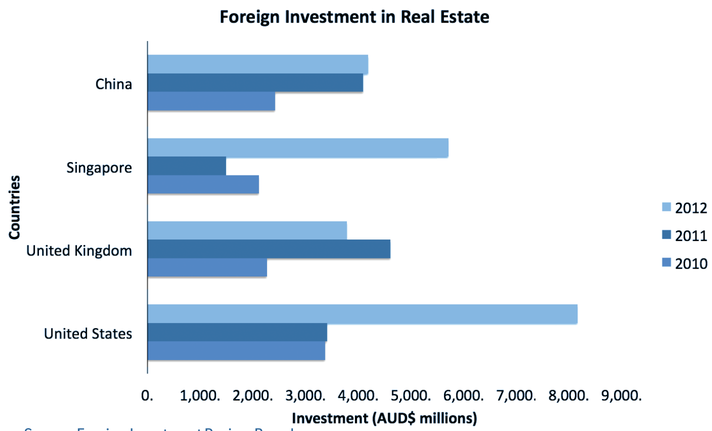
Recently, the amount being paid by developers per unit for raw development sites in the South Sydney area has risen sharply. In some cases, development sites are fetching prices as great as AUD$160,000 per D.A. approved apartment. What has caused this sudden escalation in property value in South Sydney?

On a macroeconomic level, the historically low cash rate of 2.75%, which looks set to continue its downward trajectory, is promoting investment in development. At the same time, sustained population growth means that there is increasing pressure on residential supply. According to the Australian Bureau of Statistics, population growth is on a steady rise due to overseas migration, which grew 17% during the year ending 30 September 2012.

The sources of demand include both domestic and overseas investors. On the home front, AREITs and real estate giants, such as Meriton, are making large purchases hiking up their inventory of residential development sites. According to Colliers, AREITs accounted for 60% of assets purchased by institutional investors in the year to date (Australian Capital Markets Report 2013). Such heights were last reached in 2007, when the figure was 50%, representing a major increase in domestic real estate investment. Over the past 6 months, Meriton has amassed $147m in property purchases in the Mascot area alone.

On an international level, there has been strong growth in real estate investment from the US, UK, Singapore and China. Noticeably, US investment has recently shifted away from mineral exploration and development. American investment into real estate more than doubled from AUD$3.4bn in 2010-11 to AUD$8.2bn in 2011-12 (Foreign Investment Review Board, Annual Reports). As America contributes almost a quarter of foreign direct investment in Australia, this shift towards real estate investment is particularly salient. Similar movements towards real estate investment can be seen in the figures for the UK and Singapore, which showed a 283% year-on-year growth in real estate investment in 2011-12.

Chinese FDI in Australia has also grown rapidly. In 2008, Chinese direct investment in Australia totaled AUD$3.6bn. In 2012, this figure had grown to AUD$16.7bn, representing a 363% increase over 4 years (ABS).



Source: Foreign Investment Review Board

Chinese investors have been motivated by a desire to move their holdings out of China, where political instability and property cooling measures impose constraints. Recent legal developments in Beijing include restrictions upon those who already own homes from owning more than two properties and upon those who do not yet own homes from buying more than a single dwelling. The rate liberalization by the People's Bank of China effective as of July 2013, is expected to have little impact on funding costs and in turn relatively little influence on property prices in China.

In contrast to China's property cooling measures, the Australian government has actively invited foreign investment through the introduction of the 'Significant Investment Visa'. By investing at least AUD$5 million for a minimum of 4 years, foreigners are able to apply for permanent residence in Australia. It should be noted that the AUD$5 million investment must be committed through a specified vehicle such as an ASIC regulated managed fund. The visa is designed to appeal to private families and businesses wishing to migrate to Australia.

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Why South Sydney?

What has made South Sydney so attractive to investors, young families and white collar professionals?

Situated between the airport and CBD, South Sydney benefits from strong transport links through both Mascot and Green Square stations. The area's excellent central location and accessibility make it particularly desirable for investors and owner-occupiers alike.

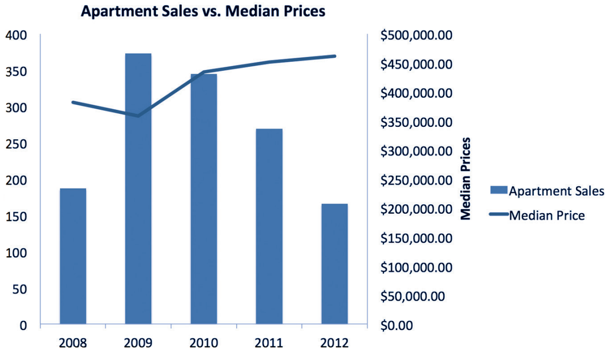
As industrial sites are replaced by residential and mixed-use developments, the area has grown increasingly attractive to those looking to live close to the CBD. Additionally, apartments in South Sydney are more reasonably priced than those found in areas such as Surry Hills and Darlinghurst. While two bedroom apartments can fetch in excess of AUD$1million in Surry Hills, a similar property can be found in Alexandria for a more modest price of AUD$700,000. The relative prices per square metre reflect this contrast between the two areas, with properties in Surry Hills demanding as much as 25% more per square meter compared with similar properties in Rosebery.

Surry Hills vs Alexandria Price Comparison

	Price	SQM Dec-12	AUD$/SQM Dec-12
Surry Hills			
East Central, 1 bed	$ 575,000.00	44.8	$ 12,834.82
The Bedford, 1 bed	$ 635,000.00	57.3	$ 11,082.02
801/425 Bourke, 2 bed	$ 1,065,000.00	106.0	$ 10,047.17
Alexandria			
144 Dunning , 2 bed (Sold Dec 2012)	$ 665,000.00	91.0	$ 7,307.69

Source: Trident Real Estate Capital

Residential demand has further increased as a result of the influx of trendy cafés across Alexandria and Rosebery, bringing an attractive vibe to the area. The prospect of a retail high street on Joynton Avenue in the Green Square Town Centre is also enhancing the appeal of living in areas like Alexandria and Rosebery.



Source: RP Data

The rising median prices of apartments demonstrates the strength of demand for residential property in the suburbs of Alexandria and Rosebery over the past few years. During 2009 and 2010, apartment sales were particularly strong due to the development of several new development sites such as Victoria Park. More recently, apartment sales have slowed as a result of lack of supply. However, pre-sale numbers reveal that demand for residential property remains buoyant. At 'Divercity', a development in Waterloo, where two bedroom apartments start from $649,000, one of the blocks has seen 107 of 126 units sold 'off-plan'. APEX in Zetland, which is comprised of 148 apartments ranging from one bedroom apartments for $465,000 to three bedroom penthouses for $1.3m, has had 100% take-up in pre-sales. The level of demand for such developments reflects just how saturated the supply of residential property in South Sydney is.

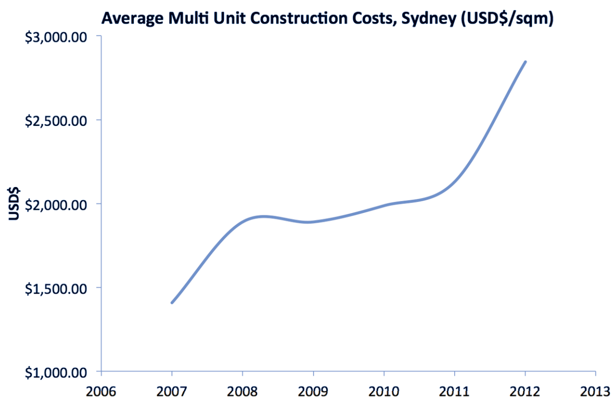
Pre-Sale Figures

Address	Total No. Units	No. Units Sold	% Units Sold	Commencement	(dw/mth)
Divercity, Sydney Gate, Waterloo (Block D)	126	107	85%	Mar-12	18
APEX, 6 Defries Avenue, Zetland	148	148	100%	Nov-10	8
Viking Apartments, 30 O'Dea Avenue, Waterloo	110	77	70%	Jul-10	5

Source: Colliers

Challenges and Constraints Faced by Developers

Developers moving in on the largely industrial areas of South Sydney face several hurdles in their pursuit of high-rise success. First, construction costs have been rising for developments across Sydney. According to Aecom's Global Unite Platform, Sydney ranks as the fifth most expensive city in terms of construction costs for an 'average multi-unit high rise', putting it behind only New York, London, San Francisco and Los Angeles (AECOM, Blue Book 2013). The chart below shows the gradual rise in building costs per square meter, based on an apartment development of fewer than 10 levels and of a medium standard. The chart does not include soft costs, among other things.



Source: AECOM, Blue Book

To add to the already rising construction costs, developers in South Sydney must be acutely aware of the environmental hazards and potential contamination clean-up costs. Due to the fact that much of the land around South Sydney has historically been used for industrial purposes, the land itself is not always best suited to residential developments. For example, Trident Real Estate Capital recently considered the purchase of a site up for sale in Rosebery. Unfortunately, the Sales Contract disclosed the presence of four abandoned underground storage tanks (USTs). The process of loading, carting and disposing of the USTs and the surrounding contaminated soil was quoted by Australian Enviro Services at AUD$180.50 per tonne, assuming that all contaminated product was classified as general solid waste. The end result for the developer was an additional cost of AUD$500,000. To minimise the impact of unforeseen environmental costs, developers generally negotiate the purchase of a site to be conditional on a clean Phase 1 and 2 Environmental Site Assessment (ESA) conducted by their own nominated company. The results from an ESA allows a developer to laterally and vertically delineate the extent of any contamination onsite above ongoing or intended land use. Developers may then negotiate a cost reduction from the sale price to cover remediation costs and mitigate the risk. Experienced developers will always negotiate customized provisions to deal with known and unknown environmental liabilities.

An unavoidable stumbling block is the large contributions required by City of Sydney Council. Where a development is approved, the conditions specified as part of the approval will require a developer to make a financial contribution, known as Section 94 Contributions, to the City to contribute to the cost of infrastructure needed to support a growing population. In the City of Sydney Southern Precinct, which includes the Green Square area, these Section 94 Contributions require, at the time of writing, for each one bedroom or studio dwelling nearly AUD$15,000 and for each two or three bedroom dwelling approximately AUD$20,000.

Developers in the Green Square area are required to make an additional contribution towards affordable housing. This levy can be paid in two forms. Either developers ensure that 3% of the total residential floor area and 1% of total non-residential floor area is set aside for 'affordable housing', or developers may contribute $136.87 per square meter of the total residential floor area and $45.61 per square meter of the total non-residential floor area. In addition, the newly gazetted City of Sydney Local Environmental Plan 2012 (Sydney LEP 2012) allows developers in the Rosebery area a bonus floor space ratio by either providing recreation areas, indoor or outdoor recreation facilities, drainage or flood mitigation works, or by paying a levy of $475 per square meter of the potential additional floorspace. Once again, this levy will subtract from a developer's bottom line.

According to the SGS Employment Land Study March 2013, traffic and transport issues will be the biggest long term constraint on development across South Sydney. A case in point is Botany Road and Southern Cross Drive, which serve as part of the strategic corridor between Sydney Airport, CBD and the port. These roads currently are operating at capacity during morning peak periods. The poor traffic conditions have meant planning controls restrict developers from providing parking in new residential projects. In some cases, planning controls dictate a maximum of 0.3 car parking spaces only for each newly constructed one bedroom apartment. Newly installed cycleways have proved to be a further nuisance, limiting the flow of traffic, exacerbating existing parking woes and proving to be a major safety concern for drivers in the already congested South Sydney area.

These hurdles have not deterred developers from moving in on South Sydney, nor are they likely to start doing so. Despite the risk of dealing with contaminated land, the material contribution costs, and the transport difficulties, the allure of South Sydney, by way of the strong demand and rising land values, make it an enticing playground for developers.

Supply shifting gears

During the Global Financial Crisis there was a significant slowdown in construction due to lack of available finance for redevelopment. Following the lag time, the residential market is now feeling the squeeze of this slowdown in supply. As developers look to sate the rising demand, areas suitable for residential developments, such as South Sydney, are experiencing strong increases in land values. What makes South Sydney so attractive to residential developers?

South Sydney has traditionally been dominated by industrial and manufacturing sites. Unfortunately, Australian manufacturing has been on a steady decline over the past 3 years. South Sydney has not escaped this decline. The

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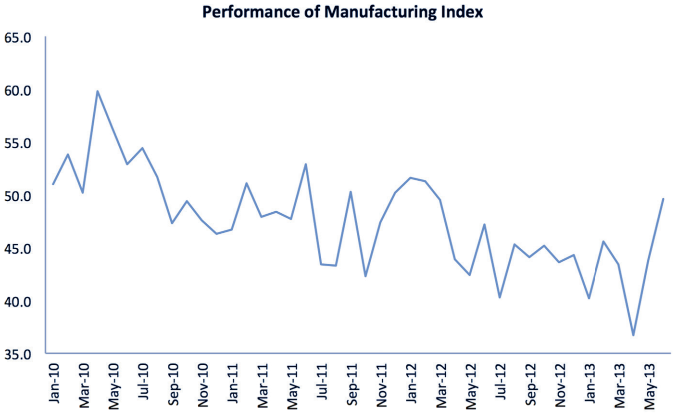
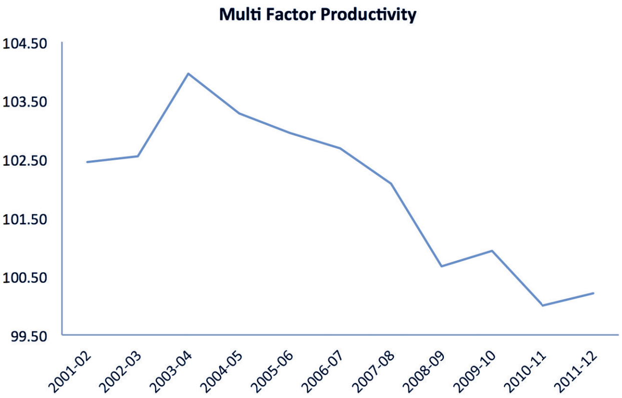
Australian Performance of Manufacturing Index (PMI), which is a composite measure of levels of production, new orders, deliveries, inventories and employment, most recently was at 49.6 in June and in May 2013 was at 43.8 (a reading below 50 indicates contraction in manufacturing activity).



Source: Australian Industry Group

Declining productivity since 2004 and high wages have put manufacturing businesses in South Sydney on the back foot, a problem compounded by the strong Aussie dollar, which remains relatively high, notwithstanding the currency's recent depreciation.



Source: ABS

As a result, industrial sites in South Sydney are under pressure, facing rising costs and increased competition from low cost countries, as well as from the increasing popularity of e-tailing. In response, many businesses are moving to more affordable areas in Western Sydney, such as Smithfield and Silverwater, while others have relocated offshore. This decline has made large undivided plots, formerly used for manufacturing, available for residential development in the South Sydney area.

Re-location is also an attractive alternative to owners of industrial sites as the value of the land and rent rises due to re-zoning. Many sites previously classed as Industrial have been converted to Mixed Use (B4) or Local Centres (B2) by newly gazetted planning controls, allowing for medium to high-density residential development. One agent that Trident Real Estate Capital spoke to claimed that many business landowners had won the lottery as a result of the rezoning brought about by the new Sydney Local Environmental Plan 2012.

Government pushing high-density centres

The Sydney LEP 2012 has rezoned certain 'industrial' zones around key growth areas to encourage sustainable and responsible residential development. According to the NSW Government, one of the ultimate aims of the Sydney LEP 2012 is to, 'focus on housing and employment growth in areas like Green Square and the Waterloo-Redfern renewal area, and to support existing plans for the delivery of other significant new urban renewal projects'. In layman's terms, the City of Sydney is intending to promote the development of high-density urban spaces.

The revitalization of Waterloo is a case in point. The suburb's gentrification began in 2004 with the launch of the Redfern Waterloo Authority with the objective of revitalising the suburb. The population increase of 25% between 2006 and 2011 in the Waterloo area and the increase demand for properties as reflected in the 15.1% capital growth in median unit prices in 2012 alone, as recorded by RP Data, is reflective of the success of the NSW government push to develop new urban centres. Projects such as 17 Dank Street, which involves the construction of a mixed used development compromising 43 residential units (priced at $875,000 for a two bedroom), is an example of the type of development that is active in the area.

Most recently, the City of Sydney's Draft Corporate Plan promised a further $400 million for Green Square to be spent on new roads, parks and open space, a new town centre, library and recreational facility and affordable housing over the next 10 years. In March 2012, the Green Square Town Centre urban redevelopment kicked off with the demolition of the Royal South Sydney Hospital.

The Sydney LEP 2012 together with the boost from government investment has clearly led to increased interest from a range of developers some of which are known for high rise apartments such as 'High-Rise Harry' and others more focused on boutique projects such as Trident Real Estate Capital.

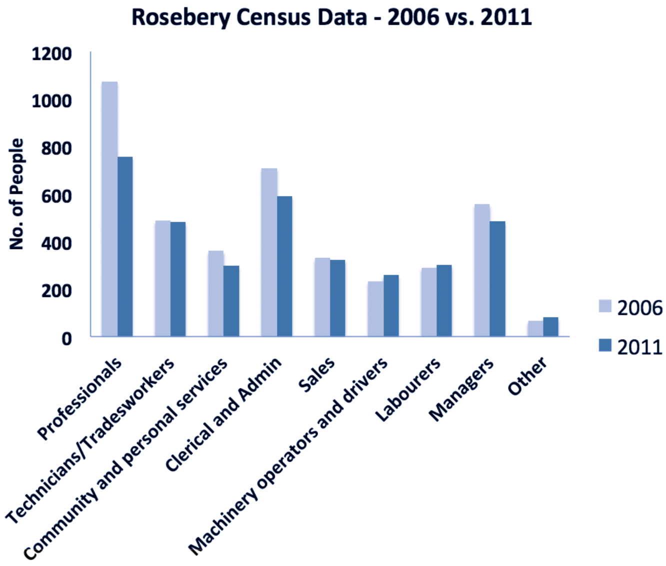
Creative Industries, Trendy Cafes and Changing Demographic

With industrial sites being transformed and government funds budgeted for urban renewal in South Sydney, the arrival of creative industries and trendy cafés has heralded the area's upward trajectory.

Many 'creative' businesses have moved into the South Sydney area migrating from suburbs such as Surry Hills and Chippendale. These 'creative', knowledge-centric businesses demand smaller spaces, typically ranging from 140 to 350 square meters. This has led to the construction of sites such as Goodman's two-storey industrial complex at 198 Bourke Rd, which is designed to house creative and light impact storage users. Similarly, 'Collins on Bourke' in Alexandria has been constructed as a hub for creative and light industrial users, with smaller spaces and a range of 'high-tech suites' suited to knowledge intensive businesses. In addition, trendy co-working spaces have set up shop around the area, with the arrival of Platformation at 603 Botany Road in Rosebery, designed for energetic individuals to cluster in an open plan environment and share knowledge, a case in point

New trendy cafés that have sprung up include Sonoma, an artisan sourdough bakery, on Birmingham Street and Bourke Street Bakery on adjacent Ellis Avenue. The artisan vibe is also found at nearby 'Kitchen by Mike', a first mover in the adoption of rustic interior design. A similar concept is found at 'The Grounds', a headquarters for the brand's specialty coffee. The establishment of these trendy eateries accommodates the palate of the changing demographic of the area as professionals and young families take up residence in the newly developed residential towers.

Accompanying the creative businesses is a changing demographic migrating into the area. According to the SGS Employment Land Study for November 2012, 59% of dwellings in the area are now apartments, the majority of which are 1 and 2 bedroom apartments. Furthermore, the 2011 ABS Census figures show 26.1% of people over 15 years old in the Rosebery area classed as professionals, in contrast with 11.8% and 7.1% as trades workers and labourers respectively. These figures reflect the shift in demographic towards young professionals unable to buy stand-alone dwellings and looking for more affordable accommodation.



Source: ABS

Bottom Line

The decline in South Sydney's industrial precinct will continue, with only strategic industries surviving. Future supply of industrial stock will be difficult to imagine although 'creative', knowledge-centric complexes consisting of smaller strata spaces, typically ranging from 140 to 350 square meters, will remain in demand.

South Sydney's future will be primarily to provide strategically located development sites to sate strong residential demand. As the Green Square urban renewal effort gathers pace and the retail presence increases, residential developments will intensify. The expansion of mixed-use zones around the Alexandria, Waterloo, Rosebery, Beaconsfield and Zetland areas foreshadows further changes to zoning as industrial sites become mixed use or local centres. Trident Real Estate Capital expects prices for apartments in South Sydney to continue rising underpinned by low mortgage rates on the one hand and population growth on the other. The trajectory for the South Sydney area is decidedly upward!

If you have any questions or would like more information, contact Trident Real Estate Capital.

Our Team

Trident Real Estate Capital is a real estate investment and advisory firm which is active in the Australian commercial property market. We draw upon 30 years of real estate market experience and utilise an advanced suite of property data and analytical tools to provide client tailored specialist real estate advice including market assessments and forecasts, due diligence and location analysis to a variety of corporate, investor and institutional clients.

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