Contact Asset Management

INSIGHTS

MAY 2021

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Australian Housing and a site visit to one of our housing-exposed investments

Activity in the Australian housing market is booming as approvals recover and house prices seem to be constantly exceeding expectations – in both metro and regional areas. In this insights piece, we look into some of the macroeconomic factors at play. We also share our thoughts on a small cap property company that we hold in the Contact Australian Ex-50 Fund, Cedar Woods Properties (CWP). In recent weeks, we visited one of CWP's signature projects, Glenside in Adelaide.

The residential housing market has bounced back . . . hard!

Residential building approvals boomed in March 2021 by over 17% to 278k. This was the second highest monthly level recorded, and only marginally below 280k recorded in November 2017. This was well ahead of market expectations for a 5% increase. The buoyant approvals number follows a very strong 20% increase in February 2021 and highlights the underlying strength in the market. The following charts from UBS Research are illustrative:

Figure 3: March residential approvals spiked 17.4% m/m to 278k annualised; led by multi's rebounding sharply (+63.6% to 103k), with houses flat at a record high 169k

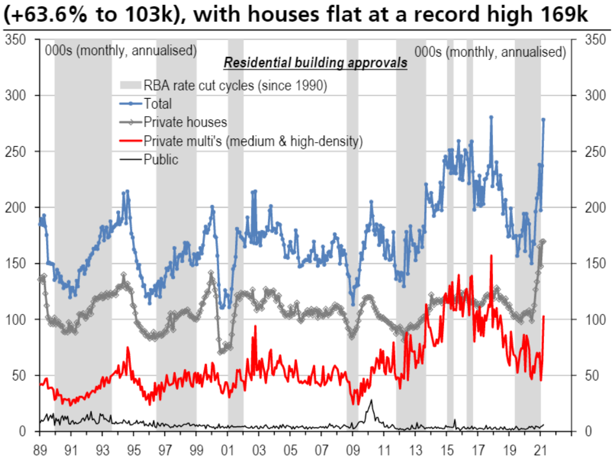
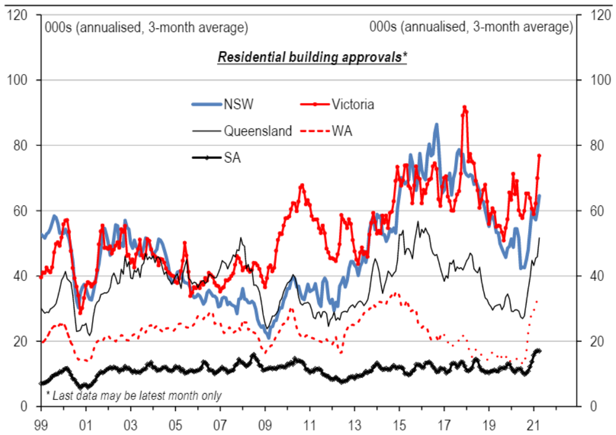


Figure 4: The increase in residential approvals has been broad-based over several months

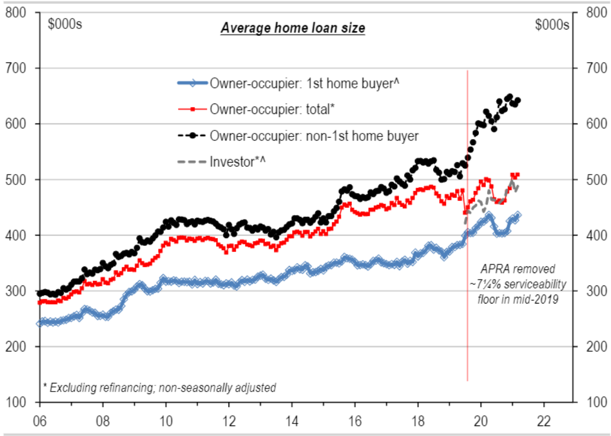


We believe that there are several factors driving the market:

- There is likely a pull forward of demand by First Home Buyers to beat the expiry in March of the HomeBuilder stimulus (which was tapered from $25k until Dec-20, to $15k until Mar-21). Importantly, the deadline to commence construction was recently extended – thus, activity should remain high over 2021;
- Very low unemployment rates. Employment outcomes coming out of COVID-19 have been strong. Australian employment increased by around 200k between December and March, and the unemployment rate declined to 5.6%. Of note, the recovery in employment has been broad based;
- Record low interest rates; and
- A situation whereby the lower rates are fuelling a greater willingness to borrow at a time when APRA has also removed the serviceability test for new loans.

We have included charts on the impact of serviceability ratios and long-term interest rates on the following page.

Charts: the relaxation of serviceability tests combined with low interest rates and solid employment have boosted house prices.



Source: ABS, UBS

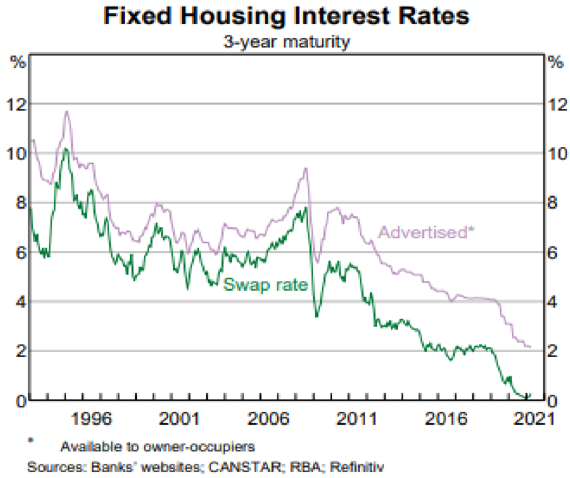


Table 2.1: Housing Price Growth

Percentage change, seasonally adjusted

	April	March	February	January	Year-ended	Past five years
Sydney	2.4	3.4	2.1	0.4	7.5	23
Melbourne	1.2	2.2	1.7	0.2	2.2	22
Brisbane	1.6	2.2	1.3	0.9	8.3	14
Adelaide	1.8	1.5	1.0	0.9	10.3	18
Perth	0.5	1.4	1.2	1.2	6.7	–9
Darwin	2.3	1.6	1.1	2.1	15.3	–10
Canberra	1.6	2.8	1.7	1.4	14.2	36
Hobart	1.0	3.1	2.1	1.5	13.8	56
Capital cities	1.8	2.6	1.8	0.6	6.4	18
Regional	1.9	2.2	1.8	1.4	13.0	24
Australia	1.8	2.5	1.8	0.7	7.8	19

Sources: CoreLogic, RBA

What does the RBA think?

For now, it appears that the RBA is more focused on jobs than house prices and any future mortgage defaults. In a recent speech to the University of Western Australia, the RBA Governor conceded that record-low interest rates are contributing to soaring house prices but warned governments and regulators that it is their problem to solve as the central bank focuses on driving down unemployment. Mr Debelle argued that while high house prices created problems, a lift in interest rates would hurt the jobs market even more.

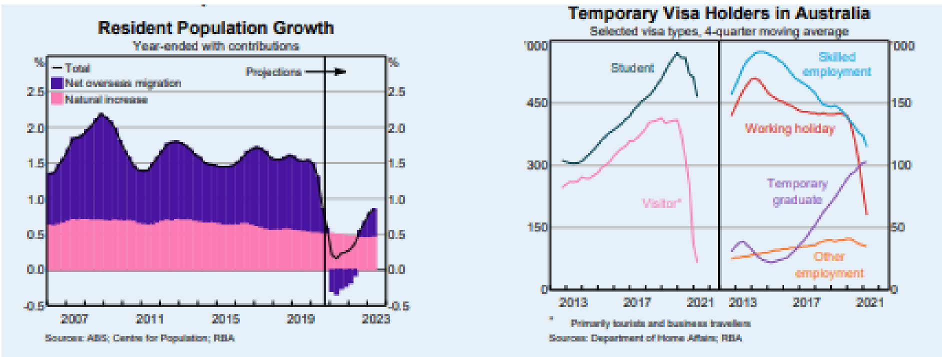
In the May 2021 Statement on Monetary Policy, the RBA stated: *"The current package of monetary policy measures continues to support the economy in part by keeping financing costs very low. Interest rates on business and housing loans continue to drift down from already low levels, which is positive for the cash flows of firms and households overall,"* and *"The Board is committed to maintaining highly supportive monetary conditions to support a return to full employment in Australia and inflation consistent with the target. It will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, the labour market will need to be tight enough to generate wages growth that is materially higher than it is currently. This is unlikely to be until 2024 at the earliest."*

Australia is not unique here. There seems to be increasing divergence between rhetoric from central banks on inflation (who seem unconcerned) and many corporates. At the Berkshire Hathaway Annual Meeting on 1 May, Warren Buffett said that, "We're seeing substantial inflation. We are raising prices; people are raising prices to us. And it is being accepted. We weren't expecting it." Buffet added that Berkshire had significant operations in housing and was now seeing the cost of construction materials rising. Proctor & Gamble also noted higher freight costs and commodity cost increases. The CFO said, "This is one of the bigger increases in commodity costs that we've seen over the period of time that I've been involved with P&G, which is a fairly long period of time". P&G has raised prices of some consumer products in the mid-to-high-single digit percentage range.

Population growth will be an important dynamic – immigration will return

For many many years, Australia has benefited from population growth that has exceeded many other advanced economies. Immigration has been an effective tool in addressing labour market shortages and driving economic growth by targeting specific cohorts, such as international students. Immigration brings many advantages but also a requirement to spend of essential infrastructure and demands for housing.

The pandemic has negatively impacted inward migration and population growth. It is expected that growth from immigration will be delayed rather than disappear. In the near term, it is the economic benefits of temporary visitors that Australia has missed (refer following chart). It is estimated that the decline in education exports alone subtracted almost half a percent from GDP. With interest rates at record lows, household finances and confidence in good shape and a business community that has shown the ability to innovate, we believe that the near-to-medium term prospects for the Australian economy and equities markets remain robust.



However, we believe that the attractiveness of Australia as a destination for immigrants will only increase when borders reopen. Australia's success in dealing with the pandemic relative to other countries has been immense. This, combined with the climate, stable government and wide-ranging career opportunities will appeal to migrants more than ever. In addition, we believe that many ex-pats will look to return home. In all, we think this bodes well for the housing market in the medium-term.

Stock in focus: Cedar Woods Properties

We believe that Cedar Woods Properties (CWP) will be a long-term beneficiary of Australia's sound economic outlook and demand for housing from robust population growth. CWP is currently held in the Contact Australian Ex-50 Fund. When we consider CWP across Contact's six investment fundamentals, we conclude the following:

Principal Activity: CWP was established in 1987 as a developer of planned master communities in Western Australia. The company expanded into Melbourne in 1997, Brisbane in 2014 and Adelaide in 2016. CWP offers diversification across region, price points and property type – a strategy that holds broad customer appeal and performs well in a range of market conditions. It has an enviable track record of disciplined land acquisition (often taking a counter-cyclical view) and quality development. CWP currently has 30 projects across the four states.

Income: CWP has a solid track record of profits and fully franked dividends. Pre-COVID, the group would pride itself on maintaining a growing dividend. We anticipate a growing income stream and CWP offers an attractive grossed-up dividend yield of >7%.

Financial Strength: Net debt was $152m with net debt to equity of 36% at December 2021, which is at the low end of its target range. CWP has a large land bank with c.10k lots spread across 30 projects. CWP's NTA at 31 December was $4.89, however the land bank is on the books at cost (roughly $20-30k per lot, so NTA is not a true reflection of the company's underlying value if realised at market rate). Earnings are expected to recover as settlements bounce back from some COVID-related delays.

Management: CWP has a stable and experienced Board/Management team. The Chairman/ Founder (William Hames) and Deputy Chairman (Robert Brown) have considerable alignment owning $82m worth of stock collectively. Contact values alignment highly. We believe that founder led businesses often outperform their peers and co-investors are rewarded.

ESG Considerations: Contact now utilises MSCI ESG ratings to help us form a robust opinion on ESG (Environmental, Social and Governance) considerations. CWP has recently been upgraded to an A rating with MSCI, which is equal to or better than almost 90% of its peers. MSCI noted that CWP recently implemented a Corporate Behaviour policy and has strong business ethics policies and practices relative to peers.

Valuation: We continue to see upside in CWP based on a range of valuation metrics. We note that, based on forward estimates, the CWP share price implied a negative 5% Earnings per Share growth into perpetuity. We believe that this discount, combined with assets underpinning much of the valuation, provides us with a margin of safety.

Recent site visit: Cedar Woods Properties, Glenside, Adelaide

Glenside is a 16ha, $400 million, 1,000 medium/high density home development, located 2.5km from the CBD of Adelaide. This urban infill project is well serviced by road transport being on major roads Fullarton and Green Hill. There are excellent retail and amenities in nearby suburbs and the site has a great blend of used historic character buildings (heritage) and natural parklands. The project commenced in 2017 and is expected to run for 10 years. CWP has teamed up with Renewal SA who leads urban renewal in Adelaide on behalf of the Government of South Australia.

Contact was given a site tour and walk through of the development by the Glenside Project Manager including Stage 1 "Botanica" which has reached Practical Completion (PC) with all lots being sold. Stage 2 "Grace Apartments" which has also reached PC with only 3 apartments left to be sold. And Stage 3 which will reach PC by the end of June, sales in Stage 3 have also exceeded expectations. Stage 4-12 will take CWP another 8-10 years to complete.

Glenside's Project Manager (PM) explained to us that "The site had attracted good support from the community and the council. It forms part of the "30 Year Plan for Greater Adelaide". He also noted, like all other areas of the country, house prices have grown significantly in this area over the last 12 months. CWP are trying to meet the market where they can on pricing and have also been able to "*meet the market with re-designs of two-bedroom apartments into three- bed options*."

Cedar Woods produce good quality builds. *"We never cut corners on quality. My name is on this project and I want to deliver the best possible product. I've been here from the start of this project and want to be here in 10 years when we finish".*

All apartments had Smeg appliances, fixtures and fitting were of a high standard and finished well. There was top quality landscaping and common areas were very appealing. Digital and keyless access had been installed and e-commerce facilities were available to all residents. Architects used on the development are local firms Studio Nine and Hames Sharley and Home Builders used are Sarah Homes.

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