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LARGE FORMAT RETAIL

Linking the Housing Market to LFR

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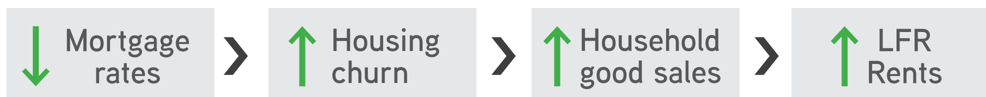
Summary

The Large Format Retail (LFR) sector has come under an increasing level of scrutiny, as regulatory measures, designed to address medium term risks associated with the domestic housing market are implemented. Our analysis demonstrates that a relationship between the housing market and LFR sector exists, specifically, an inverse relationship between mortgage rate movement and LFR rental growth. However, while the establishment of such a relationship paints a subdued outlook for the LFR sector on face value, our analysis also demonstrates that the upward movement in mortgage rates required to meaningfully reduce LFR rents is material, and unlikely in the medium term. In this regard, the outlook for the LFR sector in terms of rental growth is far less bearish that some recent media headlines suggest.

How do mortgages rates impact LFR rents?

Although it is difficult to create a direct correlation between the movement in mortgage rates and the performance of LFR rents, it is still possible to map out a series of events that would reasonably imply a relationship between the two. Essentially our thesis is that mortgage rates influence the availability of capital flowing into the residential market, which is reflected within the measure of housing churn (transactions involving existing housing stock, and lending associated with the construction and purchase of dwellings). As housing churn picks up, so too do the sale of household goods such as furniture, electronics, whitegoods, hardware items, building materials and garden equipment. In turn, increased household goods sales lead to increased earnings for tenants in this sector, enabling them to expand and pay higher rents.

Since 2013, the below relationship has broadly held true:



However, a possible risk facing the LFR sector, is the reversal of this relationship, as policies are introduced to alleviate price inflation within the domestic housing market. In this case the opposite chain of events could play out:

Connecting the dots between housing and LFR

While the direct relationship between mortgage rates and LFR rents is not statistically significant, the relationship between other variables is significant, especially when looking a higher frequency data points over longer periods.

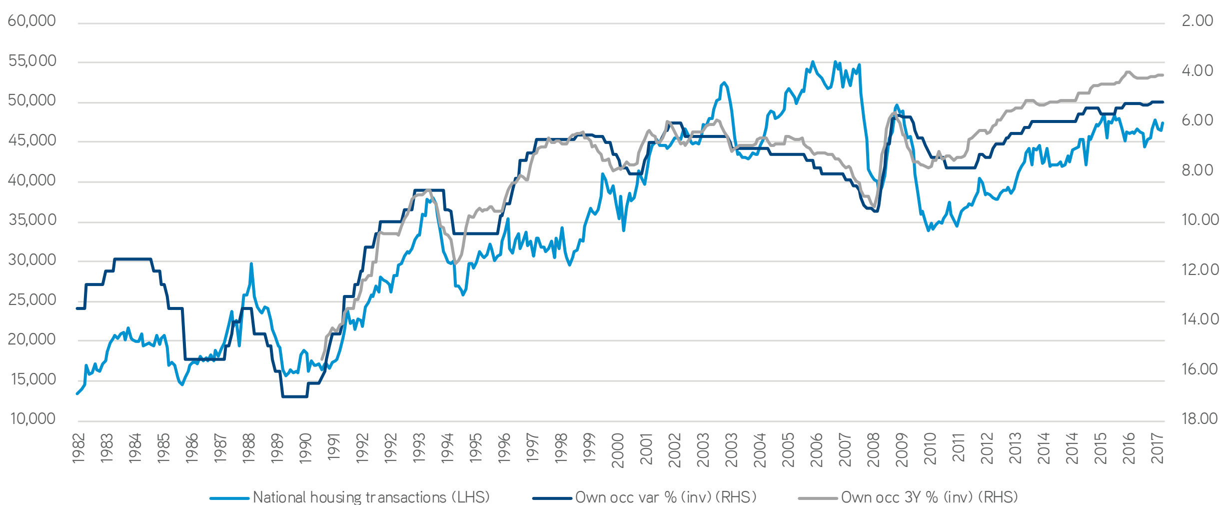
1. The dependency of housing churn on mortgage rates

To examine this relationship, we looked at housing churn. Specifically, this refers to the purchase of existing dwellings, rather than the construction of dwellings of the purchase of new dwellings. The number of transactions within the pool of existing housing stock is far higher (86% of total) than those being constructed (8% of total), or those that are new (6% of total). As part of housing churn, we also look at lending finance, specifically finance used for the purchase and construction of new dwellings, which is a much larger pool of funds, relative to finance used only for alterations and additions.

For mortgage rates, we specifically used the standard variable lending rates and 3-year fixed rates for owner occupier mortgages. These have the longest time series (back to 1959 and 1990 respectively) vs investors (only since 2015).

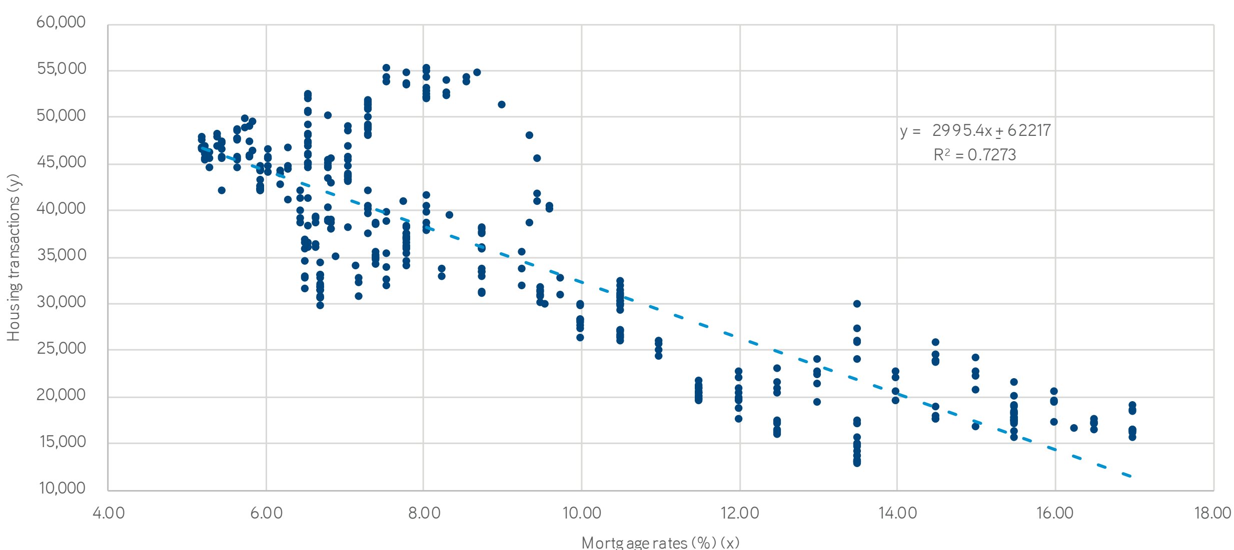
Our charting reveals the negative relationship between these factors. Note the mortgage rate time series are inverse, which is supported by our regression analysis implying that almost **73% of the movement in housing churn is explained by the movement in mortgage rates.**

National housing transactions (#) vs mortgage rates (%)



Source: ABS / RBA

National housing transactions (y) dependency on mortgage rates (x)



Source: ABS / RBA

2. The dependency of household goods sales on housing churn

There are several factors that drive household goods sales, although we have found that housing churn (transactions involving existing housing stock, and lending finance associated with the purchase and construction of dwellings) hold some of the strongest relationships from a statistical standpoint.

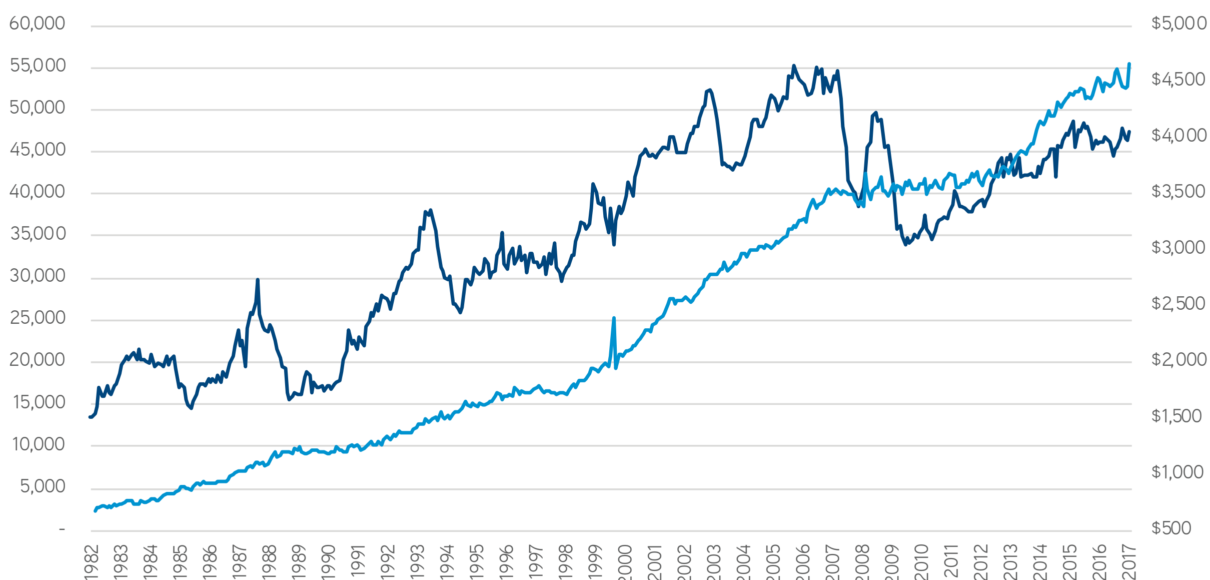
In terms of household goods sales data, there wasn't an overwhelming difference in correlation across various household goods categories, therefore the total was used. See example of New South Wales correlation matrix;

HOUSING TRANSACTIONS

HH GOODS	NSW Construction	NSW purchase new	NSW purchase existing	NSW TOTAL
NSW furniture	-27.27%	55.83%	69.21%	**67.45%**
NSW electrical	-32.56%	57.74%	72.04%	**69.80%**
NSW hardware, building & garden	-32.94%	56.20%	71.84%	**69.49%**
NSW HH GOODS	-31.60%	57.44%	**72.10%**	**69.93%**

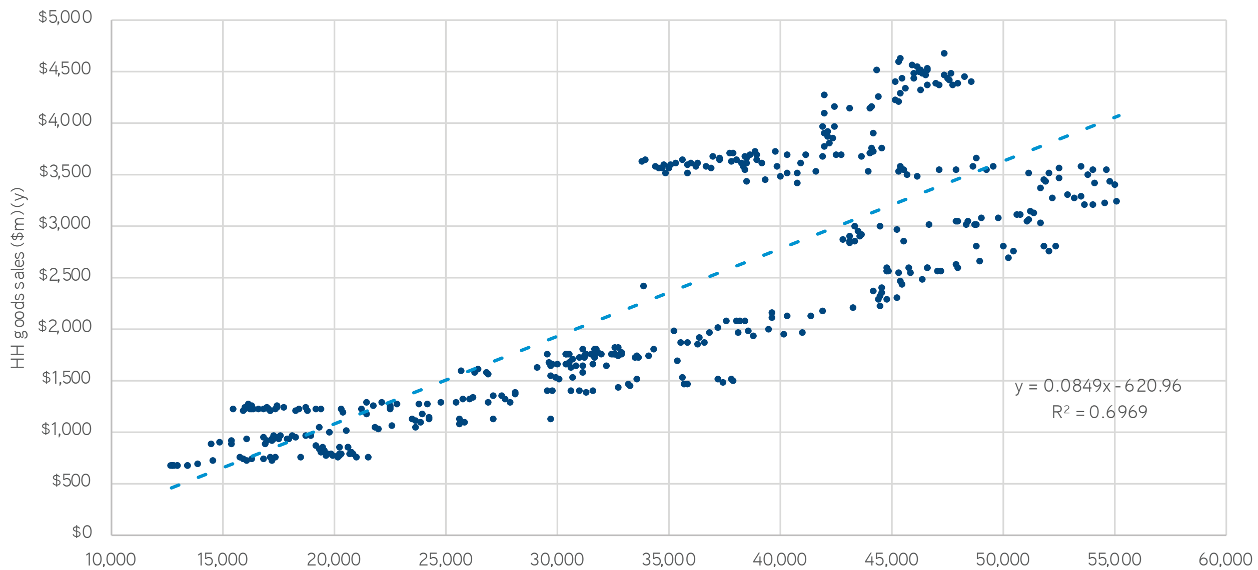
Charting of these variables also reveals a fairly strong positive relationship which was supported by our regression analysis implying that **almost 70% of the movement in household goods sales is determined by residential transactions within the pool of existing housing stock.**

National housing transactions (#) vs HH Goods Sales ($m)



Source: ABS

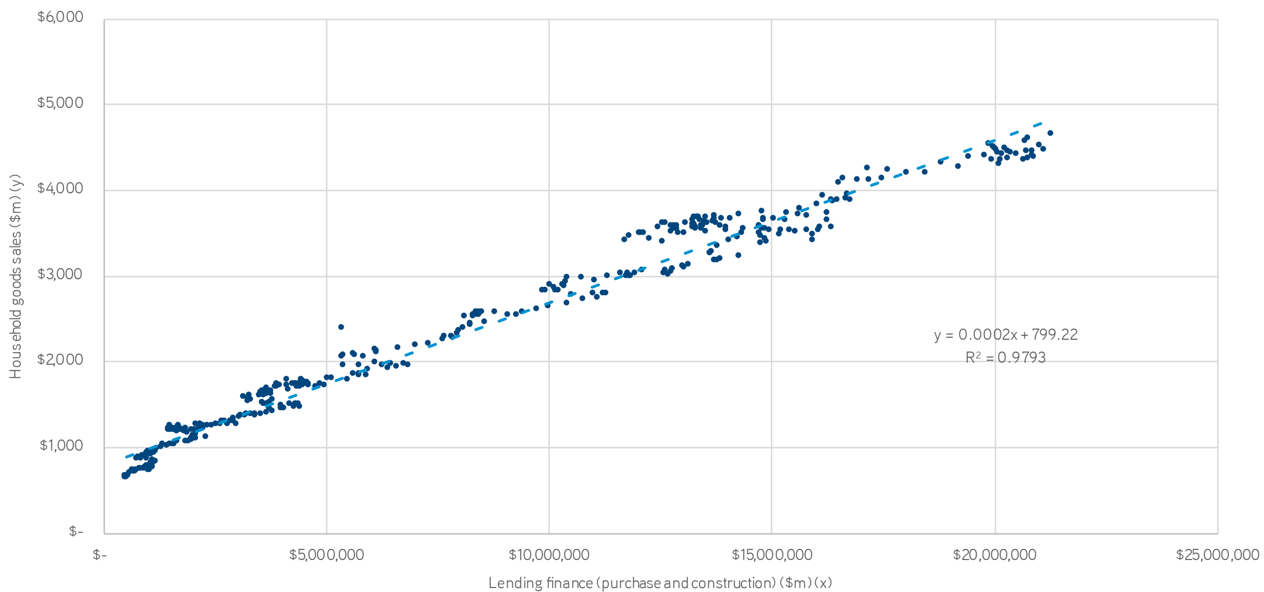
Household goods sales (y) dependency on national housing transactions (x)



Source: ABS

There was also a very strong positive relationship between lending finance (associated with the purchase and construction of dwellings), and household goods sales. In this case, regression analysis suggested that almost **98% of the movement in household goods sales is determined by housing related lending finance.**

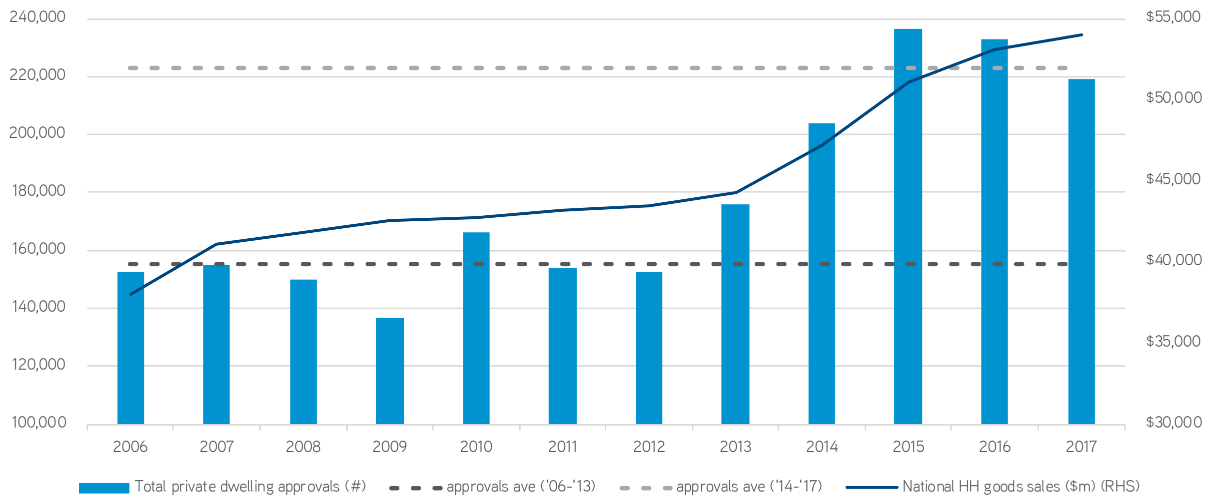
Household goods sales (y) dependency on lending finance (x)



Source: ABS

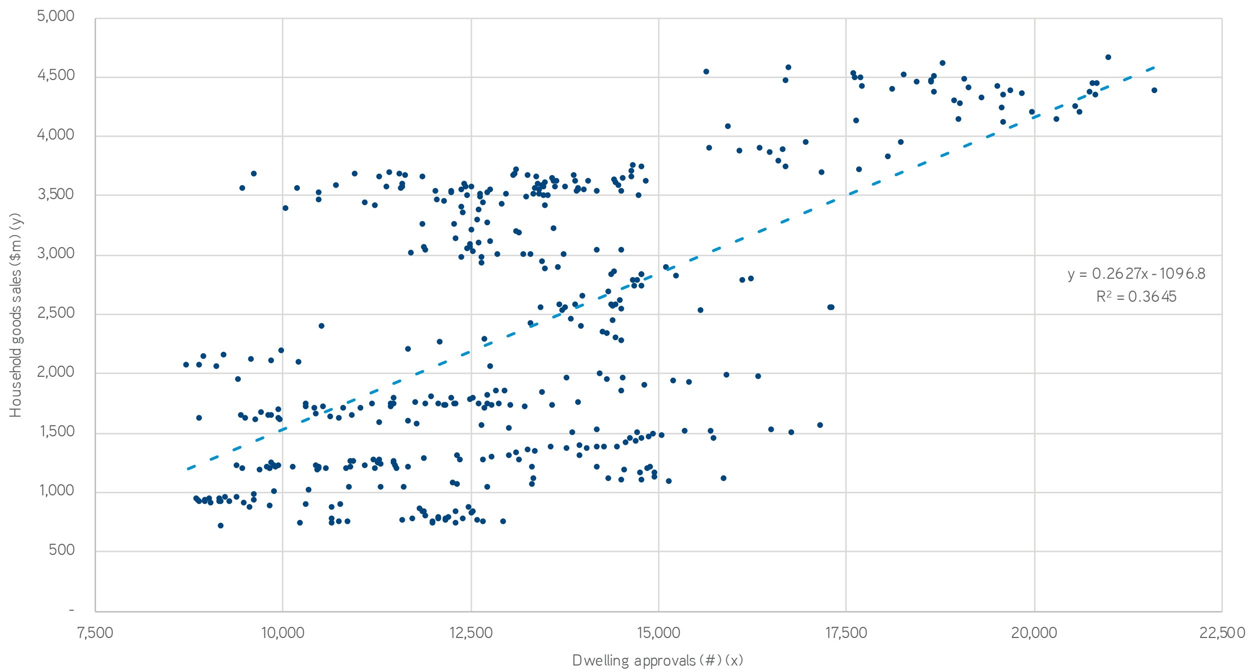
We note there are other factors that could reasonably impact the sale of household goods such as; house prices, dwelling approvals, and population growth. However, while these factors make logical sense, the relationships are not statistically significant in the manner demonstrated by housing churn. For example, the correlation between household goods sales and dwelling approvals is only 60.37%, while the R2 is only 36.45%.

Household goods sales vs Private dwelling approvals (annual totals)



Source: ABS

Household goods sales (y) dependency on dwelling approvals (x)



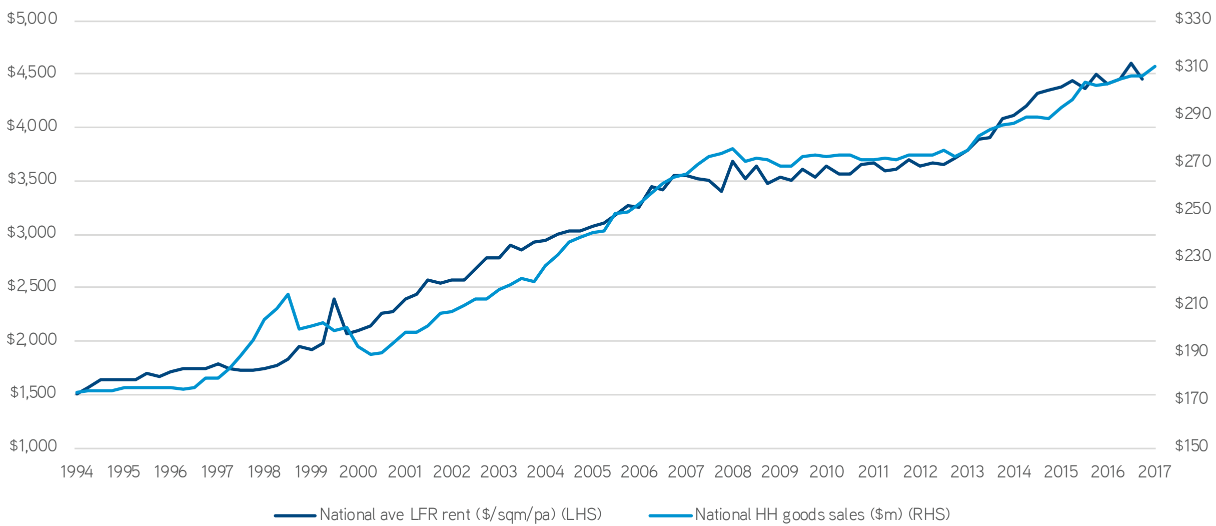
Source: ABS

3. The dependency of LFR rents on household goods sales

Quarterly LFR gross face rental series dating back to 1994, paired with household goods sales revealed one of the strongest statistical relationships.

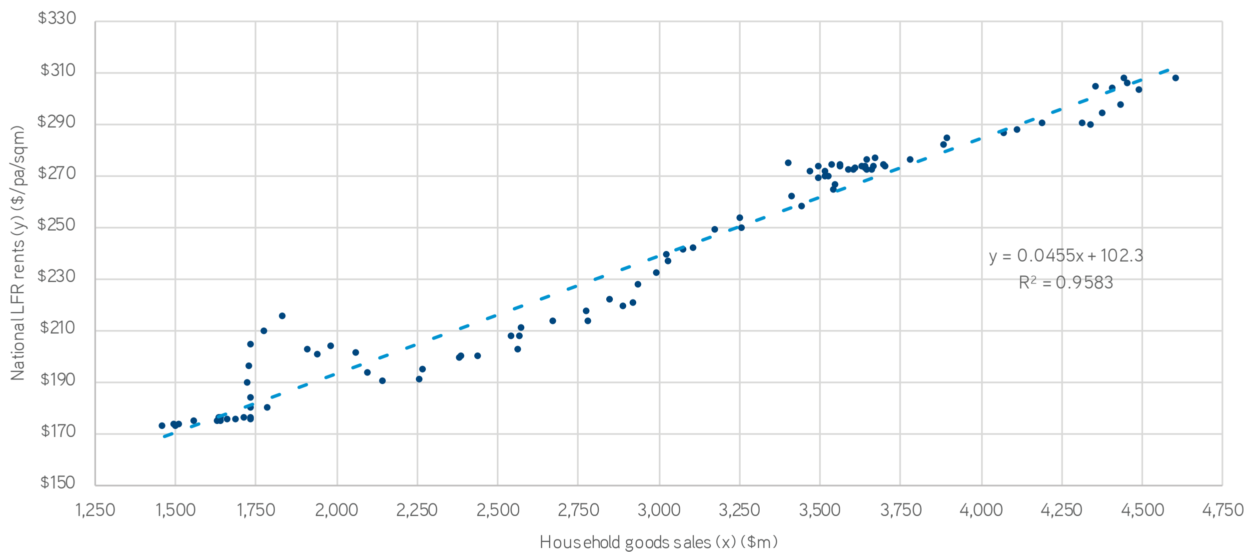
Charting and regression analysis revealed a strong positive relationship between these two variables implying that **almost 96% of the movement in LFR gross face rents was attributable to fluctuations in total household goods sales.**

National HH goods sales ($m) vs National ave LFR gross face rent ($/sqm/pa)



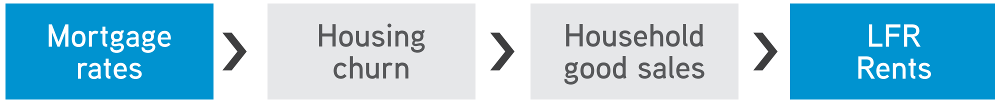
Source: ABS/Colliers Research

National LFR rent (y) dependency on household goods sales (x)



Source: ABS/Colliers Research

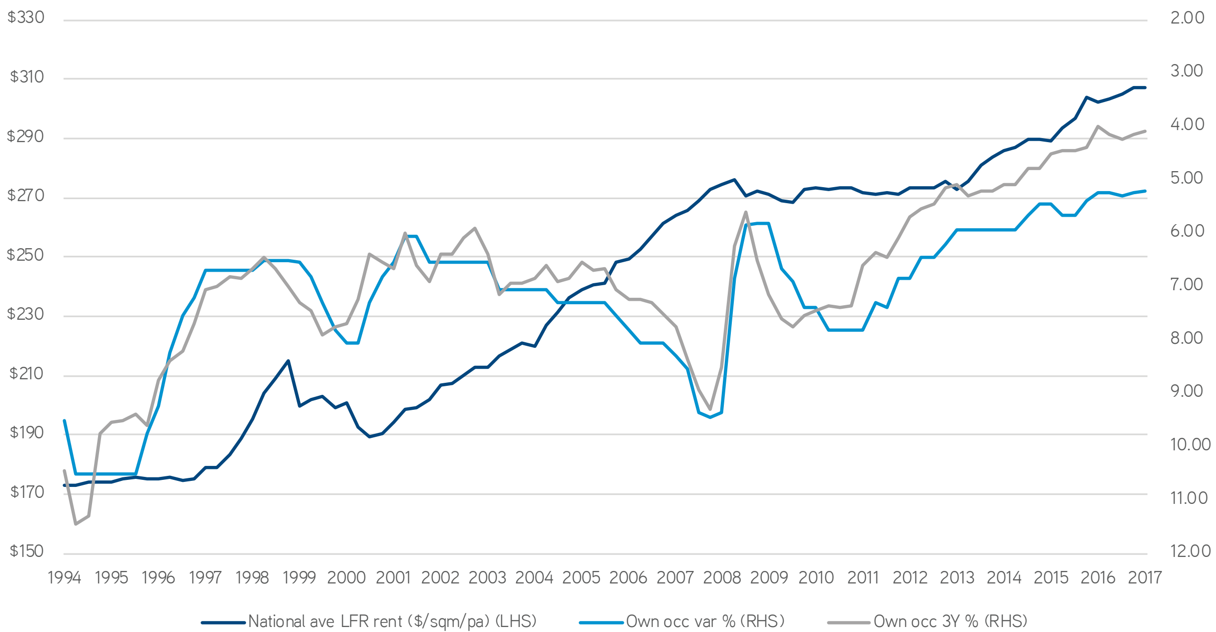
What about the direct relationship between mortgage rates and LFR rents?



While the discussion so far steps us through the relationship between mortgage rates and LFR rents, a direct relationship is harder to prove.

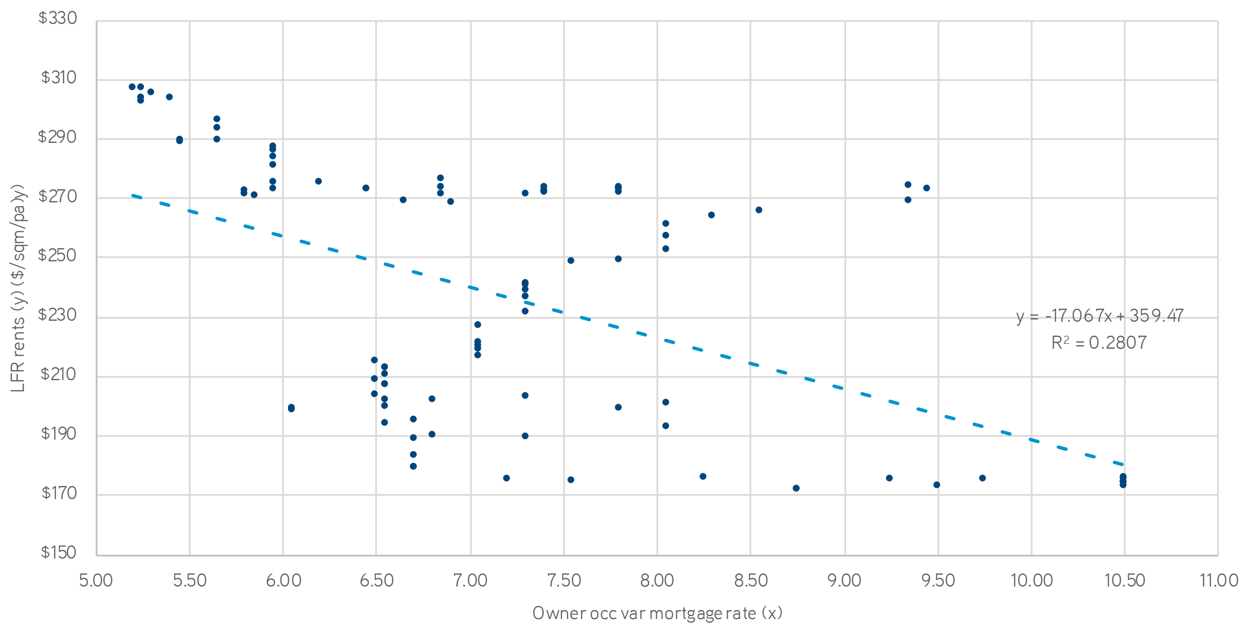
Regression analysis between the two reveals quite a weak direct relationship, implying just 28% of LFR rent movements are affected by mortgage rates. Charting the quarterly data shows a resemblance of a relationship, but the relative volatility of the mortgage rates compared to the smoother, less volatile LFR rental series explains this weakness.

LFR rents ($/sqm/pa) vs Mortgage rates (qtrly)



Source: RBA/Colliers Research

LFR rents (y) direct dependency on mortgage rates (x)



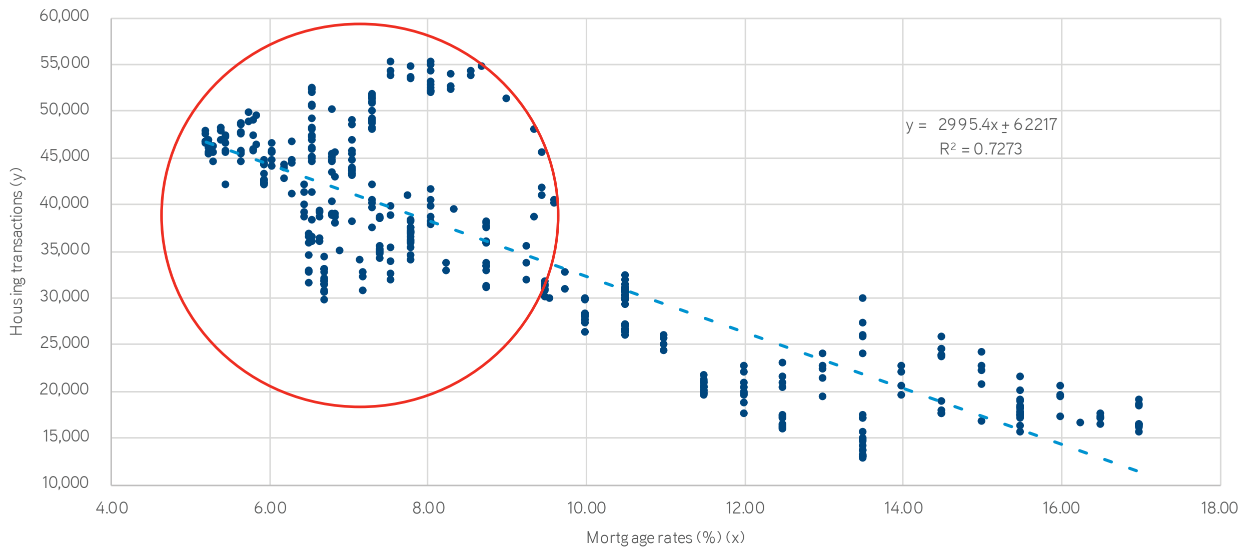
Source: RBA/Colliers Research

Would mortgage rates ever move high enough to impact LFR rents?

So yes, we have established that an inverse relationship exists between mortgage rates and LFR rents, but how high would mortgage rates need to climb before housing churn **slowed convincingly**, setting off a series of events that would, according to our thesis, lead to lower LFR rents?

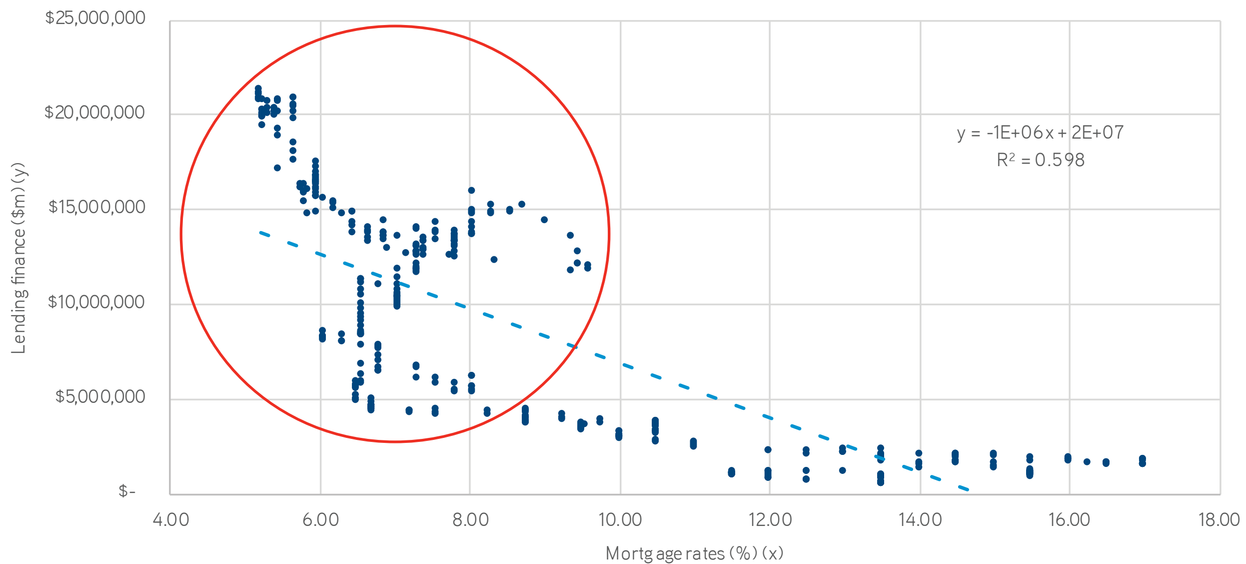
Taking a closer look at the following charts can assist in answering this question.

National housing transactions (y) dependency on mortgage rates (x)



Source: ABS / RBA

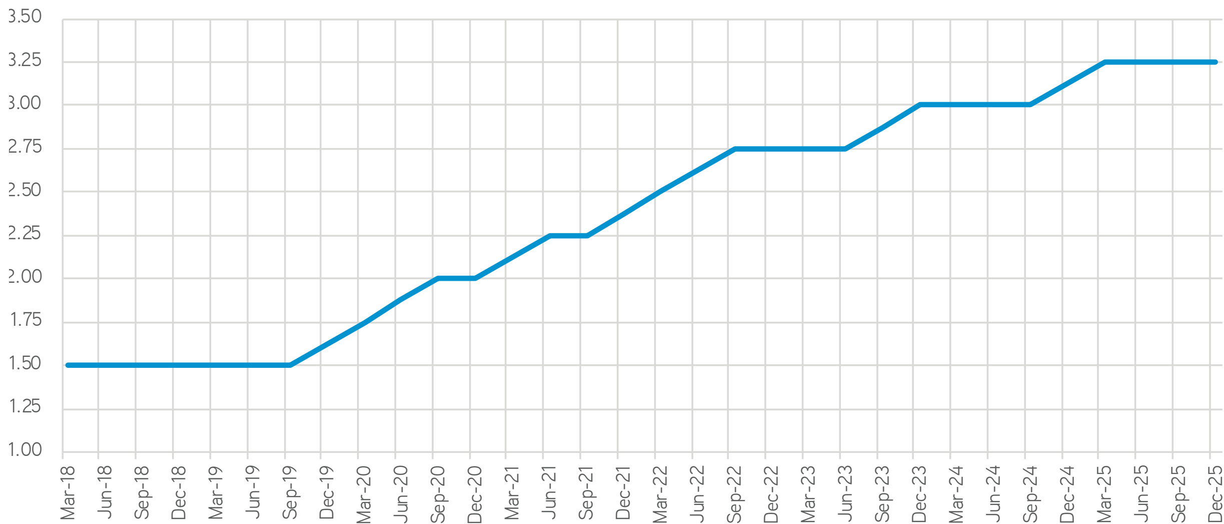
Lending finance (y) dependency on mortgage rates (x)



Source: ABS / RBA

It appears that a statistical relationship only starts to convincingly take hold after standard mortgage rates (as tracked by the RBA) move higher than 9 per cent, far higher than current levels (5.2 per cent according to RBA data). Until these more extreme levels are reached, housing transaction volumes and housing related financing deals appear to be somewhat inelastic, hovering around long-term averages. In this respect, the relationship is far less certain when standard mortgage rates as documented by the RBA remain within the range of 5-9%.

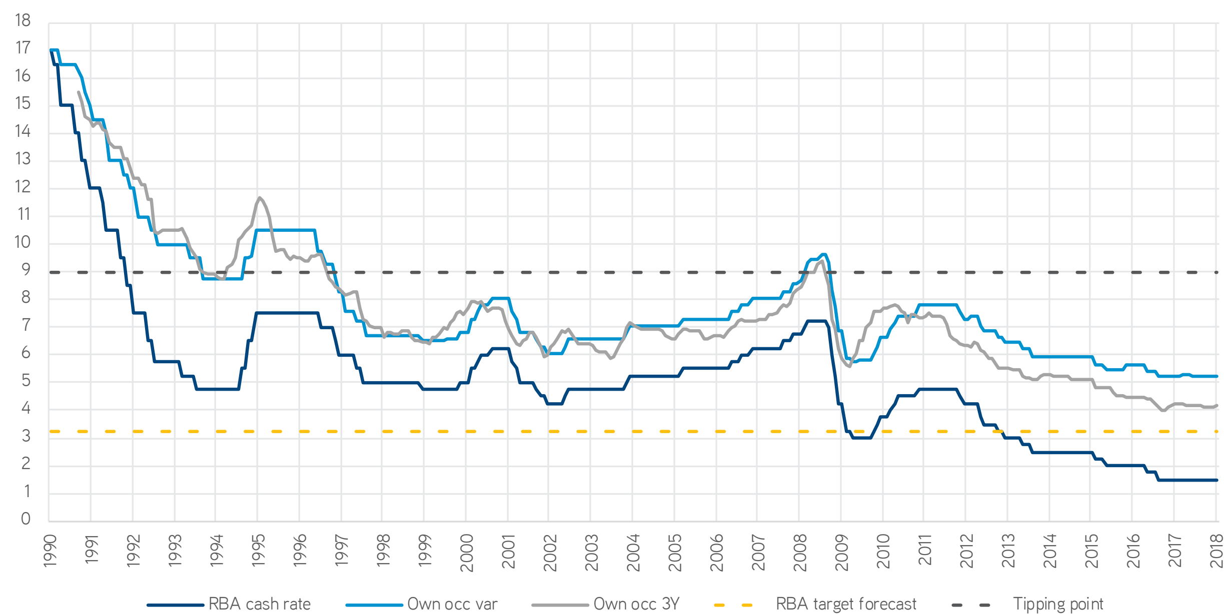
Cash rate target forecast (%)



Source: Oxford Economics

Even when we factor in the possibility of a higher RBA cash rate, the likelihood of these standard mortgage rates breaking through 9 per cent appears remote. Oxford economics are currently forecasting a move higher in the cash rate from late 2019, eventually reaching 3.25% by 4Q25. At this elevated level, corresponding standard mortgage rates, have historically only reached a range of 6.05 – 6.65%, far lower than the 9% tipping point, highlighted within our analysis.

Mortgage rates vs RBA cash rate (%)



Source: RBA

Conclusion

Our analysis demonstrates that it is possible to create a statistical relationship between the national housing market and the LFR sector. While a direct relationship between mortgage rates and LFR rents appears to be weak on face value, we can connect the dots through a series of logical relationships (mortgage rates, housing churn, household good sales and LFR rents), that are indeed statistically significant.

At first glance, the establishment of such a relationship between mortgage rates and LFR rents paints a subdued outlook for the LFR sector, particularly in the current economic climate where the consensus outlook for global interest rates is shifting higher.

However, upon further analysis we highlight that even though an inverse relationship exists, mortgage rates would need to move meaningfully higher before LFR rents commence a convincing shift lower. In fact, standard mortgage rates (as tracked by the RBA) would need to lift from current levels of 5.2 per cent to above 9 per cent (>380bps), which appears unlikely, even after factoring in incremental hikes to the RBA cash rate from 1.5 per cent currently to 3.25 per cent by 2025.

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