Charter Insight

Currency Exposure & Off-The-Plan Apartment Sale Contracts

A Case Study of Chinese Purchasers

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RESEARCH

The volume and nature of Off-The-Plan (OTP) contracts for new apartments in Australia is continuously evolving in response to currency exposure and exchange rate movement for international purchasers.

The recent decline in currency exchange and its impacts has highlighted the potential impacts on international purchasers' propensity to settle.

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OTP PURCHASE PROCESS IS DIFFERENT

Off-The-Plan (OTP) contracts for new apartments share conceptual characteristics with Forward Contracts. These contracts are primarily designed to hedge price risk for the developer through the market cycle between contracting and settlement. The OTP process is also a means to satisfy financiers' requirements for pre-commitment to a significant portion of apartments prior to commitment of funds for construction.

OTP contracts can exist over an extended period, with 2 - 5 years typically between the points at which they are contracted (purchased) and settled (transferred). Sale prices for OTP contracts are nominal and, importantly, they are expressed in the denomination of the currency where the real estate is actually situated.

MELBOURNE APARTMENT MARKET STATUS

Melbourne's new apartment market has become increasingly exposed to offshore purchasers, which has been reinforced by the participation of international developers. Residential apartment projects completed by international developers have also been of a larger scale than domestic developers, which has increased the number of OTP contracts exposed to international purchasers as well as extending the inter-settlement period for these projects (see Figure 1).

According to Charter's proprietary apartment database, 4,100 apartments in Melbourne's Central City Region (CCR) were completed in 2015. Although these contracts settled in the current market environment, some of these projects commenced selling in 2011 when market conditions, expectations and relative purchasing power of offshore purchasers were significantly different to that which existed at the point of settlement (Figure 2).

Of the 5,770 apartments anticipated to be completed and settled in the CCR in 2016, 35% are contained in projects undertaken by international developers, while 58% are contained in projects which commenced marketing prior to 2014.

It is evident that as international developers have become more active in the Melbourne apartment market, so too has the market become more exposed to offshore purchasers.

Large scale projects are inherently exposed to a longer period between contracting and settlement meaning that the time dimension of foreign exchange risk is therefore also greater.

CASE STUDY: CHINESE OTP PURCHASERS

The relative pricing of OTP contracts to offshore purchasers (with currency exposure) has rarely remained consistent with the contracted price. This is due to the variance in settlement periods and fluctuations in relative pricing derived from shifting currency values through the inter-settlement period.

The relative value of the Australian Dollar (AUD), to the Chinese Yuan (Yuan), has been in decline since 2011, with an acceleration in this decline since 2013. Due to this decline, and the nature of delay between contracting and settling of OTP contracts, Chinese purchasers have been settling under more favourable conditions than those under which they purchased. These circumstances have reduced the relative nominal price for this increasingly significant cohort of purchasers.

Figure 1: CCR Project Size and Settlement Period by Developer Origin

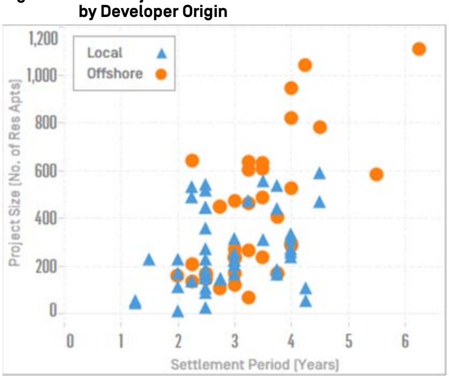
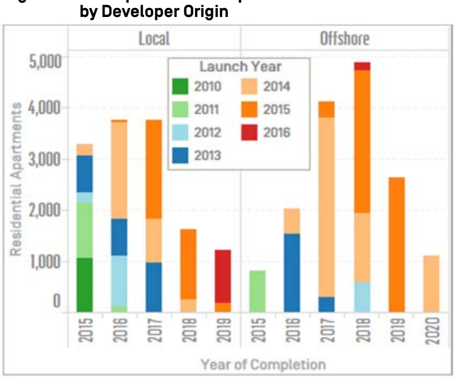


Figure 2: CCR Apartment Completion and Launch Year by Developer Origin



SOURCE - Charter Keck Cramer

CHINESE CONTRACTS - MOVING FROM "IN THE RED" TO "IN THE BLACK"

The declining AUD relative to the Yuan has largely benefitted those purchasers whose contracts have settled since 2013. As the nominal terms of the contract remain unchanged, the declining value of the AUD has proportionally reduced the effective sale price and balance of funds required to settle.

The potential financing obligations for Chinese purchasers will have also been reduced if the purchaser funded the sale through a combination of debt and equity.

INDIVIDUAL CONTRACTS - INDIVIDUAL IMPACTS

While real estate prices have become relatively cheaper to Chinese purchasers through currency depreciation, the benefit to these purchasers has potentially occurred from years prior. This is due to the settlement lags introduced by the OTP sales process.

It is therefore critical to understand that as contracts settle they must also be considered in the context of the market conditions under which they were contracted to adequately quantify how prevailing market conditions may impact at the point of settlement. Contracts that settled through 2015 have had an approximate 20% - 35% currency benefit depending upon whether they were contracted 2 years or 4 years prior (Figure 3).

Ultimately, given the differing inter-settlement periods affecting projects settling at the same time (as well as contracts within the same project entered at different points in time through the marketing campaign), it is simplistic to assume that prevailing market conditions at settlement will impact all settling contracts equally. Some will experience greater or less benefit (or moving negatively) compared to others.

It is therefore clear that settlement risk relating to purchasers whom contracted previously may not be materially impacted by negative market conditions at the point of settlement.

SHORT TERM OUTLOOK FOR RECENT PURCHASERS

Chinese purchasers settling over the next 2 - 3 years (contracted through 2013 - 2015) will be likely to be settling under more favourable pricing conditions than they were contracted. This benefit will also likely extend to other international purchasers.

It is important however to note, assuming a relationship between offshore purchasers and offshore developers, that the significant proportion of these sale contracts are not due to settle until after 2016.

This lag allows some time for current market volatility to moderate, or for (Chinese) government policy that may materially constrain relevant cross-border capital flows to soften before the higher levels of settlements commence.

Any devaluation of the Yuan will only create settlement risk insofar as the relative shift is significant compared to the exchange rate at the time the sale was contracted. Recent volatility has demonstrated that despite devaluation of the Yuan, there has been a greater softening of the AUD. This has resulted in a net appreciation of the Yuan against the AUD, which highlights the importance of considering the secondary, and not just direct impacts of currency movements.

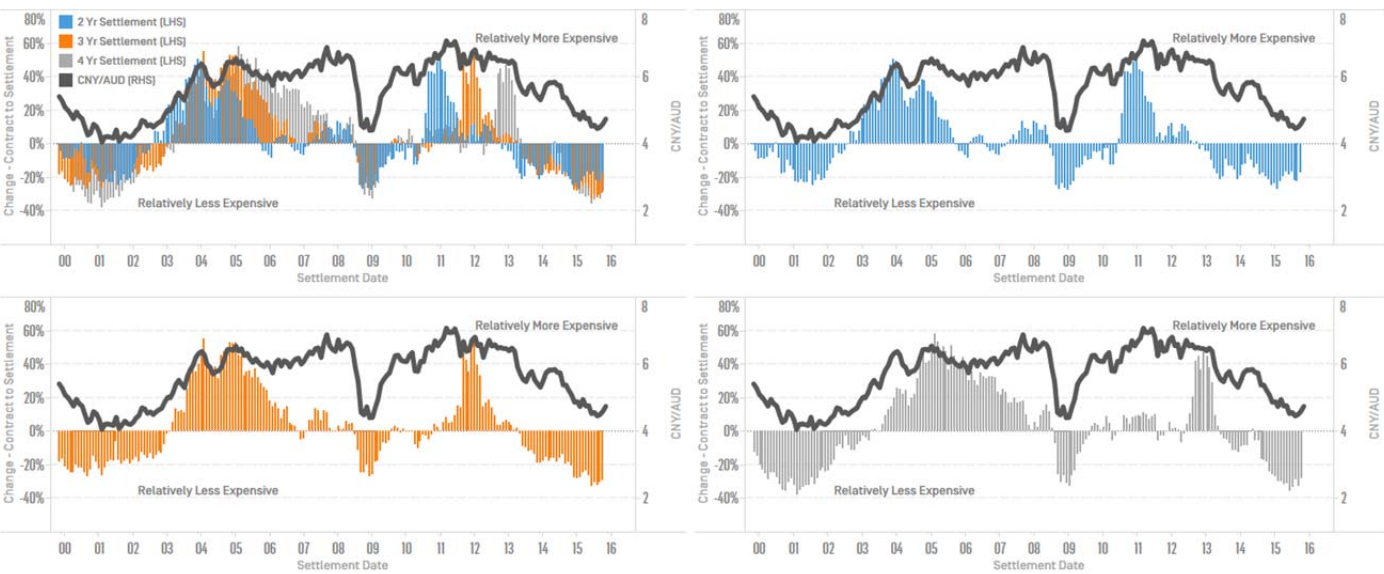
In the short term, the most prevalent potential risk to settlement of offshore OTP contracts is likely to be due to the limiting of capital outflow directed by Chinese government policy rather than local real estate market conditions.

OUTLOOK FOR FUTURE CHINESE PURCHASERS

With potential strengthening of the Yuan relative to the AUD, new Chinese purchasers will benefit from favourable currency movements. This however will be contingent on the long term strategy implemented by the Chinese Government as they move to a more freely traded Yuan.

There remains a firm prospect that future Chinese purchasers of new apartments in Australia will buy relatively more cheaply than current prices.

Figure 3: Proportional Change Between Purchase and Settlement, CNY/AUD (Two, Three and Four Year Settlement Period)



SOURCE - RBA, Charter Keck Cramer