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# Central City Apartments – Looking Beyond Today

*On a range of measures, Docklands can be considered as the best performing precinct in the Central City Region which includes the CBD Grid, CBD North, Southbank, St Kilda Road & Docklands precincts …*

Melbourne's apartment market has arguably been Australia's most maligned property segment over the past year. Accordingly, informed consideration is needed to bring some facts and perspective to the discussion rather than it being based on compounding, and sometimes misleading, anecdotes about oversupply, falling prices and abandoned projects that grab the headlines. This Insight aims to provide a forward-looking perspective based on the fundamental drivers of the Central City Region market.

It is undeniable that the market is experiencing a short-term correction, a predictable outcome of overheated conditions in 2001 – 2002. Just as predictable as the current situation was, proper regard for the fundamental factors underlying the market indicates a return to balance of the supply – demand equation beyond the present uncertainty as the cycle inevitably turns upwards– the question is when?

**Current Conditions and Sentiment**

*Negative sentiment in 2003 was reinforced by incessant coverage of RBA warnings and bad news property stories; ASIC and ACCC investigations of a high-profile property marketeer and the consecutive interest rate increases late in the year …*

The apartment market will not implode as some suggest. The extent of the correction since mid 2002 when the Reserve Bank began warning about the overheating conditions is definitely overstated due to the height and inevitable short-term unsustainability of the preceding peak. Sentiment since mid 2002 has been impacted by the compounding effects of several events that have threatened to create, or at least the perception of, a self-fulfilling prophecy of doom.

**The drivers of long-term sustainable demand**

The evolution of Melbourne's apartment market since the early 1990s has been primarily driven by long-term trends relating to population growth, household structures and housing preferences. These fundamentals will continue to generate sustainable community demand for more apartments, particularly as the community becomes more accustomed to the concept and its benefits. The lifestyle attractions of apartment living in high-amenity locations and the suitability of the apartment form to growing population segments (such as singles and couple households) will continue to drive occupier demand, from owners and renters alike, irrespective of property market conditions.

*Changing residential preferences have stemmed from significant shifts in social and cultural norms as well as from smaller households …*

Long-term investors have also demonstrated an appetite for apartments due to a growing pool of rental demand ranging from students to young professionals. The appeal of central city living is further enhanced by unsurpassed accessibility to education, employment, lifestyle and entertainment opportunities. The availability of generous tax incentives along the way also reinforced investor demand.

**Some Facts and Observations**

The following points provide a broader and factual understanding of the market:

*The median price of a new OTP 2 bedroom apartment has moved from $270,000 in 1998 to $550,000 in 2003 …*

- This apartment market is still a relatively immature property segment with 16,300 completed apartments that account for only just over 1% of Melbourne's total housing stock. Its evolution has been rapid and its size will continue to grow significantly from 1,300 in 1990 to 24,000 in 2006;
- Prices of new off-the-plan apartments have virtually doubled between 1998 and 2003 driven by increased demand but perhaps more significantly, by higher construction costs;
- Peak demand occurred in the 1999 – 2003 period when an average of 2,960 apartments p.a. were sold off-the-plan (OTP). Despite the negativity surrounding the market in 2003 it is estimated that there were still 1,900 OTP sales, importantly, equal to the long-term annual average sales rate;
- In 2003, developers released only 1,500 apartments down from 4,500 the preceding year.

**Figure 1:** Apartment Completions, OTP Sales & Releases

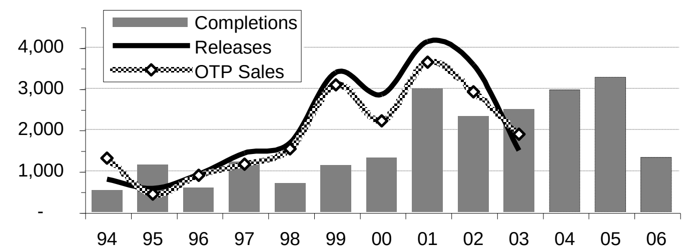
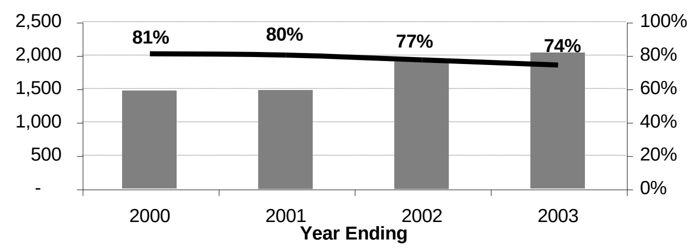



**Figure 2:** Number of unsold apartments (RHS) and Absorption rate (LHS) of apartments in projects Completed, Under construction or Marketed



Some additional facts that further explain the current and future conditions include:

- At the end of 2003, there were 1,100 unsold apartments under construction with a further 700 in marketed projects; and
- 82% of all apartments under construction at the end of 2003 have already been sold OTP.

*Positive sentiment in 2001 – mid 2002 overrode the signals of caution suggested by the market fundamentals (high supply, climbing vacancy, rampant price growth) which were virtually disregarded by many investors in the rush to secure a piece of the action…*

**Influence of speculative demand (short-term)**

The market will never be immune from cyclical fluctuations and inevitably there will be periods when demand is inflated by speculators. Such an aberration occurred in 2001 - 2002, driven by the following:

- *Economic* – prolonged prosperity, historically low interest rates, outperformance of property relative to other assets, increased home equity, easier finance;
- *Demographic* – fearful baby boomers seeking quick-fix to superannuation inadequacies;
- *Policy* – reduced Capital Gains Tax, attractive tax and depreciation benefits, OTP stamp duty savings.

Such an environment created a period characterised by the herd mentality of speculators driven by "irrational exuberance" and unrealistic expectations of large capital gains over the short-term.

*Gen X singles and couples are seeking more flexible living arrangements and their lifestyles are far removed from a generation ago resulting in different housing needs …*

**Future sustainable demand**

Charter estimates that around 35% of historic apartment demand has been attributable to owner-occupiers. Other than for during the recent peak, the majority of investor demand is attributed to long-term investors. Speculative investors constitute around 15% of demand during periods of normal market activity but up to 35% during peaks. On these assumptions, it is calculated that an average sustainable demand for 1,380 apartments p.a. has historically been generated from owner-occupiers and long-term investors. Such a level is still expected to persist in the future although annual sales volumes may vary from this average. The validity of this estimate is confirmed by comparison to the average demand of 1,050 apartments during 1994 – 1998 when the then immature market was also subject to some uncertainty related to fears of potential oversupply and the 1997 Asian financial crisis.

*Off-the-plan sales were introduced by a more risk-adverse property sector to keep a balance between demand and supply by requiring a minimum level of OTP sales prior to construction …*

**Is this debate too late?**

The current debate has come too late given that it largely focuses around the predictable consequences of an unsustainable level of demand during the past peak. The market must now deal with the consequences of the inevitable unwinding of events that occurred 2 - 3 years ago given the in-built time lag created by OTP sales. The reality is such that OTP purchasers form the most significant group of purchasers in the market's relatively short history. Furthermore, they will also be faced with the reality of having to execute their commitment in a period of unprecedented media commentary.

*As the apartment market has matured there has been increasing segmentation by price, location, size, design, finishes, project size, views and a range of intangible factors …*

**The risks and outlook for different market segments**

Whilst it is sometimes necessary to generalise, it is imperative to recognise the different outlooks for specific product and purchaser segments. Greatest risk still relates to highly-geared purchasers with inadequate financial resources to service holding costs. Those engaged in multiple holding strategies or heavily reliant upon realising high capital growth over the short-term face greatest risks. Such speculators are usually attracted to secondary projects containing generic apartments. Importantly, not all speculators fit this description given that the majority are likely to have the financial capacity to carry an investment for longer than may have been the initial intention.

Market risk relating to quality apartments with a clear point of difference, by design, location and a high concentration of owner-occupiers is considered low given the evident stability in the higher value market, the lesser sensitivity of owner-occupiers to interest rate movements and the scarcity of truly high-quality sites. Furthermore, capital values will be underpinned by the expectation of increased future construction costs. Quite clearly, the future cost of delivering luxury apartments will be higher than currently, implying that future prices will have to increase correspondingly.

*There is expected to be a greater propensity of more conservative longer term investors to ride out the short-term correction than sell into a declining market …*

The current state of the market suggests a predictable set of future outcomes. In the simplest terms, it is known there are around 1,800 apartments in current projects remaining unsold. It is also identified that there are 1,000 new apartments that have some prospect of release over 2004 – 2005. From the demand side, we can adopt an estimate of 1,400 sales p.a.. **It is therefore calculated, albeit crudely, that demand for new projects may again characterise the market by late 2005 as the supply pipeline of new stock diminishes in the interim. This does not suggest a return to the overheated recent conditions but rather, a sustainable balance between demand and supply.**

Undoubtedly there are short-term risks for purchasers, vendors and developers in the current market but there also is reassurance for those able to retain a medium-term perspective in their decision making rather than be dictated to, or confused by, current conditions. **The fundamentals of demand will remain in place regardless of short-term cyclical fluctuations that inevitably occur.**

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This Research Insight presents extracts from Charter's 'State of the Market – Residential Apartments in the Central City Region' which is now available. To find out more about the firm's full range of services including Corporate Real Estate, Strategic Research, Valuations, Quantity Surveying / Tax Depreciation and Development & Project Management contact:

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