September 2003 **Melbourne's Apartment Market – Facts and Misunderstandings**

Melbourne's Central City apartment market has also gained the attention of policy makers at the highest levels …

Melbourne's property market has proven a hot topic of discussion in recent times across the broader community. Within such discussions, focus inevitably turns to the Central City residential apartment market, despite it representing only 1% of Melbourne's total housing market !

Given the extent and diversity of opinion expressed about this market, a number of misunderstandings have inevitably emerged, particularly in relation to Docklands and Southbank. Furthermore, in a vacuum of reliable information, the issues related to "oversupply" and "abandoned projects" have almost become enshrined in the market's thinking with little industry debate.

The Central City differs significantly from surrounding suburbs (i.e. Carlton, South Yarra, Port Melbourne) despite the common experience of recent apartment development in that the latter have always been primarily residential …

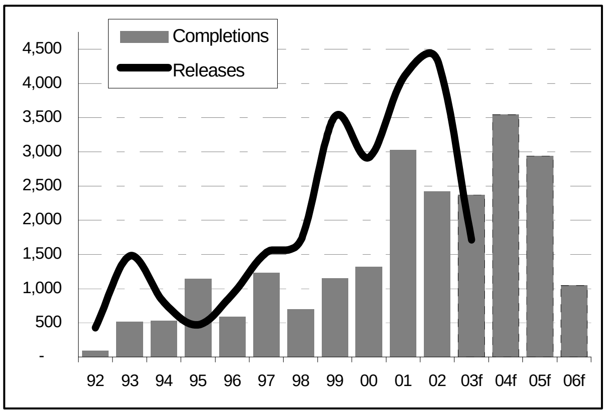
Firstly, Some Facts

Charter defines the Central City apartment region to be the five contiguous precincts of the CBD Grid, CBD North, St Kilda Road, Southbank and Docklands. From the demand perspective, off-the-plan sales in 2003 have slowed although still tracking near the long-term average of around 1,950 sales p.a.. This reduction not only reflects poorer purchaser sentiment but also a significant drop in new releases (Figure 1). The current slowdown needs to be put into perspective by recognising that any slowdown from the recent unsustainable peak, where an average of 3,040, sales p.a. were recorded, will always appear overstated.

From the supply perspective, there was a total stock of just over 14,400 completed apartments as at July 2003. This stock has grown significantly from less than 1,400 apartments in January 1993 and has doubled since January 2000. Based on Charter's current forecasts, the stock of completed apartments will further increase by 66% to 23,900 apartments by the end of 2006, with completions peaking in 2004.

Figure 1:

Central City Region: Historic and Forecast Completions & Releases of Residential Apartments



At July 2003, there were 6,330 apartments under construction and 3,110 being marketed. The future supply pipeline is well stocked with just over 17,000 apartments in Planned and Mooted projects. The reality however is that very few of these projects will be offered in the current cycle. This quantum of **potential** future stock does not form the basis of a "supply bubble".

It is significant that 86% of apartments being constructed have already sold off-the-plan with 55% in projects being marketed similarly sold. The overall absorption of 76% is higher than in January 2003 (71%) but still lower than the average of 82% recorded in the boom.

Oversupply of New Apartments – More potential than actual

The hype about oversupply has certainly impacted upon purchaser sentiment …

Despite the intense media coverage of "oversupply", this debate has perhaps incorrectly focussed upon the new sales market. "Oversupply", as it relates to this market should refer to a situation of an excess number of apartments remaining unsold upon completion relative to purchaser demand, thus leading to a significant fall in prices. Extensive research on resales over the past decade conducted by Charter however shows that apartments have typically had marginally stronger price growth than underlying inflation.

Current conditions are better described as "potential oversupply" due to high levels of unsold apartments being restricted to marketed projects. The number of unsold apartments has certainly risen, from 1,500 in January 2000 to 2,290 in July 2003 and such a situation is unsustainable. One of the potential outcomes is "oversupply", but only if all of the currently marketed projects proceed to construction without adequate precommitment. Too often, this is not acknowledged in the verdict of the market's impending death !

Between September and December 2002, 14 new projects containing 1,800 apartments were released …

The reality is that although the market has been subjected to an unprecedented rate of new releases through 1999 – 2002, there was a corresponding increase in underlying demand. In the second half of 2002 however the market became imbalanced with the overhang of unsold apartments reaching historic highs as the broader Melbourne residential market also began to slow. The prevailing high level of stock overhang, although it has moderated slightly, is a legacy of this period.

It is arguable that the suspension of projects at the pre-release stage represents a properly functioning, self-regulating market to restrict the build up of unsold, completed supply …

The notion of oversupply has become perpetuated because of the failure to recognise that the new apartment market is unique – demand must be expressed prior to the delivery of a project. If a minimum level of precommitment (usually 70%) is not demonstrated via the off-the-plan sales process, it will simply not be built because financiers will not provide construction funding nor will developers proceed at such risk and therefore an accumulation of unsold, completed apartments is prevented.

Another commonly cited, but incorrect, reason for suggesting that Melbourne's apartment market is entering "oversupply" is because of the high levels of building approvals in the Central City. Misinterpretation via the simplistic assumption that approvals will translate into construction does not hold for large apartment projects as it fails to recognise this industry's fundamental workings. Whilst approvals data is a reliable indicator of short-term future supply in the broader housing market, comprised primarily of single dwellings in the suburbs, its applicability to the apartment market must be questioned. There is a much greater complexity of issues needing to be resolved in the period between the approval and delivery of a multi-storey apartment project when compared to the much simpler process for a single dwelling.

There is no oversupply of completed apartments relative to purchaser demand because projects now reaching completion are typically entirely or near sold at the point of completion.

Oversupply of Rental Apartments – Yes, it is happening

Interestingly, VicUrban statistics for July 2003 indicates a much lower vacancy rate of 3.2% for Docklands …

However, the notion of oversupply in the current environment is perhaps an apt description for the situation relating to completed apartments relative to rental demand.

Charter's research has found a fall in rents across nearly all segments of the market regardless of apartment type and location with a 5% decrease in the overall average rent ($378 p.w. for H1-2003). Furthermore, the REIV's preliminary measure of vacancy in the Central City Region (8.2% for the June 2003 quarter), suggests that there is currently an excess of rental apartments relative to demand. Whilst underlying rental demand is growing, it will not increase at the same rate as new rental stock with a peak vacancy expected in 2005 resulting in downwards pressure on rents.

The Central City market has a much higher concentration of more mobile renters relative to the typical renter in the suburbs resulting in more churn of the dwelling stock …

The potential fallout from this situation could undoubtedly be severe. However the majority of investors are still expected to take a longer-term view and accept the lower income returns and minimal capital gains over the short-medium term rather than sell at low prices. The continuing positive economic environment, lack of investment alternatives and prevailing taxation regime also supports this conclusion. It is recognised that while there will be a percentage of over-exposed owners forced to sell due to their inability to service loans, this percentage with respect to the overall apartment market will be small.

Abandoned Projects – Not due to market failure

Several recent articles suggest that Melbourne's landscape should be littered with abandoned apartment projects, with one article reporting more than 10,000 apartments sitting in shelved projects with virtually all being in inner Melbourne. Such a suggestion is grossly misleading as it fails to recognise that these projects almost exclusively relate to projects that have yet to reach the marketing phase, let alone construction, and are often controlled by speculators. Furthermore, the majority of such projects would never pass initial financial feasibility tests applied by any experienced and prudent developer.

Misreporting of abandoned projects has reinforced negative sentiment and undermined purchasers' confidence in the delivery of projects …

The apparent "abandonment" of projects has come about primarily because of rising construction costs and the resultant impact upon project feasibility rather than due to a lack of purchaser demand. Other major factors include a combination of poor design; secondary / compromised location; and lack of developer experience. Interestingly, some of the most highly publicised shelved projects in Melbourne were diversely located from the beachfront at Port Melbourne to Doncaster Hill rather than in the Central City Region.

Whilst it is acknowledged that there have been some failed projects in the Central City Region, Charter's analysis indicates that of the 123 projects (containing 16,480 apartments) released since 1999, only 9 projects (1,300 apartments) have been subsequently withdrawn. These figures indicate that only 8% of apartment stock released since 1999 has failed after being offered to the market with 86% proceeding. Going forward, it is likely that 2 projects (1%) released in 2002 will not proceed. Interestingly, despite the negative press, all projects launched at Docklands have been built or are still expected to proceed.

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This Research Insight presents extracts from Charter Keck Cramer's just released **'State of the Market – Residential Apartments in Melbourne's Central City Region (July 2003)**. This Report provides a comprehensive market overview and further explores these issues in greater depth to quantify the facts and tests some of the widely held beliefs and assumptions.

Charter Keck Cramer offers detailed briefings by engagement. 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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