Charter Insight

COVID-19 Impacts to Date

Off-The-Plan Apartment Sales & Settlement Risk

September 2020
charterkc.com.au

CHARTER. KECK CRAMER

RESEARCH

The COVID-19 outbreak has spurred an exceptional headwind for the development industry. Exceptional given the widespread economic impact as well as the unfamiliar and unpredictable path associated with such a significant global health crisis. Consequently, it is important to explore just how considerable an effect it has had, will continue to have, and how best to navigate through such an unprecedented level of uncertainty.

Ben Carter
Property Research Analyst
E ben.carter@charterkc.com.au
T +61 (0) 3 8102 8843

To gauge the response of Melbourne's off-the-plan residential apartment market to date, we have assessed projects in metropolitan Melbourne which are at two key stages of their lifecycle. Firstly, apartment projects that are early in their marketing campaigns; and secondly, those which have reached the settlement stage.

'Off-The-Plan' Apartment Sales

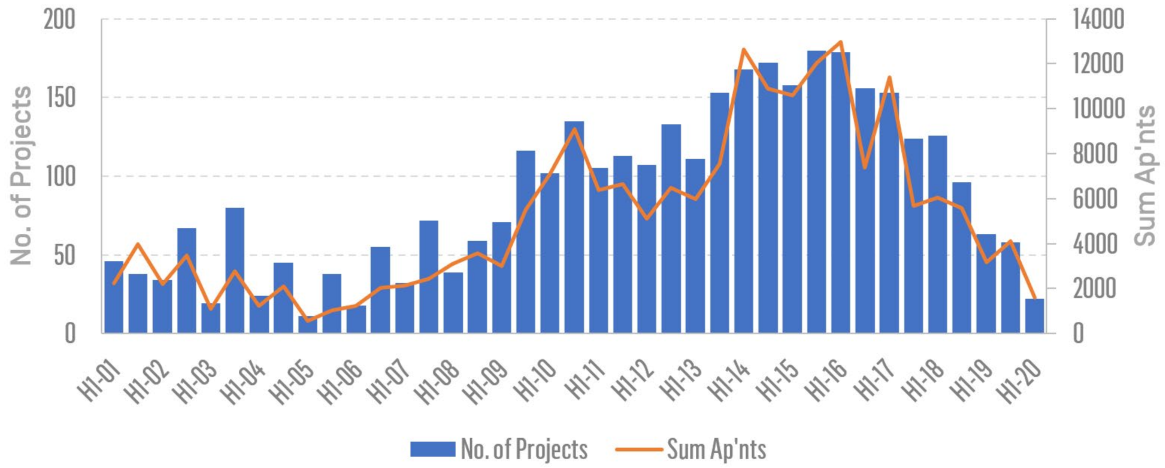
The sales velocities of off-the-plan apartment projects have remained generally buoyant since restrictions were first introduced in March – a testament to selling agents and developers who have grappled with impositions on traditional operations as well as a growing level of anxiety among prospective purchasers.

Based on a sample of projects launched during the first half of 2020, approximately 40% of all apartments had been pre-committed. Sales rates presented strongest in small-scale owner-occupier specified projects within Melbourne's inner suburban 'lifestyle' suburbs. Although much of this absorption relates to the downsizer market, it also includes a sizeable and seemingly growing proportion of first home buyers. This is a cohort which, looking beyond the short-term implications of the pandemic, is attracted to the lifestyle and amenities these suburbs offer but which is priced out of the local established housing market. In conjunction with historically low interest rates, the federal government's HomeBuilder scheme has empowered first home buyers to engage in this sub-market. Given HomeBuilder's contract price cap of $750,000, it has promoted a large volume of two-bedroom apartment sales within projects that meet the construction timeframe stipulations.

While this instils a level of optimism, overall sales volumes are down on pre-pandemic conditions – akin to the established housing market – and velocities for individual projects have been buoyed by the declining supply of new apartment projects entering the market.

Unsurprisingly, we have seen a steepening of the already prevailing downward trend of apartment projects being launched. 1,607 apartments were released across 22 projects from January 1 to June 30. This is the lowest volume of apartments to be offered to the market in a six-month period since 2006 (see Figure 1 next page).

Figure1: Historic Apartment Releases – Metropolitan Melbourne



Source: Charter Keck Cramer

Many projects that were intended to launch since March have been placed on hold, as developers await containment of the outbreak and gain confidence in an economic rebound. Despite the number of projects waiting in the wings, apartment supply will be slow to return due to the lag on delivery paired with a declining pipeline of approvals. Depending on the momentum that migration numbers return, Melbourne's dwelling supply may well be tested - fuelling tightened vacancy rates, rebounding rental yields and capital growth.

However, while state border restrictions may be eased in the short to medium term and spur interstate purchaser demand, national borders are likely to remain closed for an extended period. Subsequently, we can expect a subdued level of demand to be the new norm until containment of the virus is achieved more globally.

While housing demand generated by migration and foreign interest is crucial to Melbourne's residential market, projects geared towards the owner-occupier market are sequestered to a certain degree from volatility in this regard. This stability is underpinned by local demand brought about by demographic change and presents in the type of projects being released as well as those which exhibit the strongest sales velocities in the current environment.

'Off-The-Plan' Apartment Settlement Risk

Melbourne is currently in a state of peak apartment completions (see Figure 2 below).

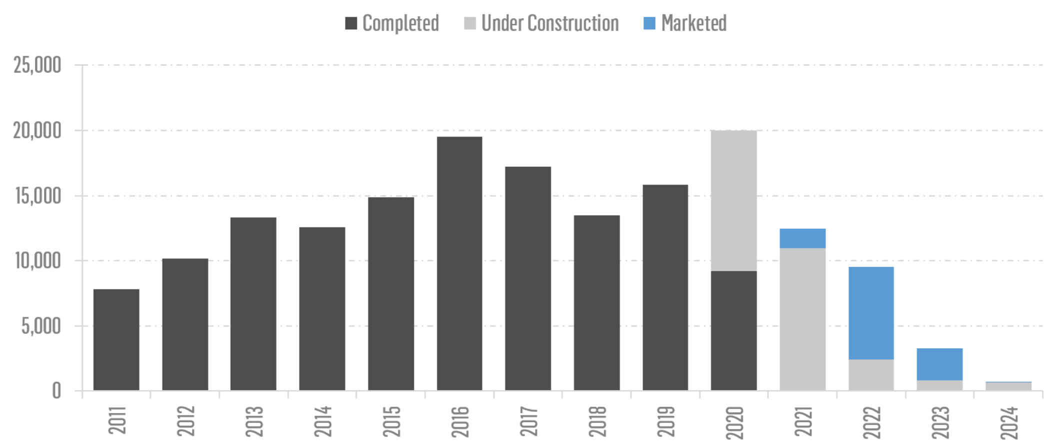
Pair this with the adverse economic impacts of the pandemic and it is understandable that there is growing anxiety from developers and lenders over settlement risk.

Research undertaken by Charter assessed a number of apartment projects which have settled since March and has revealed an average settlement default rate of close to 10%.

While the pandemic has evidently generated a heightened level of settlement risk for Melbourne's apartment projects, it is important to understand that this has not presented equally across all segments of the market. For instance, boutique projects that have a purchaser profile dominated by local owner-occupiers have demonstrated little to nil evidence of COVID-19 related settlement risk. This relates in particularly to downsizers – a cohort with greater financial insulation from the adverse monetary impacts of COVID-19 and who are less reliant on bank finance. Furthermore, these are purchasers who are less concerned by market indicators (ie. vacancy rates and rental yields) which might lead to increased discretionary risk among other purchaser groups.

Instead, the elevated default risk is shouldered by larger scheme projects which possess a diverse composition of purchasers – essentially, those projects relying on the dissipating investor market. Such projects have experienced a more arduous settlement process with levels of default ranging up to 15%. This is a notable increase on pre pandemic conditions. Evidently, developers are now more than ever needing to work closely with

Figure 2: Apartment Completions (Active Projects) – Metropolitan Melbourne



Source: Charter Keck Cramer

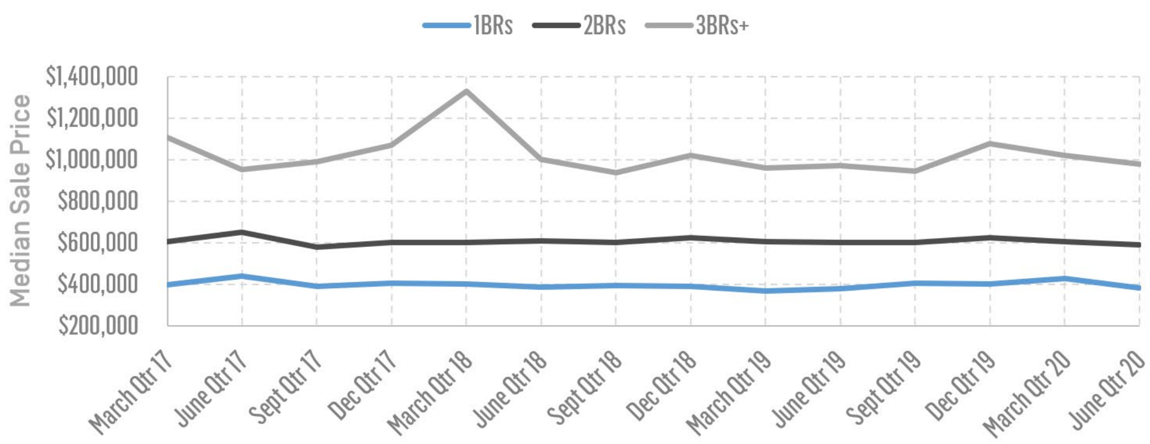
counterparties to deal with the increased challenges brought about by unfavourable valuations and evolving purchaser circumstances. In some cases, settlement dates are being extended to allow for greater navigation of these issues.

The unemployment rate climbed to a 22 year high of 7.5% in July. Purchasers who have lost their jobs or alternatively had hours reduced may have limited capacity to secure finance for settlement. Additionally, banks may reduce the amount they are prepared to lend as a result of increased due diligence regarding serviceability although this is partly offset by record low interest rates.

There is a justifiable nervousness surrounding downward price pressure and its contribution to mortgage valuations recording below the original contract price. Encouragingly, prices have proven generally resilient to date and there is scant evidence to support any significant deterioration Melbourne-wide. Despite this, certain sub-markets possess a greater exposure to the negative impacts of the pandemic and thus are susceptible to more explicit price declines. This is the case for Melbourne's Central City Region (CCR) due to its dependence on migration, particularly student arrivals, and to a lesser extent a pandemic induced trepidation towards high density forms of living. We do note however that migration factors have had a more direct and pronounced impact on the CCR's rental market compared to its capital values.

There were prevailing market circumstances separate from the pandemic which have contributed to the elevated settlement valuation risk at present. Many of the large scheme projects currently settling in Melbourne's CCR were launched at the peak of the property cycle during 2016 and 2017. These were endowed with a range of financial incentives including undisclosed discounting of prices, stamp duty concessions, rental guarantees, furniture packages and specification upgrades. While this led to price inflation at the date of sale, it meant contracts were naturally going to be exposed come settlement if there was limited price growth in the established unit market between the date of sale and mortgage valuation.

Figure 3: Established Unit Price – Melbourne's Central City Region 2017 – 2020YTD



Source: Charter Keck Cramer, Pricefinder

Apartment projects in Melbourne's CCR currently exhibit the highest levels of settlement risk. However, all projects are naturally exposed to a certain degree, even by the rigid requirements for settlement valuations themselves. This especially relates to the criteria stipulating the sales evidence that panel valuers can rely upon. Charter is equipped to help you better understand the comparable evidence available and how best to minimise risk in this regard come settlement.