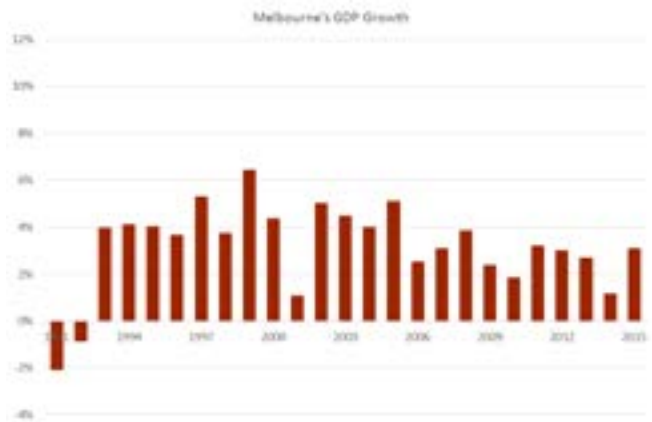
GRIMACING IN THE MOST LIVABLE CITY OF THE WORLD: MELBOURNE

Melbourne property investors have got their knickers all twisted these days. Especially those who had bet their hard earned monies on properties in and around this 5 consecutive winner of the most liveable city in the world. - DAN TOH



Today, reports are coming in about settlement valuations failing to match up to the prices sold years back throughout inner city Melbourne. Most average about 10-15% short but some as high as 30%. Rental yields have also dropped to approximately 4%, compressed by the overvalued sale prices. Just so you know, it used to be over 8% in the 1990s.

Many investors are perplexed about the market. How did this well accoladed city that stands heads above 140 other cities around the world and receives the highest number of international migrants find itself having the most blacklisted postcodes among banks lending on properties?

Some may deem that the problem lies in the oversupply of apartments. That is true as major Australian cities (barring Sydney since it's already fairly "apartmentalised") are transforming into urban metropolitan cities. Australia is looking to complete a total of 92,102 units over the next 12 months (Corelogic New Settlement Risk Report), and 231,129 units in the next 24 months. Of which, Melbourne's share is 29,541 units in the next 12 months and 80,503 in the next 24 months. The numbers are only slightly second to Sydney at 34,300 units in the next 12 months and 81,696 in the next 24 months.

However, more than supply conditions, which can be easily mitigated by the continual positive population growth over time, what is of greater concern about Melbourne is the geographical concentration of the developments in the inner city.

The boom in apartments over the last 10 years has mostly been driven by investment reasons and foreign investors were a significant portion of the buyers. To understand why that is the case we have to go back and understand how the Melbourne market evolved in the last decade.

During the GFC (Great Financial Crisis) in 2007-2008, the Australian government removed the limitation on developers being able to sell only 50% of any project to foreigners in an effort to encourage more foreign investments. However, banks providing construction loans stepped in, making it even harder by limiting foreigner participation in any single project to approximately 20%, citing excessive foreign settlement risks. That technically should have moderated the supply, but the market took on a life of its own.

Throughout the GFC, Australia's economy remained incredibly resilient when the other G20 nations were faltering into recessions. It demonstrated to the world that Australia is quite the safe haven in a global economic crisis. The Australian dollar was at a record low while the country's housing stayed strong and saw impressive growth. This, timed together with Melbourne's natural property cycle, which was at a stage where vacancy was sub 1% and yields were hovering around 6%, made Melbourne a prime candidate for foreign investments seeking safety and profits.

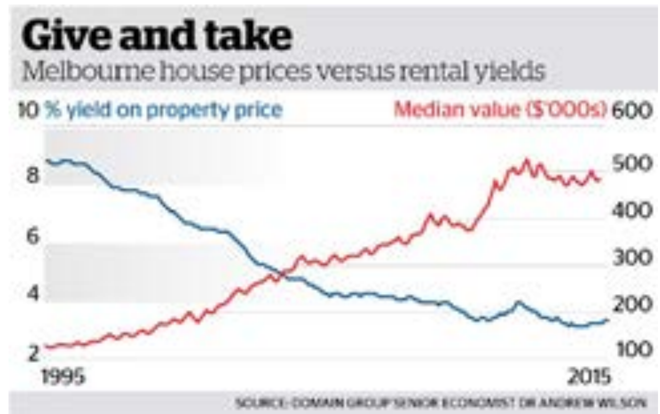
Foreign developers began to jump onto the Melbourne bandwagon. Those with strong cash positions or the ability to obtain capital without the need for Australian banks came. Without having to yield to Australian banks' restriction on number of foreigner sales, these developers built apartments in areas appealing to foreign investors and priced products according to foreign appetites instead of local market fundamentals.

The Melbourne property market soon developed into a dual track market. One supported by essentially foreign monies and the other driven by local economics. The former naturally skewed towards inner city areas and key Asian suburbs such as Glen Waverley and its surroundings.

Meanwhile in Victoria (where Melbourne is the capital city), the state economy was not doing great. The economic boom in Australia post GFC was largely driven by commodity and Victoria not being a resource state did not benefit as much. The state GDP was noticeably lower post GFC and the state government had to depend on housing construction to bolster the economy and employment. Wage growth remained fairly flat and hence rental affordability did not move in tandem with the somewhat unreal prices of new developments in the market.

The world then went into a lower interest rate environment with the EU crisis adding pressure on a global economy that was already weakened by the GFC. High yielding investment instruments were hard to come by and thus Australia's relatively high rental returns (even though by then the yields were compressed to almost 60% due to rising prices) looked attractive and the investment buying continued with the foreign developers making hay while the sun shines.

The mixture of macro and micro factors all contributed to make the Melbourne market what it is today. With rent failing to keep pace with prices, and resale prices (marked to local affordability and interest due to the fact that foreigners cannot participate in the resale market) significantly below marketed prices, banks began to see the risk and in the last few years tightened their lending policies to foreigners.



Today, investors are grimacing as the apartment projects in the inner city completes. Valuations are coming in 10-15% on the average below contract price. To add salt to the wound, banks are not lending more than 70%, or completely not lending to foreigners at all in Australia. Many are forced to source loans from offshore banks instead. Buyers are seeing their cash outlays doubling for settlements. That is beyond what some can bear and therefore we do expect settlement fall-overs to increase over the next 12-24 months.

The recent increase in foreigner levy to 7% (effective 1 July, 2016) is looking to further dampen foreign investment interest. Developers, particularly those banking on selling to foreigners, are now caught having to throw in significant incentives either to buyers or to the agents so as to move stocks quickly. We are seeing some developers, especially foreign ones, offering to agents prices as low as 15-20% below the list prices and allowing them to earn commissions based on how high they can sell the units, as long as it is at or below the list prices. In view of the distress, the government has also halted development permits in the inner city.

Why, you may ask, would the Victorian government not see that coming and stop the development permits earlier to avoid such a distressing situation? And why would they start constraining the markets now when it seems to be already in trouble?

Well, the truth is, every government's primary concern is about its economy and its people. Foreign investors are often pawns used to achieve socio-political and economic stability. Investors need to realise that foreign investor interest is seldom of significant concern to the governments.

Today, the Australian economy has shifted. With the AUD now at a low, the Australian market is no longer about commodity export but tourism, education, manufacturing and dairy. Victoria's GDP in 2014/15 recorded a 3.1% - highest since 2011 while Australia's GDP hit a high of 1.1% for the first quarter of 2016.

If you are looking to invest into Melbourne today, the best advice we can offer for would be to follow the old adage of "buy where the locals buy".

Dan Toh, CEO of RunningStream and have been involved in various projects across Asia, Australia, Europe and the UK for over a decade. He has coached many investors across Asia and leads a team of highly qualified professionals helping investors with their global real estate portfolios.

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