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Welcome!

Welcome to the very first issue of Stamford Investor Perspectives. We plan on issuing semi regular updates on Stamford's view of the real estate and real estate capital markets for you, our investors as another means of communication with you. We truly value your continued support and adhere to our core principle of maintaining long-term relationships with our select investor base, which has essentially developed by word of mouth.

Stamford continues to invest in every transaction, and is dedicated to identifying opportunistic investments and delivering wealth with a focus on mainstream commercial real estate assets and developments on the eastern seaboard. Since inception, we have invested in excess of AUD20million in capital and funds returned have averaged 24.82% IRR per annum. Given current market and economic conditions, Stamford has invested limited capital in 2016 with the bulk of capital invested into existing assets rather than project finance.

Our focus for this update is the residential apartment market. It is always a topic that garners strong interest from our investors, given most have some sort of exposure to residential markets through home ownership and generally have investment exposure in residential apartments.

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We do believe that we're at inflection point in the new residential apartment market with prices likely to fall over the next two years.

We have seen significant supply of residential apartments over the last five years. We have particular concern with markets in Brisbane and Melbourne – especially given the supply/demand imbalance that is emerging in those markets, accompanied by the generic and some would say commoditised apartment market - where all stock looks and feels the same with no product differentiation.

Prices have been growing at an unsustainable rate. Prices that have been driven by foreign purchasers – it's always the person with their hand up last at the auction that determines the market price, the marginal purchaser– but what happens if those parties driving the market aren't there anymore?

These foreign buyers are paying significantly more in stamp duty as of 1st July – in all states and more crucially, the local banks will not fund these foreign purchasers, leading to increased likelihood that these purchasers will default on their contracts and stock will return to the market for resale. This is at a time where we estimate that these same foreign purchasers will need to settle approximately AUD15billion in apartments each year for the next two financial years. Some estimates have the aggregate foreign purchaser numbers at approximately AUD50billion over the next two and a half years.

“ Our view is that we have reached a medium term peak in new apartment pricing. We believe that Sydney and Melbourne markets are likely to see values decline with respect to new residential apartments in the vicinity of 5% to 10% through 2017. We believe that Brisbane faces significant downward pressure on values and have the view that Brisbane markets will decrease in values by 10% to 15% through 2017.

Given supply is being curtailed by the banks reducing appetite for construction finance and ignoring any potential for global asset value corrections, we do believe that markets will stabilise through 2018 and the apartment markets will then bottom out and recommence increasing in values from 2019 onwards but at very benign rates reflecting the growth over the past five years and the very low interest rate / inflation environment.”

Macro Market Conditions

The key issues and current status of conditions that have potential impact on the pricing of new residential apartment market are summarised as follows;

1. The banks have all essentially stopped funding foreign purchasers of Australian apartments - investors from overseas. This leads to increased settlement risk.

2. Given concerns around settlement risk, the banks have significantly reduced appetite for construction funding. A number of projects are likely to be put on hold and site values will come under pressure.

3. Over the last five years there has been significant supply of apartments in all three markets – Sydney, Melbourne and Brisbane. This has outstripped local underlying demand and creates a potential risk if capital from China cannot continue to fund acquisitions.

4. Interest rates are at historical lows.

5. Over the last five years there has been significant growth in professional real estate marketing businesses, which have targeted selling into foreign markets – particularly China. A number of these businesses have sold apartments into these markets on 8% commissions creating real concerns around the capacity of these buyers to settle – particularly if there is any emergence of values falling.

6. Capital flows into Australia from China have grown significantly over that same five-year period – will these continue or slow and what impact will this have?

7. The AUD has depreciated significantly over the last four years which in turn makes the relative pricing of apartments here less in foreign currency terms.

8. State governments in NSW, Victoria and Queensland have all recently introduced loading to stamp duties for foreign purchasers with foreign purchasers now paying stamp duty of approximately 12% in Victoria, 9% in NSW and 8% in Queensland compared to an average of 5% for local buyers.

Given all of these points above, what is the likely impact on the value and supply of the residential apartment markets in Australia? It's a complex issue as many of the above observations are conflicting in terms of whether it will have a positive or negative effect on pricing.

To answer this question the above points need to be considered at a macro level and then fundamentals of actual markets – particularly with demand and supply, need to be better understood.

Foreign Buyers

Arguably the key reason Australia has experienced such staggering growth in residential market pricing over the last five years has been the effect that foreign purchasers are having on the market. It seems almost weekly that we read of some trophy home that has sold to a foreign buyer – particularly buyers from China.

The new residential apartment market has been a specific investment vehicle for foreign purchasers as a means of gaining local residency status via the relevant visa programme but more so a vehicle to expatriate capital from China. Australia is not alone here with markets in Canada, New Zealand, UK and US all experiencing similar effects from foreign purchasers buying stock in these markets.

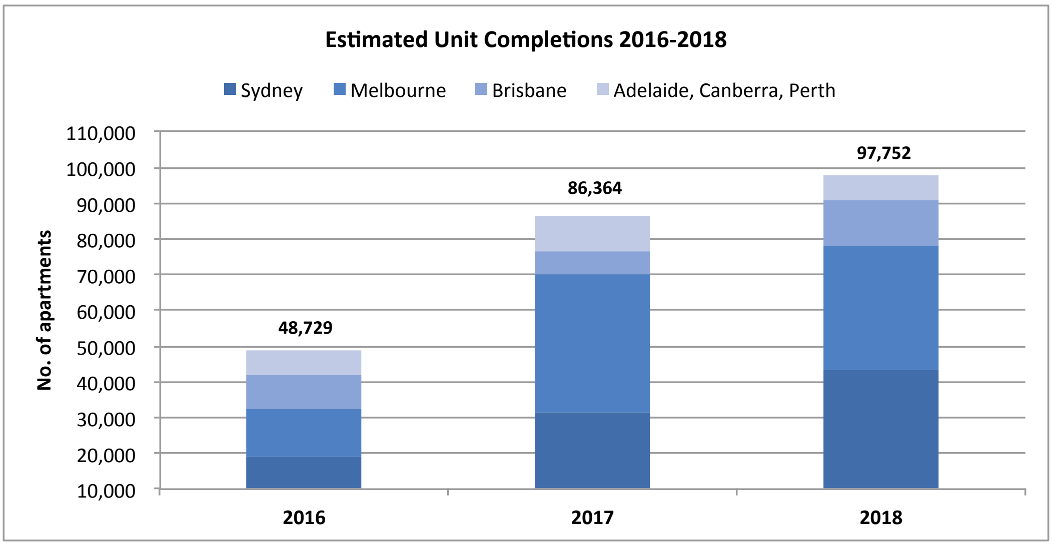
We estimate that foreign purchasers have contracted to buy over AUD15billion of apartments each year for the next two years. This represents approximately 30% of all new apartments being supplied in the three key markets over this period. Some other contemporary colleagues estimate the total foreign settlements at AUD50billion over the next two and a half years.

Any slowdown in the appetite from foreign purchasers or their capacity to settle the apartments they have purchased will have a significant impact on the values of these apartments.

All local banks have now indicated that they will not be funding the settlement of foreign purchasers. We have seen the recent emergence of some foreign banks and some potential non-bank lenders looking to provide capital into this market given the local banks have stopped financing.

However, we do not believe given the quantum of money involved that there will be sufficient capital delivered to this market over the next two years to fill the financing gap.

Supply and Demand



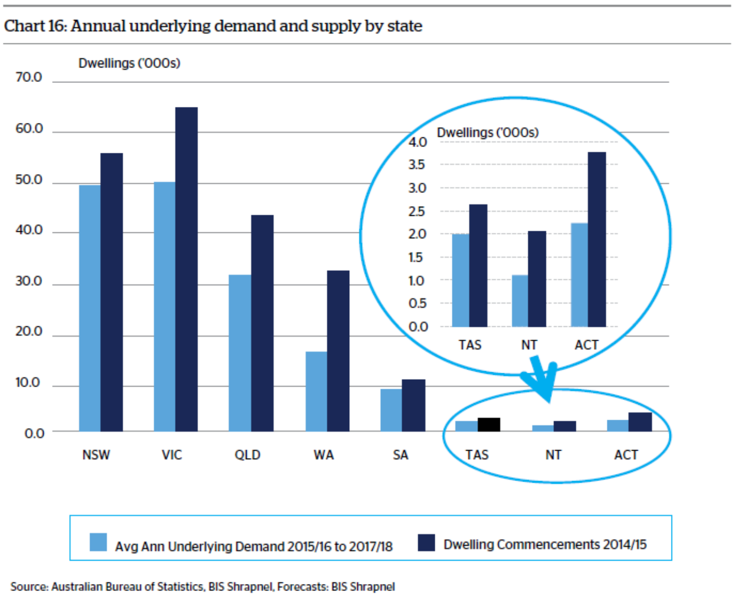
The above chart demonstrates our forecast of supply into the three key markets for 2016, 2017 and 2018 and the markets of Adelaide, Canberra and Perth combined. Unit completions across the Australian capital cities are projected to increase, with substantial growth in Sydney and Melbourne in the next twelve months.

Oversupply is determined by the level of underlying demand with population growth, household formation and vacancy rates as major components. The decreasing correlation between population growth and dwelling completions outlined in the CBA Insights March 2016 quarterly report, as well as the disconnect with apartment volumes and subsequent apartment sales in the major capital cities is consistent with our view of oversupply over the next 24 months. The following chart by ABS & BIS Shrapnel supplements this view and presents average annual underlying demand for additional dwellings from 2015 to 2018 as notably lower than dwelling commencements in 2014 and 2015 nationally. Average underlying demand figures approximate to 49,000 in NSW with a 7,000 oversupply, 50,000 in Victoria with a 15,000 oversupply, 32,000 in Queensland with a 12,000 oversupply, and 28,500 across SA, ACT and WA with a 16,500 oversupply.

Sydney, Melbourne and Brisbane

In this update we look at the new residential apartment markets in Sydney, Melbourne and Brisbane. All markets are somewhat similar insofar as there significant run up in supply – the key differentiation that Sydney and Melbourne enjoy relative to Brisbane is the depth of their markets as well as favourable investment capital flows as they are recognised as global cities.

Ranking these three markets by risk shows Brisbane is by far the market that has the most potential downside as the vacancy rates in this market given forecast supply of apartments under construction is estimated to increase to up to 10%.



ABS & Citi Research data depicting estimates of housing demand relative to completions and approvals in Sydney, Melbourne and Brisbane conclude that underlying demand already exceeds approvals and completions in Brisbane.

This is by far the weakest market. The vacancy rates in Sydney and Melbourne are not anticipated to get anywhere near this high.

Interest Rates, inflation and the AUD

We anticipate the inflation rate and interest rate to remain low over the medium term. Further we believe the AUD will range trade between USD70c and USD80c. These macro conditions are unlikely to impact the appetite for foreign buyers on new apartments either positively or negatively.

The downside risk to local demand for apartments and for that matter housing in general will be driven by interest rates.

Whilst we anticipate the medium term outlook for interest rates to remain benign we are seeing the early rerating of longer-term bond yields with only last week the 10-year bond rates increasing in the US and also domestically.

Any increase in interest rates will have a significant impact on local demand and therefore the pricing of new apartments, particularly if the rate increase leads to an appreciation of the AUD/USD and the relative pricing of these apartments in RMB terms looks more expensive.

State Government Stamp Duty

All State governments in NSW, Victoria and Queensland have recently increased stamp duty payable by foreign purchasers. This is significant as relative to local buyers foreign buyers are paying a 7% premium in Victoria, 4% in NSW and 3% in Queensland. This will undoubtedly have a softening impact on foreign demand – particularly for projects that are yet to come to market.

Pricing and Valuations

By far the greatest impact on the likelihood of foreign purchasers settling will be whether valuations of assets holds firm. These buyers have all deposited a minimum of 10% on each apartment they have purchased. If prices fall by 10% or more in any market it creates a significant financial disincentive to settle.

Notwithstanding the unconditional contracts, we anticipate that a significant number of these buyers will not settle. If they are being advised by an independent valuer/bank that the apartment that they have purchased is worth only 90% or less of the original purchase price, then the likelihood is that they will treat the 10% deposit as an option fee and walk from the contract.

If there is any meaningful default in the settlement of these apartments because of values falling, this will lead to stock being put back onto the market as completed apartments. However, this time around the buyers of the stock will not be foreign and there will be no high-pressured marketing and sales strategies to drive up values. The negotiating position will shift from seller to buyer and the stock prices will fall further. There will be much less urgency in relation to the acquisition. In addition, if the developer has a significant amount of this stock sitting on their books they will resort to discounting the stock to move it.

We are already seeing the early emergence of foreign purchasers failing to settle their contracts and developers having to re-sell this stock at discounts to the original contract price. Whist this evidence is anecdotal at this stage and not wide spread as the supply of new stock grows through 2017/2018, we expect the settlement risk to bear out through defaults, stock being resold and prices falling.

Conclusion

Given the increased risk of foreign buyers settling, the supply outstripping underlying demand fundamentals, the banks refusing to fund foreign purchasers, as well as the likely reduction in demand from foreign purchasers as a consequence of increased stamp duties and the optionality with which these purchasers will treat their contracts, we believe prices of new apartments will fall.

We anticipate value falls of between 5% and 10% in NSW and Victoria and 10% to 15% in Queensland. With some sub markets falling by more – particularly in those markets that are heavily oversupplied with generic, undifferentiated stock.

Stamford Capital Investments

Think we can help you?

Stamford Capital Investments is a leading investment firm in Australia's commercial property market, providing full asset management services to deliver optimal, risk-adjusted investment returns for our wholesale investors.

Should you require further information or wish to register your interest we can be contacted at

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