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Triguboff has reason for concern about apartment market threat

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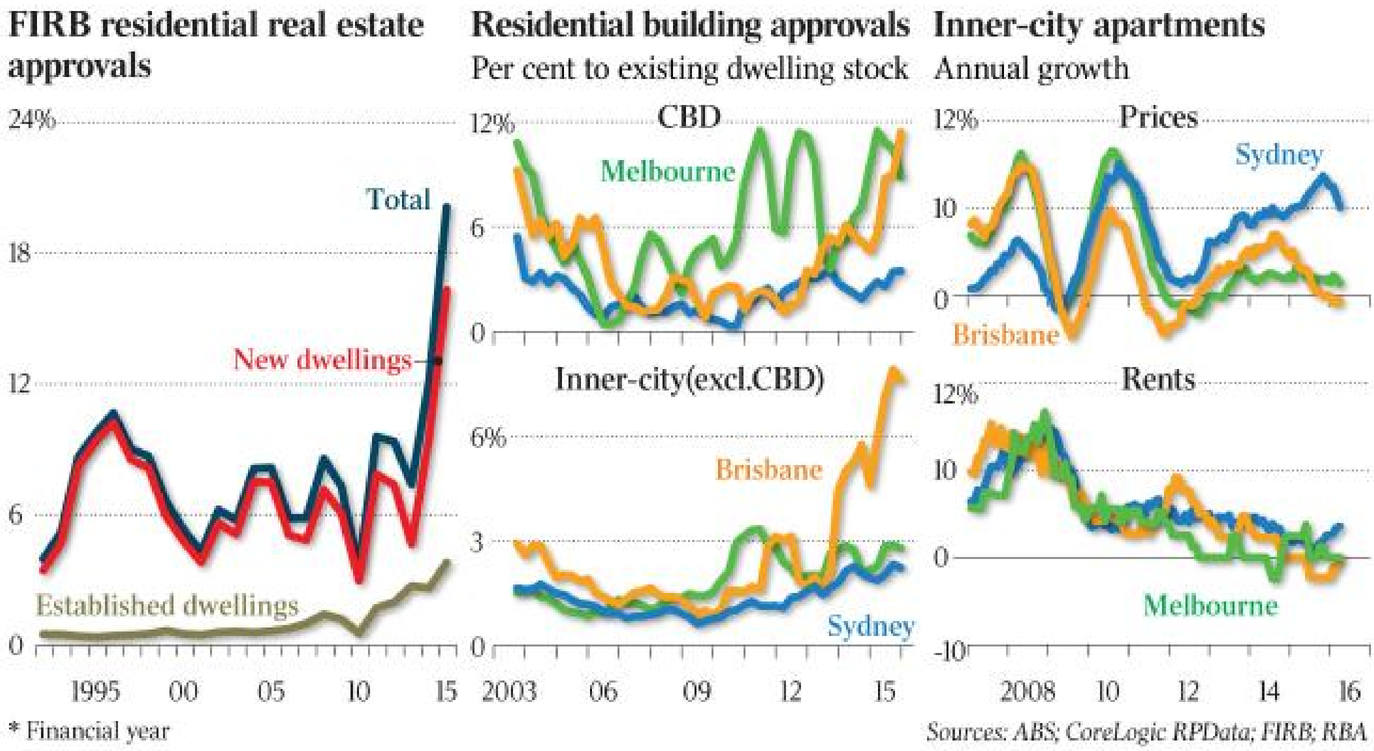

Australia's leading apartment owner and developer, Harry Triguboff, visited the Australian Prudential Regulation Authority and the Australian Securities & Investments Commission this week. The visits were unprecedented and reflect the deep concern Triguboff has with the looming potential crisis in sections of the Australian apartment market.

I obviously don't know what they discussed but Triguboff says the talks were open and he welcomed the fact both bodies had agreed to see him at short notice.

His visits coincided with the warnings yesterday from the Reserve Bank about the possibility of a severe contraction in the amount of Chinese money coming to Australia for apartments.

Unfortunately, Triguboff did not also go to the Reserve Bank because yesterday's statement indicates that the central bank does not fully understand the events taking place behind the scenes and their possible effect on Australia's financial stability given the warnings about China.

Remember, the apartment market is looking at approvals of about $65 billion and even

If only half that amount is actually being developed, it is a huge industry. If it cracks it will spread to other parts of the residential market, boost bank bad debts and probably mean bank dividends must be cut.

To understand the potential crisis that caused Triguboff to go to the regulators you have to look at just how this apartment building boom is being financed. While some apartment developers such as Triguboff's Meriton have strong balance sheets, most have weak balance sheets and rely on forward or off-the-plan sales to Asian and local buyers to gain their funding.

The Asian buyers are by far the majority of off-the-plan buyers. If the developers are using Australian bank financing, they get their money to build the apartments first from the 10 per cent deposit made by the off-the-plan buyers, then from banks, which usually will lend between 45 per cent and 50 per cent of the cost of the completed building. The balance is borrowed by the developers on second mortgage. If the project is funded by a Chinese bank then different arrangements are in place.

On the off-the-plan buyers' side, most of the Chinese buyers have had conversations with our local banks. While some may have been funded using Chinese banks, our local banks are the main source of funding for individuals finalising the purchase when the apartment is completed.

Clearly if Chinese (or local) apartment purchasers can't raise the money to complete the purchase, it will cause huge losses by the apartment developers and their lenders because they will be left with unsold apartments.

The Reserve Bank says the volume of the apartments being built in Sydney and Melbourne is pushing up costs and a downturn in apartment markets "could weigh on developers' financial health". That comment from the Reserve Bank will increase pressure on vulnerable developers.

But in terms of financing the purchasers, the Australian banks feel safe because their arrangements with off-the-plan buyers have escape clauses. The Reserve Bank endorses that feeling of safety but the situation facing the banks is far more complex.

The Chinese investors were told that if, on apartment completion, they could raise another 20 per cent to bring their equity to 30 per cent, the bank would then lend them a further 70 per cent, but this offer was subject to valuation of the apartment at the time of settlement and a security assessment of the buyer.

In the recent past, with a rising apartment market, these escape clauses have not presented a problem for the buyers because the apartments were worth more than the purchase price. But this year three events have taken place:

• The big rise in supply has caused the Australian apartment market to slip. It is generally believed that apartment prices in Sydney have fallen by 6 per cent to 7 per cent, though rents are still strong. In Melbourne the value of a "used" apartment is a lot more than 6 per cent to 7 per cent below purchase price value, so a second-tier “used apartment” market is pushing down bank valuations markedly.

According to the Reserve Bank, in Brisbane developers are having increasing difficulty gaining presales and the market in Perth has deteriorated. And in Brisbane lower profit margins mean developers have borrowed a much bigger proportion of the building cost.

Chinese and other Asian investors have a remarkable record of settling off-the-plan contracts. They made an agreement and they like to stick to it. Most settlements are proceeding smoothly but the change in the value of apartments is an ominous sign.

• APRA is concerned that banks are too exposed to the dwelling markets and they have leveraged it too far, so it has demanded extra equity be raised by the banks, which is also in accordance with global rules. But it also has warned at least some banks that if they allow their investor lending on dwellings to grow by more than 6 per cent or 7 per cent then extra capital will be required.

So the banks are restricting their lending, creating a credit squeeze. When the banks were agreeing to back Asian and local purchasers there was no sign of a credit squeeze. It is not now a serious problem but the huge avalanche of apartments coming forward will make it a serious problem for the economy unless the APRA credit squeeze is eased.

In addition there is pressure being placed on banks to choose their borrowers more carefully. They are being asked to stress-test the Chinese borrowers and impose more onerous benchmarks. For example, they are beginning to ask Asian investors details of their personal incomes. Somewhat bemused Chinese investors are being asked to supply a tax return, which is usual in Australia but unusual for the Chinese because they normally don’t pay tax.

• Finally, while most of the Chinese can raise 30 per cent of the apartment purchase price, the rules governing money leaving China are much tougher. The Reserve Bank emphasises the difficulty of taking money out of China is increasing, so if the Australian banks reject loan applications from Chinese, many simply will not be able to get the extra money required out of China.

There is strong apartment buying demand in Sydney and Melbourne’s population continues to grow, which underpins demand. But if buyers of off-the-plan apartments can’t raise the money that they counted on from the local Australian banks and/or in China, Triguboff estimates that apartment prices will fall by 20 per cent to 25 per cent.

In theory, that will almost certainly cause large losses for the second mortgage lenders to property developers and some of those lenders will be financed by banks. The blows to the developers and their financiers will be compounded because the buyers paid only a 10 per cent deposit and won’t pay the additional 20 per cent if no funding is available. And then, as we saw when the mining boom collapsed, many suppliers will available. And then, as we saw when the mining boom collapsed, many suppliers will go to the wall, leaving a trial and creditor and bank losses.

What is brewing is a potential major bank and apartment market crisis. However, such dire predictions carry a caveat. The Chinese have been meticulous in honouring contracts and they will work very hard to get the money out of China even though this process is now much more regulated.

Triguboff wants APRA and ASIC to allow the banks to honour their undertakings to fund 70 per cent of the apartments even if those undertakings had escape clauses based on valuations and so on. If the loan undertakings are not honoured, it will not only cause an Australian downturn and lower apartment prices but severely damage the relationship between Chinese investors in Australia. It may take a generation before they return to our market.

Some Australians will regard this as a good thing but our building activity underpins the economy given the decline in mining.