Stamford Capital
AUSTRALIA

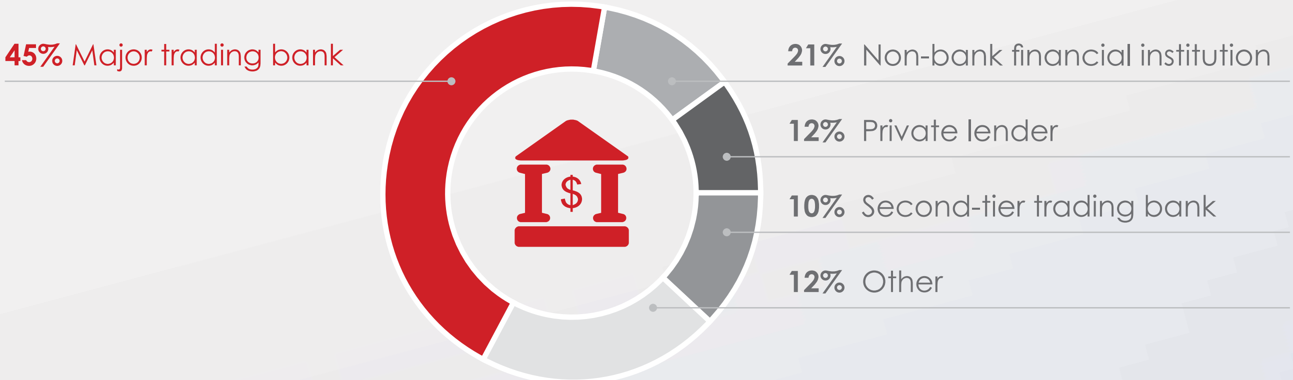
REAL ESTATE DEBT CAPITAL MARKETS SURVEY

2018 STATE OF PLAY

ABOUT THE RESEARCH

105 PROVIDERS

105 providers opted in to an online survey about real estate debt capital markets. Almost half were major trading banks, followed by non-bank financial institutions (21%), private lenders (12%) and second-tier trading banks (10%). A few foreign banks, super funds and family offices also participated. This is generally representative of Australia's debt capital landscape.



1 in 2

Almost half the respondents have a loan book **greater than $500million.**

NEW FORCES AT PLAY IN REAL ESTATE DEBT CAPITAL

After riding high through the property boom, Australia's developers and property investors have faced tight liquidity constraints and challenging yields over the past year – especially in riskier pockets of oversupply.

This is likely to become business as usual in the year ahead. But how will capital providers respond to the shift in the market? We surveyed just over 100 individuals from banks, non-banks, foreign banks and other lenders to learn the true state of Australia's debt capital market for property assets – and what we can expect in 2018.

Their responses revealed five important trends.

1 The market cycle has peaked

Almost three-quarters agree the commercial property market has peaked, and 59% say the residential development market is now in decline. There is general concern about apartment oversupply in inner-city Melbourne, Brisbane and some parts of Sydney.

With pressure on pre-sales, developers will need to be more strategic with their acquisition and construction plans.

73% say the commercial property market has peaked

59% think the residential development market is now in decline

50% believe residential apartment and housing markets are now in decline

2 Yet loan books are still expected to grow

The overwhelming majority (92%) of lenders say they expect to increase their loan book – including 87% of major banks and 95% of non-banks. Of these growth-focused lenders, half expect to do so by at least 15%.

This growth appears to be more focused on investment loans – although how they will do this and simultaneously lift investment loan margins (as 50% expect they will do) remains to be seen.

However, only 14% expect major banks to increase construction lending activity while 58% expect it to be maintained – and 28% say it will decline.

We are seeing banks face balance sheet pressure and they need to replenish their book. Meanwhile, non-bank lenders are ready to capitalise on any gap in the construction funding markets.

92% lenders expect to increase their loan book, of these half by 15%+

40% expect major banks to increase commercial property lending in 2018

58% expect major banks to maintain construction loan activity

50% expect major banks to further tighten construction credit criteria

50% expect major banks will increase investment loan lending margins

62% expect major banks will increase construction loan lending margins

3

Non-bank lenders are increasing their stake

Half the respondents expect the major banks will maintain credit criteria and another 40% expect it to tighten. So it's no surprise most also expect non-bank investment and construction lending activity to increase. At the same time, non-bank margins are also expected to increase – or at least stay steady – although this may be challenging given the increased competition.

61%
expect non-bank investment lending activity to increase

63%
expect non-bank construction lending will increase

50%
expect non-bank construction margins will increase

41%
expect non-bank investment margins will increase

4

New funding sources are emerging

While there is still uncertainty over the potential of crowdsourcing or other new platforms as a credible competitor, over a third of capital providers are developing new products and foreign banks may play an increased role in property lending.

5

Originators are increasingly important in a complex market

Third party intermediaries and advisors in the commercial property finance markets will become increasingly important for growth, given the ever-increasing number of new lenders and evolving complexity of the Australian market. There are so many new ways to structure a viable deal, and without the support of a trusted partner, developers and investors could miss out on the chance to improve return or yield.

54%
expect originators to grow as a source of capital deals

RE-THINKING TRADITIONAL FUNDING SOURCES

A pivot away from major banks

"Finance is as acute a risk as ever for both investors and developers," comments Stamford Capital Executive Director Michael Hynes.

Major banks are certainly dealing with the impact of APRA constraints, which came into effect in March 2017. This has significantly impacted the ability of smaller independent developers to get their projects off the ground. Once able to borrow up to 80% of cost with debt, they now need to meet tougher lending criteria with pre-sales commitments and carry mezzanine debt or more equity capital.

We've seen firsthand the growing appetite amongst developers for non-bank funding. "When it comes to construction finance, we expect the non-bank sector to dominate with senior debt finance," explains Hynes. "Developers are far more savvy with capital raising, they're aware the market is more dynamic and relationships with the big four aren't as reliable. Developers are also cautious about being too heavily tied to one financier."

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>
> **Michael Hynes**
> Executive Director,
> Stamford capital

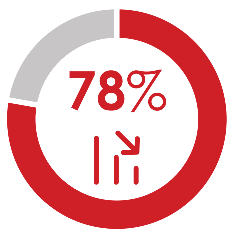
However, the non-bank sector is also likely to face greater restrictions on lending criteria – with 71% of respondents saying they expect APRA to increase oversight. Riskier projects will of course face higher borrowing costs, but alternative financing options (including joint ventures or preferred equity) may be the only way to get a viable development off the ground.

"We actually expect non-bank capital costs to reduce, and credit conditions to ease, due to the competitive pressure in the market," notes Hynes.

Major banks still have an appetite for investment loans

If 87% of major banks expect to still grow their loan book under these conditions, it's likely to be driven by new products as almost half of the new products under development are investment loans.

But they may be hampered by lending constraints. 78% of respondents say the Royal Commission will have a negative impact on bank lending capacity – and 50% rate it as 'high impact', or 7+ on a scale of 1 to 10. "I'd expect increasing regulatory oversight and impact on the banking sector into the foreseeable future," commented one respondent.



say the Royal Commission will have a **negative** impact on bank lending capacity

Non-banks may face competitive pressure

Although most respondents expect non-bank lenders to maintain or increase their construction and investment margins (85% and 83% respectively), we are already seeing some respond to increasing competition in this market.

"Some non-bank lenders are dropping their interest rates as they race to take advantage of the construction lending void left by the banks," comments Domenic Lo Surdo, Executive Director Stamford Capital. He doesn't expect development returns to be squeezed further. "Development margins will need to be maintained at around 20% – I cannot see this changing."

Expect lending criteria to remain tight

Half the respondents expect banks to further tighten their construction lending criteria. "It's difficult for developers to obtain development finance, and the cost of construction is increasing," said one respondent.

"Developers are facing bigger funding obstacles than ever before," said another. "Funding appetite from the major banks continues to decline and the credit conditions imposed are forcing developers to look at alternate funding sources including non-bank lenders. Site values are falling – and some developers who bought sites one to two years ago are now under water."

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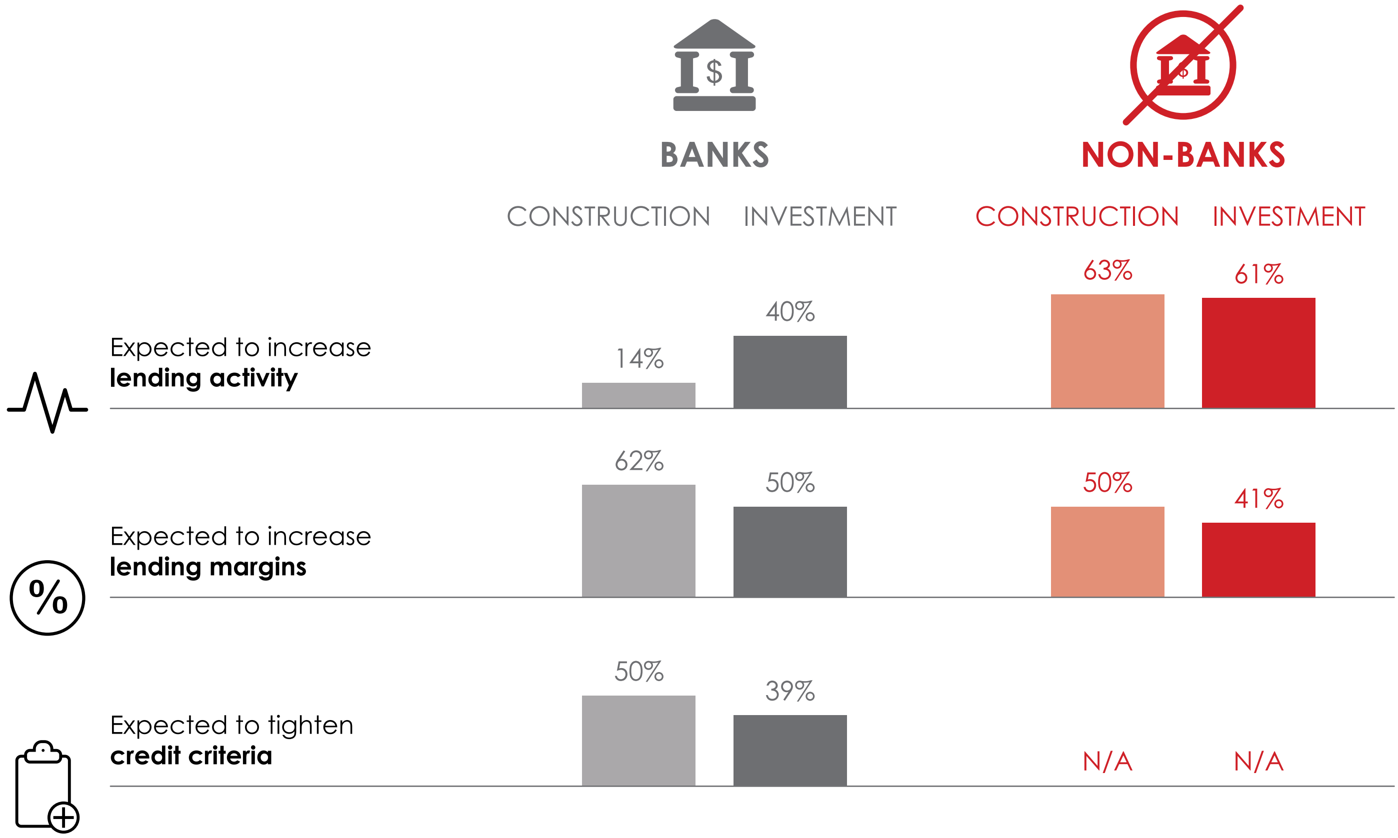

POCKETS OF RISK AND OPPORTUNITY

After so many years of consecutive growth, Australia's property market appears to be slowing down. But across different states and asset classes, the story varies.

Residential

Almost all respondents believe the residential development market cycle has peaked (38%) or is now in decline (59%), and just over half believe the residential apartment and housing market is also in decline.

"This does not surprise me – we felt it peak about a year ago," comments Lo Surdo. However, Hynes notes the rates of return on investment in real estate debt are still good relative to cash – and with the equity market still skittish he doesn't expect the market to "come off" any time soon. "While Chinese investor activity has slowed, it wouldn't take much to move the dial again."

Respondents voiced their concern about apartment oversupply – especially large developments in inner-city Melbourne, Brisbane and some parts of Sydney. "Those projects in Melbourne CBD and Southbank with over 200 units previously sold to overseas investors," noted one. "Now the demand is greatly reduced."

Another emphasised the impact of "restrictive lending to specific purchasers, especially FIRB and investors." However, while investor buyers may decline, affluent downsizers are expected to pick up.[1]

59% believe Australia's residential development site market is in decline

50% believe Australia's residential apartment and housing market is in decline

2/3 are concerned by specific market sectors

Commercial

In contrast, there may still be a little more growth left in the commercial property cycle, with 73% of respondents saying it has peaked but only 10% saying it's already in decline. "Business confidence is improving and the economy is still growing – this augers well for commercial markets to grow in terms of rental income," notes Lo Surdo.

"The key for commercial investors is managing income at the asset level," notes Hynes. "Yields have come down, so interest cover is coming down, and that's a greater driver of funding than LVR. It's important to manage tenant expiries."

While demand for CBD commercial space is still strong, the 'Amazon ecommerce' effect is also pushing commercial demand away from retail and into industrial warehouse stock – particularly across the east coast.[2]

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1 Battle of the states, The Urban Developer, April 2 2018
2 Industrial property landlords preparing for Amazon impact, SMH, November 2017

The local view

NSW and Victoria

Tighter lending standards and more realistic price expectations are dragging down housing prices this year – with expectations they could fall 5%.[3] However, this is coming off five years of exceptional consecutive growth and is likely to affect areas with oversupply more than others.

"I'd be wary of large scale apartment developments in parts of Sydney such as the greater west or south – but in general, it's not a bad market," comments Hynes. "Developers just need to be more strategic about their deals before they start seeking funding."

The composition of developer stock is likely to change as a result of APRA lending restrictions. As seen in other states, developers are pivoting from investor-oriented stock to targeting owner-occupiers. This can make hitting presale targets more challenging, as investors were traditionally more likely to buy off the plan than owner-occupiers.

Hynes also sees potential for future commercial CBD growth in Sydney; "it's running strong." Prime office rents in Sydney are increasing faster than anywhere else in the world, with Melbourne in second place, thanks to ongoing jobs growth and constrained supply.[4]

House prices could fall 5%

Developers need to be more strategic

Potential future commercial CBD growth

Queensland

Barn Wilson, Stamford Capital's Queensland Associate Director, believes capital pricing on the southeast Queensland apartment market should be steady through 2018. "Brisbane's apartment supply has now peaked, and there will be a steady drop off in completed units in the back half of this year and into 2019. Coupled with strong net interstate migration, this should give off the plan sales more momentum."

However, hitting pre-sale targets to trigger construction debt is still a significant headwind for most developers in this region. "From an investor's point of view, southeast Queensland still represents great value for money and great opportunities in terms of residential yields," notes Wilson.

He also sees opportunities for developers in small mixed-use retail/commercial developments on the urban fringes. "Leasing sites to petrol station and fast food operators in areas of urban sprawl allows construction funding to be triggered, so this is still a viable option for developers."

Capital pricing in the apartment market should be steady

Southeast QLD has great opportunities in resi yields

Urban fringe mixed-use retail opportunities

3 Sydney, Melbourne housing prices tipped to fall another 5%, SMH, April 9 2018
4 Sydney leads the world for office rent growth, REA, November 2017

South Australia

"This is an historically conservative market, but we're now seeing increasing non-bank funding entering the Adelaide market on a second or first mortgage basis for residential developments, as well as commercial property investment," says Adam Miller, Stamford Capital's SA Director.

There are reasonable activity levels in specific retail and commercial developments, such as childcare and fuel. "But the major banks are lowering their leasing risk tolerance, and with less deviation from their underwriting standards irrespective of the end take-out position, I expect the need for structured funding solutions will increase."

Increasing non-bank funding

Increased need for structured funding

Alternative funding models on the horizon

While non-bank lenders are racing to fill the gap left by bank funding, there are other options for developers and investors in the current market.

Half the respondents believe foreign banks will increase property lending in Australia this year, with 41% expecting them to increase construction lending. However, Hynes and Lo Surdo suspect foreign banks will play a minimal role. "They tend to fund as part of a syndicate, rather than direct lending. For example, you might see a Singapore-based bank lending to a Singapore consortium buying a commercial tower in Sydney," explains Hynes.

Instead, they both believe new technology platforms will grow, especially as non-bank lenders develop their own models to access capital.

Hynes points to the recent ASX listing of Metrics Credit Partners' investment trust, MCP Master Income Trust (MXT), as an example. The IPO creates a unique opportunity for first time investors to access a strategy usually reserved for institutional investors.

"New platforms, including 'crowdsourcing' models, will definitely play a part in providing new ways to fund developments," he says. However he urges caution for those considering investment in these platforms. "Some seem to offer a debt-level return for an equity-level risk – I think we're all still working out what these opportunities mean, which is why they may not be seen as a credible threat yet."

Meanwhile, traditional capital providers are bringing new products to market. One-third of respondents say they're developing new products, including stretched senior debt for investment and construction, as well as stretch preferred equity and syndicate property investments.

50%
say foreign banks will increase property lending in Australia this year (41% increase construction lending)

58%
don't see crowdfunding as a credible competitor

26%
are uncertain about the role new platforms will play

37%
are developing new products

46%
of those new products are investment loans

NAVIGATING NEW MARKET CHALLENGES

With a much wider capital market now available, and so many new ways to structure an effective, viable funding deal, the role of loan originators in this market has never been more important.

"Before the GFC, when the big four banks dominated, we were probably seen as an outsourced facilitator," says Hynes. "Now there's huge value add in connecting developers and investors to a broader capital universe. We're operating in the non-bank market every day now."

Funding providers acknowledge that value as well. Indeed, just over half the respondents said they expect originators to continue growing as a source of capital deals.

"Markets are increasingly complex. Non-bank lenders don't have a retail office, they need partners to bring them credible deals," says Lo Surdo.

This can provide a real advantage for property investors and developers. "If they don't use an experienced intermediary, they'll end up negotiating sub-optimal terms," Lo Surdo advises. "We're creating competitive tension in this market, which ultimately means better yields for investors, and improved returns for developers."

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> Executive Director,
> Stamford capital

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