Stamford Capital
AUSTRALIA

REAL ESTATE DEBT CAPITAL MARKETS SURVEY

2019 STATE OF PLAY

ABOUT THE RESEARCH

108 PROVIDERS

108 providers opted in to an online survey about real estate debt capital markets. 38% were major trading banks, followed by non-bank financial institutions (27%), private lenders (9%) and second-tier trading banks (7%). Super funds, foreign banks 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.

80% are construction lenders.

KEY FINDINGS

1. The presales hurdle is now a barricade
2. ICR is the new LVR
3. More flexibility for investors who tick the right boxes
4. Non-banks expand their foothold
5. New products respond to the market constraints

A BRAVE NEW WORLD: REAL ESTATE DEBT IN A HIGHLY REGULATED MARKET

With Australia's property market now in decline, it's time to deal with the reality. Property developers and investors are seeking new opportunities in a more challenging market as the promise of the property boom wears thin and presales become next to impossible.

In a post-Hayne Report environment, major banks are still hamstrung by stringent credit controls – but they are also under pressure to replenish their loan book.

All these factors make way for non-bank lenders to increase their footprint in the debt capital market, and for new products to find creative solutions to the fundamental challenge: cost-effective, sustainable construction and asset finance.

For our second annual market survey, we heard from over 100 individuals from banks, non-banks, private lenders, family offices and super funds to get the current pulse of Australia's debt capital market for property assets – and their insights into the year ahead.

Their responses revealed five significant trends.

1 The presales hurdle is now a barricade

The pressure to reach presale targets are now one of the biggest impediments for developers gaining access to bank capital. 62% of our respondents said the minimal level of presales they need to fund construction is 60-100% and 85% are looking to maintain these presales hurdle requirements. However, 8% said they are actually looking to decrease.

When we break this down by bank and non-bank lenders, the difference is clear. 84% of major and second-tier banks require presales of 60 to 100%. However, 34% of non-bank lenders say their presale requirement is zero.

> This is a huge shift from 12 months ago, when nearly all lenders had a requirement for presales covering 100% of peak debt

Michael Hynes
Executive Director,
Stamford capital

56% say the commercial property investment market has peaked

27% say it's in decline

83% think the residential development site market is now in decline

59% up from last year

85% believe residential apartment and housing markets are now in decline

50% up from last year

2

ICR is the new LVR

Interest cover ratio, net rental income divided by the interest cost, is now the favoured metric for bank credit assessments. And 60% of term debt lenders want an ICR of 1.5x or higher for investment lending. However, that number is much higher for banks: almost one in two banks will expect at least 2x ICR.

What's interesting is that 15% of all lenders say they're prepared to look at financing at 1x or less ICR – including 24% of non-bank lenders. If there's a reasonable yield, there's still a willingness to put money into debt. The real issue for banks is that APRA governs their ICR criteria.

> The results clearly point to ICR being the key threshold for investment lending by banks.
>
> **Michael Hynes**
> Executive Director,
> Stamford capital

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More flexibility for investors who tick the right boxes

Despite rigid lending criteria for banks, 73% of respondents are looking to increase the size of their loan book. This is down from 92% expecting growth the year before, and one in two expect their investment loan margins to remain the same – compared with the one in two who expected to increase them last year.

For those projects that fit within the banks' tighter criteria, pricing tension could lead to more competitive credit rates.

Construction lending is still going to be tough due to the presales hurdle. But for investment loans: if you're a customer who can fit into the regulator-imposed rules, then you're likely to get a much better deal.

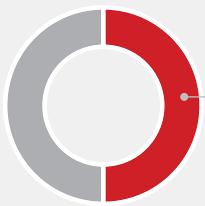
And in more good news it seems likely the RBA will reduce cash rates during 2019 – with 29% of respondents agreeing rates would drop, up from 3% last year.

60% all lenders need minimum 1.5 x or more ICR for investment loans – including 95% of banks

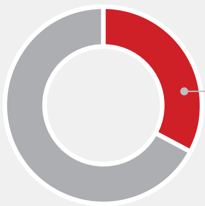
59% of non-bank lenders are willing to lend for projects with 1.5 x ICR or less

15% of lenders will look at financing projects at 1 x ICR or less

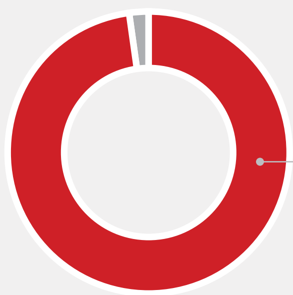
90% expect their interest cover hurdle to remain the same.



50% expect loan margins to remain the same



33% expect loan margins to increase



98% lenders looking to maintain or increase loan book size

> The banking market is clearly constrained, but they are all competing for quality investment applications that fit their rigid parameters – and they need to replace their construction books.
>
> **Michael Hynes**
> Executive Director,
> Stamford capital

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Non-banks expand their foothold

Despite the challenges of this market, which respondents almost universally agreed is in decline, both bank and non-bank lenders are expecting to increase their loan books.

"Over 50% of respondents say they're expecting to increase by 15%. That may sound optimistic, but it's likely to be driven by the number of non-bank lenders who entered the market over the last 12 months. They're starting from a low base." Michael Hynes.

Non-bank lenders will have a lot more flexibility than banks waiting for Royal Commission changes to be legislated. So if you're concerned about presales, it's time to look at these alternative providers.

> Non-bank lenders are growing in terms of volume and appetite in this market, while the banks have reduced appetite for certain risk."

Domenic Lo Surdo
Executive Director,
Stamford capital

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New products respond to the market constraints

Lenders may be nervous about market risks, but they still expect to increase their loan books – with margin growth offsetting any reduction in volume. However, many are also looking at more innovative ways to respond to investor demand.

41% of respondents said they're looking to develop new products in 2019/2020, with build-to-rent clearly the new flavour of the month. More than half of those developing new products say they're looking at build-to-rent, while 36% are also looking at new investment loans and 34% stretched senior debt investment products.

It's clear that lenders need to find new ways to operate under the current regulatory framework, and to overcome presales hurdles. But these are unlikely to be crowdfunding platforms – just 9% saw them as becoming credible competition in the Australian commercial lending marketplace.

- **56%** of lenders want to increase loan book by 15%
- **62%** of non-bank lenders expect it to increase by 15%
- **90%** of non-bank lenders expect to increase or maintain their loan book
- **50%** say the Royal Commission will have a negative impact on bank commercial lending capacity and credit control
- **65%** expect APRA to increase oversight of the non-bank financial sector
- **37%** expect major banks will increase appetite for investment loans
- **15%** expect major banks will increase appetite for construction loans
- **75%** expect non-banks will increase appetite for investment loans
- **67%** expect non-banks will increase appetite for construction loans

A MARKET IN DECLINE?

Rising above the risks

It's of no great shock that, overwhelmingly, respondents believe the residential market is in decline, and the commercial market has either peaked or begun its descent. UBS' Australian economics team reported last year that it believed this housing downturn could be 'the longest in several generations' due to reduced borrowing capacity for anyone with existing debt.[1]

The perfect storm of near-impossible presales, post-Royal Commission APRA scrutiny, and the uncertainty of an impending federal election have subsequently contributed to a near-freeze on any construction lending – especially if the project hints at any element of risk.

For residential investors, 2018 housing prices dropped by 4.8% nationwide and are expected to continue to fall through to 2020.[2]

In the commercial market, Sydney, Melbourne, Brisbane and Adelaide are all experiencing record tightening in commercial office space with vacancies and yields at all-time lows.

So where are the opportunities now for developers and investors? It might be time to think creatively, and focus on strategic projects that can withstand industry volatility.

> Lenders are nervous about the current markets and unlikely to want to increase their exposure to lending in a falling market
>
> **Domenic Lo Surdo**
> Executive Director,
> Stamford capital

Diversification for developers

Every new property cycle brings its winners and losers. So while property investors face tight borrowing restrictions, and owner-occupiers hold tight in case the market continues to fall, affordable housing could provide an intriguing new opportunity.

But while we see interest from state and federal governments to subsidise more affordable housing developments through build-to-rent products, this is unlikely to be a sustainable solution for the longer term. Unlike international markets, Australia's tax regime hampers project returns and this product is likely to be dominated by local institutional capital. That said, Labor has flagged change to MIT if elected.

Smart developers are quick to pick what's in demand. Across Australia, there will still be a desire for quality design, along with proximity to amenity and transport.

"This is very different to the last credit crunch post-GFC. The market is shaken, but there is still a lot of liquidity. Quality sites will still hold value. But if developers are in the financial position to wait, they should have patience." Michael Hynes

1 UBS now thinks the housing downturn could be 'the longest in decades', D. Scutt AFR, 26 September 2018
2 Australian dwelling values fell 4.8% through 2018 marking weakest housing market conditions since 2008, T. Lawless CoreLogic, 2 January 2019

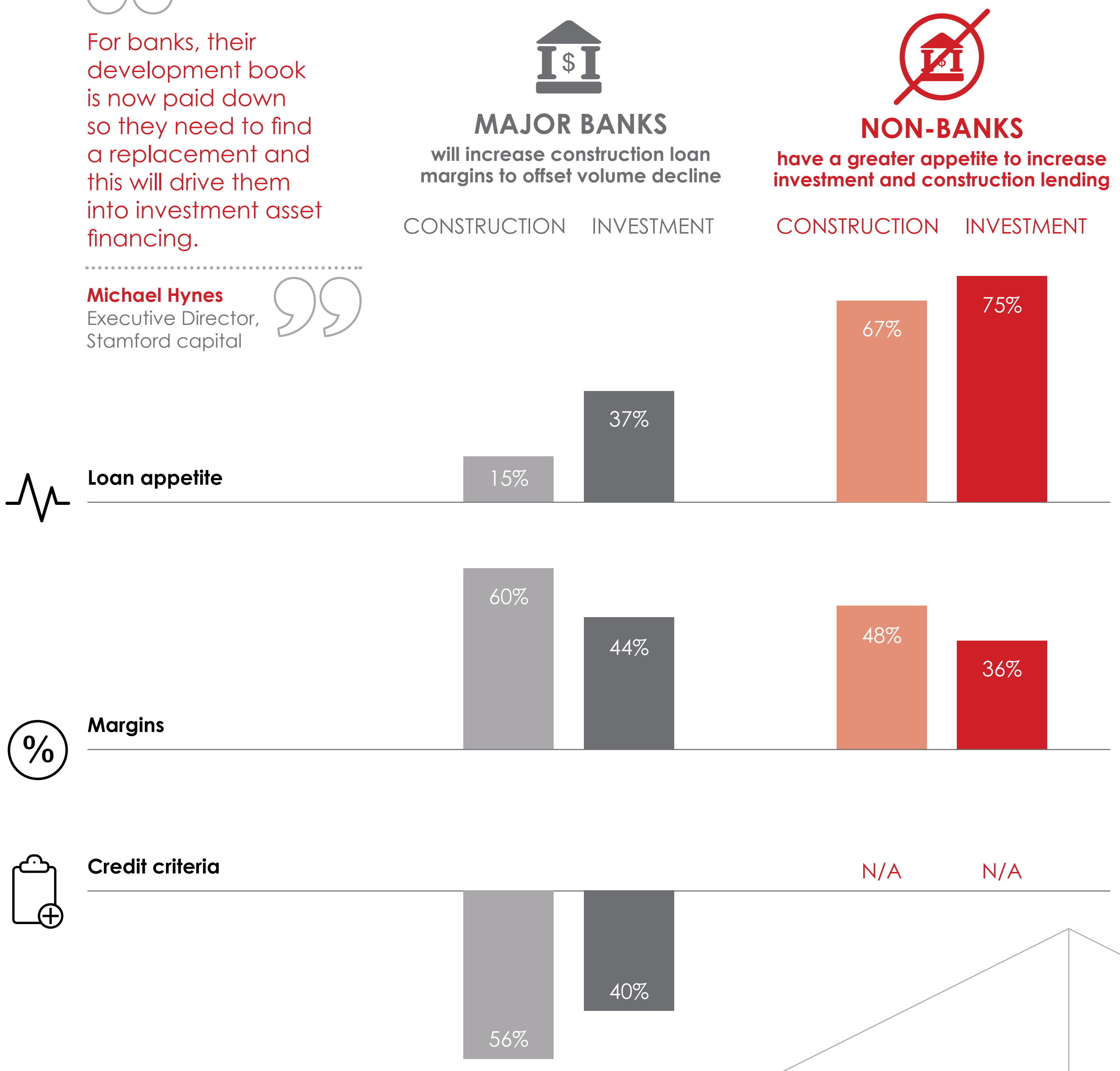
Capital is hunting for opportunities

While there may be less appetite to lend for construction, banks and non-banks need to replace their books as the apartment boom eases.

This is where investment loans with quality fundamentals might have the advantage.

> For banks, their development book is now paid down so they need to find a replacement and this will drive them into investment asset financing.

Michael Hynes
Executive Director,
Stamford capital



POCKETS OF CONCERN

Almost two in three respondents said they had concerns about specific market sectors or geographies. These included:

Over-supply of high rise and apartment developments in some areas, including inner-urban areas of Sydney, Melbourne and Brisbane.

"Residential property in high supply areas, given the presales market has dried up somewhat, and the Opal tower saga has affected whether people trust buying new." - respondent

Residential settlements

"If valuations are less than purchase price, it results in a squeeze for purchasers. Investors and FIRBs are not buying." - respondent

Development site values, where feasibility inputs have taken a hit

"Pre-development site values are under pressure. They're becoming harder to sell – often with the roadblock being the buyer's inability to access debt." - Domenic Lo Surdo

Retail assets, due to the shift to online shopping and weaker consumer sentiment

"We see poor trading for many discretionary spend retailers, and a changing dynamic of retail space requirements." - respondent

As the residential market continues to soften, some respondents expect to see a shift to office and hotel development – as long as Australia's macroeconomic factors remain strong.

The local view

New South Wales

The NSW residential market continues to experience a significant correction to house prices and the market is expected to further decline into 2019-2020. We expect a 15% to 20% fall in Sydney, with prices bottoming in 2019-20. However, it is important to view the decline in context: dwelling prices still remain above their mean values of several years ago.

Developers are now waiting out this period of correction, as failure to meet lender presale hurdles creates delays. Many are holding onto built stock and undeveloped sites, with residual stock and land banking facilities more prominent where credit is available.

"We expect the NSW economy, which is being underpinned by solid economic and population fundamentals, will absorb the increasing supply in the market and prevent a hard landing," says Domenic Lo Surdo, Stamford Capital Executive Director.

"New office supply in Sydney non-CBD markets, such as North Sydney, Parramatta or Macquarie Park, will satisfy the demand that currently sees vacancy well below historic averages." While Sydney Prime Net Effective Rents grew 14.6% in 2018, outperforming all other Australian markets, further compression is expected throughout 2019. The increase in Sydney's CBD lot land values have increased almost 48% over the past three years, and this will compress super prime yields.

Retail assets will face a volatile 2019 as they adapt to the structural change in this industry. "With consumers cutting back on discretionary spending, retail exits continue to be a significant risk to retail assets valuations. Landlords are under pressure to fill vacated spaces, and market rents will trend downwards."

Industrial and logistics growth can be attributed to the significant investment into NSW infrastructure projects such as the $16.8bn Westconnex in Sydney. Industrial yields are considered to be at or close to the bottom of the cycle with a shortage of quality stock for lease.

Market is expected to further decline

Developers are now waiting out this period

Retail assets will face a volatile 2019

Victoria

Victoria is seeing strong population growth, with both interstate and overseas intakes of residents. This will continue to underpin housing demand, but the residential market has already softened with a double-digit decline in values over the past 12 months. This will potentially exacerbate an already under-supplied residential housing stock situation.

Land sales have reverted to historical levels at 5 to 15 lot sales per month, depending on the scope of the estate. For apartments, off-the-plan sales have declined considerably due to investor restrictions so focus continues to shift towards owner-occupier stock. With residential vacancy rates below 2%, this is likely to underpin 'build-to-rent' strategies and may create more demand for investment stock.

Seeing strong population growth

Shift towards owner-occupier stock

Victoria (continued)

"The national issue of online shopping is impacting traditionally strong retail strips, which are showing vacancy levels we haven't seen for a long time," says Henry Buwalda, Stamford Capital Director, Victoria.

"The commercial and industrial sectors have seen further firming in yields over the past 12 months. These are proving a popular alternative to investors looking to diversify their assets, or concerned about volatile equity markets."

In the short to medium term, Henry advises developers and investors to consider construction cost escalations, a likely reduction in Australia's cash rate, declining property values, off-shore purchaser settlement risk, and rising US interest rates.

Developers and investors to consider construction cost escalations

Queensland

The three major Southeast Queensland markets, Sunshine Coast, Brisbane and the Gold Coast, are all reasonably well-placed in terms of underlying fundamentals. Low unemployment rates and strong population growth in the two coastal markets should continue to see steady if not spectacular capital growth for well-located, well-built apartments.

"Brisbane should also see a return to moderate capital growth over the next 12 months as the oversupply story that has plagued certain pockets of the city continues to fade away on the back of limited new supply and strong population growth," says Barn Wilson, Stamford Capital Director, Queensland.

It's certainly been a two-speed market in the residential apartment space with higher quality, well-located apartments experiencing steady growth. Affordability is still good relative to the southern states, despite the pull back of pricing in Sydney and Melbourne. Investors should feel comfortable entering the Brisbane market – as long as they target larger apartments in smaller developments with good proximity to amenities and transport links.

According to JLL, the CBD prime office vacancy rate finished the year at 7.2% and the near city vacancy rate at 10.6% – the lowest levels for five years[3]. This is expected to continue given the game-changing level of infrastructure projects currently underway in the CBD. The state is investing $15billion in increased amenity and recreational options within the CBD boundary.

Meanwhile, the prime office space pipeline is relatively weak, with only two significant developments under construction at the end of 2018.

Markets well-placed in terms of underlying fundamentals

Low unemployment rates and strong population growth

Investors to feel comfortable entering Brisbane market

3 Australian Office Investment Review & Outlook 2019, JLL, 23 March 2019

The local view

South Australia

In contrast to most other national markets, the Adelaide residential market is not showing evidence of downturn. Its ongoing stability is thanks to affordable housing prices, a better balance of supply and demand factors, and positive local economic conditions. However, continued credit tightening in both owner-occupier and investor markets will exert pressure, and slow population growth and an ageing population remain key challenges for the South Australian economy.

With substantial supply of inner-city apartments under construction relative to market demand, it's likely this will also place pressure on CBD apartment values.

"We expect to see minimal new starts of major city apartment projects in the short-medium term," said Adam Miller, Stamford Capital Director, South Australia. For suburban infill developments of up to 20 dwellings, and smaller townhouse projects within 12km of the CBD, demand remains stable.

As with other states, CBD office vacancy is tightening from 14.7% to 14.2%. Recent measures of business confidence in South Australia reveal a near eight-year-high, although there is still some caution – especially in the retail sector. Funding for new projects will be highly dependent on tenant pre-commitment, however there is selected opportunity for single tenant or big box development with franchise-based retailers like Aldi and PetStock.

The federal government's commitment to base Australia's national space agency in Adelaide, along with unprecedented government investment in defence in SA, has also started to yield improved demand in associated industry sectors.

Market is not showing evidence of downturn

Substantial supply of inner-city apartments

Improved demand in associated industry sectors

OPTIMISING RETURNS IN A CHALLENGING MARKET

As Australia's property markets adjust to post-boom conditions, both developers and investors face significant challenges. Without presales, developers need to find more creative ways to finance their strategy – whether that's build-to-rent, or sitting tight on residual stock as they ride out the cycle. This inevitably will need more equity from developers.

Property investors will also struggle to access capital, especially if they cannot meet the increasingly stringent credit requirements for banks, ICR in particular.

However, as our survey indicates, lenders are still looking for opportunities to maintain or grow their books. Credible investments with strong fundamentals may even benefit from pricing tension, but construction lending will continue to be tough.

Whatever the challenge, the support of an experienced intermediary can make a significant difference. There are many alternative ways to structure a viable deal: it comes down to having the right connections to a broader capital universe. More than half of all lenders expect loan originators to grow in importance. As well as acting as a valuable channel for quality deals, they ensure investors and developers negotiate the best possible terms.

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