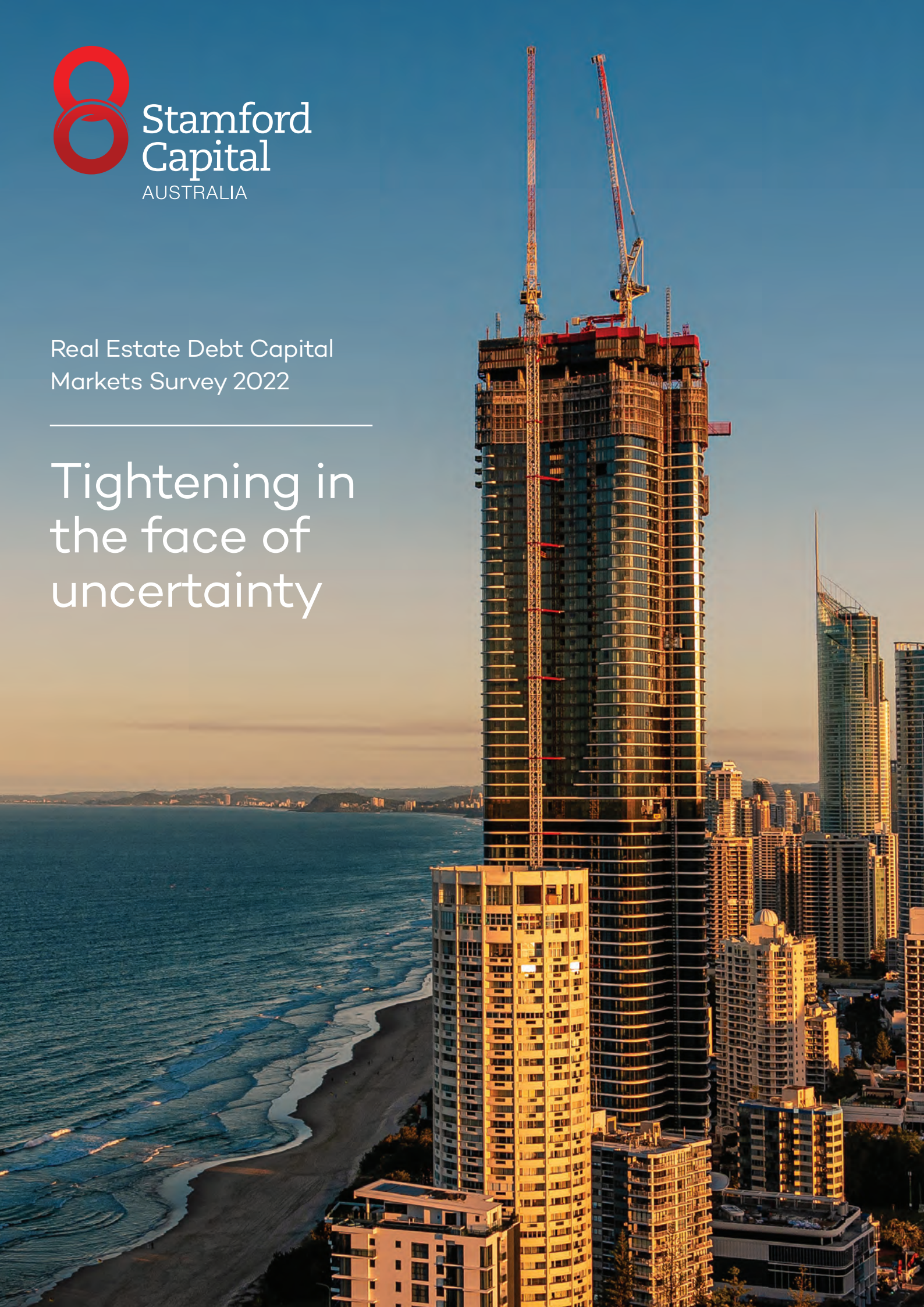
Stamford Capital
AUSTRALIA

Real Estate Debt Capital Markets Survey 2022

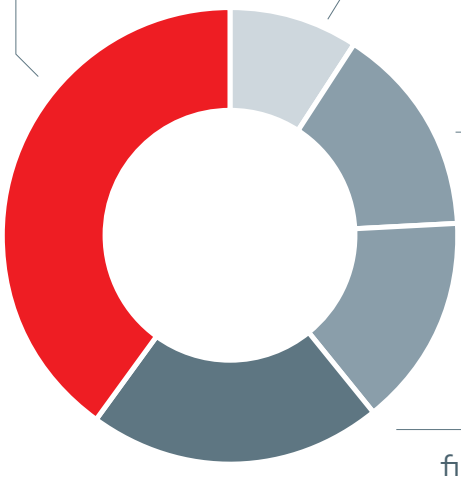
Tightening in the face of uncertainty

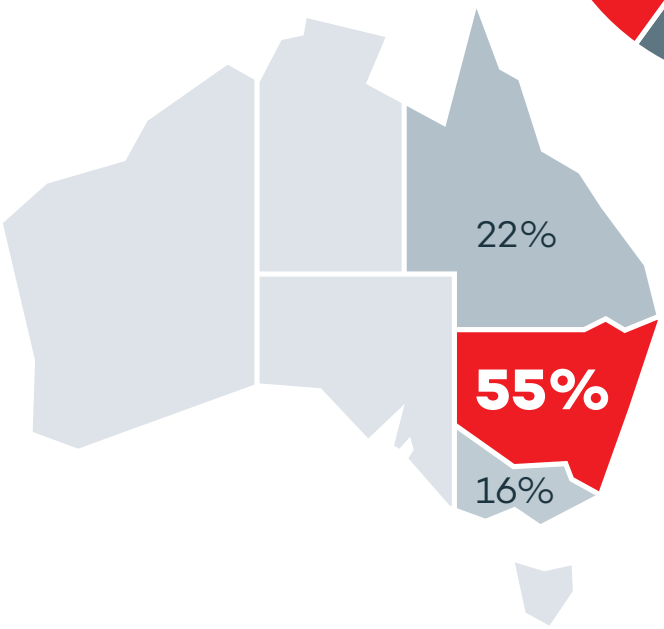


About the research

Online survey conducted in March 2022

OVER **100** PROVIDERS





56% have property loan books greater than **$500 million**

01

A more conservative outlook following the great re-set

Are we set for another booming year? Or is the outlook more conservative with the threat of rising interest rates having now come to fruition?

Australia's residential real estate markets burned bright throughout 2021, spurred on by interest rates remaining at all-time lows despite cooling sentiment near the year's end. Commercial real estate debt also grew to $286.1 billion after a $7.9 billion increase from foreign banks[1].

Although the outlook isn't as overwhelmingly positive for 2022, according to our survey, lenders remain optimistic about their own loan book growth. Off the back of a strong 12 months, real estate debt also continues to look attractive with non-bank and private lenders having secured their presence.

With presales back to pre-COVID levels and expectations loan margins will rise, our survey respondents showed a more conservative outlook. They are still optimistic – particularly across the industrial sector and residential development – but mentioned specific pockets of concern. These include ageing retail assets, B- and C-grade office stock, cost pressures for builders who are struggling to remain solvent[2], and construction challenges for developers facing labour and material shortages and supply chain issues.

As major banks prepare to tighten their focus to lower-risk deals in the face of impending uncertainty, non-banks are expected to fill the void and increase their construction lending. However, those non-banks are increasingly aware they need to be more careful with their due diligence.

[1] https://www.afr.com/property/commercial/foreign-bank-commercial-real-estate-debt-jumps-to-69-5b-20220329-p5a913

[2] https://www.businessnews.com.au/article/Cost-pressures-building-risk-rising

> "Loan books have grown and appetite continues to exist. The challenge for non-banks is to find significantly or sufficiently low-cost capital to be competitive in this market. And we are seeing big institutions take a real interest in the non-bank sector and reduce their cost to capital."
>
> Michael Hynes
> Joint Managing Director | Stamford Capital

When we published our last survey results in May 2021, there was sweeping positivity around lending growth. This year's results indicate a minor pull-back but still great expectations around lending appetite.

In March 2022, we surveyed more than 100 major banks, non-banks, private lenders, second-tier banks, family offices and foreign financial institutions to gather their perspectives for our fifth annual markets survey. With insights from three distinct data sets – pre-COVID, during COVID and the post-lockdown recovery phase – we now have a greater understanding of how Australia's debt capital market is bouncing back post-pandemic and readjusting its sentiment for the coming year.

The responses revealed five significant trends:

1. Loan books will continue to grow, but margins will also rise
2. Presales have returned to pre-COVID norms
3. As many sectors enter recovery, industrial soars
4. Greater oversight looms as non-banks enter the mainstream
5. With interest rates set to rise further, new products will emerge

03

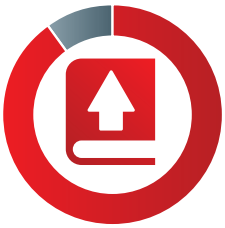
Key findings

1. Loan books will continue to grow, but margins will also rise

Despite concerns of a stalling market due to the uncertainty around COVID-19, the pandemic actually saw liquidity reach new heights, with volumes accelerating throughout 2021 and into the start of 2022. It's no wonder so many lenders expect their loan books to grow again this year despite interest-rate hikes and other factors such as the growing list of construction insolvencies.[3]

More than half of respondents have loan books of more than $500 million, whereas only 14% hold less than $100 million in debt. Intriguingly, 90% of them expect their books to grow again in 2022, which is more than the heady days of 2021 (82%).

Demand is obviously a significant driver of this positive lending sentiment. However, supply is also bolstering these figures, with both major lenders and non-banks creating a larger lending pool for borrowers to dip into. More than half (55%) of major banks expect to increase investment loans in 2022, but there is significant pull-back when it comes to construction loans with the majority saying current levels will either maintain or decrease (39% and 29%, respectively). To combat this, non-banks are looking to plug the gap left by major lenders, with almost two-thirds (62%) expecting greater investment in construction lending this year.



90%

of lenders expect to increase their books in 2022

Alongside this strong appetite for lending, margins are expected to increase. Almost half (47%) say loan margins will rise throughout 2022; a substantial shift from sentiment in our 2021 report, which indicated only 17% of respondents felt this way. Unsurprisingly, construction will be hardest hit and borrowers will need to look further afield from the major lenders – one in two respondents expect big banks will increase their margins on investment and construction lending this year.

[3] https://www.abc.net.au/news/2022-04-01/building-companies-going-broke-consumers-half-built-homes/100929896

> "It's down to both demand and supply. On one side of the ledger, the market is buoyant – developers are wanting more capital. On the other side, non-banks can offer higher returns to their investors than the bank. So there's capital flow."
>
> Michael Hynes
> Joint Managing Director | Stamford Capital

2. Presales have returned to pre-COVID norms

After a swing towards zero or minimal presales in 2021, just 22% of lenders now say they are willing to finance zero presale projects. Booming house prices are starting to soften – February's Home Value Index growth of 0.6% was the lowest monthly growth reading since October 2020, according to CoreLogic. With that number remaining low – 0.7% in the April Home Value Index – it now makes more sense for residential developers to lock away some revenue with presales.

> "Appetite continues to be strong for the right transactions. This will not abate. In respect to presales on developments, we are open to structuring transactions rather than quoting a 'hard' number."
>
> Survey respondent
> (Major trading bank, NSW)

Well over half (57%) of lenders now expect to see at least 60% in presales, which is up from 45% last year. The challenges of 2021, which included lengthy lockdowns reducing the ability to walk through physical sales suites, have abated – and lenders expect developers to generate enough presales to satisfy their risk appetite.

Leverage requirements for investment loans are unlikely to change with 90% saying they will maintain their leverage standards. We are also seeing a swing back from 'no ICR' flexibility. Only 15% of lenders now say they have no ICR requirements, which is a significant drop-off from 26% in 2021.

> "There's no suggestion the banks are loosening credit requirements in any way – and if anything, APRA has kept the screws turned pretty tight."
>
> Michael Hynes,
> Joint Managing Director
> Stamford Capital

Instead, nearly two in three **(65%)** require ICR of >1.5x, which is well up from **49%** last year, and almost all of them are adamant they will maintain this requirement throughout 2022.

> "I feel the method of loan assessment will need to be more flexible to take into account the impact of COVID. I think lenders will need to be conscious of prior performance, the character of the business owners, nature of sectors and forecasting when assessing credit applications to ensure consumer confidence and economy grows."
>
> Survey respondent (Private lender, VIC)

of lenders want to see

expect to maintain this level through 2022

05

3. As many sectors enter recovery, industrial soars

There have been some interesting sentiment shifts across the various sectors since last year. Many are set to enter a recovery phase – or even decline – over the next 12 months, whereas residential (both developments and apartments/housing) and industrial are displaying signs of peaking.

Continuing the cyclical nature of these sectors, commercial and retail are slowly getting back on their feet and potentially entering recovery after lengthy COVID-induced setbacks. However, threats to both sectors remain: retail still has to overcome the convenience of online shopping, while commercial must contend with the rapid adoption of hybrid work and the exodus of full-time office-based staff[4]. At the other end of the spectrum, industrial is surging towards a peak phase, with lenders anticipating it still has legs to do more throughout 2022.

> "Everyone loves certainty of income profile, and industrial currently seems to have it better than most. It's very much an institutionally led market, and the certainty of logistics demand, big sheds, and big tenants make it attractive."
>
> Michael Hynes,
> Joint Managing Director
> Stamford Capital

Despite an overall positive outlook for most sectors, lenders believe there are three major pockets of concern for 2022:

- **Retail** – primarily ageing and sub-regional assets, due to the continual growth of online sales, plus fewer tourists after lengthy border closures.
- **Residential developments** – with continued supply chain issues, labour shortages and material cost surges.
- **B-and C-grade offices** – thanks to CBD office market contraction in this stock, and a fundamental shift in tenant demand being masked by incentives.

[4]https://www.afr.com/work-and-careers/workplace/you-will-pay-for-your-hybrid-work-freedoms-with-more-hot-desking-20220131-p59sh4

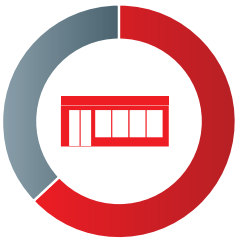
Regarding sector outlook for 2022, those surveyed say:

Commercial

21% in decline

54%
in recovery

Retail



29% in decline

49%
in recovery

Industrial

25% early growth

65%
peak

Residential development

25% early growth

42%
peak

Residential apartments and houses

24% early growth

51%
early growth/peak

4. Greater oversight looms as non-banks enter the mainstream

Similar to last year, non-banks are the flavour of the year and will look to expand their loan books again in 2022. In many respects, changes over the past couple of years have forced non-bank lenders to become as competitive as the major banks, and their offerings are evolving to reflect that.

Non-banks are also being less risk-averse than the big lenders in certain sectors, particularly around construction lending where borrowing opportunities with major banks have started to dry up. We are also more likely to see non-banks increase their margins this year, compared to 2021.

But as non-banks continue to accelerate their market-share growth, they are likely to come into APRA's sights. Whereas less than half (48%) of respondents last year believed APRA would increase its regulatory oversight of the non-bank sector, 54% now have strong expectations that this will occur in the near future.

In October 2021, however, APRA challenged this idea in a letter to authorised deposit-taking institutions (ADIs), noting non-bank lenders as accounting for only a 'small share' of total housing lending.[5] At the time, the regulator noted it can only make rules in relation to non-ADI lenders if those lenders are considered to materially contribute to risks of instability in the Australian financial system.

> "The level of competition in the private lending space continues to grow with more and more new entrants and existing participants reducing their rates significantly. There is also a lot of new investment into a number of the private lenders, which has helped increase product offering at lower rates."
>
> Survey respondent (Private lender, VIC)

Elsewhere, while we aren't expecting any drastic changes in foreign bank activity compared to last year, more than a third (36%) believe foreign banks will start increasing their investment activity. Reopening of borders is likely to see overseas borrowing become more commonplace again, with foreign lenders typically following wherever their people go.

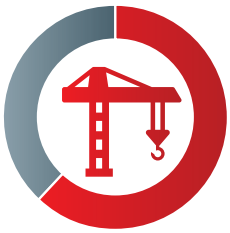
However, other competitors in the market have fallen behind in the past 12 months. While only about half (54%) of lenders in 2021 said crowdfunding would struggle to emerge as a serious lending option, almost two in three (62%) now see these platforms as being unsustainable in the lending market.

[5] https://www.apra.gov.au/news-and-publications/apra-increases-banks%E2%80%99-loan-serviceability-expectations-to-counter-rising

More than two-thirds

67%

expect non-banks to increase investment lending



62%

predicting increased construction lending

07

5. With interest rates set to rise further, new products will emerge

Finally, our survey showed a growing consensus that – yes – 2022 will be the year interest rates finally go up. And they were right with the RBA lifting the cash rate by 25 basis points on 3 May 2022. A whopping 90% of lenders expected interest rates to rise at some point this year. That's a huge turnaround from 2021, where 95% predicted the RBA would hold rates steady.

Of those, more than half (54%) expect a bump of 0.5% to 1.0%. More concerning is that some economists speculate a cash rate increase this year up to 2%.[6] This will undoubtedly raise concerns among borrowers, as there will be greater challenges to meet serviceability requirements. Whether private lenders will be able to use this as an opportunity to keep rates low, remains to be seen.

Off the back of the rise in interest rates, we expect to see the emergence of new products to entice borrowers and meet new lending appetites with 36% of lenders planning to develop new products in 2022.

[6] https://www.brokernews.com.au/news/breaking-news/cba-predicts-when-interest-rates-will-rise-279619.aspx

Lenders who are planning new products have an equal focus on:

Build to rent

Construction lending

Stretched senior debt for investment and construction lending

> "With borrowing costs moving up, interest cover will decrease. And that means ICR could become the new handbrake on lending – not LVR."
>
> Michael Hynes,
> Joint Managing Director | Stamford Capital

The local view

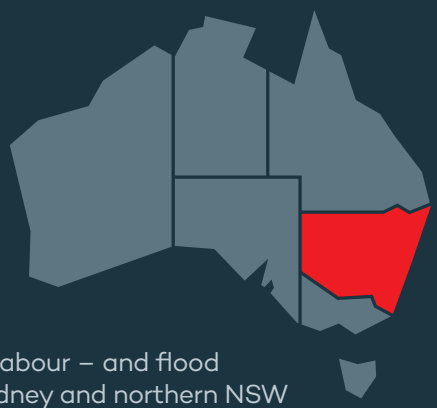
New South Wales

Peter Cutajar – Director

Like much of the country, house prices in NSW soared in 2021. The jump of more than 30% was the state's biggest rise since the 1980s. However, affordability issues – particularly for first home buyers – have now kicked in, slowing the pace of growth in the last two quarters. This market slowdown is predicted to continue throughout 2022 as interest rates start to rise.

By contrast, the rental market in Sydney has started improving as migrants, foreign workers and students return to the state capital. We've also seen regional rents increase, as cashed-up tree changers from metro areas move to the country, thanks to a combination of pandemic pressure, housing affordability concerns, and the opportunity to work remotely. This exodus from Sydney also pushed up home prices over the past two years.

Construction costs have also surged, in some cases by as much as 30%, due to a combination of supply chain shocks caused by the pandemic and global tensions, runaway inflation, a shortage of skilled and unskilled labour – and flood damage in Sydney and northern NSW amplifying building demand.



So, it's perhaps unsurprising that there appear to be fewer large construction projects commencing in Sydney in recent months, and it's taking longer to obtain development approvals, construction certificates and occupation certificates. All these factors will add further pressure to the state's rental market.

Over the past 12 months, leverage ratios stretched to unprecedented levels. Accelerated growth within the non-bank space has left the commercial debt market flush with cash, causing lenders to reduce rates and increase leverage to stay competitive.

We have also seen an abundance of liquidity in the non-bank space. A record-low-interest-rate environment has seen many investors targeting higher returns, funnelling their cash into the non-bank space. Increased liquidity in the space, coupled with an increase in competition, means LVRs have naturally crept up the curve.

09

Victoria

Barn Wilson – Director

As Victoria continues to move away from 18 months of intermittent lockdowns and begins to operate in a manner more akin to pre-pandemic life, residential developments should gain plenty of momentum. However, headwinds still exist in the market – particularly with heightened construction costs brought on by the pandemic, supply bottlenecks and geopolitical events.

Victoria, and Melbourne specifically, have long relied on strong overseas migration to support the broader economy, but there is no clear sign as to when this will return to pre-pandemic levels. We expect the residential market in Melbourne to gently build momentum in 2022 before really gathering speed in 2023 and beyond.

An abundance of capital still exists for residential development deals, with the ability to tweak leverages, presales and pricing to fund most deals. The rising cost of construction and capital should be somewhat offset by rising revenues over time in the Melbourne apartment market.

Commercial developments will undoubtedly experience further challenges posed by the 'new norm' – that is, hybrid and remote workers. A transforming office structure and a strong preference for work-from-home options across most sectors is something commercial developers will need to grapple with, potentially over the long term.

Both developers and investors will be closely monitoring the increasing cost of capital as rates rise throughout 2022. We also expect ICRs to come under increasing focus in the commercial investing space. For developers, the cost of construction will weigh heavily on their ability to make feasibilities stack to the extent they cannot be offset by rising revenues.

Most of these trends will be broad-based and not necessarily specific to Victoria. However, the run-up in established dwelling prices in the state – at least historically – would point to a subsequent increase in apartment prices, which may offset some of the cost pressures should they come to fruition.

Queensland

Chris Drummond – Director

Avoiding high infection levels throughout 2020 and early 2021 was a boon for Queensland and may be one factor in the growth in net interstate migration – especially from NSW and Victoria. With solid population movements projected to continue, demand for available residential property is expected to outstrip supply in most major segments of the market this year. However, rising interest rates along with other external economic pressures may soften demand as the year progresses.

The availability of capital for developments may see some tightening in specific segments where issues around supply and market depth exist. There is also some evidence that both banks and non-bank capital providers are already tightening requirements for projects considered overly high-end, or large-scale developments on the Gold Coast.

Underlying fundamentals for investment in the industrial sector remain strong, and we expect the availability of capital from financiers to continue, at least for well-located industrial property with strong lease tenure. An ongoing shortage of well-located industrial land supply does, however, remain an issue in most parts of Queensland.

Elsewhere, positivity is re-emerging in the commercial office market, with much of the activity happening in the Brisbane CBD fringe, and a flight-to-quality in commercial development.

Outside of external economic shocks, the biggest issues for developers across all property segments centre on construction risk and land supply – particularly given the strong residential demand in Southeast Queensland.

With near-record local government approval activity, the ability to progress development projects depends on access to suitably qualified builders. As this is currently constrained, it could lead to a very real slowing in supply of new stock to the market.

Finally, appetite from lenders in the non-bank space seems robust, with an array of options available to borrowers across all property segments. There has been some recent softening towards Gold Coast residential sites/land bank funding, but there doesn't appear to be the same concern for applications relative to Brisbane and Sunshine Coast projects.

We also see quality opportunities in term debt and investment assets, which are still highly sought after by major banks and second-tier regional lenders.

11

South Australia

Adam Miller – Director

Across South Australia, and particularly in Adelaide, we are seeing an increasing appetite, variety and presence of active non-bank lenders, with more and more developers taking advantage of this trend.

For residential developments, increasing macroeconomic pressures – given the upward interest-rate trajectory and the conclusion of most pandemic-related stimulus – will result in greater bank caution and scrutiny on presale debt cover and tempered leverage appetite for some projects.

We expect major bank appetite to top out at **65%** LVR for residential development for high-quality projects in South Australia, compared with up to **75%** LVR for non-bank stretch senior loans.

We are also seeing commercial and retail developers increasingly benefit from more non-bank debt flowing into South Australia, which can support earlier project activation and efficient equity allocation.

With the South Australian government being the largest occupier of office space in the state, many investors will need to consider ongoing demand as a catalyst for future projects, and to ensure the stability of existing assets underpinned by government tenants.

Market participants will be looking for ongoing government initiatives to assist in the recovery of Adelaide's CBD, ensuring more workers return to their offices as we move out of the pandemic. The ability of the newly elected state government to deliver material improvements in the development assessment process will also be watched with interest.

Investors will also be closely monitoring how the government can attract new investment into the state, following strong economic growth achieved by securing the National Space Agency and several global corporates.

Investment from the federal government will continue to have a major impact on the South Australian economy – the expansion of the Osborne Naval Shipyard into one of the most sophisticated construction bases in the world is just one example. Benefits such as these will flow through to significant parts of the industrial and office sectors, as well as throughout the Port Adelaide and Lefevre Peninsula region.

A partnership grounded in trust

In the hunt for yield, investors are still pumping capital into this market – and we don't expect this to change significantly in the next 12 months as interest rates inevitably increase. Likewise, our survey respondents remain optimistic about their loan book growth despite ongoing global instability and as we shift into an era of inflation growth.

Commercial loan originators will continue to play a vital role in this evolving landscape. More than three-quarters (78%) of respondents believe originators will continue to grow their share of commercial loan volumes, up from less than two in three (62%) pre-COVID.

With numerous moving parts and deals becoming more complex, borrowers are looking for expertise from established lenders who understand how to get a deal on its feet.

> "The value proposition for an arranger has never been stronger. Developers don't want to be dealing with money day-to-day – that's our business. So, they come to us. We've got the knowledge, we know who has the appetite to lend, and we can help structure the right deal for them."
>
> Michael Hynes,
> Joint Managing Director | Stamford Capital

In a market of tightening lending criteria, potential ICR pressure, and loan margin growth, it makes sense to choose partners you can trust to deliver on their promise. An experienced capital funding partner, who considers the complete lending market, will be able to help you move quickly, structure a deal that can preserve your ROI, and give you direct access to a growing number of non-bank and alternative lenders.

And they can also give you the most valuable asset in these less certain times: confidence to sustain your momentum.

78%

78% of respondents expect originators will continue to grow their share of commercial loan volumes

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