RESEARCH NOTE

SEPTEMBER 2016

PRESSURE ON AUSTRALIAN BANKS IS CREATING OUTSIZED REAL ESTATE DEBT OPPORTUNITIES

SUMMARY

Market dislocation and supply-demand imbalances in the Australian Commercial Real Estate (CRE) debt sector have created mis-priced income yielding investment opportunities where there is scope to deploy large amounts of capital.

Since 2008 the number of commercial real estate lenders in Australia has progressively reduced to the stage where over 90% of all CRE debt in Australia is provided by the Big 4 banks[1]. This high level of market concentration means that any change in appetite or capacity in the banking sector has a dramatic effect on the availability of CRE debt and the terms on which it will be provided.

In recent months bank lending on commercial real estate has once again become significantly constrained. The issue this time is not one of credit quality or risk underwriting, as the demand for funding and the quality of borrowers remains constant. Rather, it is a supply problem driven by APRA[2] led portfolio weighting concerns and continuing cost of capital issues.

The result of these structural changes has created a compelling opportunity for experienced investors to step into parts of this lending vacuum.

While the lack of bank appetite is noticeable in all sectors of the CRE debt market, the most pronounced shortage is in the CRE mid-cap sector[3] where credit tightening has been most keenly applied and where many long-established loan categories now have significant unmet demand. The optimal strategy in the current environment is to be opportunistic and to target those mid-cap loan categories where the banks have severely restricted their lending activity and where the level of risk is significantly mis-priced.

The opportunity is to provide financing solutions at high margins, on a senior secured basis, on comparatively short-dated loans, advanced to experienced borrowers where the LVR is low–moderate (and risk is mitigated by lending structures and other layers of security protection). Experienced CRE lenders can now target returns in excess of 10% p.a. without resorting to high LVRs, traditional mezzanine lending or unduly risky development lending.

To succeed in this sector an investor needs a capacity to originate sufficient volume of these type of loans, a solid credit underwriting ability, primary and special servicing capacity and specialist asset recovery expertise. These attributes have proven the key to delivering CRE debt portfolios with consistent returns, low default and low loss given default rates.

1 The Australian banking sector is dominated by four major banks: Commonwealth Bank, ANZ, Westpac and NAB.

2 The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the Australian financial services industry.

3 Mid-cap loans range in size from $3m – $50m, and are more typically in the range $5m – $20m.

CURRENT LENDING CONDITIONS

Australian CRE lending is a market of more than $300bn[4].

In recent years tighter controls by the Reserve Bank of Australia (RBA) and APRA, coupled with the impost on bank balance sheets through the BASEL II and III capital adequacy framework, has substantially increased the level of capital that Australian banks allocate against CRE lending.

In the current real estate cycle, the cumulative effect of strong CRE credit growth (driven in large part by high-rise residential apartment construction[5]) has created serious portfolio imbalances for Australian banks. This situation has been exacerbated in the past six months due to the banks withdrawal from a large swathe of residential lending (especially lending for investment purchases by foreign nationals). The net result is that Australian banks are grossly overweight in CRE loans which has led to their subsequent withdrawal from many of the key CRE lending sectors.

The pullback in lending has led to a significant increase in loan margins and a strong demand from borrowers for alternate credit providers. Many long-established loan categories now have significant unmet demand. In the face of what is effectively a mini-credit crunch, many highly experienced CRE investors and developers now need new sources of reliable, long-term loan capital for investments or projects which until recently were comparatively easy to finance. This has resulted in mis-priced lending opportunities which should persist for the foreseeable future.

In short, the market today is very different from even 6 months ago. The yields on offer for what are generally high quality and low risk lends are simply a reflection of a lack of funding. Through no fault of the borrowers, it is becoming harder and harder to source funding.

SIGNIFICANTLY MIS-PRICED LOAN SEGMENTS

As with other credit crunches the banks are trying to cause the least damage to long-term customer relationships. In this instance the banks have withdrawn most strongly from property specific transactions (what banks often term "IPRE" loans[6] i.e. CRE investment loans that rely on income from the asset rather than income from the sponsor) and construction finance. The result is a very strong lending opportunity in mid-cap CRE debt which is ironic as this sector is perhaps the strongest in Australian real estate at present due to a broad level of buyer support, a firming in yields, rising rents and no evidence of oversupply in the key commercial, industrial and retail sectors.

The following segments are rich with opportunity:

- Lending on assets where the property income is the principal form of servicing
- Income producing assets with up to a 75% 'stretch senior' LVR, albeit with good tenancy and high quality borrowers
- Commercial assets and repositioning opportunities with shorter WALEs[7]
- Residual stock loans for residential developments, typically with covenants requiring a sell-down of stock and reduced LVR's over the loan term

4 APRA Monthly banking statistics, RBA & ABS data.

5 Residential apartment construction loans are defined by banks worldwide as CRE loans.

6 Income Producing Real Estate.

7 Repositioning includes refurbishment to increase the property attractiveness to tenants, or reclassification (e.g.: from industrial to commercial zoning). Weighted Average Lease Expiry (WALE) is the the average time period in which all leases in a property will expire, weighted by rental amount.

- Lending on prime properties where the borrower simply does not meet the now strict and limited bank credit requirements, for example, commercial real estate acquisitions by foreign nationals
- Site facilities, typically with zoning approval and a low LVR, where additional security is afforded by corporate and/ or individual sponsor guarantees
- Bridging finance and shorter term loans for the acquisition of properties or repositioning of assets
- Low LVR security lends and specialist security
- Smaller construction funding, typically $20m or less, in prime locations where lower debt size obviates the need for 100% pre-sale cover.

CURRENT LENDING RATES[8,9]

The loans described above can be grouped into the categories described in the table below. The table outlines current lending rates as well as characteristics such as the maximum LVR that might reasonably be tolerated, a likely average LVR within each loan category and an indicative loan term.

PARAMETER/ LOAN TYPE	OPPORTUNISTIC SENIOR	STRETCH SENIOR	OPPORTUNISTIC DEVELOPMENT[8]	OTHER[9]
Whole Loan Rate Range	5.0% - 11.0%	5.5% - 12.0%	7.5% - 15.0%	6.5% - 15.0%
Market LVR Ranges	40% - 70%	60% - 75%	60% - 70%	50% - 70%
Average LVR	55%	72%	60%	60%
Average Loan Term (Months)	18	24	18	24

PREFERRED INVESTMENT STRATEGY

The optimal strategy in the current environment is to be opportunistic and to target the loan categories described above where the Big 4 banks have most restricted their lending activity.

Investors can be more than adequately rewarded for risk without resorting to high LVRs, mezzanine or unduly risky development lending. It is possible to construct well-diversified portfolios with capital protection enhanced by appropriate LVRs and tailored loan covenant structures. Today, the target average LVR across a lending program focussed on these loans should be 65% or less.

Experience at Balmain suggests that a loan program focussed on this segment may have a target return in excess of 10% p.a. and a loss given default rate consistent with investment grade bonds.

When considering an overall balanced portfolio strategy, CRE debt has a low correlation of returns with other asset classes. Historically the correlation of CRE lending to the Barclay's Aggregate Index is low to moderate. The correlation to the Credit Suisse Leveraged Loan Index and equities has been negative[10].

8 LVRs for Opportunistic Development Loans are based on "On Completion" ratios. Lending ratios against hard costs (LTCR) are at an average <75%.

9 Includes specialist security such as real estate secured business trading loans, bridging loans, notes, etc.

10 See 'A Fresh Take on Australian Commercial Real Estate Debt', Balmain Investment Management Limited, August 2013. This paper can be found at www.balmaininvestment.com.au

ABOUT BALMAIN INVESTMENT MANAGEMENT

Balmain Investment Management Pty Limited (Balmain) is the institutional funds management arm of the Balmain Group, Australia's leading non-bank secured private debt group. Operating for over 35 years, the Group's sole focus is commercial real estate debt. Balmain is one of Australia's largest and most experienced secured private debt fund managers and has the largest CRE Loan origination network. The Group is a primary servicer of over $9bn in commercial loan receivables and is also the largest distressed debt portfolio manager in Australia, currently overseeing more than $6bn in loan assets on behalf of a variety of investors including Goldman Sachs, Morgan Stanley, Bain Capital, Blackstone and Deutsche Bank.

Balmain has established a joint venture with Brookvine Pty Ltd to facilitate institutional investment in Australian secured private debt. Brookvine is an independent Australian investment advisory and marketing business.

Balmain Investment Management Pty Limited

Michael Holm
Chief Executive (Funds)

Ph: +61 2 9232 8888
M: +61 413 945 924
E: mholm@balmain.com.au

Melanie Stone
Asia Head of Capital

Ph: +61 2 9232 8888
M: +60 163 728 590
E: melanie.stone@balmain.com.au

Brookvine Pty Limited

Ed Day
Director

Ph: +61 2 9328 6445
M: +61 418 277 583
E: edday@brookvine.com.au

Steven Hall
Managing Director

Ph: +61 2 9328 6445
M: +61 401 232 422
E: stevenhall@brookvine.com.au