Australian Real Estate Capital Markets Observed

Commercial Real Estate Credit – Outlook on Pricing and Availability

During the Global Financial Crisis ("GFC"), the Australian real estate sector got a taste of what life is like as a nation that relies on global capital markets for its long term capital needs. Arguably the credit crunch that started in 2008/09 is the first time we have witnessed the effects of our over reliance on foreign capital coincident with a sustained recession across Europe and the United States.

The crisis in Europe worsened during the December quarter of 2011 and whilst some commentators viewed this as the GFC Part 2 we are of the view that what we are seeing is merely the result of companies and sovereigns having "kicked the can down the road" and thus delaying the inevitable consequences of having over leveraged balance sheets. As a result we expect tough times to persist in capital markets (including real estate capital markets) in Australia throughout 2012. Weaker European countries including Greece, Spain and Italy have been the main focus of capital markets during early 2012 but we should not lose sight of the potential contagion effect on other seemingly stronger European nations such as Germany and notably, France. In contrast to Europe, there are positive economic signals emerging from the US, albeit consensus is that the recovery is likely to be protracted.

Closer to home, and despite the continued positive story being told about the relative strength of the Chinese economy, there is also growing awareness of China's debt fuelled growth and the desire for the central government to manage a soft landing for their economy. This mixed message, together with the large pockets of weakness in the Australian domestic economy (particularly retail, manufacturing and financial services) means there are major hurdles for capital markets to overcome. In recognition of the global and domestic uncertainty and lower economic growth expectations the Reserve Bank of Australia ("RBA") saw fit to reduce interest rates by 25bp in both November and December with the resulting cash rate now at 4.25%. It should of course be noted that the RBA cash rate is still significantly higher than most other developed economies.

From a property market fundamentals perspective, Australian real estate prices and capitalisation rates have largely stabilised for premium quality core assets, however, we believe that slowing economic conditions will lead to a low rental growth environment, placing further pricing pressure on secondary assets, development projects and impaired bank assets. Combining expectations of low income growth with the large volume of properties for sale (either officially or unofficially) may lead to slower capital growth being achieved from institutional real estate assets.

On the debt side, the "Big Four" Australian banks (ANZ, Westpac, Commonwealth and NAB) have consolidated their position as the major source of commercial real estate debt. Their position has been strengthened by the foreign banks largely withdrawing from the market and the smaller banks having either been acquired by the "Big Four", or dramatically scaling back their property lending activities (due to a substantial rise in their commercial property loan impairments).

Whilst the CMBS market did show some activity during 2010, there was only one new CMBS transaction in calendar 2011, that being the ALE Property Group (ALE.ASX) AU$160 million CMBS issuance. Therefore, CMBS is unlikely to be a significant source of real estate capital for the next few years. As such, there is enhanced scope for new non-bank lenders to enter the market and provide an alternate and diversified source of capital for real estate borrowers. Non-bank lenders (including superannuation fund investors) are starting to emerge as an alternate source of debt capital, albeit they are only minor participants at this stage.

In our view, any shift toward the development of a locally robust mature and diversified alternate debt capital market will be evolutionary not revolutionary.

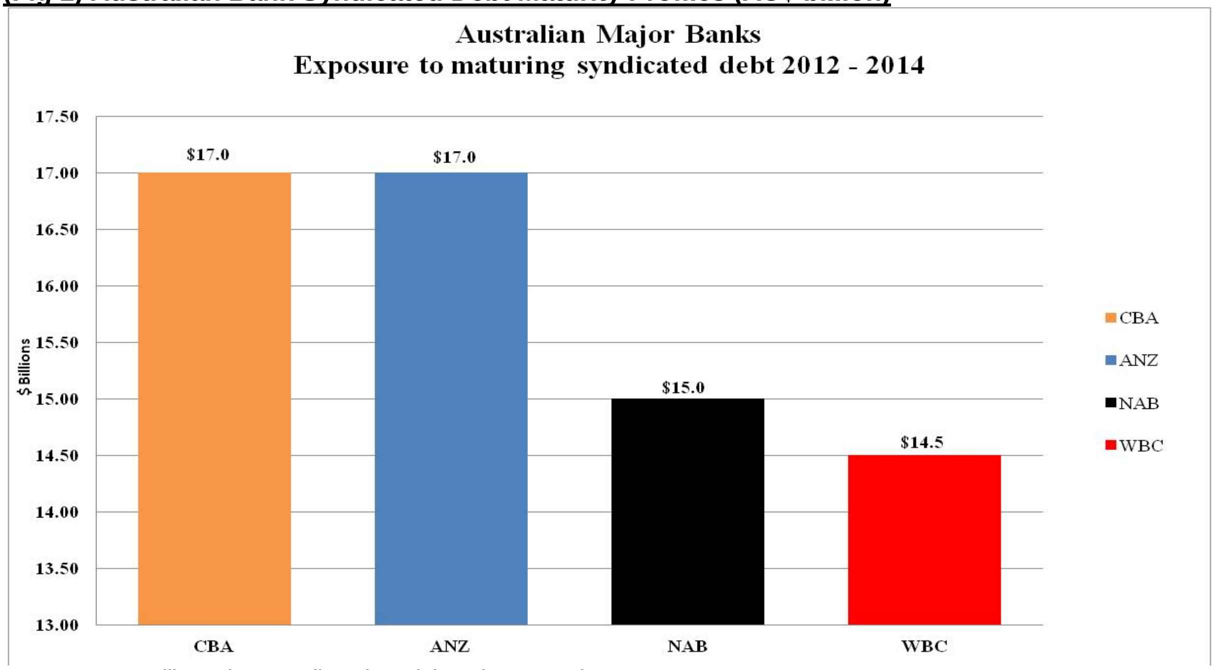
The banking sector has been largely focussed on the European crisis over the last year and whilst the "Big Four" are not directly in the firing line, they remain concerned as to the potential impact on wholesale lending markets. Though the "Big Four" have to date assured the market that they currently have sufficient funding in place, the possibility remains that the cost of wholesale funding will be significantly higher when they enter the market and look to raise debt capital later this year. This is likely to restrict Australian bank credit growth for at least the next 18 to 24 months as maturing historically cheap pre-GFC issued term debt is refinanced with more expensive longer-term debt.

While we focus on the real estate sector, the challenges confronting real estate debt finance are a microcosm of the entire Australian economy - where the availability and pricing of debt capital is inextricably linked to global sentiment and capital flows. Accordingly, the Australian economy is still highly susceptible to future shocks. The severity of any future shocks could be dampened by the development of alternative sources of home grown debt capital. Alternate sources include;

- Shoring up bank balance sheets via increased bank savings and deposits,
- Emergence of new lender participants including the AU$1.3 trillion[1] Superannuation fund sector,
- Opening up of securitisation markets, (REIT Bonds, CMBS, CLOs and other asset backed securities).

One of the key concerns regarding the availability of real estate debt is the overall potential for credit rationing from the "Big Four" together with the increasing costs for the banks in funding their own capital requirements. Credit growth (demand for bank debt) is currently moderate, however, while growth may be moderate there are significant refinancing requirements for their existing loan books over the next 1-2 years as illustrated by their exposure to just syndicated loans as shown in Fig1.

(Fig 1) Australian Bank Syndicated Debt Maturity Profiles (AU$ billion)



Source: BA Merrill Lynch, Australian Financial Review, 14 February 2012

This high level of demand is occurring at the same time there are severe restrictions on the availability of capital from both the domestic and more markedly from the foreign banks. Overlay this with the

[1] Australian Prudential Regulation Authority (APRA), Annual Report, 2011, 1 March 2012, www.apra.gov.au/AboutAPRA/Publications/Pages/annual-report-2011.aspx.

global debt concern and the general aversion to risk and the likely outcome may be further credit tightening in addition to that seen subsequent to the credit crunch of late 2008 and early 2009.

RE Debt Funding – Where the Banks Get Their Money to Lend?

Unlike most other large sophisticated economies, real estate lending in Australia is substantially a (approximately 80%[2]) bank intermediated market. Accordingly, the ability of borrowers to access debt funding relies to a large extent on the credit availability from the "Big Four"**,** i.e. any impact on the banks ability to lend has a corresponding and direct impact on overall real estate financing. This is in contrast to the major markets of North America, Europe and Japan where the non-bank debt markets are larger and have historically been more liquid.

While there is no doubt that the relative strength of Australia's "Big Four" has proven fortuitous during the GFC, this is no reason to believe it will always be thus. Put another way, in modern Australia we have always had the sense that debt capital will always be available, albeit at a price. We are presently in a period where this may not necessarily be the case and prudent capital management strategies should consider this.

To support future growth (not only of the Australian real estate sector but the wider economy) stabilisation of the global banking market and the development of alternate sources of debt capital in the Australian market will be required. In order to understand local debt availability it is necessary to appreciate the current bank funding model.

Prior to the early 1990's Australian banks funded their lending operations predominantly from retail deposits, that is to say they would take a dollar on deposit and lend a dollar out thus matching their asset to their liabilities (Fig 2). Since that time Australian banks have migrated away from this traditional funding model and have become far more reliant upon wholesale borrowing (Term Debt Financing) to arrive at the present scenario where only 60%[3] of their funding is derived from retail depositors.

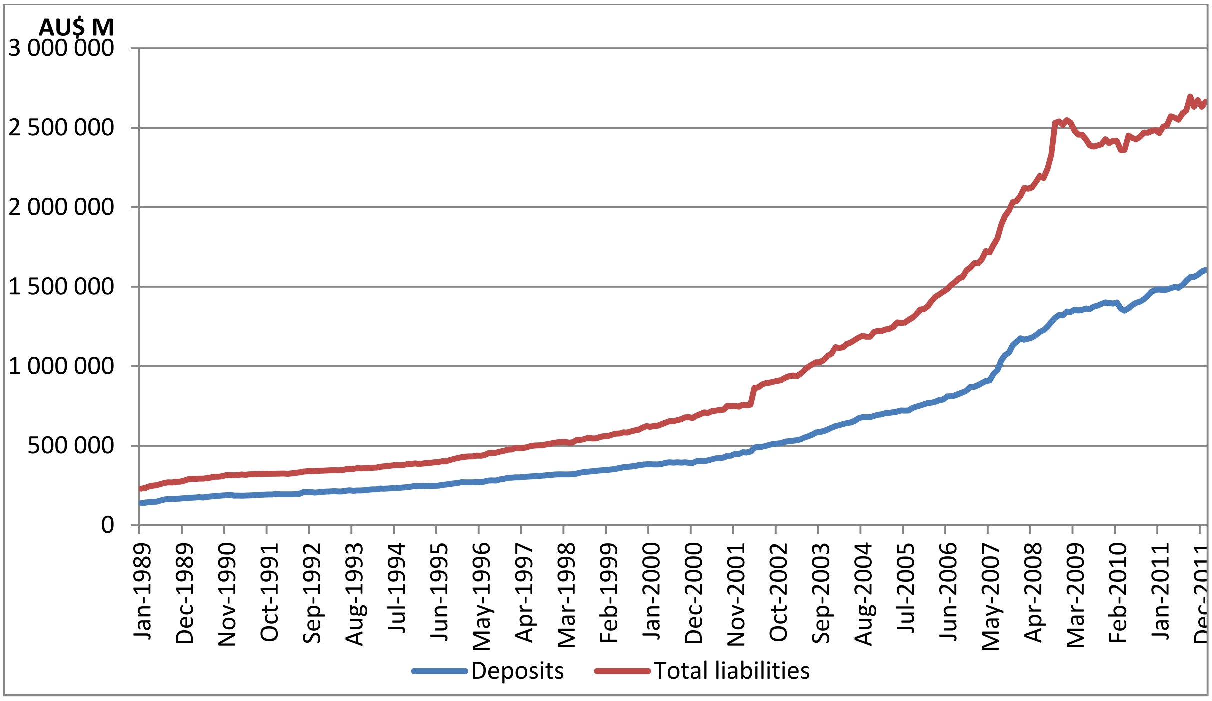
---

[2] Property Investment Research, Deutsche Bank, AFMA, Standard & Poors, APRA

[3] APRA, Monthly Banking Statistics, 1 March 2012, www.apra.gov.au/adi/Publications/Pages/monthly-banking-statistics.aspx.

QUADRANT
REAL ESTATE ADVISORS

(Fig 2) Australian Bank Total Liabilities vs Deposits Since 1989 (AU$ million)



Source: APRA, Monthly Banking Statistics, 1 March 2012

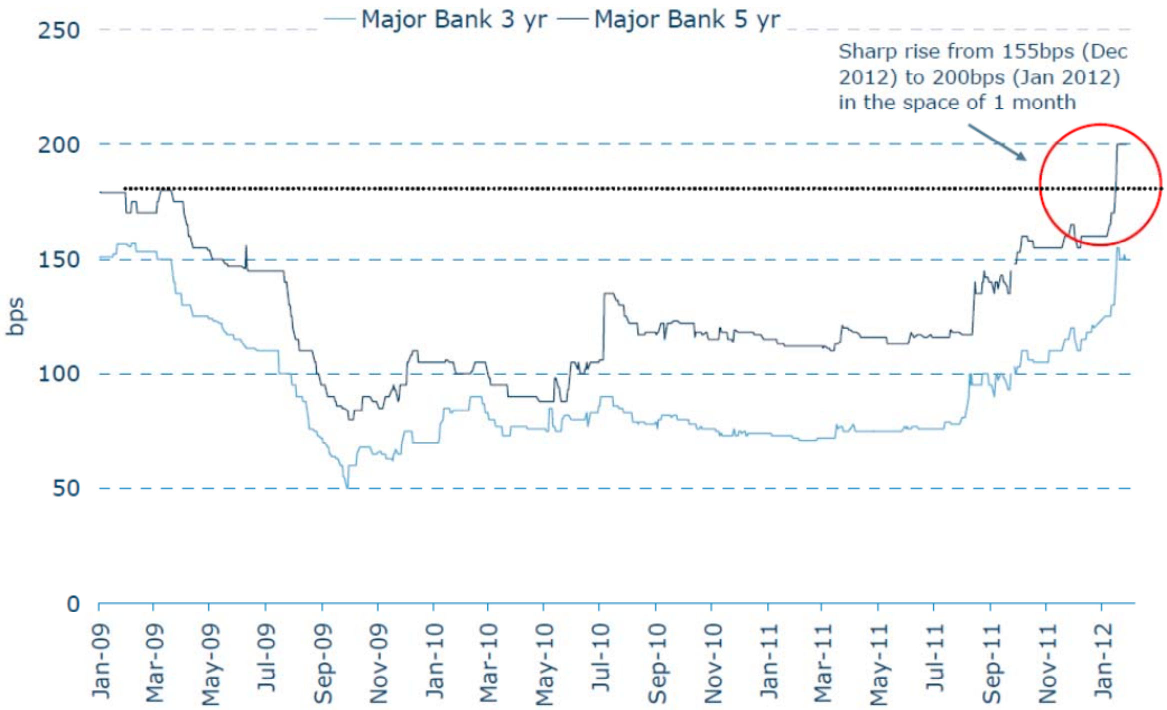
Recent efforts of the banks to increase their retail deposit base, (you will have noted the attractive rates currently on offer) have resulted in an increase from 55%[4] in September 2008 to 60%[3] today, however, there is insufficient capital available from depositors to see any structural reversion to the pre early 1990's position where there was limited reliance on foreign funding sources.

Given the Big Fours reliance on non-retail deposits, (i.e. term debt financing), it therefore follows that it is the wholesale providers that are now a major influence in the Australian banks pricing and capacity to grow lending. Further it explains the origins of our banking crisis during the early days of the GFC. As shown in (Fig 3) the bank term funding spreads have rapidly increased during the latter part of 2011 and early part of 2012 to be at their highest point since the Lehman collapse. Not surprisingly, this coincided with a recent period of margin increases by the Australian banks.

---

[4] RBA Statistics, Bank Liabilities, 31 January 2012.

(Fig 3) Wholesale Secondary Big Four Bank Funding Spreads

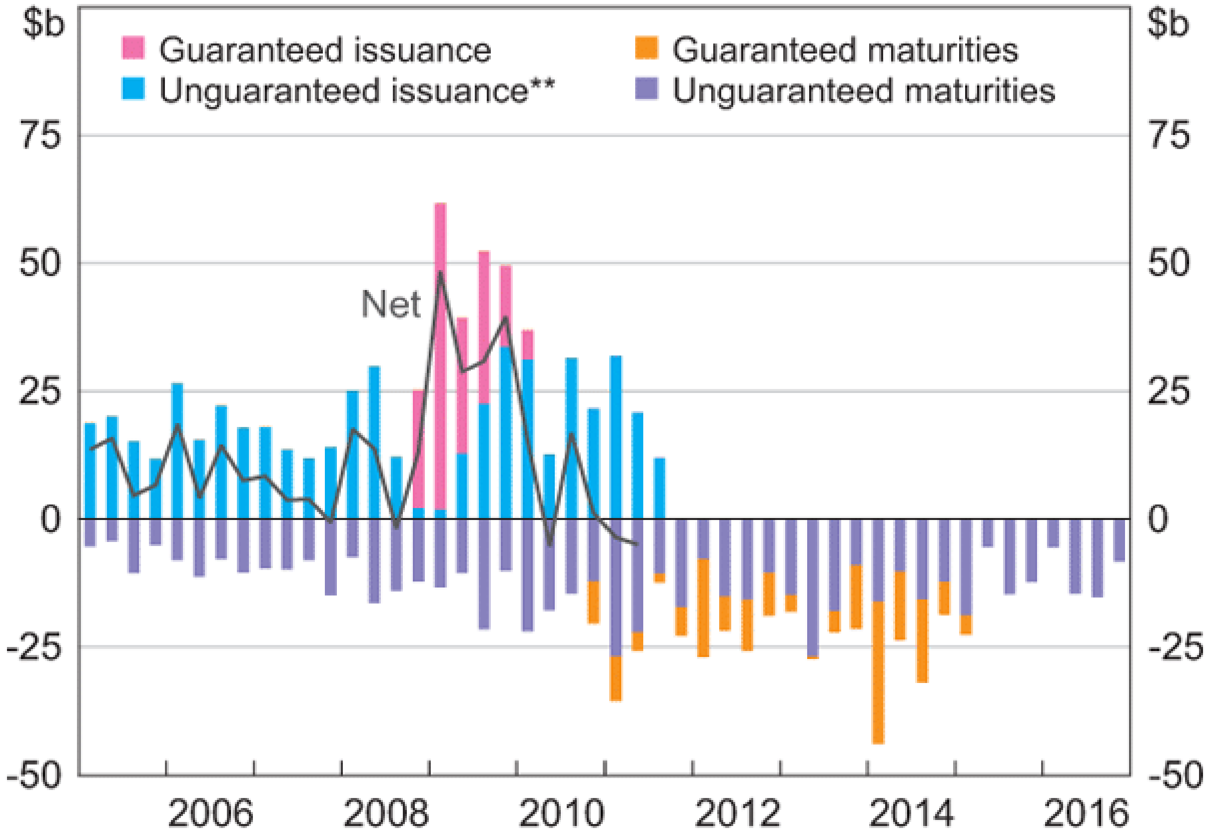


Source: ANZ, Debt Markets Newsletter, 2 February 2012

Following the Lehman collapse in October 2008 Australian banks went "back to the well" to issue term debt only to find that this source of capital had gone to the sidelines (there was less than AU$1 billion of Australian bank issuance in the last quarter of calendar 2008[5]). When the debt markets reopened, the price at which term debt financing was accessible (with and without the support of the Australian Government in the form of the taxpayer guarantee) was far in excess of that anticipated. Not knowing what the future held, the banks issued bonds at an unprecedented rate to provide a cushion in case the term debt markets locked up again (Fig 4).

[5] J.P. Morgan, Australian Banking Sector Research, 8 July 2010.

(Fig 4) Australian Bank Bonds – Issuance and Maturity (AU$ billion)*



* Excludes 12-15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme

** September 2011 is quarter-to-date

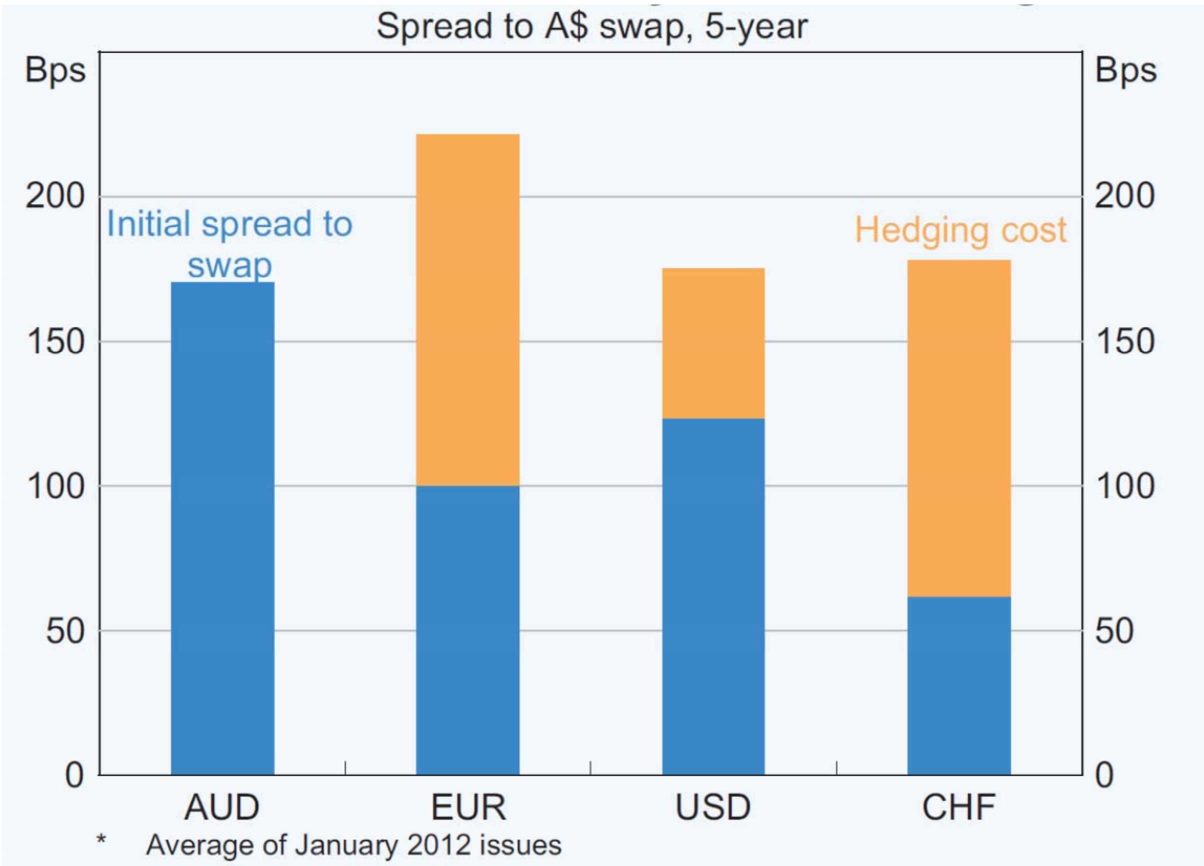
Source: RBA Statistics, Bank Liabilities, 31 January 2012.

Since the withdrawal of the government guarantee the "Big Four" have looked for alternate sources of funding and the introduction of covered bonds in late 2011 was seen as a possible panacea for bank funding. Covered bonds are on-balance sheet asset-backed securities issued by financial institutions.

Investors in covered bonds have a preferential claim on a pool of assets (called the cover pool) in the event that the issuing institution fails to make the scheduled payments on the covered bond. If the cover pool is insufficient to meet the issuer's obligations to investors, they have an unsecured claim on the issuer for any residual amount. Covered bonds typically have a higher credit rating than that of the issuer because the cover pools are usually comprised of high-quality assets such as prime mortgages, covered bond holders rank above unsecured creditors, and extra collateral is held in the cover pool.

Despite the higher credit rating and attraction of covered bonds to investors, the prevailing global uncertainty has meant that pricing of these bonds issued by Australian banks has been a disappointing result to say the least.

(Fig 5) Australian Bank Covered Bonds Pricing



Source: RBA, RBA Statement of Monetary Policy February 2012.

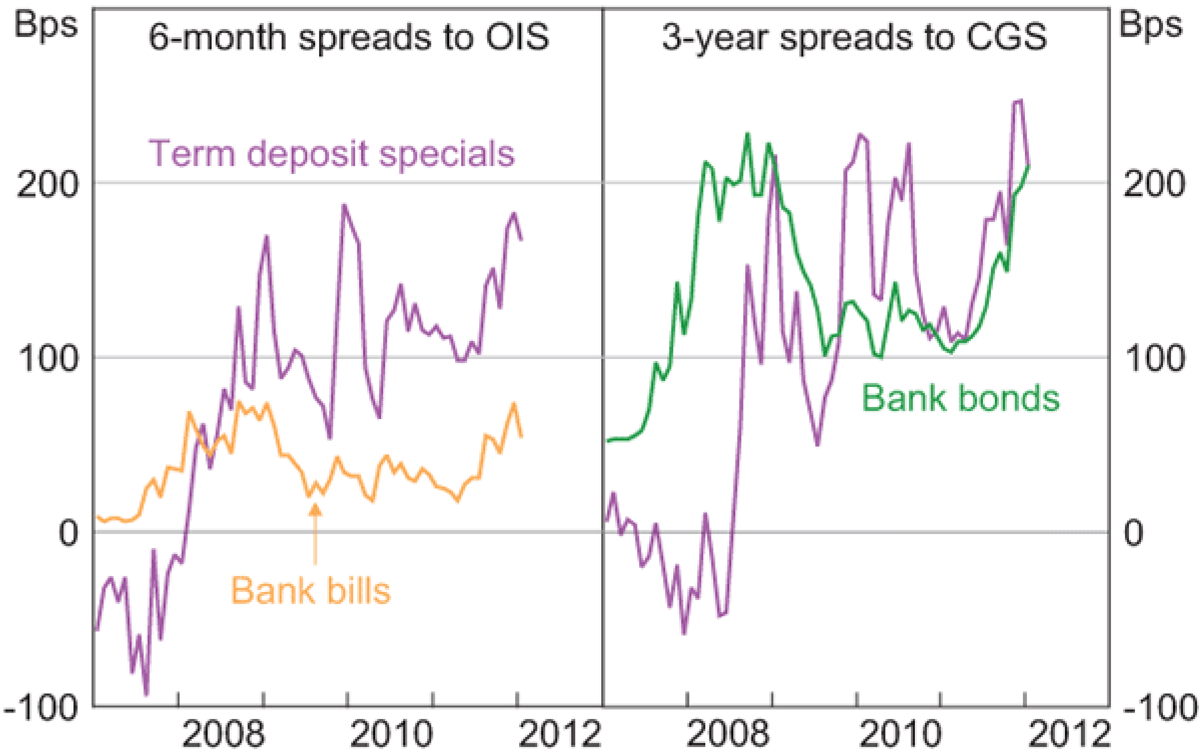
Issuance by geography and currency (Fig 5) shows over AU$6 billion of covered bonds being sold in the domestic Australian market followed by Europe and the USA. The cost of hedging foreign currency issuance back into AUD is also shown in (Fig 5). The cost of hedging currency issuance back into AU$ increases the lower initial margins to a higher all in cost than the domestic issues. There is no doubt that the cost of funds for the Australian major banks has risen significantly. However their desire to meet refinancing requirements has left them little choice but to access those markets that are open to them; regardless of cost.

Having established the source of bank funding we can now turn to the cost of bank debt as both a borrower and as a lender. As expected the demand supply equation had and continues to have a significant impact on the price banks pay for the capital they access.

The "Big Four" are currently paying depositors a premium of 175 bps above 3yr Commonwealth Government Securities ("CGS") (Fig 6). This is part of a concerted effort by the banks to secure their long term funding via retail deposit holders in marked contrast to their strategy of recent years. While depositors are being paid a premium compared to previous years, the price for retail deposits is still significantly lower than the spreads on bank bonds.

Bank funding costs for term funding (Fig 6, on right) continue to trend higher having dipped during 2009 by virtue of the price advantage afforded by the government guarantee, unfortunately for the banks this is no longer available.

(Fig 6) Australian Major Banks Average Funding Costs



Source: RBA, RBA Statement of Monetary Policy February 2012.

It is costing the banks a margin of approximately 200bp (above 3yr CGS) for their capital (Fig 6). Obviously if they are to on-lend this capital at a profit they need to charge borrowers a premium to cover their lending costs and profit margin. Accordingly, we see lending margins of 250bp – 300bp (for those transactions the banks want to do) being the norm for the foreseeable future.

Overall, given the relative global strength of the Australian banks it can be expected that they will be able to meet their existing term debt refinancing obligations in the global capital markets, however, the price they pay to access capital will continue to increase in the near term. Further, the availability of additional capital to fund credit growth is likely to be severely constrained.

It's Not Just Price - Duration is Also the Challenge

The Big Four banks fund their business with an average duration of 3.5 years[6] albeit there is a very strong desire for the banks, like all borrowers to extend this maturity profile. This means that when a bank makes a loan part of their internal risk management process aims to match their income (your loan interest and capital repayment) with their own liabilities (principally obligations to retail depositors and bond owners). In short, the current bank funding model and risk management practices discourages them from lending long term (i.e. longer than five years) without increasing overall balance sheet risk.

As an aside the provision of short term funding allows banks to regularly reset terms and conditions with their borrowers and charge fees more frequently.

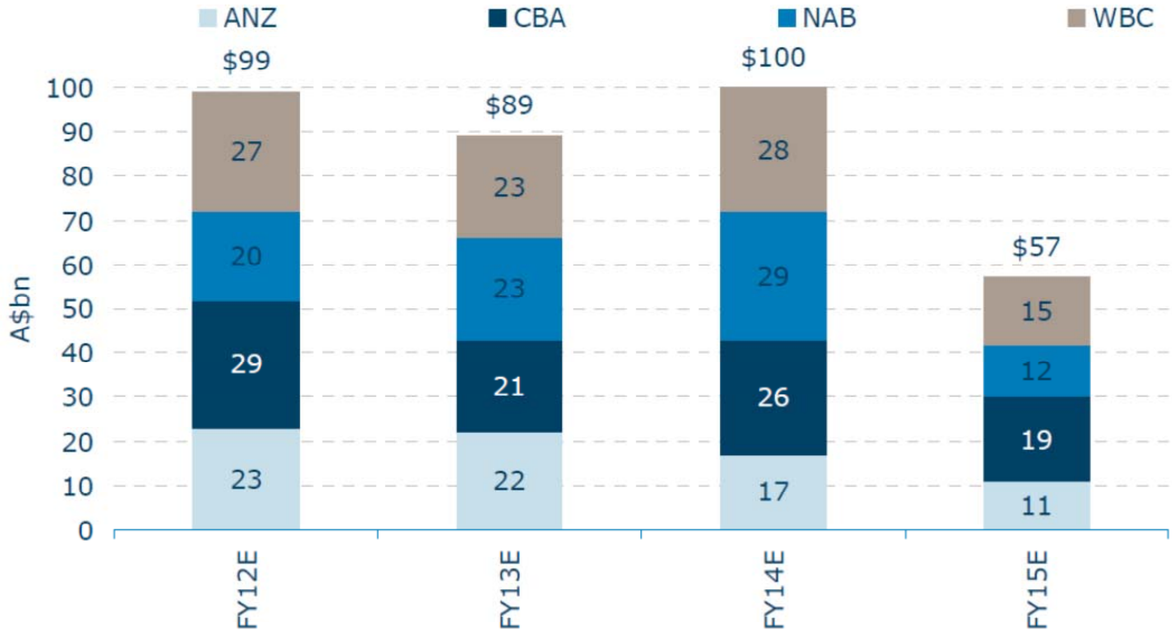
[6] UBS, Australian Banking Sector Update, 22 April 2010.

QUADRANT
REAL ESTATE ADVISORS

The Risks to the Banks' Refinancing Plans

In the five years leading up to the GFC the "Big Four" had approximately AU$36 billion[7] of bonds to refinance each year. As shown in (Fig 7), in 2012 and 2013 the banks need to refinance AU$99 billion[8] and AU$89 billion[7] respectively in term debt - a difficult challenge in a constrained global capital environment.

(Fig 7) Australian Major Banks Term Debt Maturities



Source: ANZ, Debt Markets Newsletter, 2 February 2012

Accordingly we are entering a period where the majority of the banks' annual term debt issuance will simply be absorbed by refinancing their existing maturities, leaving limited capacity to fund any credit growth.

There is also the question of who will be the buyers of those bonds originally sold with a Commonwealth Government Guarantee (shown pink in the previous Fig 4) noting that many of those buyers are unable to acquire anything other than Government guaranteed securities.

The reality is, there is only so much capital out there to acquire debt globally and foreign government backed institutions and governments themselves are presently major participants in these markets acting as borrowers. Due to the high demand for bond investor's capital, bond buyers will be more selective about which bonds they buy and will be demanding higher margins on the bonds they purchase.

In effect we are about to witness peak bank refinancing requirements at a time when the cost (margin) to do so is close to an all time high. What is also evident is that larger credit-rated corporates in Australia can tap global bond markets at pricing cheaper than the Australian banks and in some cases European sovereign borrowers.

These capital constraints and price increases will be passed on to borrowers, including those participating in the Australian real estate market. Until such time that global capital is available to fund the credit growth of the banks and pricing of the banks term debt starts to reduce, borrowers will be forced to pay the price.

[7] RBA Statistics, Bank Liabilities, 31 January 2012.
[8] Morgan Stanley Research

Superannuation Funds as Lenders

In Australia investors have been focused on the equity component of real estate notwithstanding the fact that the privately placed real estate debt component comprises approximately 31% or AU$66 billion[9] of the institutional grade commercial real estate universe domestically.

While much of the privately placed debt market in Australia is intermediated by the domestic banks, this has not always been the case with life companies being major participants in the market prior to the late 1980s.

The opportunity is therefore for institutional investors, including superannuation funds, to seek returns from the same domestic underlying assets and cash flows with capital being deployed more conservatively within the capital stack.

For superannuation funds, the key point to be aware of is that real estate debt investing involves investing in the same property types and markets that they are currently investing in (i.e. Sydney CBD office buildings, regional shopping centres, etc) merely using a structure that places the investor in a more conservative position in the capital stack.

Prudently deployed privately placed real estate loans are underwritten in much the same way as a direct equity investment with a significant amount of due diligence undertaken reviewing leases, outgoings, capital expenditure, leasing markets, valuations, building condition, etc.

Such an approach allows investors to construct a portfolio of assets that they would otherwise be comfortable owning. The downside is that privately placed loans are "lumpy" assets that are resource intensive to originate, underwrite and close and do not provide the same diversification benefits that publicly traded securities can. However, due to the long dated nature of real estate leases and the significant equity capital buffer provided by the borrower, an investor should enjoy a relatively high income return with a strong capital preservation position.

Whilst privately placed loans are not as liquid as listed REIT securities or publicly traded debt, each of the loans has a stated maturity which allows for constant repayment and redeployment of capital.

Changing Role of Banks

The capital constraints of the banks and the outcomes of the recent bank bond issuances have revealed:

- financing pressures faced by the major banks are persisting and in some cases intensifying;
- rather than being a panacea to funding challenges, covered bond issuance to date has reinforced the fact that bank financing costs are likely to remain elevated; and
- as a result, constrained bank credit is likely to continue and loan margins face an inevitable increase over the medium term.

The situation currently facing both lenders and borrowers in the investment grade Australian real estate sector should be seen as more of an opportunity than a threat. The ability to access other sources of capital to assist in the funding of high quality income producing property will be of benefit to both the Australian major banks and their borrowers. In recognition of this there has been an increasing role of banks in facilitating alternate funding sources either via assisting borrowers to access the bond or US Private Placement markets or in the case of the National Australia Bank (NAB), participating in the establishment of non-bank providers of credit. This allows the banks to offer their existing clients a range of financing alternatives whilst retaining control of the client relationship.

[9] Quadrant Real Estate Advisors, IPD, PIR Research, APRA.

Conclusion

The opportunity to deepen and broaden the sources of debt capital in Australia is something that will benefit not only borrowers but banks, non-bank lenders and investor alike. As sophisticated capital markets like those of the United States have shown, just as there are different demands for debt capital (short term vs long term, highly structured vs flexible terms, high leverage vs low leverage, fixed rate vs floating rate, diversified sources of capital vs single relationships, revolving facilities vs fully drawn) there are different investment objectives for debt providers.

Whilst there may be some cross over and competition between potential debt providers the Australian real estate capital markets needs cannot be satisfied by the domestic banks alone nor should the banks be expected to be the cheapest and/or most appropriate source of capital for all real estate capital needs. A robust debt capital market should have the capacity to match borrower requirements for duration, flexibility, capacity, leverage and loan structure from a range of sources including banks, unsecured bonds, CMBS, non-bank lenders and superannuation funds.

For further details;

Michael Wood – mwood@quadrantrea.com
Stephen O'Keeffe – sokeeffe@quadrantrea.com

Quadrant Real Estate Advisors LLC
www.quadrantrea.com