Australian Real Estate Capital Markets Observed

Debt availability – why it's (maybe) different this time

Executive Summary

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 the global capital markets for its long term capital needs. Arguably the credit crunch of 2008/09 is the first time we have witnessed the effects of our over reliance on foreign capital coincident with a sustained credit crunch and recession across Europe and the United States.

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 our developing alternative sources of home grown debt capital. Alternate sources include;

- Shoring up bank balance sheets via increased savings bank deposits,
- Emergence of new lender participants including the AUD1.3tn Superannuation fund sector,
- Opening up of securitisation markets, (CMBS, CLO's and other asset backed securities).

One of the key risks to accessing real estate debt will emerge when competing demand for bank debt emerges from the relatively low leveraged corporate sector. While credit growth (demand for bank debt) is presently a modest 1.1%[1] year on year to April 2010 it is likely this will expand markedly as we enter a growth phase of the economic cycle. It is likely that such demand will be coincident with the ***Big Four*** banks (ANZ, Westpac, ANZ and NAB) foreign term debt maturities in 2011/12. Overlay this with the global debt concern and general risk adversity and there is the real possibility of another credit squeeze - just like the credit crunch in late 2008 and early 2009.

Any shift toward the development of a locally robust mature and diversified debt capital market will be evolutionary not revolutionary. In the interim it is apparent that debt capital availability will continue to be constrained for the foreseeable future.

RE Debt Funding – where the banks get their money to lend?

Unlike most other large sophisticated economies real estate lending in Australia is substantially (approximately 90%) a bank intermediated market. Accordingly ***the ability to access debt funding relies on the fortunes of the Big Four banks*****,** 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 deep and in the main liquid. While there is no doubt that the relative strength of Australia's Big Four has proven fortuitous, this is no reason to be lulled into a sense that 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.

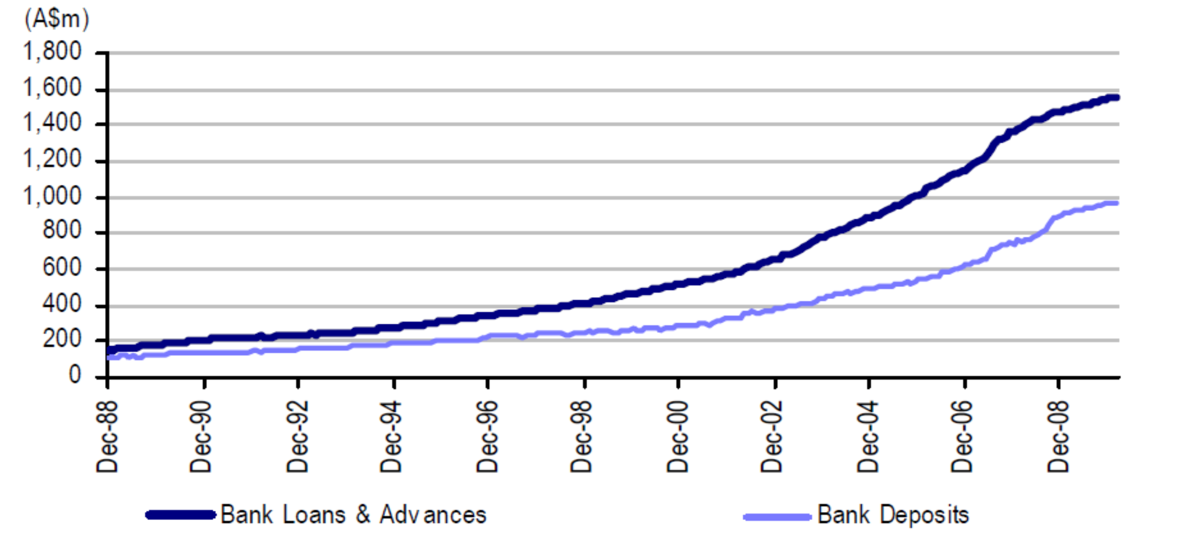
To support future growth (not only of the Australian real estate sector but the wider economy) stabilisation of the global banking market and the development of alternate sources of debt capital will be required.

In order to understand local debt availability it is necessary to appreciate the current bank funding model.

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

Prior to the early1990'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 and liability (Chart 1). Since that time Australian banks have migrated away from this traditional funding model becoming far more reliant upon wholesale borrowing (Term Debt Financing) to arrive at the present scenario where less than 50%[2] of their funding is derived from retail depositors.

Chart 1 - Australian Bank Loans & Advances vs Deposits since 1988 (AUDm)



Source: APRA, UBS estimates

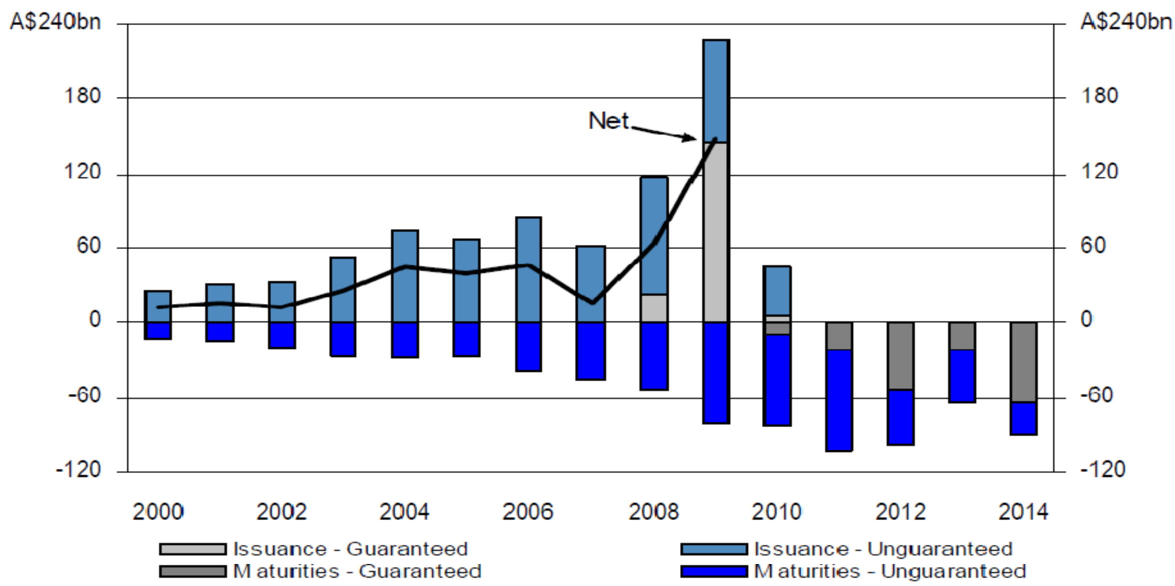
Despite recent efforts of the banks to increase their retail deposit base, (you will have noted the attractive rates currently on offer) this trend shows no sign of any structural reversion to the pre early 1990's position.

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 the major influence in the Australian banks capacity to grow lending. Further it explains the origins of our banking crisis during the early days of the GFC.

In the wake of the Lehman collapse in October 2008 our 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 $1 billion of Australian bank issuance in the last quarter of calendar 2008[3]). When the debt markets reopened, the price at which term debt financing was obtained (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, our banks issued bonds at an unprecedented rate to provide a cushion in case the term debt markets locked up again (Chart 2).

[2] Source: Westpac, RBA
[3] J.P. Morgan Australian Banking Sector Research 8 July 2010

Chart 2 - Australian Bank Bonds – Issuance and Maturity



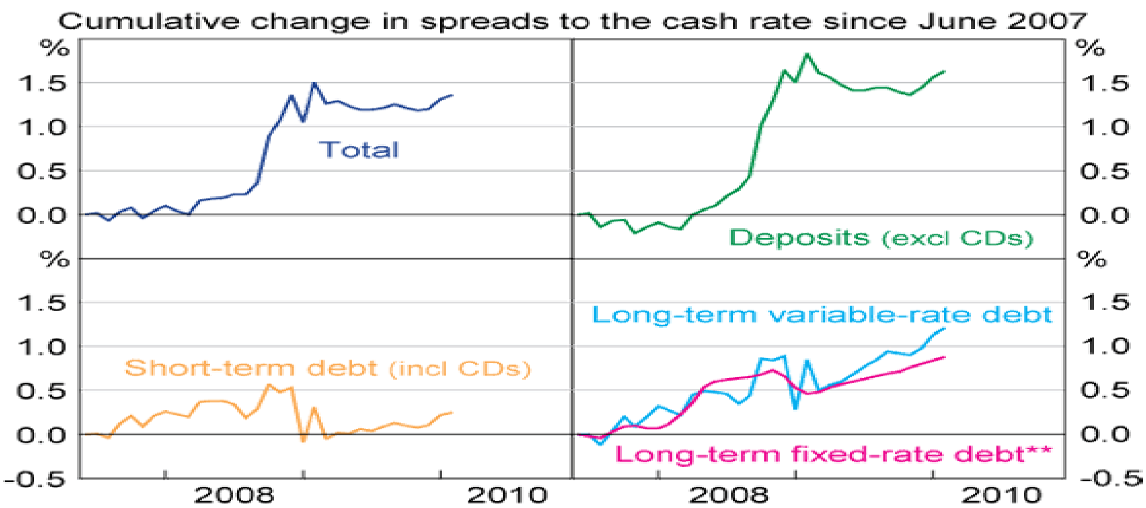
Source: Company data, RBA, J.P. Morgan estimates.
Note: 2010 Issuance data as at April 2010.

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 their capital.

By reference to the following Chart (Chart 3) you will note the Big Four banks are currently paying depositors a premium of 150 bps above 3yr Commonwealth Government Securities (CGS) (i.e.approx 490 Bps plus 150 Bps = 6.4%) being well in excess of the widely reported RBA cash rate of 4.5%. 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.

Bank funding costs across all sources (as shown top left) continue to trend higher having dipped during late 2008 early 2009 by virtue of the price advantage of the government guarantee that is no longer available.

Chart 3 - Australian Major Banks Average Funding Costs*



* RBA estimates
** Spread to 3-year average CGS yield
Source: RBA

As shown above, it is costing the banks a margin of just under 150bp (above 3yr CGS) for their capital. Obviously if they are to on-lend this capital at a profit they need to charge borrowers a substantial 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.

Duration is the challenge.

The Big Four banks fund their business with an average duration of (3.5 years[4]) 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 is to match their income (your loan interest and capital repayment) with their own liability (principally obligations to retail depositors and bond owners). In short, the current bank funding model and risk management practices places them structurally incapable of lending long term (i.e. beyond say 5 years).

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.

So where to from here?

In summary everything will be OK – so long as the merry-go-round goes on. That is the Bonds buyers continue to buy bank bonds and the banks continue to lend and credit growth is subdued and there are no global shocks................

The risks to the banks refinancing plans

In the five years leading up to the GFC the Big Four had approximately $36bn[5] per annum of Bonds to refinance in the next two years the banks need to refinance an average of $110bn[6] per annum in term debt - a massive challenge in a constrained global capital environment.

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

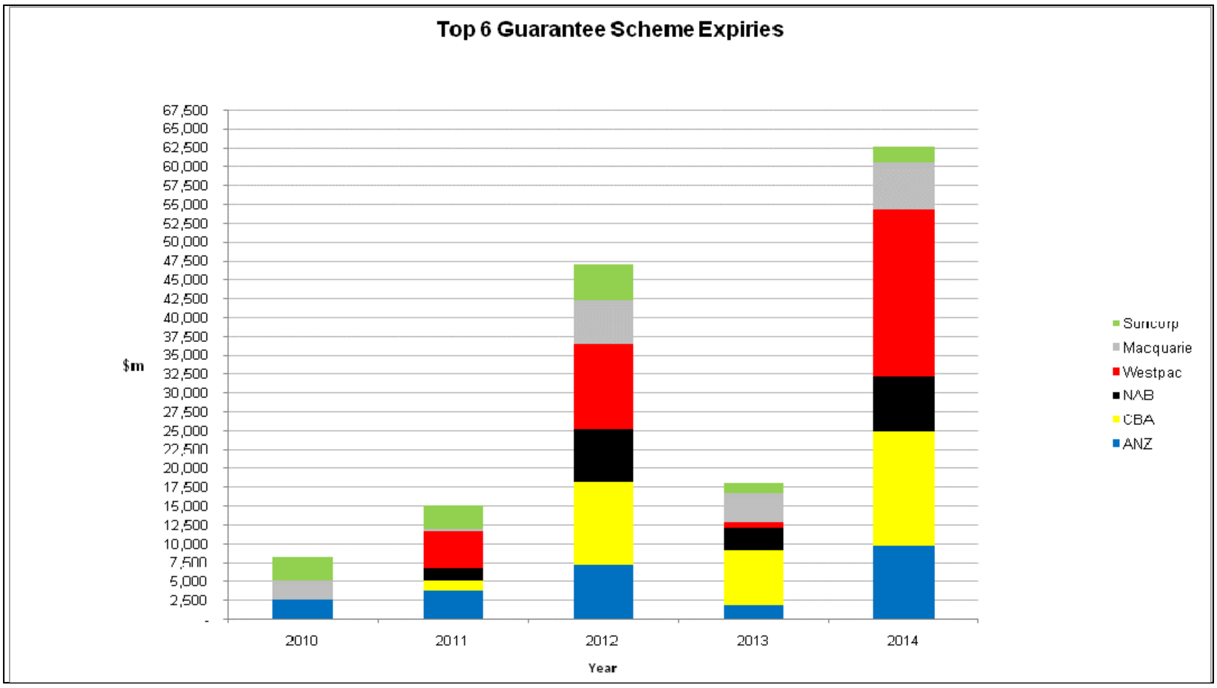
There is also the question of who will be the buyers of those bonds originally sold with a Commonwealth Government Guarantee (shown blue in the previous chart 2 noting that many of those buyers are unable to acquire anything other than Government guaranteed securities.

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 borrowers. Accordingly 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 those they do purchase.

One of the key risks to the banks own refinancing is the maturity profile of Australian Government guaranteed bank bond maturities over the next few years, (Chart 4).

[4] Source: Westpac
[5] Source: RBA
[6] Source RBA

Chart 4 - Australian Banks Government Guaranteed Bond Maturities



Source: Quadrant Real Estate Advisors LLC, RBA

Overall, given the relative global strength of the Australian banks we believe that they should be able to meet their existing term debt refinancing obligations in the global capital markets, however, the price they pay will continue to increase in the near term and the availability of additional capital to fund credit growth will be severely constrained.

These capital constraints and price increases will be passed on to borrowers, including those borrowers 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.

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