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FINANCE

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Show Me The Money

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Rod Tidwell: "Show me the money!"
Jerry Maguire: "I'll tell you why you don't have your $ million."

The only thing more eponymous with Jerry Maguire were the eternal words of Rene Zellweger **"You had me at hello".**

Non-bank lending has been progressively playing a bigger role in property projects in recent years and we see this as a trend which has been showing signs of a steady and persistent rise post-crisis. A trip down memory lane tells us all how we got here. Based on academic and international experience we have sufficient evidence that offers some instructive guidelines for a tightening in lending conditions for property in Australia.

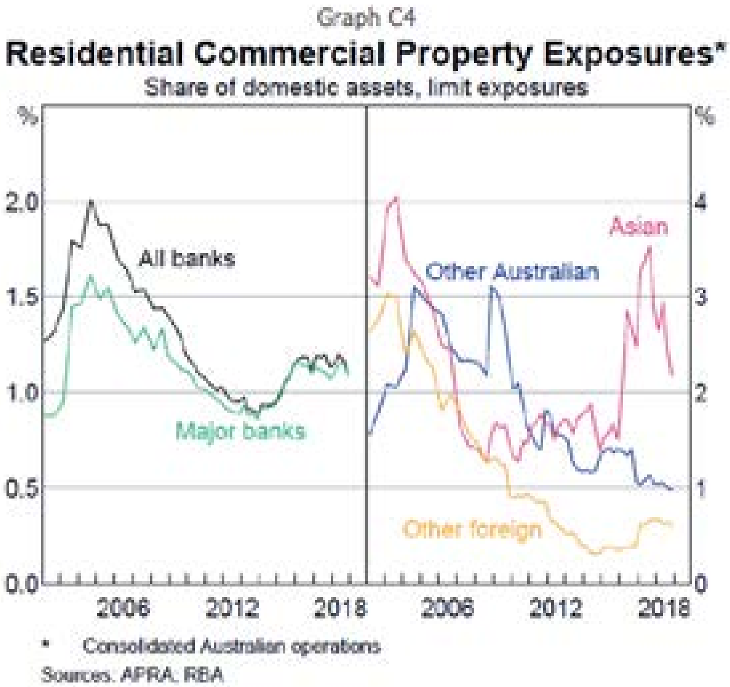
To begin with, the ability of "big-banks" to write residential mortgages have been constrained by the Australian Prudential Regulation Authority's (APRA) guidance since the end of 2014 in an attempt at promoting sound lending practices. Some of those measures included a benchmark for growth in investor lending together with tighter lending standards and limits on interest-only lending (APRA 2014; APRA 2017).

At the same time we've seen banks making the decision to reduce their lending to borrowers relying on foreign income, prompted by some cases of fraud. Banks have also reduced their appetite for property development lending following a reassessment of the associated risk, in part encouraged by supervisory changes.

Private lending has been around for quite some time now. Historically, developers have secured and financed moderate to large portions of their project with bank loans, and some have complimented this with additional finance from private lenders, such as mezzanine debt or equity.

However, the question still remains how do we show the money?

A constraint for private lending activity is their more limited funding options. Private lenders have no access to short-term wholesale markets and historically had no access to deposit funding. Securitisation is unheard of and is only openly available to ADIs. Despite these constraints other sources of capital have emerged with even institutional superfund capital stealthily entering this sector. However, the bigger catalyst has not been the perennial supply and demand argument. In our opinion it is the global search for yield especially in a world currently characterised by historically low interest rates, hence the alternative sources have been the managed funds industry, both domestic and international. As evidenced by the following chart even before the GFC there has been a decline in banking activity.



The challenge in private-lending has traditionally been pricing, but the opportunity is flexibility. The narrow and treacherous road to recovery will inevitably require the use of credit. And hence the need for specialised solutions, solutions that are not **"one size fits all"**. The diverse nature of projects within the property sector require more specialised and involved resolves. Bulge bracket banks, ADIs will remain key players however their influence is starting to diminish as stated above.

Now the bigger question is why do we show the money? Non-bank lending for property development has come from a range of sources, but the most prominent providers have been managed funds that specialise in financing property development-Specialists are in charge: credit to credit worthy individuals.

This lending is mostly funded by equity investments from wealthy individuals and institutional investors, including foreign funds. Non-bank lenders generally require lower levels of pre-sales than banks and allow greater leverage for borrowers. Pre-sales became harder to achieve as the property market cooled, and this contributed to the demand for non-bank financing from developers.

The increasing economic uncertainty brought about by the onset of COVID-19 has placed unprecedented pressures on financial markets across the world. The property sector has become an unfortunate victim to this calamity. These issues and the ongoing uncertainty are impacting loan terms offered to borrowers as credit risk has been repriced-all indications pointing towards an unwillingness to lend. However recent changes in regulation has added buoyancy to Australian property. The immediate vacancy left by non-performing sectors such as retailers has added to the significant weight of capital ready to be deployed if the terms of lending and quality of collateral do indeed remain attractive. This is the flight to safety argument that has suddenly resurfaced.

Private lenders are known for their hands-on approach and hence are likely to realign their bias towards assets with clear exit strategies and quality sponsors. This automatically implies that assets in the retail and hospitality sector would be hard to get financed however favourable attributes like long WALEs and robust tenant profile would be seen more favourably. Unlike the previous global crisis, which saw the immediate freezing of all credit channels, the disciplinary capital rectitude that followed ensured that banks remain thoroughly well capitalised. However heightened uncertainty and weak demand all seem to work to raise pessimism around a few key phrases namely the probability of default, loss given default and exposure at default. Nevertheless, we have seen a slew of rate cuts and hints of further along the way, together with a QE type bond buying programme aimed at the 3-yr bonds. Therefore, based on the above we expect borrowing costs to remain stable in the non-bank/private lending circles.

The current crisis still has a long way to play out. Unemployment has risen sharply and together with it we have seen an erratic repricing of risk. However, the real-estate/construction related sectors have been buoyant and has seen mixed activities throughout the country and so far, we haven’t seen corporate/personal delinquencies rising. Much depends on the proliferation of the virus and the interstate lockdown/travel restriction/easing period.

Non-bank mortgage businesses failed during the GFC. Mortgage funds were frozen and assets were sold to recoup funds to pay redemptions. Australian direct property markets continue to perform strongly and the ability of real estate to generate low volatility income continues to attract capital in a low yield environment. While capital growth remains broadly positive, momentum across sectors continues to slow and results continue to be mixed.

Office markets face some uncertainty in these times however the growth in ecommerce continues to drive up demand for modern logistics facilities.

At the same time retail and hospitality are two sectors that continue to face headwinds from the threat of nimble international retailers, competition from online retailers, high rental costs and contentious economic data. The path to reversals in economic fortunes has been thus far painstakingly slow.

The low cash rate environment continues to underpin one inalienable attribute of capital: seeking assets with attractive (risk adjusted) yields. Or in the words of

Jerry Maguire: “Play the game from your heart. Then I’ll show you the kwan. And that’s the truth!

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