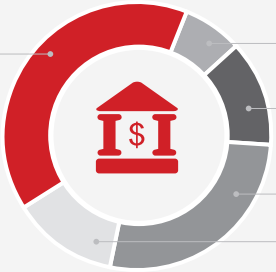
Stamford Capital
AUSTRALIA

REAL ESTATE DEBT CAPITAL MARKETS SURVEY

2020 STATE OF PLAY

ABOUT THE RESEARCH
SURVEY CONTRIBUTORS OF POPULATION

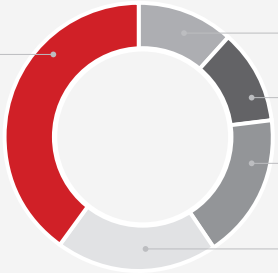
162 PRE-COVID-19 (FEBRUARY 2020) PROVIDERS



51%

have loan books larger than $500m.

OVER 100 POST-COVID-19 (AUGUST 2020) PROVIDERS



OVER 51%

have loan books larger than $500m

NAVIGATING THE COVID-19 TSUNAMI: IMPACTS OF A GLOBAL PANDEMIC ON THE AUSTRALIAN REAL ESTATE DEBT CAPITAL MARKET

How Australia's debt capital market is weathering the pandemic

In early 2020 the real estate debt capital market was quietly optimistic. By January, the residential market had recovered almost all of the losses suffered between 2017 and 2019. Most lenders were looking for new opportunities to reduce their loan books, with 87% expected to maintain or loosen their investment credit criteria.

And then COVID-19 entered our vocabulary.

The pandemic brought a tidal wave of uncertainty to the real estate debt market. And while we're yet to feel its full impact on the economy, property markets have certainly begun to suffer as a result.

However, there are some marked differences to the Global Financial Crisis in 2008/9, the last time markets faced significant challenges. There is still liquidity in the market, thanks to the RBA, government support schemes and the empathetic actions of lenders. Plus, with interest rates at historic lows, debt remains an attractive asset class for investors.

As new risks continue to emerge, investors and lenders are likely to face ongoing uncertainty for at least the next 12 to 18 months.

We surveyed 162 participants in banks, non-banks, private lenders, family offices and super funds in February. In August, just over 100 provided their perspective pre- and post-COVID 19, for our third annual market survey. Their views help us form a better understanding of how the pandemic is shaping Australia's debt capital market for property assets – and what we can expect in the year ahead.

The responses revealed six significant trends:

1. Liquidity remains, despite declining markets
2. Leverage levels decrease, lending criteria tightens
3. Non-banks move in…
4. ICR pressure eases but heightened risk remains
5. Margins expected to increase
6. Most markets in decline, industrial powering through

There is still liquidity in the market, thanks to the RBA, government support schemes and the empathetic actions of lenders. Plus, with interest rates at historic lows, debt remains attractive.

KEY FINDINGS

1 Liquidity remains, despite declining markets

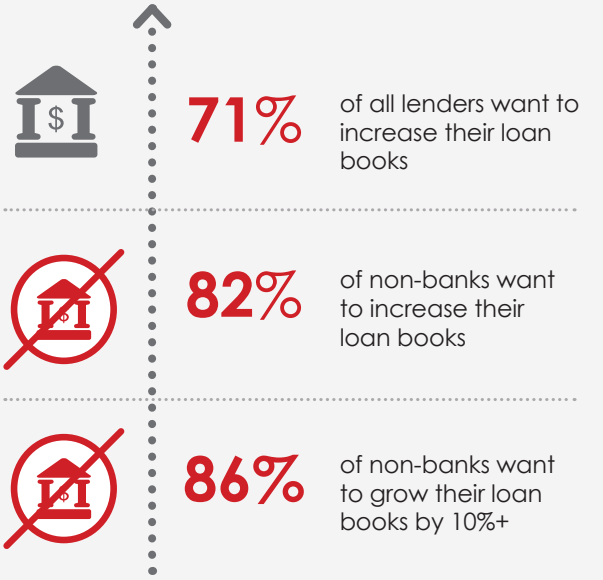
The market expects lending activity to continue, with 70% expecting major banks and 84% expecting non-banks to maintain or increase their investment loan appetite. Construction lending appetite is slightly less optimistic, with 57% of major banks and 68% of non-banks expecting to maintain or increase it.

Various government initiatives, including JobKeeper and the HomeBuilder grant, have propped up the economy in Australia. This has helped to retain liquidity in market.

So, it's interesting to note that 71% of respondents in August said they still expect to increase their books. This figure increases to 82% for non-banks, with the majority planning an increase of 10% or more.

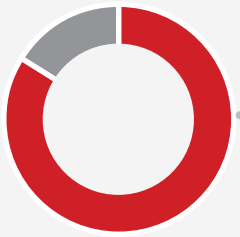
> Private and institutional investors are seeing senior secured debt over real estate as a relatively attractive asset class, especially given essentially no return on cash.

Michael Hynes
Joint Managing Director,
Stamford capital



70% expect major banks to maintain or increase investment appetite

57% expect major banks to maintain or increase construction appetite



84% expect non-banks to maintain or increase investment appetite

68% expect non-banks to maintain or increase construction appetite

2 Leverage levels decrease, lending criteria tightens

As the uncertainty of the pandemic lingers, credit markets are likely to continue repricing upwards to reflect the increased level of risk. Lenders are also expecting major banks to tighten their lending criteria across the board: 62% for investment and 68% for construction, compared to 13% and 19% respectively pre-pandemic.

32% of lenders are looking to decrease leverage levels, compared to only 3% pre-COVID, and half of non-banks are looking to do the same.

67% of lenders expect an increase in loan margins in 2020/21, compared to 11% pre-COVID.

> There's this uncertainty that sits there which will result in lenders wanting to price for perceived risk and to reduce risk appetite.

Domenic Lo Surdo
Joint Managing Director
Stamford capital

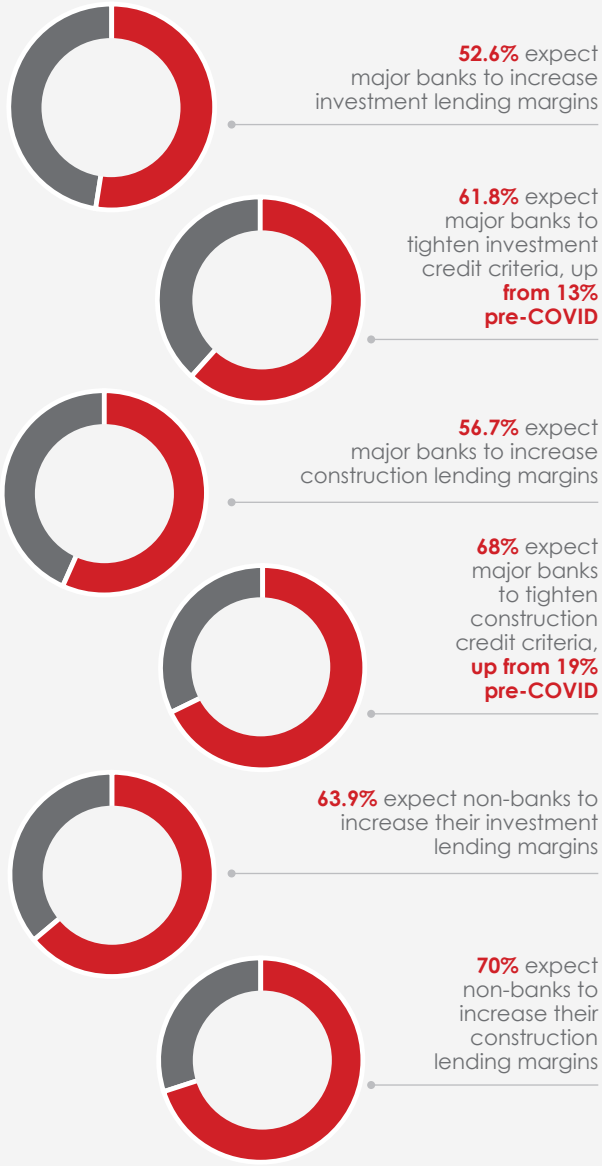
3 Non-banks move in…

As the markets navigate the crisis, lenders are increasingly treading with caution. While 60% of all lenders surveyed require 60% to 100% presales (a slight drop since 2019), 17% expect this to increase in the next 6 to 12 months. The hurdle is tighter for banks, with 93% of major and second tier banks requiring 60% to 100% presales – an 8% increase since last year.

Yet non-banks, not bound by APRA's regulations, are continuing to underwrite developments with limited presales as they increase their foothold in the market. Half of non-banks surveyed require no presales at all, although a quarter are looking to increase this in the next 6 to 12 months.

Achieving presales is certainly challenging in the current market, despite the government's new First Home Buyer $25,000 stimulus package.

"It's hard to get large projects funded, particularly for developments. As the deal size gets bigger, the banks want to see significant levels of presales," Lo Surdo says.



60% of lenders require 60-100% presales

93% of banks require 60-100% presales, up 8% since 2019

17% of lenders expect presales to increase

50% of non-banks require no presales, up from 34% in 2019

4 ICR pressure eases but heightened risk remains

Interest cover ratio (ICR) - net rental income divided by the interest cost - is not the same roadblock it was last year. Although 86% of lenders are looking to maintain their interest cover hurdles, the RBA's cash rate reduction has eased some difficulty for property investors.

However, some property investors may find it increasingly difficult to meet the ICR requirements as tenants look to renegotiate the terms of their leases – or fail to make rent payments.

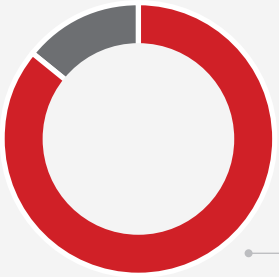
"This will lead to borrowers facing the prospect of having to refinance, because they may risk breaching interest cover ratios that were previously looking quite comfortable," says Domenic Lo Surdo, Joint Managing Director, Stamford Capital.

Non-banks might be the solution for these investors, as 47% of those surveyed in August still have no ICR requirements.

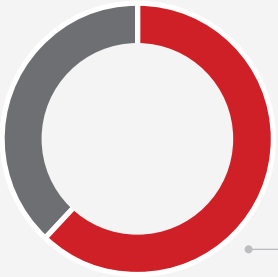
5 Margins expected to increase

There is a clear intention across both banks and non-banks to increase margins. 67% of respondents expect to see major banks increase loan margins – a significant jump from only 11% in February. With comparatively lower basis points, major banks will likely be able to widen margins without much pushback as borrowers find it increasingly difficult to secure loans and become less price sensitive.

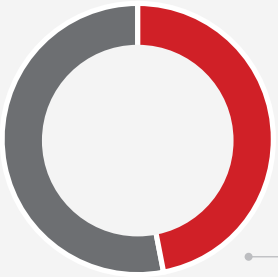
Nearly two-thirds (64%) of respondents also expect non-banks to increase loan margins – up from only 12% pre-COVID. It will be interesting to see if the market will support this. With a lot of liquidity still in market and an imbalance in supply and demand there will be more competitive tension in the non-bank market, which may prevent them from widening margins.



86% of term debt lenders are looking to maintain their interest cover hurdles



62% of term debt lenders require ICR of 1.5x or higher



47% of non-banks have no ICR requirements

67% expect major banks to increase loan margins – up from only 11% in February

53% expect major banks to increase loan margins for investment lending

57% expect major banks to increase loan margins for construction lending

64% expect non-banks to increase loan margins for investment lending

70% expect non-banks to increase loan margins for construction lending

6

Most markets in decline, industrial powering through

COVID-19 has had a profound effect on most real estate markets, with commercial and retail the biggest hit. The majority of survey participants say the commercial office (82%) and retail (91%) markets are in decline, while around half say the same about residential development sites (49.5%) and apartment housing (51%) markets. Residential was already subdued due to the regulator requiring 100% presale cover well before COVID-19, which prevented a lot of supply being built/delivered.

However, the industrial market appears to have been given a boost. The explosion of eCommerce and the increasing reliance on data centres now sees the market in the early growth or recovery phase, according to 75% of those surveyed. Lenders may become more willing to underwrite these less risky assets, possibly even reducing margins for the right investment.

50% say residential development is in decline up from 15.42% in February 2020

51% say residential apartments are in decline up from 9.26% in February

31% believe residential markets are in recovery phase

83% say the commercial property investment market is in decline, up from 4.32% in February 2020

91% say the retail market is in decline

40% say industrial market is in early growth phase

35% say industrial market is in peak phase

New risks for resi investments

Although house prices were expected to continue to fall through to 2020,[1] the market managed to recover almost all of its losses between 2017 and 2019. In May 2020, housing values only showed a mild slowdown.[2] In fact, regional markets across the country have experienced a median growth of 3.4% for year to date June 2020 – three times their capital city counterparts.[3]

The rental market on the other hand has felt the effects of pandemic-related job losses more acutely. About a third of jobs were lost in the hospitality, arts and recreation sectors, where workers are generally young and on lower incomes.[4] This group, that also makes up a big portion of the rental market traditionally, has gone back to the nest.

With international tourism restricted, some Airbnb and holiday rental owners have turned back to the long-term rental market – further increasing supply, as well as international student numbers impacting vacancy rates.

"There's a real adjustment in the rental market, that will play out in the next 12 to 18 months," says Lo Surdo. "With heavy declines in residential rental market yields and increasing vacancies, lenders will relook at serviceability on residual stock exposures."

Lenders have voiced their concerns about this market through the survey.

"In a low-presales market, with lack of confidence and liquidity for purchasers to commit, high density residential is a concern. And I don't see much confidence returning to these markets with any real velocity until there's a vaccine for COVID-19, or some other way of living with the health consequences." says Lo Surdo.

Commercial and retail hardest hit

Over two-thirds of lenders are concerned about specific market segments. Not surprisingly, retail and commercial were top of mind. Significant job losses, social distancing requirements and the majority of the country's remaining workforce working from home has an impact on both markets.

Available subleases for office space in Sydney are at their highest levels since the recession in the 1990s. The market is expected to deteriorate further as a result of rising unemployment and declining migration.[5]

"Investors and lenders alike are very income conscious, and commercial rents are expected to decline. As fewer tenants can afford to pay rent, vacancy rates will increase and landlords will

1 Australian dwelling values fell 4.8% through 2018 marking weakest housing market conditions since 2008, T. Lawless CoreLogic, 2 January 2019
2 The Property Market In 2020: What Lies Ahead?, Eliza Owen, CoreLogic, 25 May 2020
3 Australian Economic and Property Report 2020, July 31, PRD
4 The Property Market In 2020: What Lies Ahead?, Eliza Owen, CoreLogic, 25 May 2020
5 Businesses give up office space in Sydney CBD, Ingrid Fuary-Wagner, AFR, 28 May 2020

need to compete to fill them. That means discounted rates and increased incentives," says Hynes.

As rental yields continue to decline, lenders may re-think their underwriting requirements.

"As a direct consequence, assuming the capitalisation rate on the asset remains the same, asset values could decline," says Hynes.

The survey respondents tended to agree.

"Office space demand into the future is something we will be watching as we take positions on assets," said one survey participant.

Bricks and mortar discretionary retail was already under pressure, but the pandemic's restrictions have further challenged this asset class.

In 2020, retail turnover growth is expected to fall 1.4% – making it the worst year on record. Consumers' reduced willingness to spend is likely to linger, while lower population growth in the long term, due to reduced migration, is worrying for the future of the market.[6]

"Retail also is an obvious sector going through a structural change, but we are more cautious on larger centres as neighbourhood-style assets are still being met with leasing and investor demand," said a survey participant.

A new industrial boom

Physical retail may be in decline, but eCommerce is booming. This, combined with a push to reduce Australia's reliance on global supply chains by supporting local manufacturing, means the pandemic has created a perfect storm for the industrial market.

The demand for industrial assets such as warehouses and data centres is likely to continue growing – and lenders are also likely to have a greater appetite to underwrite these assets.

"The industrial market is in its growth phase, there's less risk than other asset classes, and it's less susceptible to valuation pressure. Lenders may even be prepared to increase loan to value ratios," says Lo Surdo.

6 Retail Forecasts - June 2020, Deloitte

STATE PERSPECTIVES

The local view

New South Wales

There is certainly pressure on NSW markets. But the division of asset classes and the breadth of geography means the impact of the pandemic is varied across the state.

Markets in NSW are historically driven by population growth. With an estimated 300,000 tourists, temporary workers and students having already left the country in the wake of the global pandemic, this could add further strain to consumer spending and Sydney's softening housing market. By the end of 2020 a further 300,000 are predicted to leave.[7]

"In Sydney, we've relied on foreign migration to drive housing demand. If migration doesn't bounce back the property market will suffer," Hynes says.

Commercial assets are likely to come under pressure in NSW, but Hynes predicts that capital rates for the asset class will sustain themselves.

"Because the cash rate is so low, the spread between yield and borrowing cost has only widened, which should sustain capital rates," he says. "The assets that have strong long-term income streams could potentially benefit, as investors want secure safe haven spots to park their capital."

Investors and developers are trying to assess what will be left once the pandemic is under control.

"There is going to be wholesale wreckage from certain industries, but it's a question of how quickly things pick up once things settle down," says Hynes.

Impact of the pandemic is varied

The property market will suffer

Commercial assets under pressure

Victoria

Working through stage 4 lockdown at the time of this report, Victorian markets are governed by uncertainty.

"The apartment sector in metropolitan Melbourne is facing its biggest challenge in living memory," says Barn Wilson, Stamford Capital Associate Director, Victoria. With rising unemployment rates and no interstate and international migration, inner city rents are beginning to soften.

Developers are finding it increasingly difficult to meet required presales criteria for construction finance. With the population under strict lockdown rules and uncertainty over forward valuation risk, buyers are more cautious – dramatically slowing presales across metropolitan Melbourne.

CBD office space currently under construction is 87% pre-leased. However, with uncertainty around employment levels and further developments of the pandemic, vacancy rates are likely to shift upwards.

"Of particular note will be how the Federal Government will handle JobKeeper payments after September 2020. This will impact the outlook for office demand in the near term," Wilson says.

Markets are governed by uncertainty

Buyers are more cautious

7 COVID-19: Australia's great exodus revealed, Adam Creighton, The Australian, 15 April 2020

The Victorian retail sector is perhaps the hardest hit, with all non-essential retail closed for at least the six-week period of the lockdown.

"Broader retail asset valuations will come under pressure as consumers abide by new Coronavirus-related restrictions for the rest of 2020, and possibly beyond."

If restrictions do continue in 2021, retail and hospitality assets in Victoria will come under continued pressure.

Queensland

Record low interest rates, new government support and incentives such as the First Home Buyer's Grant seem to be having a positive impact on house and land development activity in the Brisbane property market. While CoreLogic data shows slight declines over the second quarter of 2020, Brisbane has shown great resilience. In July 2020, the greater Brisbane region saw median values fall only -0.3%.[8]

But uncertainty remains on whether this is sustainable, given the potential impact of COVID-19 on key sectors of the Queensland economy. A drastic decline in international and domestic tourism, international education and foreign property investment is likely to see residential markets soften.

"In regional areas this could be quite significant, as local employment relies on the sectors feeling the biggest impact of the pandemic," says Chris Drummond, Stamford Capital Director, Queensland.

On the other hand, buyer demand for regional and coastal areas on the Queensland residential property market could grow.

"Gold Coast and Sunshine Coast areas could become particularly attractive to southern-based downsizers, retirees or simply families moving away from more densely populated capital city locations for lifestyle reasons," Drummond says.

A decline in tourism and lockdowns earlier in the year has also created tough conditions for retail and has seen "reduction in demand for what was a strong sector of the investment market", according to Drummond.

"The volume of stock for tenanted investments has declined, due to vendors withdrawing listings whilst there have been restrictions on the retail and hospitality sectors."

However, the market hasn't seen any significant change in yield since the onset of the pandemic in March.

"There are some instances of yields softening as a direct result of tenants affected by COVID-19, however there are recent examples that suggest buyers are willing to pay pre-COVID prices," Drummond says.

The Apartment sector in metropolitan Melbourne is facing its biggest challenge in living memory.

Barn Wilson
Stamford Capital
Associate Director
Victoria

Uncertainty around employment levels

Drastic decline in tourism is likely to see residential markets soften

Tough conditions for retail

Market hasn't seen any significant change

8 Brisbane Property Market Update - July 2020, Smart Property Investment, 4 August 2020

The local view

South Australia

Historically South Australia's residential market has been less volatile than eastern states – and this is expected to continue during COVID-19 and beyond.

According to CoreLogic data, Adelaide's growth continued through the worst of the pandemic so far, with the southern state recording 1.7% growth year to May 2020, continuing to grow through May.[9]

However, the market has seen increased supply of apartments over recent years, with oversupply expected in the next 2 to 3 years.

"The pandemic has triggered some speculation that lower density cities and towns may offer increased attraction to residents and businesses over the longer term . We'll watch with interest to see if the SA market benefits from this," says Adam Miller, Stamford Capital Director, South Australia.

South Australia's investment assets generally trade at 100-250 basis points above eastern states, which provide the potential for exceptional investment returns – likely serving the local market well in a nationwide downturn.

"We're starting to see increased non-bank enthusiasm for SA thanks to the lower economic impact of COVID-19 compared with the rest of the country. We continue to monitor bank credit appetite closely to see if there is a similar distinction."

Growth continued through the worst of the pandemic

Potential for exceptional returns

Increased non-bank enthusiasm for SA

The pandemic has triggered some speculation that lower density cities and towns may offer increased attraction to residents and businesses over the longer term . We'll watch with interest to see if the SA market benefits from this.

Adam Miller
Stamford Capital Director
South Australia

9 Adelaide Housing Market Overview June 2020, JLL, 12 June 2020

UNCERTAINTY AND RISK TOP OF MIND IN A SURPRISINGLY LIQUID MARKET

As Australia navigates the waves of COVID-19, lenders, developers and investors alike face the challenges of an uncertain economy.

Yet, a lot of liquidity remains in the market. Lenders are still looking for opportunities to grow their books – and they are willing to underwrite assets that offer sustainable yields. Non-banks continue to take risks to gain more foothold in the market, however they are treading with caution.

Lenders are becoming increasingly conservative, and will continue to price for heightened risk until they can see more stability and control of the pandemic.

As the weight of supply of assets increases amid a drop in investor demand, the cost of capital is likely to decrease – offering some cushioning to soften the impact of declining income rates.

Investors will need to focus on maintaining asset income streams and be careful not to breach ICR covenants on existing loans.

With unanticipated challenges surfacing through the pandemic, originators have become increasingly important in sourcing capital deals. In fact, over 60% of lenders are expecting originators to grow in importance in the next 12 months.

The Australian real estate debt market outlook will undoubtedly be influenced by ongoing developments in the pandemic. It will be interesting to see how the anticipated tightening of government initiatives and lender grace periods will impact the market – potentially triggering the next wave of challenges.

Stamford Capital
AUSTRALIA

NEW SOUTH WALES
SYDNEY

+61 2 9046 8900
Level 9
16 O'Connell Street
Sydney NSW 2000

Mailing Address
GPO Box 1607
Sydney NSW 2001

QUEENSLAND
BRISBANE

+61 7 3198 2090
Level 12
270 Adelaide Street
Brisbane QLD 4000

VICTORIA
MELBOURNE

+61 3 8375 9664
Level 3
257 Collins St
Melbourne VIC 3000

SOUTH AUSTRALIA
ADELAIDE

+61 8 7087 2134
Level 2
70 Hindmarsh Square
Adelaide SA 5000

www.stamfordcapital.com.au