[SPRING 17]

CONSTRUCTION FINANCE MARKET UPDATE

REVIEW OF THE INVESTMENT MARKETS AND THEIR IMPACT ON DEVELOPMENT

For this market update we thought to turn our attention to the investment markets and consider how continuing yield compression is impacting investment decisions and in turn the ramifications on finance and development decisions.

As we are all acutely aware, yields continue to be driven down by the sheer weight of investment funds, in particular foreign capital looking for a safe refuge. This impacts both the top of town where we see large institutions and foreign investment funds buying on lower and lower yields while at the other end of the market we see foreign individuals acquiring small retail and commercial holdings at eye-watering prices and aggressively buying residential holdings despite tightening legislation designed to slow their appetite.

The question is how does all this impact the availability of investment funding and the associated risks and secondly, does this then impact developers planning a new project for on sale?

We have looked at answering these and few other questions in this edition of our market update and as always, if you have your own views on these important issues we welcome your feedback.

Steve Wiltshire
Chairman, HoldenCAPITAL

HoldenCAPITAL
CONSTRUCTIVE FINANCE

1300 HOLCAP

Yield Compression 1

HOW LOW CAN THEY GO AND FOR HOW LONG?

The sustained low interest rate environment in Australia continues to drive yield compression in investment property and it seems like almost every day we see a new record set with sales pushing well below 5% and in some cases 4%. While this is frustrating for local buyers looking for safe investment opportunities and great for sellers, the question is where is it all going?

TThe consensus of opinion amongst most economic observers seems to be that for as long as Australia continues to be identified as a safe and stable economy, quality property assets will continue to attract foreign investment. Compared to other competing stable economies, our property sector provides solid returns for investors chasing reliable income with strong WALE's. As a consequence the short to medium term outlook appears to be more of the same with local investors forced to look for bargains amongst lesser investment grade stock and yields could potentially tighten further.

Yields could potentially tighten further

With strong competition for quality tenants driving yield compression in large format retail centres, regionals and the key commercial sectors, the prospects for investment outside of these prime assets is likely to be characterised by local investors targeting more affordable investments and the refurbishment/gentrification of areas previously passed over in order to reduce capital costs.

Volatile stock markets, low interest rates and continuing foreign investment will also continue to drive yield compression so the question is, is there a change on the horizon?

Recent press has seen some commentators forecast the potential for interest rate rises in 2018 on the back of easing concerns around the strength of the underlying economy. To be honest we have heard this before and while the press loves a debate about interest rate rises and the likely consequences, we take the view that while there continues to be pressures on SME profits, household income growth remains weak and general consumer confidence poor, interest rates are unlikely to show signs of increasing for some time to come.

Interest rates unlikely to increase

How lenders view the market for investment lending

The regulatory constraints imposed by the banking regulator APRA on development finance have been well documented and publicised over the past 18 months resulting in the banking sectors dramatically reduced appetite for construction funding. What is less visible is the impact of these constraints on investment lending over commercial real estate assets that have seen a rationing of credit albeit not to the same extent as the development sector.

As the squeeze on development funding began to bite, banks turned their attention to what they could continue to lend against and that was property assets which are income producing. Investment lending against offices, retail, industrial sectors, hotels, etc forms part of the "Commercial" loan portfolio of a bank and while the regulator would like to see overall exposures kept below 10% of their balance sheets, there was scope for them to in some cases actually grow their exposure and then maintain it in line with their balance sheet growth.

Overseas investors driving yield compression

The emerging challenge for them however, has been that many overseas investors who are acquiring property are chasing a positive yield differential as they view the returns more like annuities so their intention is to hold long term, while in some cities a number of commercial buildings are being converted into residential projects. The weight of this additional capital inflow and demand from these overseas property investors (pension funds, investors and sovereign funds to name a few) aided by local demand has been a key driver of strong commercial property sales in an already low yield investment environment and, has led to a dramatic level of yield compression across these investment sectors. This in turn has raised concerns about overvalued property prices relative to historical benchmarks leading to suggestions of value bubbles and the future sustainability of the values and as a consequence, the banks debt ratios. As to how this will resolve itself is difficult to predict with the extreme being a significant reduction in values at a future date but the more likely outcome is a smaller realignment combined with a significant period of stagnation in values.

Either way, the banks are playing close attention to these issues and will be looking to avoid a situation where a major realignment would adversely affect their clients but more particularly their ability to remain compliant with APRA's lending guidelines. All of which serves to demonstrate how the combination of regulatory constraints and concerns around rapidly appreciating values has resulted in a slowdown in investment lending by the major banks.

Funding options outside of that sector are somewhat limited. In the recent past, Mortgage Funds provided the bulk of non-bank investment loans however the GFC saw a large number of these players exit the market and the remaining funds have limited capacity and or appetite. Unlike the development finance space where many small private funds have emerged to take advantage of the increased returns (and risk) on offer, there have been few new significant funding sources emerge to fill this void.

Finance gap widening for weaker sponsors

As always, there has also been a flight to quality by banks and other lenders seeking to improve the risk profile of their loan portfolios, so while the strong sponsors are being serviced, the gap is widening between them and the rest of the market. Investment banks, hedge funds and opportunistic funds have increased their presence as funders of development property transactions, however the very nature of their return hurdles means that term debt is not a strongly targeted investment class.

There are options out there, however the challenge is to understand who can fund and what the terms are (pricing, tenure, etc) as the market evolves.

So to sum up, the investment lending landscape is not dissimilar to the construction finance sector with similar pressures and again, they are pressures that are not going to change overnight so it pays to have the right advice and support when you are thinking of raising debt for a new acquisition or refinancing.

In general, the following broadly applies to investment lending in the current market:

- Interest Cover Ratios (ICR) have increased and are typically 1.50 times or greater, delivered from either the property income (rents) or All Sources (other income).
- LVR's have reduced and most banks will want to start the discussion at an LVR of 60%, HCA have successfully achieved 70% on a merit based argument
- Non-recourse or limited recourse lending faces tighter hurdles with LVR hurdles reduced to 50% or less provided the asset is acceptable to the lender.
- Good quality assets can achieve financing and tenancy risk is being penalised.

Should you require assistance in securing finance, we as a business are across all the domestic and offshore funders for development and investment loans and would welcome the opportunity to assist you.

Its impact on developers/investors

We have certainly seen some substantial changes to the residential investment landscape over the past 18 months with a general easing of the volumes of investor sales as various markets such as the Brisbane inner city apartment precinct began to be perceived as oversupplied and investors searched for better returns with less risk.

While demand for resi investment stock continues, particularly in the house and land sector, many investors have been struggling to identify alternatives with the stock market deemed too risky (or they are over exposed) and they have found themselves shut out of the commercial sector due to the spiralling values and reduced returns becoming unattractive.

As previously noted, we see the economic fundamentals continuing to ensure that yields remain compressed in the short to medium term which is likely to limit small to medium sized investors venturing into the commercial space with developers

Local investors shutout by spiralling value

not attracted to the strata offering knowing that they can achieve faster and better outcomes selling projects in-one-line.

This applies right across the various commercial sectors so where will the opportunities arise? We would argue that investors will continue to see projects that follow infrastructure spending as their preferred targets and as such, elite developers will be ensuring that they are operating in areas taking advantage of these capital outlays.
This will see resi projects pitched at owner-occupiers supported by sound social infrastructure continue to be successful as will improving small end commercial product leveraging off growth in those sectors.

The other areas likely to offer opportunities to investors are smaller industrial projects with access to the resi growth corridors combined with general transport infrastructure along with a number of specialised sectors such as aged care, health care and transport related services.

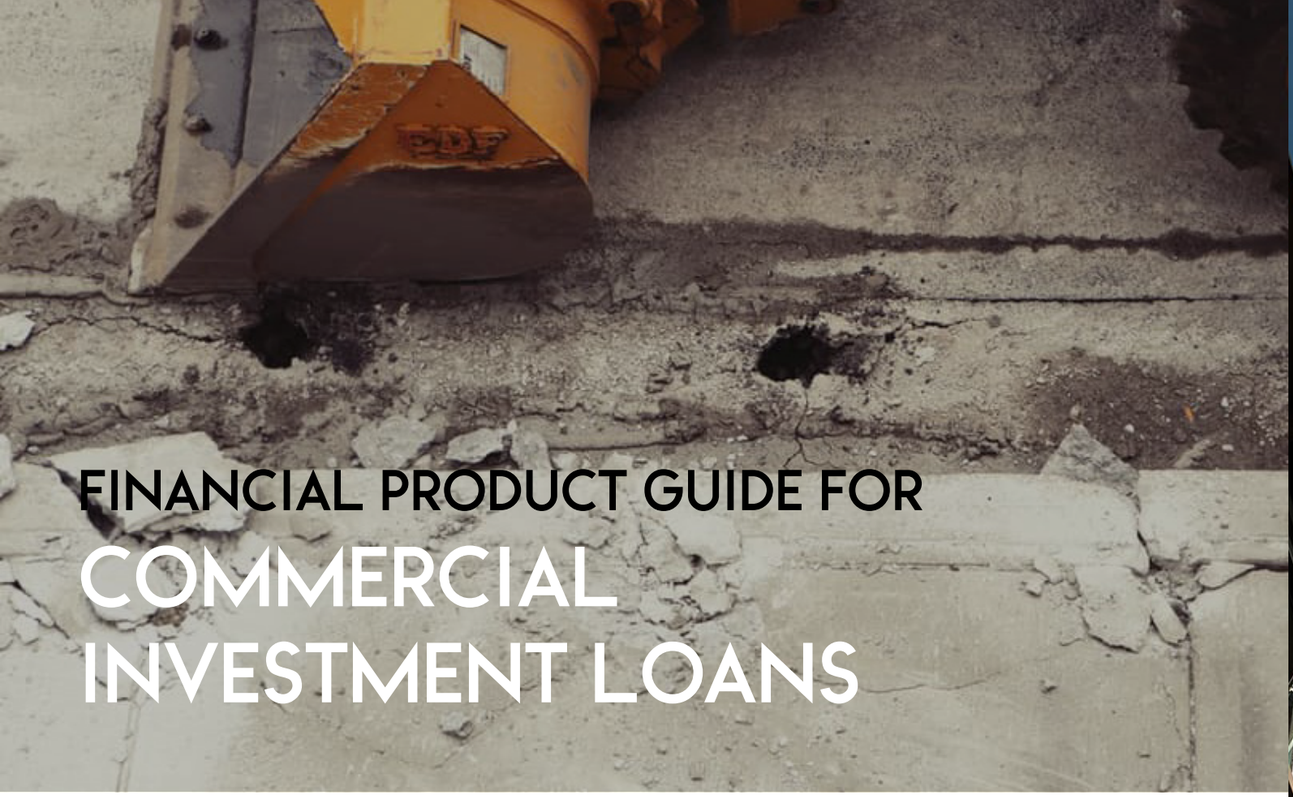
Yield compression conclusions

So, what is there to takeaway from this evaluation of yield compression?

Firstly, it's very real and has significantly impacted market values, particularly in the area of premium investment grade commercial stock and as a result there are likely to be future consequences in terms of value corrections and it is certainly impacting the availability of investment debt from the banks.

Smart developers will be cognisant of this and ensuring that their projects are targeted in a way that either directly takes advantage of this either through the provision of a product that meets specific investor return metrics or through its leveraging of location and associated infrastructure to underpin capital growth.

Either way, its important to understand its relevance to our markets and plan your next development accordingly.



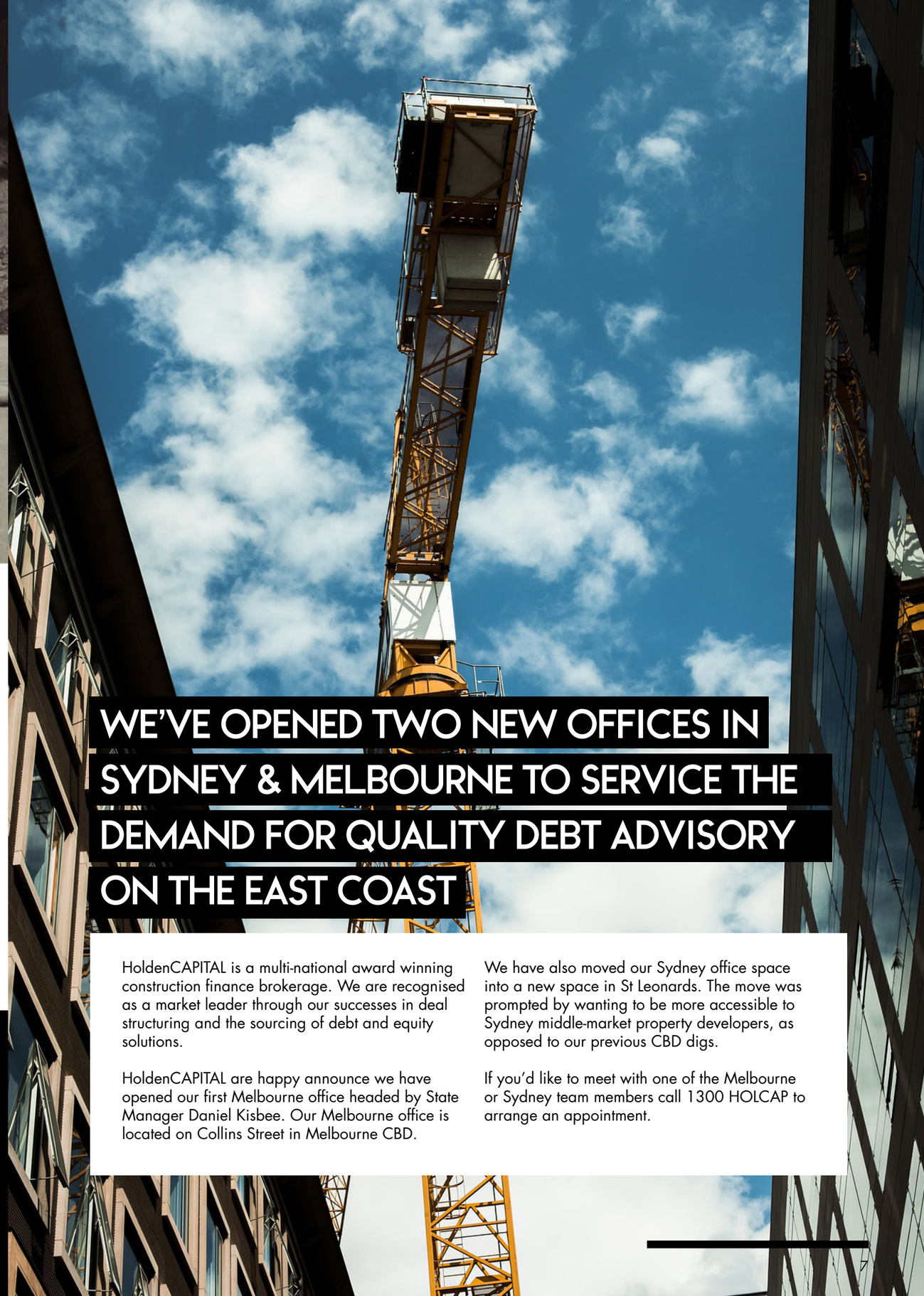
FINANCIAL PRODUCT GUIDE FOR COMMERCIAL INVESTMENT LOANS

Assets cover a wide array of uses like Retail, Commercial, Industrial, Bulky Goods, Service Stations, Childcare and Storage.

ITEM	BANKS	FUND A	FUND B	FUND C	MEZZ
Loan Amounts	Up to $15mil	<$2.5mil	<$5mil	<$ 5 to $40mil	Up to $5mil
LVR	65% Occasionally 70%	65%	70%	65%	100% of costs
ICR - Interest Cover Ratio	1.5	0.9 Single Asset 1.2 Portfolio	1.2	1.2	1.2
Locations	SYD, MEL & BNE	SYD, MEL & BNE	SYD, MEL & BNE	SYD, MEL & BNE	SYD, MEL & BNE
Application Fee Out-of-Pocket	$5k + $10k	$5k + $10k	$5k + $10k	$5k + $10k	$15k + $15k
Loan Establishment Fee	1% for <$15mil 0.6% for >$15mil	2.0%	3% for <$5mil 2% for >$15mil	4% for <$3mil 2% for >$10mil	5% for <$3mil 3% for >$25mil
Interest Rate	1.8% + 1.8%	1.8% + 3%	1.8% + 4.5%	1.8% + 3.5%	14% for <75%LVR 20% for ~80%LVR

5 Reasons why you could missing out on the best term debt options in the market!

1. Major banks have limited appetite/capacity
2. The asset class and the size of the debt can determine who will or won't lend
3. The appetite of Non-bank lenders varies widely according to funds availability
4. Some lenders are sponsor driven other aren't but how would you know?
5. How much time do you have to research the market?



WE'VE OPENED TWO NEW OFFICES IN SYDNEY & MELBOURNE TO SERVICE THE DEMAND FOR QUALITY DEBT ADVISORY ON THE EAST COAST

HoldenCAPITAL is a multi-national award winning construction finance brokerage. We are recognised as a market leader through our successes in deal structuring and the sourcing of debt and equity solutions.

HoldenCAPITAL are happy announce we have opened our first Melbourne office headed by State Manager Daniel Kisbee. Our Melbourne office is located on Collins Street in Melbourne CBD.

We have also moved our Sydney office space into a new space in St Leonards. The move was prompted by wanting to be more accessible to Sydney middle-market property developers, as opposed to our previous CBD digs.

If you'd like to meet with one of the Melbourne or Sydney team members call 1300 HOLCAP to arrange an appointment.

With only 4 major banks to chose from finding term debt wasn't that complex, now you tell me there are how many lenders?

GAIN ACCESS TO A WEALTH OF KNOWLEDGE FROM AN AWARD-WINNING TEAM

Steve Wiltshire
Executive Chairman
Steve spent 26 years with Macquarie Bank doing project finance and joint ventures and recently 3 years as Executive Director of ANZ Property.

Dan Holden
Director
Daniel brings over 15 years of development and finance experience which includes over 10 years in finance consultancy and funds management.

Dave Kelly
Manager – Major Projects
Dave is a highly experienced property banker and deal negotiator focussed on property development and commercial property transactions.

Daniel Hounsell
Finance Consultant
Daniel has over 13 years of experience structuring joint venture opportunities within a range of industries and over 10 years experience with Property Finance.

Vanessa Pace
Office Manager/Analyst
Vanessa has been employed in the Finance Industry for over 10 years having obtained experience in a Building Society and with aggregator and financier FirstMac.

Brett Cottam
Finance Consultant
Brett has over 16 years of corporate banking experience with NAB and BOSI, specializing in property investment & development including residential, commercial, retail, industrial & mixed use assets.

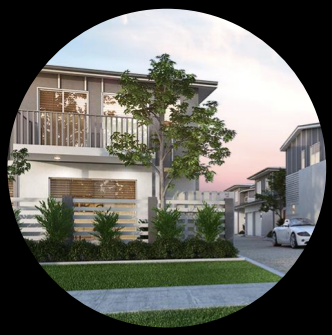
Eric Trieu
Director
Eric has over 20 years experience in project marketing. He was CEO of two international marketing firms, The Aldy Group and Empire Property Investors.

Melvin Seeto
State Manager - Sydney
Melvin has over 20 year's experience in commercial property finance with Perpetual and ING. He was Portfolio Manager & responsible for Perpetual Funds focussed on Senior, Stretch Senior & Mezzanine Loans.

Adam Hartard
Finance Consultant - Sydney
Adam has over 13 years of experience in property finance and development including Commercial, Industrial and Residential property.

Daniel Kisbee
State Manager - Melbourne
Daniel has over a decade of banking experience across both sales and credit functions. His recent consulting experience has seen him coordinating structured property finance deals, and liaising with both borrowers and high net worth's.

BRW. FASTSTARTERS 2015 · FINALIST 2016 BETTER BUSINESS AWARDS QLD BEST COMMERCIAL BROKER · BRISBANE Young ENTREPRENEUR 2015 FINALIST · AUSTRALIAN BROKING AWARDS COMMERCIAL BROKER OF THE YEAR FINALIST 2015 · AUSTRALIAN BROKING AWARDS COMMERCIAL BROKER OF THE YEAR WINNER 2015 · WINNER 2016 TheAdviser BETTER BUSINESS AWARDS QLD BEST COMMERCIAL BROKER · FINALIST TheAdviser AUSTRALIAN BROKING AWARDS COMMERCIAL BROKER OF THE YEAR 2016 · 2015 AUSTRALIAN MORTGAGE AWARDS FINALIST BROKER OF THE YEAR - FINANCE



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