

**AUTUMN
2018**

HOLDENCAPITAL _____
MARKET UPDATE & OUTLOOK



2018: DEVELOPMENT FUNDING

THE LANDSCAPE CONTINUES TO EVOLVE

Another long summer continued to dominate the Australian east coast and there is no doubt that the changing face of construction debt providers is something that more and more developers are coming to grips with as they roll their sleeves up and look to secure funding for their new projects.

In our first update for 2018 we share our views on the opportunities emerging in the construction finance sector as well as an insight as to where we are seeing our clients active.

SALES CONDUITS AND RISING PRESALE HURDLES, THE NEXT GAME CHANGER?

We have expounded on the impact of the regulatory changes and how they have redefined the construction finance landscape and don't propose to revisit it, however it is not the only force that is changing the way the market operates. Changing presale hurdles have also had a big impact, which got us thinking about the sales process generally.

Not that long ago, developers were reliant on traditional real estate agencies to secure sales and qualify for finance. This was a slow, hit and miss process dependant on the smarts of the operatives available in the location. More importantly, it was outside of the developer's direct control however; lenders were more flexible on presale requirements with consideration given to location, product and client experience, which gave flexibility. This changed, particularly in Queensland, as demand soared and then crashed on the back of record breaking net interstate migration from the southern states.

As always, developers innovated. The most effective strategy was to "on board" by hiring sales and marketing experts, two very different skills. This provided control of the process removing the risk of agents being tempted by cheaper or easier to sell alternatives. It also linked remuneration to results attracting operators prepared to back themselves. The downside was that it was an expensive exercise for all but the larger operators with a pipeline of projects to occupy these teams and spread the costs while smaller developers were forced to make do with the agency option.

Leading up to the GFC we saw the rise of the specialised sales operations starting with the "Project Sales" teams created within major agencies in an attempt to gain control

of the lucrative project sector with varying success. These teams relied on the quality of staff which was in turn impacted by remuneration considerations, quality of the product and the financial clout of the client. This option continued to discriminate against smaller developers.

Before and after the GFC, we saw the specialised project-marketing operators become dominant by assisting developers large and small based on a price per sale. This was achieved by sourcing buyers utilising a number of methods based on volume marketing strategies. Initially the focus was on pure investment sales utilising lists of qualified "investors" sourced from accountants and investment advisors. At times the market couldn't get enough product to satisfy a rampant investment market, which far outstripped owner-occupier demand.

Post the GFC, while these sales groups dominated most states, slowing local investor demand was offset by rising offshore investor interest, particularly from Asia. This ensured these methods continued to be the norm albeit eventually slowing after a period of frenzied activity followed by the inevitable political and regulatory counters. As a consequence, many larger businesses were forced to close or dramatically cut back operations, which are now a far cry from their peak.

So, once again, developers are seeking the best means of securing presales. With the Banks now regulated to the hilt, their risk models require 100% debt cover in most cases with little or no flexibility given to developer experience or business acumen.

Non-bank lenders are offering less demanding terms by assessing on the merits of the project and enabling developers to start projects more immediately and take advantage of prevailing market conditions which is the point of the exercise albeit at a price differential which is a topic for another day. However, as the non-bank sector matures and their loan books swell, we are seeing a trend towards increased presale requirements, once again slowing development starts. It's still too early to call if this will gain momentum and become a norm but it serves as a salutary warning to developers who fail to understand the importance of sales, pre, during and post construction. Profits are intrinsically linked to your sales success and the developer that fails to take notice of the prevailing winds and how to weather them is taking greater risks than they know.

RECENTLY FUNDED PROJECTS DEVELOPMENT SITES

RESIDENTIAL SUBDIVISION - WESTERN CORRIDOR SEQ

GR = \$14,000,000



LOAN AMOUNT
\$9,150,000



GEARING
65% LVR



INTEREST
9% p.a.
3% line fee



LENDER
Non-Bank



PRESALES
Nil

SUBDIVISION 57 LOTS - WESTERN SYDNEY

GR = \$22,900,000



LOAN AMOUNT
\$15,000,000



GEARING
67%



INTEREST
9% p.a.
3% Line Fee



LENDER
Non-Bank



PRESALES
40% debt cover

LAND LOAN - TENERIFFE



LOAN AMOUNT
\$3,120,000



INTEREST
12%p.a.



GEARING
65%



LENDER
Private



In 2016 inner city Apartment markets across the eastern seaboard began contracting led by Brisbane and then Melbourne and by 2017 we saw similar contractions in Sydney albeit for differing reasons in the respective markets. The residential price growth that had dominated Sydney for so long has finally started to slow in some sectors but demand remains buoyant in many others so we figured it was time to take a look at how we see 2018 playing out and asked our State Managers in Sydney and Melbourne to add their views.

SOUTH EAST QUEENSLAND - GOOD NEWS WITH A CAUTIONARY NOTE

The SEQ residential market appears to be settling after some overbuilding in the Brisbane inner city and selected focal points such as Chermside and Mt Gravatt, contrasting with extended periods of subdued growth across many locations with the Sunshine Coast the slowest to recover but now beginning to produce growth as demand builds.

The demand for finance has also begun to shift to construction after a period of consolidation through 2017 which saw developers seeking funding for sites following the downturn in development activity as a consequence of the overbuilding in the apartment markets combined with the well documented retraction from the sector by the major banks. Late 2017 and the first quarter of 2018 has seen a shift back to demand for construction finance, predominantly in the townhouse sector but also infill land subdivisions and selective apartment projects targeted at owner occupiers.

A key to the success of these projects is the growing level of supply of construction funding available with an ever-increasing range of lenders, particularly home grown sources after a period where many were forced to flirt with offshore funding. While offshore funding remains an attractive alternative price-wise, the reality is that its largely focused on major projects due the economies of scale required to justify the transfer of funds into the local market along with the currency risk and the lack of management infrastructure to oversee loans. As a consequence, most foreign lenders require a minimum facility of US\$50M; hardly a viable option for most local developers.

Conversely, while we saw modest interest from local lenders in 2017, the past 6 months has seen increasing appetite from existing lenders along with a growth in the number of

players with many who previously restricted themselves to the southern states beginning to expand their horizons.

As we have previously reported, this change in the funding landscape has seen our lender profile shift from its historical norm that saw some 75%+ of the \$250M in transactions written in 2015 set with the major banks, to one that saw us place with the majors less than 15% of the \$350M settled in the past 12 months.

As a result, competition amongst existing and new entrants is providing sound options to developers with new projects. A word of warning needs to be sounded as regards pricing. Many less experienced developers or more recent entrants to the sector have grown used to the artificial pricing environment that resulted from the major banks dominance, largely as a result of them 'buying' the market over the previous 15 years in their haste to grow market share, lending and cross-sell revenue..

Those with longer memories will remember a time when the interest costs associated with what can be a high risk undertaking were more fully priced and this has been reflected in higher project return hurdles that have progressively shrunk as the banks became "volume junkies" rather than return-focused. The reality is that many of the new smaller lenders in today's market can provide flexible and attractively structured loans, however they understand the value of their capital and this is reflected in their pricing. As a consequence we are seeing a return to more traditional long term risk pricing and developers need to lower their expectations and price projects accordingly as the 'golden rule' will always apply.

Dan Holden - Principal

RECENTLY FUNDED PROJECTS

MEDIUM RESIDENTIAL PROJECTS

16 TOWNHOUSES - NORTHERN SYDNEY

GR = \$37,700,000



LOAN AMOUNT
\$2,600,000



GEARING
66%



INTEREST
23%p.a.



LENDER
HoldenCapital Partners



PRESALES
8

12 APARTMENTS - TWEED HEADS

GR = \$6,540,000



LOAN AMOUNT
\$4,580,000 Senior Debt
\$476,000 Mezzanine Debt



GEARING
92% TDC
77% NRV



INTEREST
12% Senior
24% Mezzanine



LENDER
Non-Bank
+ Private



PRESALES
Nil

18 TOWNHOUSES - CARSELDINE



LOAN AMOUNT
\$4,850,000



GEARING
62% LVR



INTEREST
6.78% p.a.



LENDER
Bank



PRESALES
35% debt cover



SYDNEY - IT'S HOT IN THE CITY BUT THERE ARE STILL OPPORTUNITIES TO BE HAD

With the first quarter of 2018 behind us there are already some shifts being identified in the financing of Sydney development projects. The government's regulatory controls are starting to have an effect with a softening in residential prices and further tightening in credit availability through the traditional banking sector. We have been highlighting to clients that the tightening has been occurring for the past 2 years, however it is only recently where this has hit home with many developers now accepting this reality and have begun to ask us to rule out seeking bank finance option having been through the process and knowing the outcome.

Notwithstanding, demand for finance remains strong and evolving as a result of changes to bank lending appetite with the obvious trend towards non-bank financing being explored by many bank quality developers who now need other options.

The controls and restrictions put in place by regulators and banks do not need to be revisited here, however the consequences are that developers are being required to contribute more equity, secure higher qualifying presale volumes (i.e. minimal FIRB), against a backdrop of tougher residential investment and lending to foreign buyer conditions meaning a longer lead in period for a project to commence construction.

The resultant lending products required by developers are falling into the following broad categories:

- Land loans (with or without DA)
- Construction Loans (with nil or lower presale requirements)
- Residual stock lending to reduce the cost of holding unsold stock and achieving an orderly sale process.

The Residual Stock loans are becoming more prevalent as developers cast their eyes forward to completion and strategize how they will deal with what to do with unsold stock as sales rate slow, given banks have also tightened lending requirements in this area. This is particularly relevant if a developer intends to hold greater numbers than 4-6 lots in a recently completed project.

There is some good news though as non bank funds and private sources of capital continually grow and evolve to bridge this gap. There are many funding options outside the banking sector with the capacity and appetite to take on

these sorts of exposures and that excludes offshore avenues which tend to be more focussed on larger ticket loans of \$50M plus.

It is a given that non bank and private funding are more expensive than banks however the trade off is that there is greater speed of approval, lower presale requirements and generally higher gearing levels on offer. Factors such as suitability of end product to preselling are also taken into consideration, so developers targeting owner occupiers are provided with a level of flexibility to commence projects at a lower initial presale hurdle with further sales milestones to be achieved during construction instead of being subjected to a one size fits all approach.

All this means a developer can commence construction sooner and complete their project against an economic backdrop which is becoming more uncertain.

In the next 6 months we expect to see more developers bringing forward their financing plans especially where it involves settlement of new project sites. This is already happening with their aim being to establish the funding costs and lock in terms. Banks will continue funding but it will be selectively to those developers who can meet their tougher parameters.

Areas where demand for finance and lender appetite align are land subdivisions especially along growth corridors supported by infrastructure development (north west and south west Sydney). Land loans are expected to attract more interest and for longer loan terms between 1-2 years as the projects may not be as shovel ready as in prior years due to loan conditions not being met.

We expect to see less projects with high levels of foreign buyers whilst unit developments are becoming more challenging as presales are becoming more difficult to achieve. On a positive note, there have been greater volumes of capital seeking to be invested into loan opportunities as the returns are attractive to investors so pricing has improved as competition amongst non bank funders increases.

Melvin Seeto – State Manager New South Wales



MELBOURNE - STEADY AS SHE GOES IN THE WORLD'S MOST LIVABLE CITY

In Melbourne, sometimes disparagingly referred to "Australia's Number 2", renewed interest from potential residents and investors has demonstrably filtered through to the property market by way of continuing strong owner occupier and investment sales. While some concerns regarding unemployment in the outer West of the city and consumer price inflation at the state level threatened to undermine confidence; the recent cooling in the Sydney residential market and the concerns regarding inner city oversupply in Brisbane have benefited Melbourne in the eyes of many property investors.

This has also been aided by the recent Federal government support for the development of the Tullamarine Airport rail link, a consistent and glaring omission on the part of Australia's most liveable city. Current congestion on the Tullamarine Freeway is reflective of the 34 million annual passengers that the Melbourne Airport services, but recent projections suggest that figure could balloon to 60 million within the next 15 years.

All this has yet to manifest itself in a demonstrable impact on the property market along the proposed rail route, perhaps because the State government preferred path is not the same as the Federal government's, with the Andrews government expressing a preference to link the Caulfield Station precinct with Monash University via Chadstone as part of a multi-stage tram rollout that would relieve some of the current network pressure on the burgeoning south east.

As in the other states, one of the most common enquiries the Melbourne office receives is from developers struggling to finance their site acquisitions for both permitted as well as unapproved sites. Many vendors of small sites, cognisant of planning changes that would result in a lesser site yield if a developer went back to Council, are holding out for top dollar, all while last year's changes to stamp duty at the State level are dis-incentivising off-the-plan purchasers from putting down their hard-earned. This is creating a perfect storm of risk for the small-medium sized developer, many of whom are moving out of central Melbourne with a number of sensible projects coming across our desk in areas such as Pakenham, Mernda where median house prices there have gone up 30% over the last two years, and even less discussed locations such as Doreen.

Residential developments in the outer suburbs (defined as >25km from the Melbourne CBD) continue to reflect the low interest rate environment and buoyant demand from first

home buyers and young families, while closer to town we are working with a number of developers to bring medium to higher density projects to market in the growing residential hot spots of Preston, Bentleigh and Brighton.

In other sectors, retail trade remains the strongest in the nation, with Victoria's final demand growing by 3.0% year-to-date, and that's off the back of 4.4% annual growth last year. Perhaps the situation with respect to Melbourne's strong retail market is best summed up by the sale of a stake in the super-regional Highpoint shopping centre in the suburb of Maribyrnong at a 4.2% yield late last year. This is the firmest yield of such a sale in Australian history, while another notable transaction was the March 2018 sale of Coles Clayton for \$17.115M, reflective of a 2.57% yield.

The CBD office market firmed over the latter part of 2017 and currently jockeys month-to-month with Sydney as to who has the lowest vacancy rate of the Australian CBDs. In any event, at 4.6%, this is the lowest vacancy rate in Melbourne CBD since 2008. This has been reinforced by the continuing trend of withdrawing and repositioning older office space in the CBD and immediate surrounds into new residential configurations, and the international and local demand for quality, centrally-located assets in the \$5-50M price bracket.

With 6.35 million residents, 75% of whom live in Melbourne, Victoria is the benefactor of several recent demographic and economic trends that have seen the State move into the position whereby it now accounts for 37% of Australia's population growth with demographer Bernard Salt predicting it to surpass Sydney in size within the next 12-15 years due to the latter's geographic constraints to infrastructure.

While some economic pundits are forecasting interest rate hikes during 2018 and the so-called "ghost tax" is set to come into effect in 2019, the outlook for Melbourne remains positive with the well-publicised housing affordability of Sydney seeing many elect to leave the city, notwithstanding the continuing economic strength and job prospects in NSW. The primary benefactor of this occurrence is Melbourne and if the current trends hold, Salt's prediction that it will overtake Sydney as the most populous city in the country by as early as 2031 could well come true.

Daniel Kisbee – State Manager Victoria

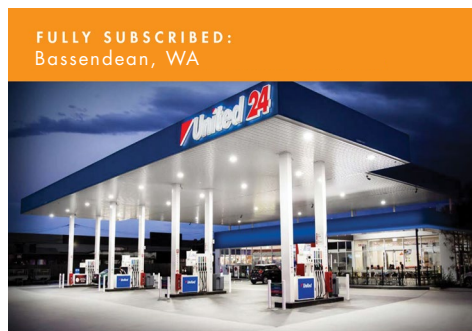
HOLDENCAPITAL PARTNERS

INVESTMENT OPPORTUNITIES FOR SOPHISTICATED INVESTORS

HoldenCAPITAL Partners provides qualified sophisticated investors with the opportunity to access the attractive returns available from investing in commercial property loans and equity opportunities sourced by HoldenCAPITAL. Below are a selection of our recent, fully-subscribed loan investments. If you would like to find out more visit [our website](#) or contact our Head of Investments Gary Connolly on 1300 HOL CAP or invest@holdencapital.com.au



TYPE	TERM	RETURN	SECURITY
Townhouses	21 months	22.5%p.a.	2nd Mortgage



TYPE	TERM	RETURN	SECURITY
Service Station	9 months	28%p.a.	2nd Mortgage



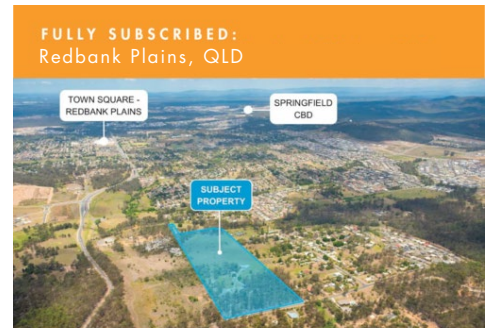
TYPE	TERM	RETURN	SECURITY
Townhouses	10 months	32%p.a.	Prof. Equity



TYPE	TERM	RETURN	SECURITY
Land Loan	3 months	12%p.a.	1st Mortgage



TYPE	TERM	RETURN	SECURITY
Land Loan	9 months	10.4%p.a.	1st Mortgage



TYPE	TERM	RETURN	SECURITY
Land Subdivision	15 months	24.7%p.a.	2nd Mortgage

**TIME TO
GET CONSTRUCTIVE
WITH YOUR
INVESTMENTS?**



First Mortgage on a
Development Site

8.5% - 12.5%p.a[^]



Second Mortgage on a
Development Project

15%-20%p.a[^]



Preferred Equity in a
Development Project

25%+p.a[^]

[^] Any quoted rates are net of management fees and costs. Please note that past performance is not a reliable indicator of future performance.

RECENTLY FUNDED PROJECTS

RESIDUAL STOCK LOANS

BUNDOORA - 36 APARTMENTS

GR = \$15,625,000



LOAN AMOUNT
\$10,156,000



INTEREST
9% p.a.
1% line fee



GEARING
65%



LENDER
Non-Bank

CHERMSIDE - RESIDUAL STOCK

GR = \$4,500,000



LOAN
\$3,030,000



INTEREST
11%p.a.



GEARING
65%



LENDER
Non-Bank



DEVELOPMENT SITES
SMALL APARTMENTS
TOWNHOUSES
LARGE APARTMENTS
RESIDENTIAL LOTS
RESIDUAL STOCK
...& MORE

OUR OFFICES
SYD - BNE - MEL - HK

Holden**CAPITAL**
CONSTRUCTIVE FINANCE

1300HOLCAP
www.holdencapital.com.au