Next generation of lenders

Australian commercial real estate debt is increasingly carving its place as a stand-alone asset class in institutional investor's portfolios as traditional lending sources dry up, writes Wayne Lasky, managing director at MaxCap Group

There exists a significant opportunity for institutional investors to fill a growing funding gap down under.

Disciplined capital deployed with specialist manager skill will find relative value financing residential development, commercial real estate assets with value-add strategies and non-traditional real estate sectors such as hotels and student accommodation.

The four major Australian banks remain the dominant lenders with 86 percent of $193 billion in Australian commercial real estate (CRE) debt exposures and less than 0.3 percent provisions (funds set aside to pay for anticipated losses).

This has been described as the 'goldilocks period' for the major banks, but as the singer Bob Dylan opined, 'the times they are a changin'.

The banks are now being forced to increase their Common Tier One equity to risk-weighted assets ratio up to 7 percent by 2019. In response, they have retracted further down the risk curve and thereby are increasing the pre-existing funding gap.

With a shallow pool of lenders, borrowers often face aggregation issues as banks are restricted by how much they can lend to any borrower.

Talking at a MaxCap Group event, the former Prime Minister of Australia, Paul Keating pointed out that: "Other institutions will have to do things in the spaces traditionally left to banks, such as property development, and we will see a shift in the balance in financing this industry."

There is little doubt the current one-size-fits-all CRE debt approach cannot prevail much longer; a view supported by MaxCap. I recently stated at an industry event that real estate

Mitigating circumstances

MaxCap has identified four major risks that institutional investors considering investments in Australia's residential developments should consider.

RISK	MITIGANT
Sponsor	-Best in class developers with appropriate experience and financial capacity to fund potential cost overruns. Guarantees (personal or corporate)
Cost overrun	-It is standard practice for a building contract to be a 'fixed price and time contract' containing an appropriate liquidated damages and liability regime. - Independent Quantity Surveyor costing, buildability, construction program and feasibility analysis undertaken to support the costings and timeframe in the contract. - In addition to cost overrun bank guarantees, a contingency allowance (typically 5 percent of contract sum) is included and drawn, subject to the financiers discretion for the purposes of meeting variations - Extensive due diligence to ensure the architect, builder, project manager and QS have the necessary experience and expertise to complete the project within the projected time and within the costed budget.
Delivery	- Adequate security is to be taken over the respective corporate entities. - Tripartite agreement between the mortgagee, borrower and builder entitles the mortgagee to 'step in' to control the Project under certain conditions. - The builder is typically Tier 1 and provides 5 percent of the construction contract in the form of bank guarantees as bonding.
Settlement (exit)	-It is generally a condition precedent in Australia that the dollar sum of unconditional apartment presales is sufficient to cover 80 percent to 100 percent of debt before funding commences. If a purchaser defaults at settlement (currently 0.2 percent - 0.5 percent for capital cities in Australia), the developer is entitled to keep 10 percent purchase deposits and generally has recourse for any losses sustained in reselling. - A certified legal opinion is required to confirm purchaser contracts. - A certified legal review to confirm soundness of the purchaser sales contract is also required.

is idiosyncratic in nature and requires diverse bank and non-bank lenders to provide a robust finance system to support real estate activity in Australia.

MaxCap was among the first investment managers to introduce institutional capital to mezzanine debt strategies in the post-global financial crisis (GFC) era and we have built on this recently by introducing a market leading whole loan offering. We have found that institutional investors have been attracted to these conducive market conditions and to those firms that can demonstrate deal velocity with high-calibre borrowers.


Lasky: looking to replace Australia's restricted banks

On the table

For unitranche facilities - a unified offering of a traditional first mortgage and mezzanine debt in one facility - expect 6 percent to 8 percent net returns a year. This product is particularly appealing to borrowers that face aggregation challenges with the major banks and for those that recognize the virtues of opening up a lending channel with a non-bank lender. Specialist asset managers are typically very nimble, able to conduct detailed credit processes and document loans to commence lending in a relatively short timeframe. Other savings are more obvious such as only paying one set of fees.

This is a nascent product offering in the Australian context, but we have already witnessed demand from a broad borrower base. For example, MaxCap recently dealt with one of Australia's premier publicly listed real estate development and investment companies on a Sydney development. The developer was precluded under internal policy from taking additional gearing in the form of mezzanine debt, but could access the higher gearing (approximately A$90 million) under one loan, via a unitranche facility.

In terms of achievable returns for CRE debt strategies in Australia, we're seeing mezzanine funding able to deliver net returns of between 12 percent and 17 percent a year. With the major banks retracting down the risk curve, offering lower loan to value ratios (LTV), the amount of equity needed is at historically high levels. For developers with a large pipeline, mezzanine debt provides the benefit of capital efficiency, enabling them to leverage their balance sheet across more projects. Getting their equity working harder also generates a higher return on developer equity.

From the manager's perspective, we value deals that have a clear exit within a defined timeframe. In this way, they closely characterize fixed income investments. In Australia, residential developments with pre-sales that cover 100 percent of debt in addition to construction contracts on a fixed price and time basis are good examples of this. Notwithstanding, we selectively provide mezzanine debt for stable assets with less defined exits. Last month we closed a deal on a major five star hotel in Melbourne at an 80 percent LTV.

Home advantage

Particularly in the current market, the highest returns have come from funding residential developments. Importantly, the risks involved funding developments are known upfront and are assessed and effectively mitigated by a specialist investment manager before funding commences.

Timing is important and credit quality remains very high in Australia. This ensures robust due diligence and that conditions precedent to lending are maintained and must be achieved in all circumstances. By funding late, the financier is able to eliminate numerous risks such as planning, market and environmental risks. The table opposite highlights the key development finance risks and outlines typical mitigants used to deliver strong risk-adjusted returns.

In the global search for value, emerging investment strategies such as commercial real estate debt are increasingly being considered by major institutional investors. Today, this has become particularly true in the land down under. Specialist Australian CRE debt managers provide new avenues to deploy investment funds with scale whilst offering strong relative value and genuine downside protection. □

About MaxCap Group

MaxCap Group is a leading Australian commercial real estate debt and investment specialist and has managed in excess of A$3.6 billion of commercial mortgages. The Group is an established investment manager for a number of major private and institutional funds. Complementing the investment management business is a strong Australia-wide pipeline of investment opportunities including development and investment facilities. The Group is proud to count amongst its clients many of the industry's largest and most respected commercial real estate players, and a growing number of internationals looking to establish partnerships with trusted local CRE debt experts. Funding solutions include end-to-end finance across the entire capital stack, with a particular focus on the provision of structured finance lending (second mortgages, preferred equity) and senior debt (first mortgages and unitranche loans).