Mind the gap

MaxCap Group Research - September 2023

The widening gap in real estate funding

A widening gap. A challenging global economy, rising interest rates and falling asset values are prompting greater caution from buyers and lenders alike. Altogether, this is creating a $5 billion real estate capital funding shortfall by diluting equity and reducing the availability of debt.

A transfer of leverage. As interest rates stay higher for longer, there are related shifts in investor focus, negotiating power and potential returns. Credit returns are lifting with higher rates and wider margins, alongside greater debt demand and weaker lender competition.

Abrupt sector rotation. Changing fortunes in real estate sectors are impacting on finance availability. Banks are visibly shifting their loan allocations, reducing their relative exposures to retail initially and office more recently, amid a long-running structural move from residential and land development, exacerbating the funding shortfall in these sectors.

Being selective on equity. Existing investors remain cautious overall, given the ongoing correction in asset prices. New buyers have a good bottom-of-the-cycle entry window ahead, although it is important to be selective about sectors and the entry price points.

A focus on private credit. The shortage of credit puts lenders at a strong advantage, at a time of improving returns and relatively resilient incomes, especially compared to other asset classes. The credit squeeze is similarly more acute for specific sectors, even as equity investors start to return with more palatable pricing.

A time for non-bank lenders. Deposit-taking lenders are facing more constraints ahead, impacted by the fallout from the US regional banking crisis, tighter lending standards and more prudent regulators, offering considerable scope for non-bank lending growth.

The shortfall in capital

The global economy is facing a difficult time right now, as slower economic growth and higher interest rates weigh heavily on most asset classes. For **real estate markets**, this adjustment is coming through via lower prices and higher cap rates, albeit to varying extents across sectors.

At the same time, there is increasing caution within the **real estate lending sector**, with the US regional banking crisis forcing banks and regulators alike into more conservative lending criteria, resulting in a narrower range of loan products, lower leverage ratios and much greater selectivity on sector exposures.

The combination of falling asset prices and lower loan-to-value ratios has profound impacts, reducing the availability of debt and driving **a widening funding gap** in real estate credit markets.

- This shortfall in capital is difficult to measure directly, but given recent transaction and lending market trends, we would estimate **a funding gap widening to A$5.3 billion** in 2024, reflecting the dual effects of falling collateral values and more conservative lending standards.
- The extent of this **credit squeeze** is likely to vary across sectors, being more muted in prime industrial (where leverage is steady and bank appetite is still firm) and more pronounced in suburban office (where perceived risk is curbing both collateral values and leverage ratios).
- Importantly, we are still a long distance away from the vicious **debt deflation cycle** – most famously seen in post-bubble 1990s Japan – when real estate and listed asset values inflated (and deflated) a lot more and banks had considerably less tier-1 reserve capital backing.

Certainly, this funding gap emerged due to **capital market drivers** and may be reversed during a subsequent cyclical upswing. However, the timing of any reversals in asset values and lending standards are likely to be measured in years. In other words, this funding shortfall is likely to be a persisting feature across Australian real estate markets in 2024 and 2025.

Falling leverage and rising cap rates are driving a shortfall in capital in most sectors, reducing credit availability and driving increased equity contributions

Cap Rates	Loan to Value Ratio: 40	45	50	55	60	65	70	75
7.0%	23	26	29	31	34	37	40	43
6.8%	24	26	29	32	35	38	41	44
6.6%	24	27	30	33	36	39	42	45
6.4%	25	28	31	34	38	41	44	47
6.2%	26	29	32	35	39	42	45	48
6.0%	27	30	33	37	40	43	47	50
5.8%	28	31	34	38	41	45	48	52
5.6%	29	32	36	39	43	46	50	54
5.4%	30	33	37	41	44	48	52	56
5.2%	31	35	38	42	46	50	54	58
5.0%	32	36	40	44	48	52	56	60
4.8%	33	38	42	46	50	54	58	63
4.6%	35	39	43	48	52	57	61	65
4.4%	36	41	45	50	55	59	64	68
4.2%	38	43	48	52	57	62	67	71
4.0%	40	45	50	55	60	65	70	75

Secondary Office

Prime Office

Regional Retail

Prime Industrial

Source: Jones Lang LaSalle REIS, Real Capital Analytics, MaxCap Group (September 2023). The table shows a hypothetical pool of assets with comparable incomes illustrating the impacts of loan-to-value and cap rate movements on potential debt availability

The impact of rising rates

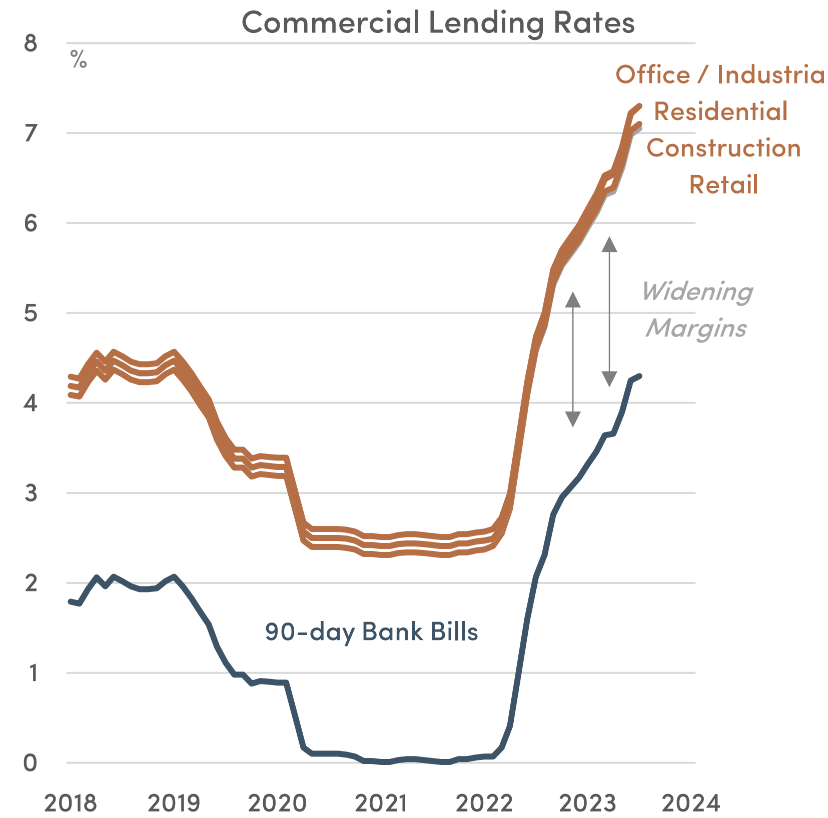
After a turbulent period of pandemic lockdowns, supply chain disruptions and rampant inflation, the most pressing challenge for investors in 2023 relates to the **rapid rise in interest rates** and contending with the adverse impacts on equity investment returns.

Simply put, higher interest rates – increasing the price of money across time – represent **a transfer of wealth** from borrowers to lenders.

- For **borrowers**, the urgent shift from near-zero interest rates has been the key driver in the unfolding asset price correction across nearly all sectors, from the buoyant industrial market to the out-of-favour office market. Residential is the unusual standout here, with prices boosted by a pent-up surge in migration-led demand and lagging supply.
- For **lenders**, rising rates present a strong financial advantage. Indeed, the credit return outlook is improving across two fronts, mostly from the sharp increase in short benchmark rates since 2022, but also with the widening margins across all commercial lending segments. This firmer return profile is likely to persist alongside above-target inflation, elevated interest rates and cautious lending standards.
- For **intermediaries**, there is a lot of work ahead given higher rates. On the one hand, there is greater strain on borrowers that requires active review and management to maintain loan book quality and careful selection of borrowers on the strength of their balance sheets. On the other, there is a clear need to guide investors out of underperforming equity positions, in order to deliver more sustainable portfolio returns.

Altogether, it will take some years for investors to find a **new equilibrium** in a world with low growth and high inflation, particularly as loans mature and funding costs reset to higher levels. Credit providers stand to be clear beneficiaries from this widening funding gap via higher returns, although there is a clear need to be selective across sectors as well.

Credit returns are being enhanced across two fronts, mostly with the rising 90-day bank bill benchmark, but also with the widening margins across different sectors



Source: Bloomberg, Reserve Bank of Australia, MaxCap Group (September 2023)

Shifting sectors

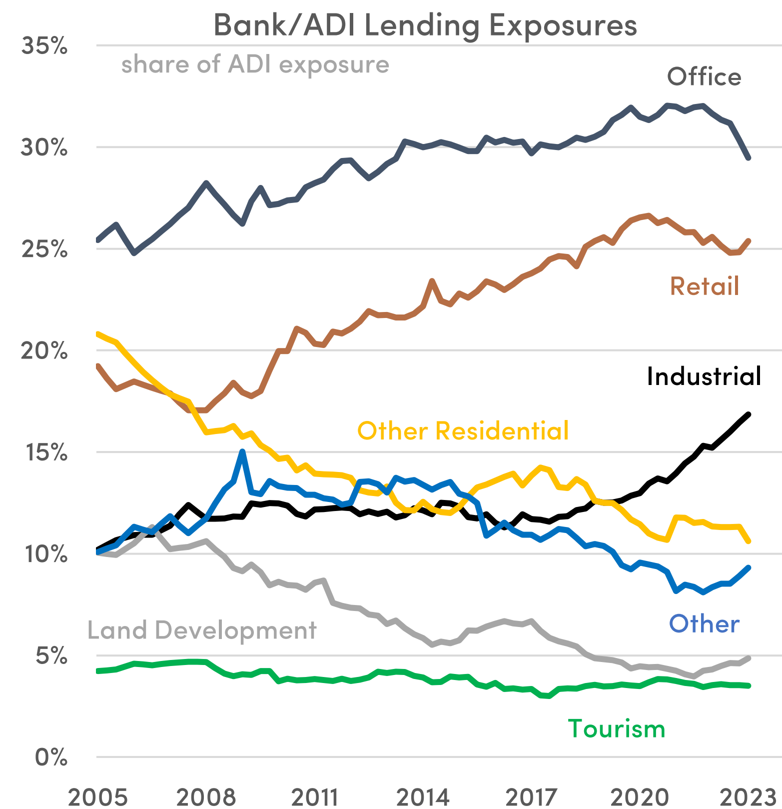
In this evolving credit landscape, borrowers and lenders are both adjusting their **sectoral exposures** to reflect actual and perceived risks in the real estate market. Looking at the reported lending exposures of banks and other deposit-taking institutions, we can readily see both the longer- and near-term exposure adjustments being made to the loan book.

- For now, lenders' love affair with **industrial and logistics** continue unabated, reflected by the near doubling in actual credit exposures for the sector over the past five years (+92% since 2017) and its rapidly increasing weight in the overall loan book.
- Meanwhile, there is a minor pull-back in **retail** exposures, where persistent market concerns over online substitution, pandemic disruptions and higher mortgage repayments are depressing shopping mall rents and values, driving a modest decline in loan exposures.
- More recently, there is a sharpening adjustment in **office** exposures, reflecting the escalating concerns about working from home and the consequential impacts on office occupancy and rents. The long-expected correction in asset prices is now starting to take hold in Australia, leading to a much more cautious tone from lenders.
- Over a longer 20-year period, we have seen large and enduring shifts to bank lending portfolios, particularly away from **land development** and **other residential** projects, partly reflecting the banks' structural retreat from these segments for regulatory and cost-of-capital reasons.

For context, it is important to note that these sectoral shifts are occurring in a growing credit market. There is **no sign of an abrupt credit crunch** as we had seen during the Global Financial Crisis in 2008-09, but rather a reallocation of credit across sectors reflecting their changing fortunes.

These shifts are providing **opportunities in credit selection**, especially where there is a mismatch between equity and bank credit appetite, as we expect to see in specific segments in 2024 and beyond.

Lender risk appetite differs a lot across real estate sectors, driving marked changes to credit availability down to specific regional locations and asset segments



Source: Australian Prudential Regulation Authority, MaxCap Group (September 2023)

The opportunity ahead

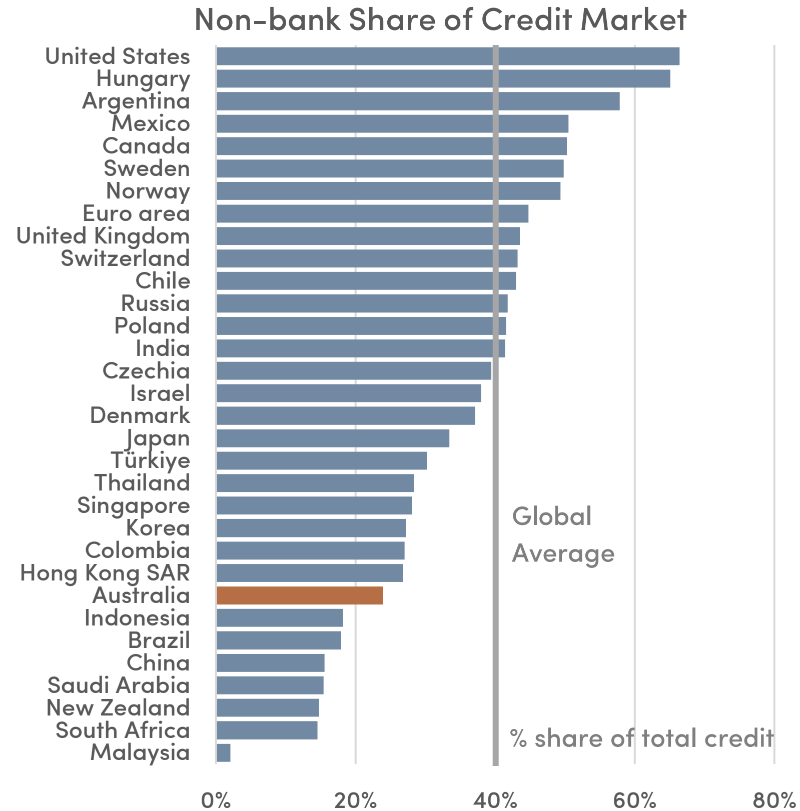
In a challenging economic environment with low growth, high inflation and rising interest rates, we see a widening funding gap that requires additional injection of equity and debt capital. What should investors make of this? Where are the most attractive **investment opportunities** ahead?

- For **existing equity** investors, there is still a difficult period ahead for commercial real estate, contending with subdued occupancies, falling asset values and tighter leverage ratios. There is a need for diligent asset and capital management right now, notably with the higher funding costs and lower loan-to-value ratios upon any debt refinancing.
- For **new equity** investors, there is a strong buying opportunity with the cyclical dip in pricing, although the adjustment varies a lot across sectors. Indeed, investors may need to push for the right entry price, amid the ongoing corrections in some sectors. At the same time, there is more focus on self-liquidating assets, including build-to-sell residential, strata warehousing and land subdivisions.
- For **credit** investors, higher interest rates and a wider funding gap are driving robust demand for capital and presenting attractive opportunities for returns. In this market, bank lenders are expressing clear preferences for specific exposures, skewed relatively towards industrial and away from residential development, office and retail.

Notably, we see a prime window of opportunity ahead for **non-bank lenders**. In a global context, Australian non-bank lenders are still a relatively small part of private credit markets, with considerable room for increased market share, following the well-established paths in the developed markets of North America and Europe.

From an economic perspective, this shift towards non-bank real estate lending is very beneficial for the overall **financial system** (OECD 2020), by increasing competition and diversification in the lending sector, by adding pension and insurance capital to reduce maturity and banking systemic risks and by ensuring credit availability across the cycle.

Amid a widening funding gap and genuine constraints to bank lending, we see growth ahead for non-bank lenders, similar to what has already occurred offshore.



Source: Bank of International Settlements, MaxCap Group (September 2023).
The credit market here relates to the private non-financial sector (core debt).
OECD (2020) The rise of non-bank financial intermediation in real estate finance.

Additional information

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