MERRICKS CAPITAL

MERRICKS CAPITAL SENIOR LENDING THOUGHT PIECE
JUNE 2017

IN THIS THOUGHT PIECE WE ILLUSTRATE HOW THE VACUUM IN BANK LENDING CREATES UNIQUE, HIGH RETURN-LOW RISK REGISTERED FIRST MORTGAGE INVESTMENT OPPORTUNITIES

EXECUTIVE SUMMARY

+ Merricks Capital CIO Adrian Redlich describes an almost perfect storm of investment potential via senior lending opportunities in development property finance – where strong underlying fundamentals combined with regulatory change have created a risk/return imbalance.
+ Regulatory authorities have announced measures and issued directions to improve lending practices, including restrictions on interest-only lending and measures to limit growth in investor lending and ensure the serviceability of loans.
+ The major banks have responded to these regulatory changes by reducing their exposure to investment lending, resulting in a void in the commercial property financing market.
+ Senior lending provides attractive investment opportunities - Returns are high due to bank changes combined with a lack of loan competition, while the risk is low due to strong structural demand for property and low levels of leverage or LVRs.
+ This market dislocation has created an outstanding investment opportunity

Recent changes in the Australian commercial property financing market have seen the emergence of outstanding senior lending investment opportunities, with high investment returns due to a lack of lending alternatives and a low risk profile from quality assets with low leverage. The combination of strong underlying fundamentals and increasingly negative sentiment towards property investment means it is the ideal time to take advantage of the current imbalances through senior lending.

Merricks Capital CIO Adrian Redlich describes an almost perfect storm of investment potential – where strong underlying fundamentals including changes in bank lending practices, mining construction lags, low interest rates, high immigration and unmet or "pent-up" demand are combined with negative sentiment and a barrage of headlines predicting doom. "Good quality developers and great quality projects are struggling to find capital."

THE OPPORTUNITY

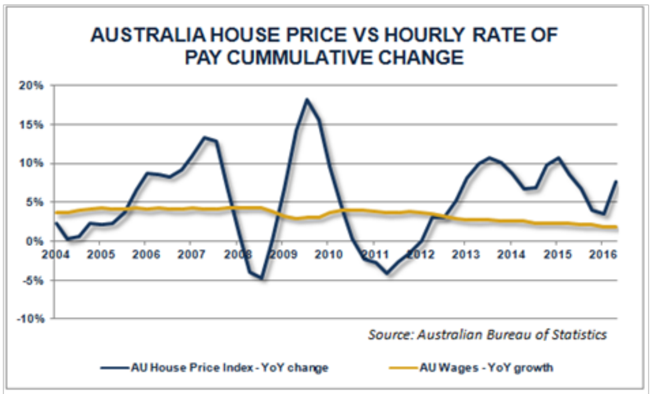
The Australian Prudential Regulation Authority (APRA) has been implementing a variety of measures to address responsible bank lending, including limiting interest-only loans, which are high by historical and international standards, and improving lending practices to limit excessive growth of investor lending and ensure serviceability of loans.

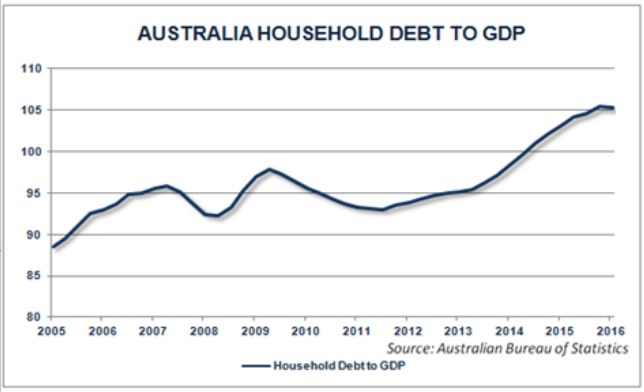
While improving the quality of new mortgage lending generally and moderating the growth in investor lending, these measures have also created a property financing void. With the major banks now reducing the available capital for project development and project financing, Mr Redlich says "a number of very attractive investment opportunities emerge."

Not only has the market dislocation resulted in impressive investment returns, but the risk profile of senior lending is also restricted due to the priority ranking of senior debt and the prudent investment criteria applied.

"Where we provide senior lending on a construction project at an LVR of say 65%, a significant collapse in the underlying property valuation would be needed to have an impact on the investment." Merricks further mitigates investment risk through its property selection process – avoiding those areas subject to oversupply and bubble-like conditions and instead focusing on financing properties in areas with strong organic or underlying demand.

It is this unique combination of high investment returns combined with a low risk profile that makes senior lending against property such a compelling investment opportunity.





The property background *– Rising house prices combined with slowing wages growth have resulted in escalating levels of household debt.*

ARE WE IN A BUBBLE?

Prospective investors might be forgiven for questioning the health of the Australian property market given a series of warnings, including those from ratings agency S&P which last month downgraded the credit rating of the banking sector due to the increased risk of a sharp correction in property prices and a resulting significant rise in credit losses.

These are not new concerns. APRA continues to point to an environment of high housing prices, high and rising household indebtedness, subdued household income growth, historically low interest rates and strong competitive pressures.

There have also been strong words from the Reserve Bank of Australia (RBA) about the levels of household debt, housing prices and bank lending.

In its latest Financial Stability Review, rather than taking comfort from figures that on average households are 17% ahead on their mortgages, the RBA warned about the variance. "…one third of borrowers have either no accrued buffer or a buffer of less than one month's repayments. The RBA suggests this could "amplyify the size of a subsequent downsizing in housing prices."

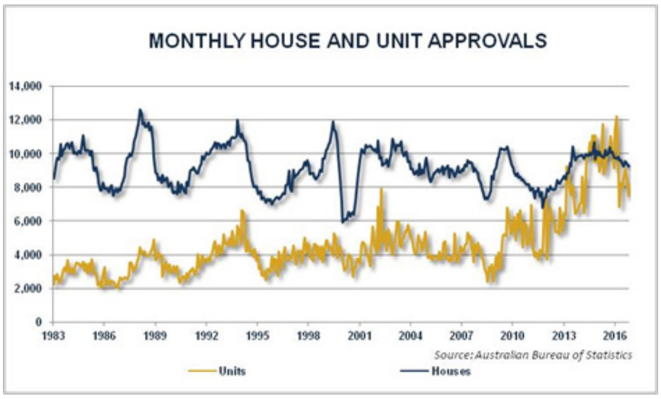
Another frequently discussed property market risk is that a building boom has led to an oversupply of apartments which further increases the likelihood of a price "crash".

The conclusion, at face value anyway, seems to be that we are in a housing market bubble.

But it's not that simple. While it is certainly true that there has been a boom in construction activity, most of the building has been demand driven, not "on spec" or in the hope that if you build it, they will come. Construction has also received a much needed catch-up boost from the return of skilled labour in the aftermath of the mining boom, when many builders struggled to source adequate labour to meet construction demand.

So while there are certainly some elements of oversupply, it is generally limited to pockets - and these pockets are characterised by poor quality planning and often poor quality building. Some were "triple-F" projects" – foreign buyer, foreign builder, foreign lender – and in many cases were sub-standard. It's probably a good thing to see them go.

Looking at total supply in more detail, approvals for houses have remained at the levels of the early 1980's despite this being a time of significant population growth and high levels of immigration.



Apartment construction has been the sole source of growth in Australian housing supply, and this has been insufficient to address the almost critical shortages and the associated issues of housing affordability and low vacancy rates. Federal Budget measures to provide a tax-effective savings vehicle for first home buyers and the recent NSW housing affordability reforms are some of the latest attempts to resolve the housing affordability "crisis". These are not the types of measures you'd expect in a bubble.

The experts aren't convinced we're in a bubble either. As S&P said when it downgraded the bank sector, "in our base case we expect that recent and possible further actions by the Australian authorities should aid in an unwinding of the imbalances in an orderly fashion."

S&P noted that the likely response would be slower growth – or even a mild drop – in property prices over the next 2 years, without any "significant increase in credit losses by the Australian banks". The banks seem to support this view, with ANZ saying it expects a soft landing in the housing market, with a "really low" probability of an outright crash.

In another words, we're entering a period of "bad news is good news", where data showing a gradual moderation in housing prices should be welcomed as evidence of a stronger-for-longer market.

POSITIVE LONGER TERM FUNDAMENTALS

Merricks notes a few special features about Australian property which means a standard comparison with international property markets isn't completely straightforward. Most Australian mortgages are full recourse loans, which means we don't have the option of handing in the keys and walking away from the house and the mortgage like US homeowners do. When the going gets tough, most Aussies will tough it out. They won't sell but instead make do.

Australia is also one of the few countries to allow the unrestricted use of "negative gearing" losses to offset income from other sources. This tax benefit greatly increases the perceived – as well as the real – attraction of property for Australian investors.

The economics of financing construction and development projects makes sense due to low interest rates, population growth/high levels of immigration, low housing supply growth and significant pent-up or "unmet" demand.

Supporting the investment fundamentals, the banks haven't just created a vacuum of financing options with their investment lending changes, they've also improved the macro-economic backdrop for the property sector. By raising interest rates independently of the RBA (mainly for interest-only and fixed rate mortgages) and curtailing investment lending, the banks are contributing to S&P's call for "unwinding the imbalances in an orderly fashion".

In particular, their actions reduce the inherent need for an increase in RBA rates in the long term and that is good for the health of the economy and the housing market overall.

Merricks believes the Australian lending market is currently undergoing significant change. The structural changes, combined with a "fearful" environment, now provide a unique opportunity for investors to take advantage of the significant returns and low risk profile available through senior lending.