

Debt markets

Are lenders open for business?

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The increasing economic uncertainty brought about by the onset of COVID-19 is placing pressure on financial markets across the world; the property sector has not been immune to this. Retailers are struggling to stay open and meet rental obligations; effective rents have declined in most Australian office markets and in some markets sublease space is increasing to levels not seen since the 1990s. These issues and the ongoing uncertainty are impacting loan terms offered to borrowers as credit risk has been repriced and the willingness to lend has decreased. However, such is the desire to invest in Australian property, particularly office assets, there remains a significant weight of capital ready to invest if transactions volumes pick up.

What's happening to existing loans?

Domestic banks were heavily encouraged by the Australian government to remain open for business to borrowers in order to mitigate the impacts of the shutdown period on the wider economy. They were keen to offer assistance to small and medium enterprises (SME) to keep them from going into liquidation as a result of the COVID-19 outbreak, as this would hamper the economic recovery.

Loan monitoring or covenant monitoring is where a lender who is underwriting a loan establishes benchmark metrics that are designed to safeguard the lender's investment by monitoring the financial viability of the borrower. When the economy went into lockdown, covenants that were normally monitored quarterly for interest coverage ratios (ICRs) and loan to value ratios (LVRs) were delayed or altered. This was primarily done to give businesses some leeway during the worst of the shutdowns. Ultimately, though, the lender will need to protect their investments so the viability of these businesses will need to be revaluated, and the question needs to be considered: what will lenders do once they restart covenant testing?

Of key consideration to lenders is what is happening with the value of the underlying asset. We have already seen reductions in the value of retail assets in the last few years, but we are now projecting to see declines in the office sector as well. Figure 1 illustrates how the major sectors are expected to perform over the next few years. If an asset's value falls enough creating a breach to the LVR covenant, then depending on the terms of the agreement the loan would be in default. In this situation typically a default interest rate would be charged, and the borrower would have to pay down the loan to an amount that satisfies the LVR covenant.

Chart 2 – Projected Peak to Trough Value Falls – National Averages



Source: CBRE Research

Whilst breaches of LVR covenants have not been a widespread occurrence to date – assets have yet to be repriced primarily because of a lack of transactions – ICR breaches have. An ICR is simply a measure of an entity’s ability to pay the interest on its outstanding debt: essentially it measures the interest serviceability of the loan.

Typically when an investor enters into a loan agreement an ICR is agreed upon that they must then satisfy for the duration of the loan. As a result of COVID-19, the government stipulated that rent abatements be given to tenants that meet certain financial criteria. These rent abatements, in some instances, reduced the cashflow for owners who, therefore, were in breach of their ICR covenant.

Given the current situation remains fluid and uncertain, lenders have been more flexible than in previous economic downturns regarding breaches so have worked with borrowers to devise strategies around asset management and offer waivers as opposed to implementing financial penalties.

What about pricing?

Unlike the GFC which was brought about by a credit crunch, this downturn is a result of a virus outbreak. Banks and non-banks are not short of capital – thanks in part to stricter regulations implemented as a result of the GFC such as Basel III – so they have money to lend. Yet, economic uncertainty inevitably leads to lenders becoming more risk-averse and therefore increasing the cost of capital for investors.

Increases have ranged anywhere from 50-100bps on commercial loans; however, when you consider there have been two interest rate cuts since February, some investors are likely paying a similar amount to 2019. Table 1 shows how rates are expected to track over the next 18 months.

Table 1 – Major Interest Rate and Bond Yield Forecasts

Swap Rates	Q220	Q320	Q420	Q121	Q221	Q321	Q421
Cash	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%
1M BBSW	0.12%	0.12%	0.11%	0.11%	0.11%	0.11%	0.11%
3M BBSW	0.13%	0.13%	0.13%	0.12%	0.12%	0.12%	0.12%
6M BBSW	0.19%	0.18%	0.18%	0.18%	0.17%	0.17%	0.17%
3-year	0.38%	0.33%	0.28%	0.28%	0.28%	0.28%	0.28%
5-year	0.50%	0.45%	0.40%	0.40%	0.40%	0.40%	0.40%
10-year	0.80%	0.80%	0.81%	0.82%	0.82%	0.85%	0.87%

Source: CBA, CBRE Research

Most banks are primarily floating-rate lenders, meaning they typically use BBSW/Y with a margin and some hedging cost requirement to price loans and non-bank lenders generally use swap rates as a base, then add their margin as well. Given that all rates are projected to remain below their long-term averages, this may keep a lid on debt costs increasing too much. Indeed, the RBA is keen to keep costs under control so has been buying up 3-year government bonds as part of its policy response to COVID-19.

Are lenders becoming more selective?

Flight-to-quality is a trend seen in every downturn as investors pile into perceived safer assets, such as prime CBD offices; the debt market is no different. Lenders are becoming more selective with a preference for assets with clear strategies and quality sponsors. New loans for the hospitality and retail sector are proving to be the hardest to facilitate, but assets with long WALEs and a quality tenant profile are viewed favourably, particularly in the industrial sector which is expected to be the most resilient throughout the downturn.

Serviceability of the loan is of paramount importance to lenders, so they need to be sure that the risk of default is minimal. Lenders have return hurdles that they need to hit so will invest in loans that give them acceptable returns.

Traditionally real estate lending does not illicit the best returns compared to other sectors so there is an internal *competition for capital* underway whereby lenders are becoming more fastidious. This is not only resulting in fewer loans issued but is also significantly delaying the approval process as lenders take their time when undertaking due diligence, particularly for new clients. Whilst loans on acquisitions are still being funded, LVRs are down below 50% for many borrowers, and in some cases it is likely that more than one senior lender on common terms is required to facilitate the amount needed to cover the acquisition.

Offshore lenders – both banks and non-banks – are looking to capitalise on domestic lender's more cautious approach to funding and increase their market share. Offshore groups have always been attracted to Australia's stable and transparent market and are generally more competitive on longer-term (3-5 years) loans than their domestic counterparts. The problem they currently have is getting into the country, so must either have a local business or rely on third-party brokers to assist, but provided they are comfortable with this arrangement they too are keen to lend.

So, yes, lenders are open for business, but it must be the *right* business.



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