THE COST OF DEBT

COMMERCIAL PROPERTY INVESTORS WEIGH THE COST OF BORROWING IN 2021, AS REGULATORY PRESSURE CONSTRAINS BANKS' ABILITY TO LEND ON COMMERCIAL PROPERTY AND MORE NON-BANK LENDERS ARE TIPPED TO ENTER THE MARKET.

THE COST OF DEBT IS ONE OF THE biggest factors commercial property investors are weighing up in their decisions during 2021.

While bank lenders are currently offering historically-low mortgage rates to residential property investors, their view on commercial property is more cautious.

Commercial property lending accounted for about eight percent of banking system loans, and historically experienced large credit losses in economic downturns. In recent years, banks have maintained tight lending standards, including limiting development lending to 15 percent of total commercial property lending, according to the Reserve Bank.

A recurring theme from many commentators is the likely emergence of non-bank funding, albeit usually more expensive funding.

Mark Farrands, chief investment officer New Zealand for MaxCap Group, said bank debt was always the cheapest option but not everyone could get it for property transactions at the exact time they required it.

"Banks are very selective and want to lend to the most experienced operators with strong track records, on projects with the best financial metrics.

"They don't want to be seen to be growing their balance sheets faster than their peers or growing their property lending out of balance with other forms of business lending on their own balance sheets," Farrands said.

"When financing commercial property purchases, banks seek lower gearing and higher interest cover loans to mitigate any future market correction and potential for tenancy loss and vacancy.

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MARK FARRANDS - CHIEF INVESTMENT OFFICER NEW ZEALAND, MAXCAP GROUP.

"When lending on development projects, banks want the strongest pre-sale cover so that the loan can be fully cleared from sales settling when the project is complete - and they want that in place before drawing down the loan (the pre-sales)," according to Farrands.

"Borrowers that need higher leverage or can't meet bank pre-sale requirements or need more flexibility of credit conditions must look to the non-bank market.

"In the non-bank market, there are currently limited options for investment lending in New Zealand, as most non-bank lenders here only have appetite for shorter term loans with less than two to three-year terms. They also seek returns on their capital at higher rates than banks. It can also be difficult to find lenders that are happy to lend on larger tranches of debt of $20 million-plus.

"The cheapest non-bank loans are currently priced around seven to eight percent, and some are more expensive at eight to 12 percent," Farrands said.

Development loans were priced according to the risk assessed by the lender, and varied depending on the borrower reputation, quality of asset, builder strength and strength of pre-sales and pricing, he said. The total cost of a development loan was made up of an upfront establishment fee, line fee and interest rate.

"Currently combining all those together gives a total cost ranging between nine to 14 percent. Some non-bank lenders provide residual stock loans for financing unsold stock at the end of a development loan, usually for short terms of no longer than 12 to 18 months.

"These are mostly sized between $2 million and $20 million and are priced at between six and eight-percent interest rates with upfront fees of one to two percent," Farrands said.

"With bank lending remaining restrictive it is expected we will see more non-bank lenders arriving in New Zealand from offshore as well as more local operators starting up new lending businesses."

Farrands said that it may increase competition and drive down the cost of borrowing - but currently there was a big gulf in the total cost of borrowing between bank and non-bank lending.

Phil Bennett, BNZ's head of property finance, said that while the Reserve Bank had delayed proposed increases to capital reserve requirements, this will ultimately flow through in the next 12-24 months and could affect credit cost and availability.

"But this could also open the New Zealand market to new lenders," Bennett said.

PHIL BENNETT, BNZ'S HEAD OF PROPERTY FINANCE

Funding costs were significantly cheaper than 20 years ago, however lending criteria and thresholds for commercial property investment have changed following finance and construction company failures, earthquakes, changes to the Resource Management Act and the Construction Contracts Act, COVID-19, and new regulatory requirements around responsible lending, he said.

"Loan documentation is more all-encompassing, valuation processes more robust, banks have new minimum seismic building thresholds, and full replacement insurance cover is becoming harder to obtain," he said.

"More emphasis is placed on surety of income following recent COVID effects on different asset classes and tenants, and banks' levels of portfolio concentration risk, and industry type - retail, office, industrial and tourism and hospitality."

Bennett said that 20 years ago, most banks were looking at loan-to-value ratios of a maximum of 70 percent, and net income-to-loan interest cover of around 1.5 times.

"In January 2000, the OCR was 5.67 percent and using industrial property as an example, yields were 10 to 12 percent - if the property had a net income of $1 million the value was in the $8 million to $10 million range and the bank charged, say, a two-percent margin over the overnight cash rate – on a 1.5 times interest cover the banks could easily lend up to 70 percent loan to value range."

Recently banks had pulled back to a loan to value range of 60 to 65 percent and interest cover at two times, he said.

"However, given the current forecast stable, low interest rate environment and yield trends, if we took the same industrial property example with net rental of $1 million, and the overnight cash rate currently 0.30 percent plus same risk margin of two percent and yields at 5.25 percent, then the value of the same property is now about $19 million.

"As such, banks will be looking to increase interest coverage ratios to maintain appropriate gearing ratios – so look for lenders to want somewhere in the 2.5 to three times interest coverage ratio which will see gearing in the 55 to 60 percent loan to value range."

Bennett said with global reserve banks continuing to suppress both short and long-term interest rates, and property's strong return profile relative to other asset classes, we're likely to see continued demand in the sector and potentially further yield compression in coming years as investors chase returns when compared to bank deposit rates.

Economist Cameron Bagrie of Bagrie Economics said rental yields on both industrial and office properties have continued to decline, but this can be attributed to further declines in long-term interest rates, and does not necessarily suggest an overvaluation in asset prices.

Bagrie was quoting from the Reserve Bank of New Zealand November 2020 Financial Stability Report.

"The statement summarises in a nutshell the commercial property market. We need to be mindful of structural changes in the market such as working from home which is changing demand for office space, and economic risks potentially lifting vacancy rates.

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CAMERON BAGRIE,
BAGRIE ECONOMICS

"But the broad story has been dominated by interest rates. Commercial yields have fallen and have followed lower interest rates. Residential property yields, dividends and corporate bond yields have done the same, not always in step, but in the same downward direction.

"The entire term deposit curve for one to five years is below one percent. When you take off inflation you are moving backwards," Bagrie said.

However, there were three key points, he said.

"The first is the spread between interest rates and yields. It is still respectable at around 400 basis points, even though some commercial yields have fallen to eye-watering levels in some parts of the country.

"But the lower they fall and that gap closes, the less investors are being compensated for taking risk. That gap is not worrying at present. Industrial has been the darling. Yields may have fallen but the spread has widened in some areas such as retail and office," Bagrie said.

"The second point is how long will interest rates remain low, potentially pressuring the spread from below if interest rates rise. We've seen interest rates bounce off lows as expectations that the Official Cash Rate (OCR) could go negative have been pared back. Inflation trends need to be watched.

"But interest rates remain incredibly low and the Reserve Bank expects the OCR to remain low for an extended period." Bagrie said.

The economy had surpassed all expectations but still faced a long road ahead.

"After undershooting its inflation target for a decade, the Reserve Bank is likely to be very cautious before it considers lifting interest rates," Bagrie said.

The third key point for investors was access to credit and the pricing of it.

"Credit has become tougher to get as banks' risk tolerance has fallen. That's partly a by-product of the economic environment and heightened uncertainty, overlaid with some regulatory changes. It started pre-COVID-19. At this stage it is a complication rather than the key driver, but a niggle factor nonetheless," Bagrie concluded.

ANZ's head of property finance Alain Hoodless said that while returns to commercial property investors were low, they were still better than bank deposits which were less than one percent.

"Banks will assess the risk of a commercial property loan taking account of type and location of the asset, the loan to value ratio, the interest cover ratio, the weighted average lease term, the financial strength of the tenants as well as an assessment of the market outlook for the asset type and the commercial property market in general."

When it came to investing in syndicates, banks would lend to the entity that owned the property rather than to the individual investing in the syndicate so that first mortgage security can be taken over the asset, Hoodless said.

The economic outlook for New Zealand in 2021 is generally positive according to recent bank research reports, although they all warn of unforeseen problems that may rise, particularly in relation to Covid-19.

ALAIN HOODLESS,
ANZ'S HEAD OF PROPERTY FINANCE

Most bank commentators anticipate that the Reserve Bank is unlikely to raise the overnight cash rate, at least until after mid-year, with Capital Economics Australia and New Zealand predicting a rise in interest rates in the second half of 2021.

This was based on the widespread view that the New Zealand economy had already returned to pre-virus levels by the end of 2020 as evidenced by constrained unemployment growth compared with previous forecasts, and an inflationary housing market.

The market watchers have their eye on the inflation rate currently at 1.4 percent annually which may rise to two percent - the mid-point of the Reserve Bank's one to three percent range. The Reserve Bank's last Financial Stability Report said it expected inflation to remain below two percent over the coming months.

Office price inflation had accelerated over the past year, with low vacancies, however secondary office properties in major cities were at risk of increased vacancies as demand shifted to newer stock, and firms reassessed long-term floorspace needs as regular remote working became a permanent feature of operations.

"Industry contacts have reported significant subleasing activity in Auckland and Wellington offices in recent months, suggesting this shift is already underway," the Reserve Bank said.

Industrial property remained strong, but the economic downturn has hit the accommodation sector hard and exacerbated pre-existing vulnerabilities in the retail sector which experienced spending decline over lockdown periods. Retail property valuations across the major cities plunged 16 percent in the year to the September 2020 quarter.

"Revenue for hotel and accommodation providers has significantly declined, with a very difficult outlook for the next few years especially in Queenstown and Auckland.

"A development pipeline of new retail and accommodation supply is expected to enter the market over the next six months, particularly in tourism-exposed regions, presenting a further risk of oversupply. This would challenge the viability of some retail property loans, with heightened risk particularly for hotel lending," the Reserve Bank said.