Davis Langdon
An AECOM Company

RESEARCH REPORT

Access to Finance Survey

Property and Construction Industry – July 2010

Executive Summary

Davis Langdon surveyed developers and financiers from Australia and New Zealand with a view to discovering both sides of the story on financing property and construction projects. Those seeking funding for projects were invited to participate, as well as brokers, consultants and representatives from financial institutions that are known lenders to the industry.

It was found that the issue of access to finance in the property and construction industry is an ongoing concern. Developers viewed the loan to equity ratios as very conservative and unworkable, particularly when combined with shrinking valuations and a lack of second tier finance, while the finance sector expects a turnaround when global markets stabilise.

While developers expressed a willingness to go beyond traditional sources of funding, it remains to be seen whether second tier financing will re-emerge, enabling greater competition in local funding markets and reduced borrowing costs.

Key Findings

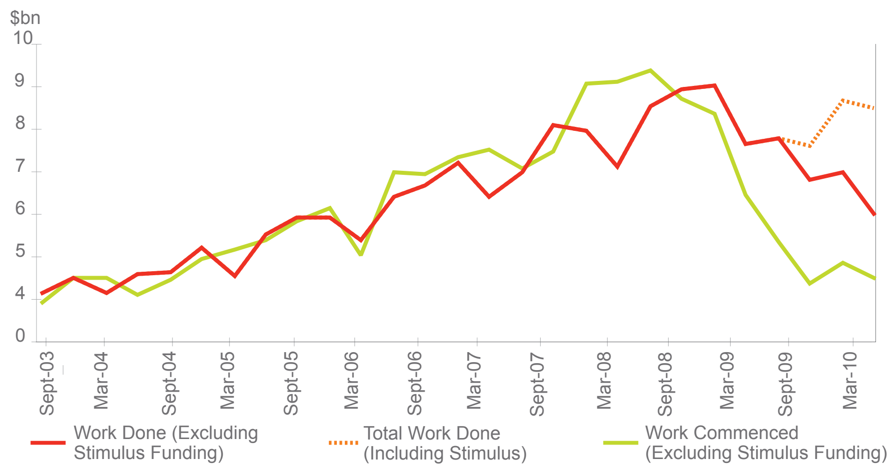
- Lending for construction projects restricted – limited lending targeted at cash flow assets
- Recovery in lending liquidity not expected for at least 18 months
- Developers lose interest in local banks – focus moves to private syndicates
- Risk assessment criteria considerably more stringent
- Residential sector surges ahead of other sectors but with great caution
- Finance sector highly concerned about lack of competition in the market

Current State of the Market

The Access to Finance Survey was conducted to assess the issues faced by the private sector as Federal Government stimulus funds begin to decline.

Excluding the stimulus boost to the industry, Work Done and Work Commenced in the non-residential sectors is down 34% and 52% respectively from their highs during 2008.

National Non-Residential Construction Activity



Source: ABS 8752.0, Davis Langdon Research

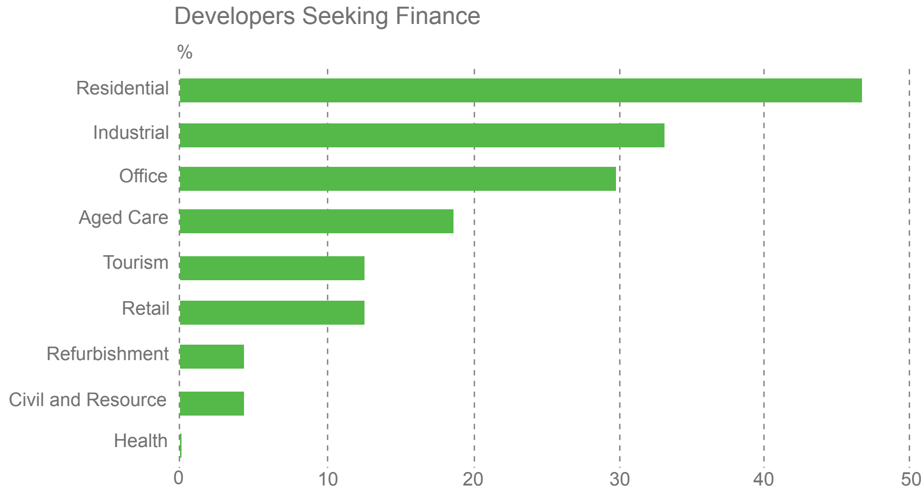
Seeking Finance

Of the developers surveyed, 74% have recently sought finance for projects in the last six months, or were currently seeking it at the time of the survey.

76% were seeking finance for projects valued at less than $20 million, while 13% were looking to fund bigger projects over $100 million.

These developers were mostly seeking finance for Residential projects, with 46% of those surveyed targeting this sector. Industrial and Office followed as the next most sought after sectors for finance.

None of the surveyed developers in Australia and New Zealand had attempted to recently finance a project in the Health sector, and only 4% had tried to obtain finance for Refurbishments and Civil & Resource projects. However, it is noted that a majority of Health projects are commissioned and funded by State, Territory or Commonwealth Governments which were not represented in this survey.



Obstacles to Financing Projects

Many of the developers and financiers surveyed identified the same barriers to financing projects:

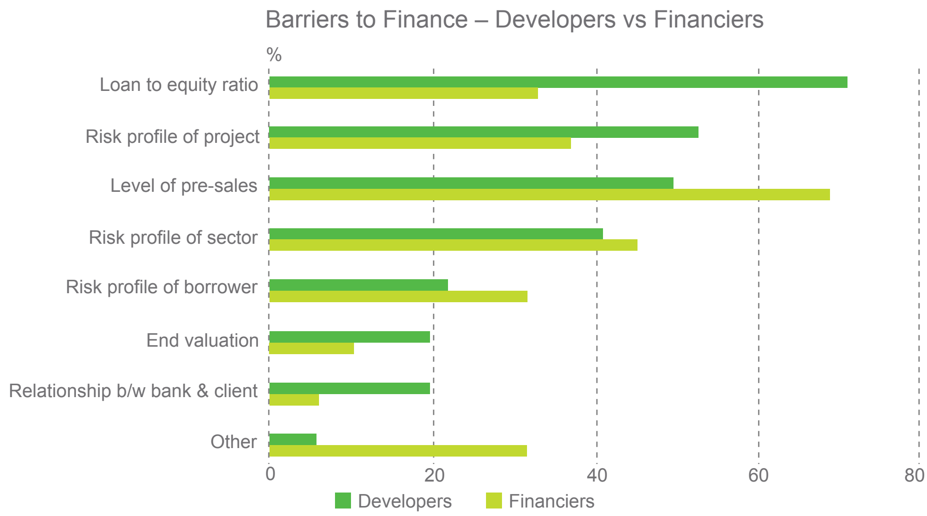
- the loan to equity ratio
- the risk profile of the project
- the level of pre-sales
- the risk profile of the sector

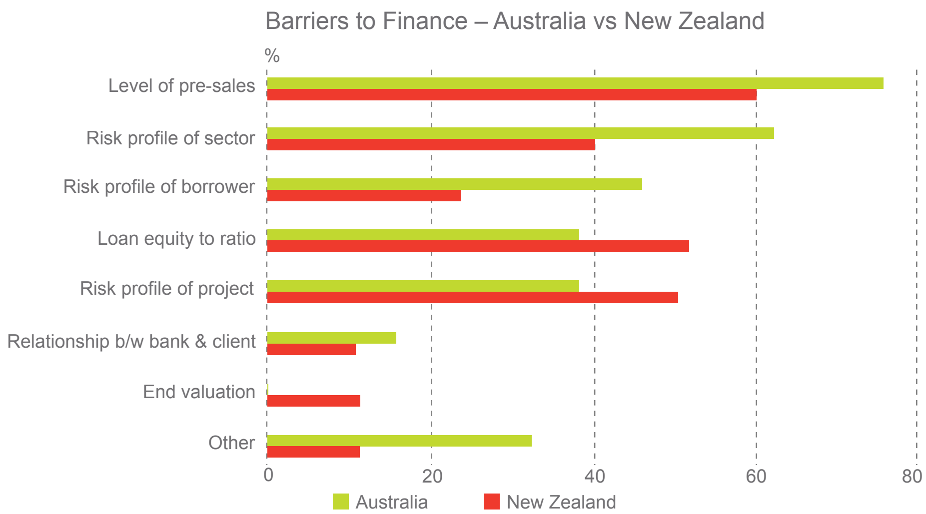
However, financiers were more focused on levels of pre-sales (68%) and risk profile of sector (45%), while 70% of developers cited the loan to equity ratio as their number one obstacle.

Most developers viewed the loan to equity ratios as very conservative and unworkable, particularly when combined with shrinking valuations. However, some respondents believe that this has returned to more sensible levels. Finance representatives agreed for the most part that the loan to equity ratios were substantiated and explained that it does vary depending on the sector and feasibility of the project and its developer.

One finance respondent pointed out that profitable projects with a clean exit strategy, carried out by credible developers will get funded. Others conceded that the industry was also suffering from a lack of second and third tier lenders for higher risk transactions or mezzanine finance.

There was some common ground between participants from Australia and New Zealand. Both agreed on the importance of pre-sales, but more Australian respondents (62%) saw the risk profile of the sector as a greater factor than New Zealand participants. Instead, 49% of New Zealand respondents saw the risk profile of particular projects as a more significant consideration in obtaining funds.





Respondents also highlighted the way financing in the property and construction industry was affected by broader issues in the economy – both locally and on a global scale. Several mentioned lender capacity and the cost of raising capital, particularly when global markets are still nervous.

A move by banks to limit their exposure to the property and construction sectors was identified as another obstacle faced by the industry. Not surprisingly, the increased risk of construction and development loans – which are inherently more prone to fail in a downturn than secured loans due to the potential for construction lags – meant they were less likely to obtain funding than an existing cash flow property asset. This perceived risk seemed to override any previous relationship between the bank and client. As one New Zealand developer lamented, past success and proven abilities seemed to count for little.

Another issue raised by those surveyed was a lack of second tier and mezzanine finance. This has created a situation where large developers/REITs able to raise extra capital during 2009/10 are positioned to meet equity requirements and continue 'business-as-usual' while small and mid-sized developers that are unable to raise funds have limited or no option of raising capital.

"A new mechanism to bridge [the] equity gap needs to be found" – Finance Sector Participant

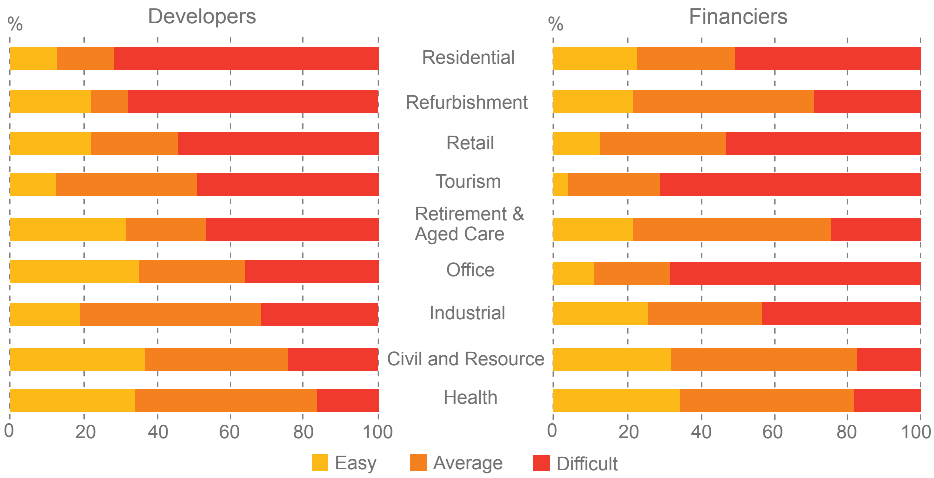
This divide in Australia has been exacerbated by a lack of competition in the banking industry, referred to by several participants, particularly following the recent consolidation – Westpac's takeover of St George, and Commonwealth Bank of Australia's acquisition of BankWest.

Participants in New Zealand also pointed to the expected changes to depreciation (most completed the survey prior to the budget) and the uncertainty this was creating for investors in the property market. Now that the budget is finalised and depreciation is no longer a tax allowance the sentiment of investors and their ability to secure pre-sales is probably lower than what is recorded in this report.

Access to Finance by Sector

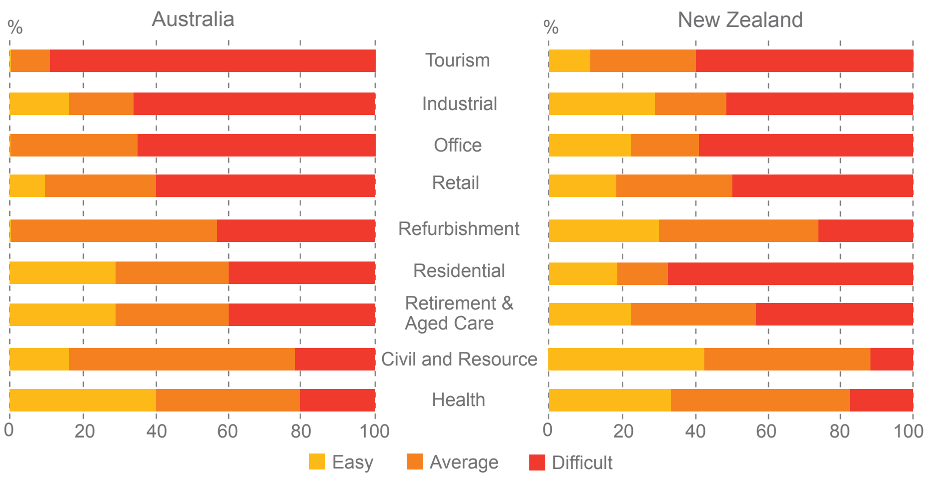
Most industry participants agreed that the Residential sector has been hardest to finance, with 75% of developers and 54% of financiers placing it in the Difficult category. However it is noted that Residential is currently the highest targeted sector by developers and therefore the results are not surprisingly skewed.

Civil and Resource and Health sectors ranked highest in ease of securing finance, neither of which carries high risk to end value compared to other sectors surveyed. Conversely, 50% of developers and 73% of financiers found Tourism projects tough to fund. Meanwhile developers have greater expectations of securing funding in the Office market compared to views from the finance industry.



Access to Finance by Sector – Australia vs New Zealand

The property and construction industries in Australia and New Zealand shared some common ground in their views on which sectors were harder to finance. However, as evident in the charts to the right, New Zealand is having greater difficulty in the Residential sector, with 68% of respondents finding these projects Difficult to fund. Conversely, the increased demand and Government stimulus measures in Australia's Residential market has helped make these projects more appealing to banks with only 40% of Australian participants classifying this sector as Difficult to fund. Instead, more Australian respondents have had trouble funding Tourism (93%) and Industrial (67%) projects.

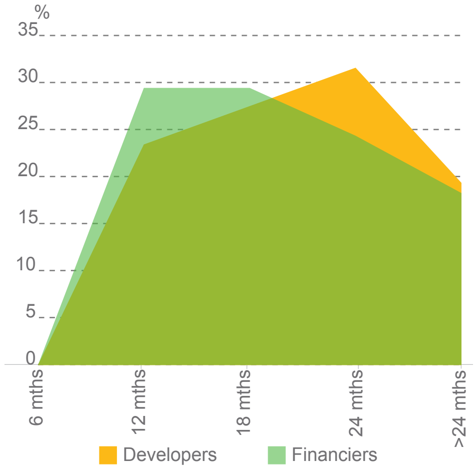


Industry Expectations of a Turnaround

Although opinions are mixed regarding when credit restrictions will ease, both developers and financiers are certain there will be no change during 2010 – with no respondents confident of a turnaround in the next six months.

58% of financiers expect the situation to turnaround in 12 months (29%) to 18 months (29%), while developers have a more pessimistic outlook with 58% expected to wait 18 months to 24 months. Expectations of prolonged credit restrictions – greater than 24 months – are also considered feasible for 19% of developers and 18% of financiers.

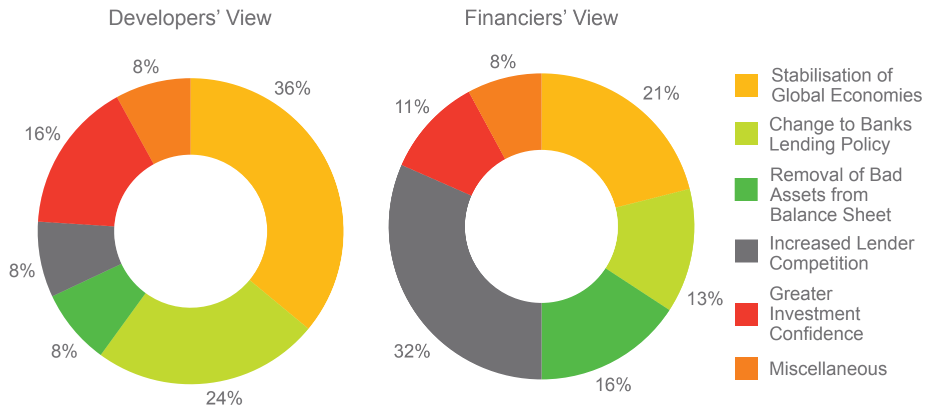
Overall, New Zealanders surveyed envision a quicker turnaround with 59% expecting a better finance situation in 12 months to 18 months, whereas 60% of Australian respondents are expecting to wait over two years.



What Needs to Change to Improve Market Transactions

"Good, profitable projects with clean exits being carried out by credible developers will get funded" – Finance Sector Participant

When asked what would need to happen to bring about change, developers and financiers differed in opinions. Developers cited Stabilisation of Global Economies (mainly sovereign debt concerns) as the prominent issue affecting credit liquidity – indicated by 36% of respondents – while **financiers are more concerned about lack of increased lender competition in the market** – noted by a majority of respondents (32%).



This difference of opinion supports the findings for 'Industry Expectations of a Turnaround' (see above). The current levels of sovereign debt will require years to recover and therefore justifies developers' views of a more pessimistic outlook than financiers. Several developers responses also noted the impact of global economic stability on investor confidence, diminishing their ability to secure the necessary level of pre-sales required in today's market.

Several bankers and brokers – particularly in Australia – pointed to a need for increased competition in the banking sector, such as the return of non-bank and mezzanine funding. However, this may not necessarily guarantee cheaper, more readily available funds because domestic banks remain heavily reliant on the foreign capital markets. For the foreseeable future, our banks are likely to have to compete with sovereign and top quality corporate borrowers, as well as foreign lenders, in wholesale capital markets.

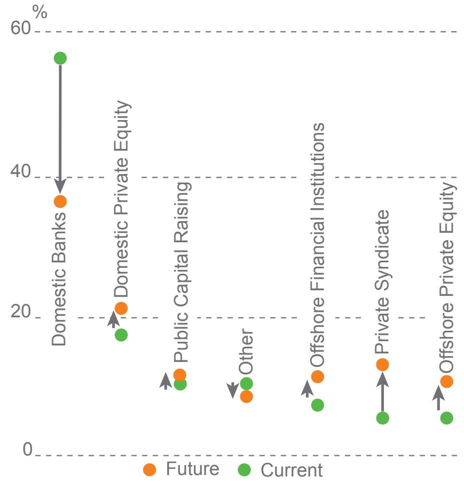
In a sign that the spread between the official cash rate and lending rates is likely to go up further before it starts to come down, only developers noted that lending costs were currently too high. Banks, obviously aware of increased regulation and wholesale capital liquidity restrictions, have been pushed to raise the spread between wholesale lending and market lending considerably higher than in recent years and it seems the worst is yet to come.

One respondent from the finance sector noted that the 'big 4' Australian Banks **"...have a prized oligopoly and are abusing their market power"**. This is reflected in the finance sector's collective sentiment, with 32% of respondents advocating Increased Lender Competition. Participants indicated that greater competition may be the only way to prevent unnecessarily high lending rates in the future.

16% of finance participants noted that the 'unwinding of bad debts' was far from complete and before credit restrictions could be lifted or lending policy could be relaxed these debts must be restructured or removed from the banks' balance sheets. Finance industry representatives also said banks should only lend to developers that are willing to cover considerably more of the risk than in the past, with a clear exit strategy for the project and 'fail-safe' alternative arrangements should any unforeseeable issues arise. Without these measures, developers face a significantly reduced likelihood of securing project finance. As one banker warned "the days of 'easy money' are over".

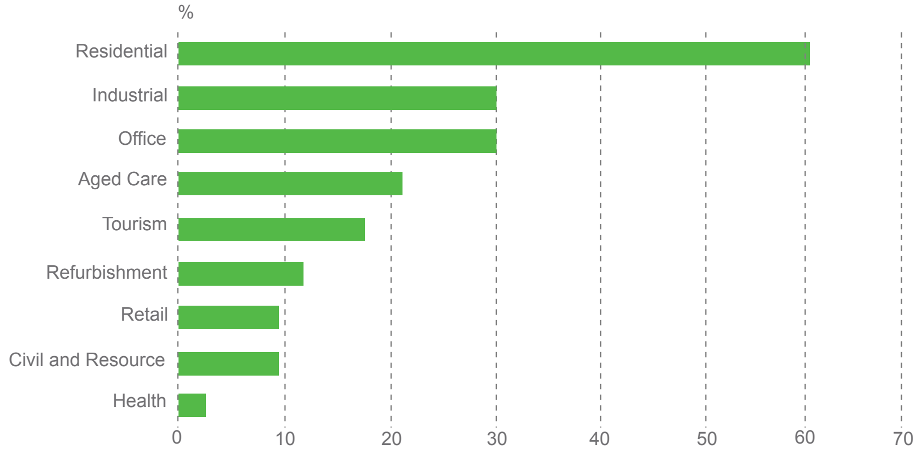
Looking Ahead for Finance

Developers indicated that they would consider moving away from domestic bank funding (56% down to 36%) compared to pre-GFC practices. Their intentions for future financing show a shift towards private syndicates (currently 3%, in the future 11%), domestic private equity (18% to 21%) and offshore private equity (3% to 8%).



Looking Ahead at Sectors

The top target sectors for the next 6-12 months remain the same as sectors currently being targeted, but there was a considerable rise in the number of developers who expressed an interest in pursuing Residential projects – increasing from 46% to 61%. Interest in the Industrial and Office sectors remained relatively equal, while pursuit of Aged Care projects rose slightly to 22% – up from 17%.



If you would like to discuss the details of this report further, please contact Michael Skelton, Davis Langdon's Research and Knowledge Manager, by email: mskelton@davislangdon.com.au or by phone: +61 3 9933 8800

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