ALLIED CAPITAL

Announcement

WHATS GOING ON? A summary of the Finance and Property Markets February 2009

Given the very volatile times we are experiencing in the economy at the moment I am frequently asked about the factors that are currently influencing the Property and Finance markets in Australia.

Below is a summary of the key factors presently influencing business and property finance.

Interest rates : Interest Rates were cut by 1.00% at the Reserve bank meeting on Tuesday the 3rd of February, this brings the RBA rate down to 3.25%, the 5th reduction from a peak of 7.25% in March 2008. The Reserve bank is likely to see only a small potential to further reduce rates. We may reach a minimum level of 2.50% over the coming months however cuts beyond this level are unlikely.

Residential Property : The under supply of housing in Sydney will act to offset under any collapse in average house and unit prices. However a reluctance to increase gearing may see some reductions.
The latest RP Data-Rismark National Property Value Indices found that “in the 12 months to end October 2008, Australian property values had only declined by -1.2 percent. This is despite mortgage rates peaking at 9.6 per cent in August and the benchmark share market measure, the S&P/ASX 200 Index, falling by around 40.5 per cent over the same period.”

Australian Banks: Local banks are not immune from current problems, write-offs of selected assets and revaluations have occurred, given recent company failures, and provisions for bad debts have increased; however this has been minor compared with problems experienced by many banks in the US and UK. Australian Banks have been extended a facility by the Federal Government to raise money in wholesale markets, using a government guarantee which bank must pay a fee to use, in addition to the deposit guarantee protecting retail clients.

Commercial Property Market:
Industrial and commercial sales in Sydney over $5m in Sydney dropped by 68% and 70% respectively in 2008 vs 2007 which has resulted in valuers are taking a very conservative approach.
We are also seeing the unwinding of compressed capitalisation rates. This week for example in a banks review, a commercial property in Sydney’s lower north shore

purchased for $11.5m on 6.5% capitalisation rate in 2006 was recently re-valued; the new valuation was based on a capitalisation rate of 8.5% reducing the property value to $8.8m.

Business Loans: Business loans are still being made. However inline with other lending policies criteria have been tightened.

Finance / Credit Market: Maximum Loan to Value Ratios (LVR) at big 4 banks on commercial property have generally dropped from 70% (and many exceptions above that level) to 65%. In some cases those clients who borrowed over 65% may now be outside bank policy.
Recent article in the Australian Financial Review (pg 3, 17/01/2009) indicates for syndicated debt deals (i.e. property and infrastructure deals), approximately 50% was sourced from offshore banks. The expected reduction of this lending, will possibly lead to a slowdown in larger projects, beyond what has occurred to date.

Credit availability: In order to maintain their capital adequacy and own credit ratings, Australian banks are being selective about extending credit to business and commercial customers. This will affect business investments in new and future projects. This will also result in slowing economic growth.

Credit Pricing: Business and corporate clients who still fit the lending criteria of banks in 2009 can expect to pay relatively more for their money.
In recent years lenders were frequently willing to look past their traditionally conservative lending criteria and lend money at increasingly thinner margins, driven by the threat of loosing market share to overseas based banks and securitised lenders.

Business Clients cost of funds are now being influenced by

Banks repricing the risk associated with the client, and adding a bigger margin above the wholesale market BBSW / BBSY benchmark rates.

Banks cost of funds: Banks raise a significant portion of their funds (sometimes 50% or more on “wholesale” money markets. An Australian bank in early 2007 might have paid 0.16% above the wholesale rate for money. In 2009 that might be 1.25%, this gets passed on to a client not absorbed by the bank.

Lending in Mid 2007 versus a new loan in Feb 2009 might look like this for some clients

	1 Aug 2007	**9th Feb 2009**
Reserve Bank Rate	6.25%	3.25%
Wholesale Rate (30 day BBSW)	6.52%	3.36%
Client Margin (risk loading)	1.00%	2.75%
Client Interest Rate	7.52%	6.11%

A client may have only received a 1.41% decrease in interest rates despite the RBA dropping 3.0% over that period.

Banks are regaining margins in their business loans which unlike home loans have not been dropping in line with the RBA.

Opportunities on the Horizon?

- Cashed up buyers will selectively re-enter the property market as those forced sellers divest assets.
- Those developers with the capacity to purchase assets will then selectively construct residential properties that can be brought to market providing stock to residential buyers.
- The undersupply of housing in Sydney particularly, will help these developers

if they can purchase these sites at reasonable prices.

- Residential investors are likely to cautiously return to the market in Sydney. Rising gross yields in some cases over 5%, and falling interest rates, under 6% are likely to be available soon - providing investors with neutral or positively geared property in capital cities for first time in more than five years.

NSW Government
New South Wales Premier Nathan Rees and Planning Minister Kristina Keneally recently announced major cuts to infrastructure levies charged to new housing and business construction. This would produce a reduction of up to $64,000 per dwelling, a move welcomed by the Property Council of Australia "[the] Announcement is just what the NSW economy needed," said Ken Morrison, Property Council NSW Executive Director. "These big cuts to infrastructure levies will be a significant stimulus to new housing and business construction, and will save jobs in NSW."

I hope the above has assisted with understanding some of the key drivers of today's property and finance markets.

Robert Stevens
CPA BEc BAc
Director
Allied Capital