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Rising commercial real estate prices trigger warning that cheap debt is raising risks

by Matthew Cranston

Cheap money is fuelling risky investments in commercial real estate and could lead to a correction, real estate industry leaders and financiers believe.

There is not enough demand for office space to alone warrant the big price rises over the past year and it is low interest rates that are pushing them up, according to fund manager Roger Montgomery.

"The analogy I give is that the band is still playing, the party is in full swing, but you want to stand near the door because you don't want to be in the rush for the taxi when the music stops," he said.

More sources of funding, including Chinese banks and cashed-up private investors and private equity groups, is creating pressure on the traditional Australian banks to offer cheaper credit for property loans.

DEXUS Property Group's executive director for finance and chief operating officer, Craig Mitchell, said debt was cheap and plentiful. "In this buoyant environment we have been able to recently secure $250 million of 12-year debt in the US Private Placement market at competitive rates," he said.

DEXUS, one of Australia's largest commercial landlords, can borrow over five years for less than 4 per cent. Last year it paid about 5 per cent, Mr Mitchell said.

Deloitte's James Walsh, who acts for developers and other property clients seeking to raise equity and mezzanine debt, has seen rapid changes in funding.

"We have seen a big reduction in the cost of subordinated debt for developers which is being driven by increased demand from new investors, especially from offshore and some from domestic investors, chasing higher yield and higher risk," Mr Walsh said.

COMPETITION FOR ASSETS

"We are also seeing more deals available for those offering the debt because developers are being able to bring projects to the table where they have already gained enough presales."

The cheap money is driving competition for assets and a re-assessing return expectations for real estate, which has resulted in lower yields.

"On a global scale Australia's commercial property markets remain very well priced and we expect the weight of capital chasing yield from quality property to continue as a result of the low interest rate environment," DEXUS's Craig Mitchell said.

There have been some significant gains on value. Anton Capital sold out of a North Sydney office tower for $157.5 million in January. Anton had purchased it 12 months earlier for $84 million. In Melbourne, DEXUS sold an office tower last year at 40 Market Street for $105 million – more than double what it paid less than 18 months before hand.

The Reserve Bank of Australia is concerned about some of the value jumps.

"Commercial property markets are rising in association with fast price growth in some cities, heightened investor activity and strong price competition among lenders," the RBA said in its financial stability review on Wednesday.

The gains for property values have also been very high for residential land sites. With Melbourne Sydney and now Brisbane achieving huge jumps in purchase prices – some show a doubling in value in 12 months.

At the institutional level the overall gain on values for real estate investment trust has only been a few per cent and most if not all REITs expect values to rise further.

In the last year Charter Hall has sold commercial properties at 59 Goulburn Street, Sydney, Charter Grove, St Leonards and Moonee Ponds, Victoria, all for premiums to book value. At the same time, its own debt facility was repriced producing a 55 basis point reduction in average margin.

HIGH RISK, WEAK FUNDAMENTALS

With such an arbitrage between growing property values and cheaper funding costs most in the industry think now is the time to make money. But the risk is also high with weak fundamentals. Plenty in the industry are aware of this divergence.

Abacus Property Group managing director Frank Wolf said: "The weight of money distorts the pricing of assets." Cromwell Property Group's Paul Weightman said: "I think risk is being underpriced and that means people are paying too much."

The key will be timing. And, much of that will depend on whether fundamentals

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return before interest rates rise. Some expect the US Federal Reserve to raise rates this year but historically it takes a few rate rises to really slow down the fervour in the market.

Some pundits, such as CLSA's Chris Wood, expect interest rates will be "lower for longer" in Australia and could hit zero. He also expected the Australian dollar to fall further – another attraction for investors likely resulting in more upward pressure on values.

UBS analyst Grant McCasker expected that an interest rate hike by the US in September would see Australia's 10-year bond yield rise 50 basis points, and historically, he said, a 50 basis point rise in the 10-year bond causes REITs to underperform the broader stockmarket by around 5 per cent.

Using Roger Montgomery's analogy that might be the time to start calling a taxi.

The Reserve Bank of Australia said on Wednesday that risks in the area of lending for commercial real estate appeared to be building.

"Investor demand for both new and existing commercial property developments has been strong, despite weakening leasing conditions in a number of market segments."

"Lenders should also be mindful of the collective effects of strong lending activity within particular market segments."

mcranston@fairfaxmedia.com.au

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