Eureka Funds Management Limited

Submission to Senate Inquiry into the Australian Business Investment Partnership Bill 2009 and the Australian Business Investment Partnership (Consequential Amendment) Bill 2009 c

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Table of Contents

1 Purpose 2
2 Background........ 2
3 Issues / Consequences 3
4 Issues Summary: 6
5 The Australian Business Investment Partnership Bill 2009:........ 7
6 Alternative Solution / Proposal:........ 8
7 Summary: 11

1 Purpose

This submission to the Senate Inquiry into the Australian Business Investment Partnership Bill 2009 and the Australian Business Investment Partnership (Consequential Amendment) Bill 2009 seeks to bring to the attention of the Inquiry the serious liquidity and capital management issues arising from the Global Financial Crisis (**GFC**) in respect of investments by Australian Superannuation Funds (**Super Funds**) in the Australian commercial real estate markets.

This submission proposes how the planned Australian Business Investment Partnership (**ABIP**) Bill could be improved to address the major issues raised for the benefit and protection of returns to the many millions of Australian Superannuation Fund members and at the same time continue to provide job security for the many direct and indirect employees of the property fund industry.

An alternative to ABIP being the establishment of a Super Fund Property Investment Partnership (**SPIP**) is outlined for the Senate Inquiry. SPIP is proposed to address the immediate certainty of funding that the Super Fund industry needs, in the event that the establishment of ABIP can not be achieved in the short term.

2 Background

Super Funds have been major investors in Australian real estate on a medium to long term basis with typically, real estate allocations being between 5% to 15% of each Super Fund's total assets. WPFs investments in real estate currently represent approximately 25% of the total commercial property market.

The unlisted wholesale property fund (**WPF**) industry has grown significantly over the last 15 years to become the principal conduit for Super Fund investment into Australian real estate. Australian real estate investment trusts (**AREITs**), which are listed on the ASX, have been more suited to retail investors than to Super Funds. Many Super Funds see listed property as having the same characteristics of an equity investment rather than the defensive investment characteristics of unlisted property.

The top 50 Super Fund investors have total investments of $32 billion in WPF real estate investments[i]. These same Super Funds represent in total some 11.5 million superannuation members

	Asset Values	Debt / Gearing	No of funds
AREITs[ii]	$205 billion	$72 billion / 40%	28
Unlisted Funds [iii]			
▪ **wholesale**	$75 billion	*$40 billion / 50%	187
▪ **retail / syndicates**	$30 billion	*$20 billion / 66%	106
Total	**$310 billion**	**$132 billion / 49%**	

* guesstimate

The majority of the WPF real estate exposure is in income producing investment property rather than speculative development property. The nature of underlying investment property leases has traditionally provided an appropriate long term inflation hedge for the Super Fund industry. Accordingly Super Fund investors have been long term property investors rather than short term speculators.

3 Issues / Consequences

The GFC has brought about a number of issues for the WPF sector that are now adversely impacting on Super Funds' current and forecast investment returns from the Australian commercial real estate markets.

These issues have not to date been fully addressed through Government GFC initiatives such as the proposed Australian Business Investment Partnership (**ABIP**) or the recent budget stimuli. Unless the 4 main Australian banks (**Major Banks**) can be encouraged into changing their property lending practices as part of their "social contract" in return for the Government deposit / inter-bank guarantee support and / or the ABIP legislation is amended, the serious lending issues are expected to continue in the medium term.

Major WPF Lending Issues

De-leveraging of Property

- Domestic and foreign banks are forcing borrowers in the property sector to significantly de-leverage their capital structures as part of their own GFC de-leveraging and / or capital constraints.
- WPF borrowers although generally conservatively leveraged at between 25% and 40%, are still facing demands by banks to further de-leverage. This is more of an across the board bank de-leveraging policy on all property exposures, rather than any particular concerns about the WPF's debt.
- Despite the flow of deposits into the banking system following the Federal Government's deposit guarantee scheme, the banks have capped / reduced their exposure to property financing.
- De-leveraging has been brought about by APRA's requirement for domestic banks to reduce their overall exposures to the property sector.

Wholesale Property Fund Liquidity

- Unlike the AREITs which can raise new equity through discounted share issues in the listed markets (circa $10 billion raised in the last 12 months[iv]) WPFs have limited sources of new equity other than the Super Funds.
- Falling values across all asset allocations, members switching their funds into cash and hedging costs of international equities has caused most Super Funds to have liquidity issues.
- Although the Major Banks have been a beneficiary of increasing Super Fund cash investments there is no nexus between such cash and bank lending to WPFs . Term deposits in domestic banks have increased by 50% to $330Bn in the last 12 months according to CBA.[v]

Refinancing / Restructuring

- Credit rationing, aggregation (discussed further) and an unwillingness to refinance other banks' exposures are causing significant pressure on WPFs.
- The scarcity of debt financing has reduced the number of property transactions significantly and until credit markets normalise and sufficient debt is made available to facilitate transactions then the values of property assets will continue to decline through 2009 and 2010. Anecdotally, a 20% decline in value has already been experienced by the property market.

- Despite the fall in asset values, the ability of WPFs to service the debt remains strong with satisfactory debt service cover ratios.

Bank Concentration

- The property lending market is now dominated by the four majors who now account for over 70% of the market[vi]. Consolidation of the industry following the takeovers of St.George by Westpac and BankWest by CBA has further concentrated the market. There has also been the withdrawal of Suncorp from lending to the institutional property market in late 2008.

- Foreign banks provide about 30% of loans to the Australian commercial property sector with most exposure being in multi bank syndicates. AREITs are the largest user of the syndicated market ($20 billion[vii]). WPFs rely more on bilateral arrangements with domestic banks.

- In summary therefore the refinancing in 2009 and 2010 of the withdrawal of the foreign banks syndicated property debt together with Commercial Mortgage Backed Securities (CMBS) maturities, Suncorp's withdrawal and APRA's requirements on the four major banks to reduce their commercial property exposures, a total estimated to be well in excess of $50 billion, will create a huge refinancing risk and further liquidity pressure on the property market.

- The Federal Government, in conjunction with the major banks, has proposed to establish ABIP as a source of funds to replace the foreign banks as and when syndicated debt facilities mature or come up for restructuring.

- Interestingly, the exposure of AREITs to foreign/offshore assets represents approximately 40% of their total assets[viii] – an exposure which has gradually increased from 20% in 2001.

Diversified Funding Sources

- The capital markets, mainly through CMBS were an important diversified funding source for the property sector from 2000 to 2007 for both AREITS and WPFs. At its peak the CMBS market funded $12 billion of real estate assets with total issuance of $22 billion since 1998[ix].

- The GFC has brought about the closure of the CMBS markets, with no prospects of the markets opening in the short to medium term.

- The refinancing of maturing CMBS ($3.8 billion in 2009, $1.0 billion in 2010 and $2.3 billion in 2012[x]) produces a significant refinancing overhang for the property sector[xi].

- Domestic banks have significantly benefited from the Government's guarantees of retail deposits (up to $1 million) and inter bank capital markets issuance by the banks albeit at the cost of a fee to the government. Such guarantees have had a material adverse impact on the property sector's ability to borrow. The deposit guarantee has accelerated the demise of the mortgage trusts (once a source of over $30 billion to the sector), whilst investors' appetite in the capital markets is being fully satisfied by sovereign backed issues.

Short Term Funding

- Shortening debt maturities, imposed by the banks when refinancing, has heightened refinance risks. There is a major mismatch between the medium to long term funding horizon of the Super Fund industry and the banks' current market practices.

- Banks are only providing new commitments on a short term basis making facilities of longer than 2 years unavailable or uneconomical to borrow.

- The banks are not differentiating from a risk profile perspective between the long term investors such as the Super Fund backed WPFs and those with shorter investment horizons such as hedge funds.

Funding Costs

- The benefit to borrowers of the RBA's monetary easing of 4% in the last six months has been offset by the banks' increasing credit margins (from 1% - 1.5% pa rising to 3% - 5% p.a. now).

- Bank requirements for extensive hedging (60% to 80%) of loan exposures in the high interest rate periods of 2006 to 2008 mean that most property sector borrowers are locked into high fixed rate arrangements and will not benefit in the short to medium term from the lowering of the cash rates.

- Banks are taking advantage of imbalances in demand and supply of property debt markets by demanding ever increasing margins that significantly increase their returns.

- The banks are also imposing fees on restructures / refinancings caused by market conditions rather than borrower dynamics. Without alternative funding sources it is impossible for borrowers to get competitive pricing tension.

Sustainability & Energy Efficiency Expenditure

- With the collapse of the financial markets globally since September 2008, and the corresponding dramatic effect this has had on property markets, many (if not most) participants in real estate capital markets have had their attention and focus diverted away from any sustainability initiatives on their property assets and portfolios.

- Up until this point, WPF's have been very active in investing in sustainability initiatives that improve the energy efficiency of their assets and future proof their real estate investments. This would typically involve allocating a significant portion of capital expenditure to retro-fit and upgrade building services, equipment and general 'low hanging fruit' in order to achieve the highest possible Green Star or NABERS energy efficiency rating.

- However, in times of liquidity constraints and where capital expenditure cuts are being implemented, such initiatives are being deferred or cancelled. This is likely to continue until WPFs are able to regain some buoyancy and stability in their cashflows and normalise their capital expenditure programmes.

APRA Regulations

- Traditionally aggregation limits for banks' exposures across a group was self regulated by each bank in its reporting to APRA. Following the demise of groups such as Allco and Babcock & Brown, APRA has apparently taken a more active involvement in such aggregations and how groups are determined.

- Banks are now starting to apply aggregation exposures on fund managers (rather than solely on exposures limited to the assets of the WPF managed by the fund manager). This is causing constraints with certain banks reaching the "aggregation limits" for fund managers. This overlayed with previously discussed bank concentration is creating further refinancing pressure.

- Any further changes in aggregation limit policy / interpretation would constrain appropriate rationalisation of the funds management industry. Stronger fund managers will be unable to takeover failed and / or weaker managers if the banks' have aggregation limitation problems.

Risk weightings

- There is no recognition by the banks of strong borrowers such as those representing the Super Funds. The risk weighting mechanisms of the banks do not reflect differentiation in borrowers.

- Super Fund backed borrowers are being punished for being unlisted and unrated rather than being rewarded for the strength of their underlying sponsors.

Property Market Activity

- Lack of debt has reduced property market transactions to a trickle. The multiplier effect of this has been material particularly in respect of stamp duty revenue for the States (not to mention land taxes and rates). Until the property debt markets open up there will be no material improvement in transaction markets.

- Until credit markets normalise and sufficient debt funding is made available the downward spiral of the property sector will continue adversely affecting transaction volumes, valuations and employment.

4 Issues Summary:

In summary Super Fund sponsored borrowers in the real estate markets:

1. have been adversely impacted by the GFC through changes to domestic bank lending practices and de-leveraging of the capital structures for real estate investment;

2. are incurring ever increasing challenges in refinancing existing facilities, due to bank concentration, credit rationing and a general reluctance to refinance other banks' facilities;

3. are facing further refinancing challenges in competition with exiting foreign banks, CMBS maturities, APRA deleveraging requirement of the Major Banks and Suncorp's withdrawal;

4. can no longer appropriately fund their real estate investments on a medium to long term basis that matches their investment horizons;

5. have no capacity to make new investments in the real estate sector or energy efficiency improvements of existing stock due to constraints on the debt side of the capital management structure; and

6. are facing regulated constraints through changes in APRA polices on aggregation that do not reflect segregation of fund assets normally applied by wholesale fund managers.

All of these issues ultimately have an impact on the retirement savings and returns of members in Super Funds.

5 The Australian Business Investment Partnership Bill 2009:

The Federal Government has proposed that the Australian Business Investment Partnership Limited (ABIP) is established, to address the risk of such a funding gap emerging in the commercial property sector by providing liquidity support for viable commercial property assets where financiers have withdrawn from debt financing arrangements as a result of the global financial crisis.

The members (shareholders) of ABIP will be the Commonwealth of Australia (Commonwealth) and Australia's four major domestic banks; Australia and New Zealand Banking Group Ltd, Commonwealth Bank of Australia, National Australia Bank Ltd and Westpac Banking Corporation. The shareholders will provide initial loan funding to ABIP and an amount for working capital. ABIP will then raise funds through the domestic and international capital markets supported by a Commonwealth guarantee.

ABIP's objective is to provide refinancing for loans relating to commercial property assets in Australia in situations where finance relating to those assets is not available from commercial providers (other than ABIP), and the assets would otherwise be financially viable. Its further objective is to provide financing arrangements in other areas of commercial lending if circumstances necessitate and provided those arrangements are agreed unanimously by the members of ABIP and where the underlying assets, and the income streams from those assets, are financially viable.

On 19 March 2009, the Senate referred the provisions of the ABIP Bill 2009 and a related bill to the Senate Standing Committee on Economics for inquiry and report by 7 May 2009. The closing date for committee submissions is the 7 April 2009.

This initiative is seen to be well founded and certainly a step in the right direction, but unfortunately the ABIP Bill as currently drafted does not fully cover the WPF issues raised earlier in this paper. Eureka strongly believes that ABIP can be enhanced by simple amendments along the following lines:

ABIP Bill Enhancements:

1. Allocations Policies

    - Priority needs to be given towards the refinancing of domestic banks looking to reduce their commercial real estate exposures in addressing APRA concerns about being over exposed to commercial property. This can be achieved by way of the domestic banks receiving an allocation of say [70%] of the total funding that will be provided by ABIP Limited (based upon their current share of Australian real estate debt).

    - Priority should be given towards refinancing involving wholesale property funds. This can be achieved by way of the wholesale property funds receiving an allocation of say [25%] of the total funding that will be provided by ABIP Limited (based upon their current share of Australian real estate debt).

    - No single borrower (or related group) to access more than say [5%] of the total funding that will be provided by ABIP Limited.

    - Compulsory minimum funding percentage that a domestic or foreign bank must maintain to receive ABIP funding (e.g. domestic banks only permitted to refinance 50% with ABIP of their current exposure).

2. Term

- Extend the maximum term to 5 years to meet the medium to long term funding requirements of the real estate industry (which match the long term investment horizons of the Super Funds and their members).

3. Governance

- Have a governance structure such as a Supervisory Board to which the ABIP Limited board reports so that stakeholders other than the Commonwealth and the Major Banks can provide their property expertise and also put in place independent checks and balances to address any concerns of ABIP becoming "bank centric".

- Limit the ability of the Major Banks to veto a transaction. The Banks or ABIP management only have to make sure that the proposed loans are in compliance with lending guidelines / criteria set by the Supervisory Board.

4. Definitions

- Have a broad enough definition of commercial property to cover investments and loans in respect of trading operations such as hotels and car parks. (Such investments come under Super Funds property allocations but are sometimes deemed as business loans by banks).

5. Other

- Properly address ABIP restrictions that the commercial property assets being funded are only located in Australia and that there are no portfolio refinancings involving commercial property assets partially located outside Australia or financing of a head company that has invested partially in commercial property assets located outside Australia.

- Allocation for the refinancing of CMBS or situations where the Major Banks were warehousing portfolio loans in expectation of a CMBS refinancing.

- Provide a financial disincentive for those looking to refinance through ABIP (in order to discourage excessive use of ABIP).

- Have transparency in the pricing of ABIP loans.

- Have urgency in its establishment that recognises that the funding problems of the WPF are a "now" matter and something that cannot wait beyond the middle of 2009.

6 Alternative Solution / SPIP Proposal:

Eureka is concerned that the ABIP Bill has already faced resistance in both the House of Representatives and the Senate and that its establishment may be further delayed after the senate committee inquiry. The current state of the property sector and the fact that the Super Fund industry needs certainty about funding its real estate investments before the start of the next financial year means that a solution is needed now rather than latter in the year.

It is therefore proposed that as an alternative to ABIP that the Federal Government gives serious consideration to a scheme which is targeted to assist the Super Fund sponsored unlisted wholesale property funds on a medium to long term basis.

The proposed scheme is an adaptation of the ABIP initiative in that the main stakeholders being the Super Funds, the Major Banks and the Federal Government invest alongside one another in a special purpose vehicle - the Super Property Investment Partnership (SPIP) - that lends to the unlisted wholesale property funds that are sponsored by Super Funds.

The structure of SPIP would tap into the structures that have or are being developed for the ABIP and set up as a "virtual" organisation where all its main functions are outsourced on a cost plus basis to ABIP or other existing organisations such as the Major Banks. The intention would be for SPIP to be up and running in a short space of time so that it fulfils the urgent needs of the Super Fund industry.

It is not intended that SPIP will "bail out" non performing loans. SPIP will at all times be a commercial arrangement that, apart from Government funding support, can justify its own existence. The life of SPIP would depend upon the outcomes of the GFC. The intention would be for SPIP to expand and contract depending on market conditions. It would be hoped that any return to normal market conditions would mean that SPIP would not need to be a long term entity.

Investments by the Super Fund participants in SPIP would obviously need to satisfy all requirements under the Superannuation Industry (Supervision) Act, in particular the "sole purpose test".

Source and application of funds for the SPIP:

1. The stakeholders to proportionally fund the SPIP in order to raise total equity of up to say [$1.5 billion]. Such funding to only be drawn as required based on WPF demand.

2. Super Funds and Major Banks given tax and / or APRA incentives for their SPIP equity investments.

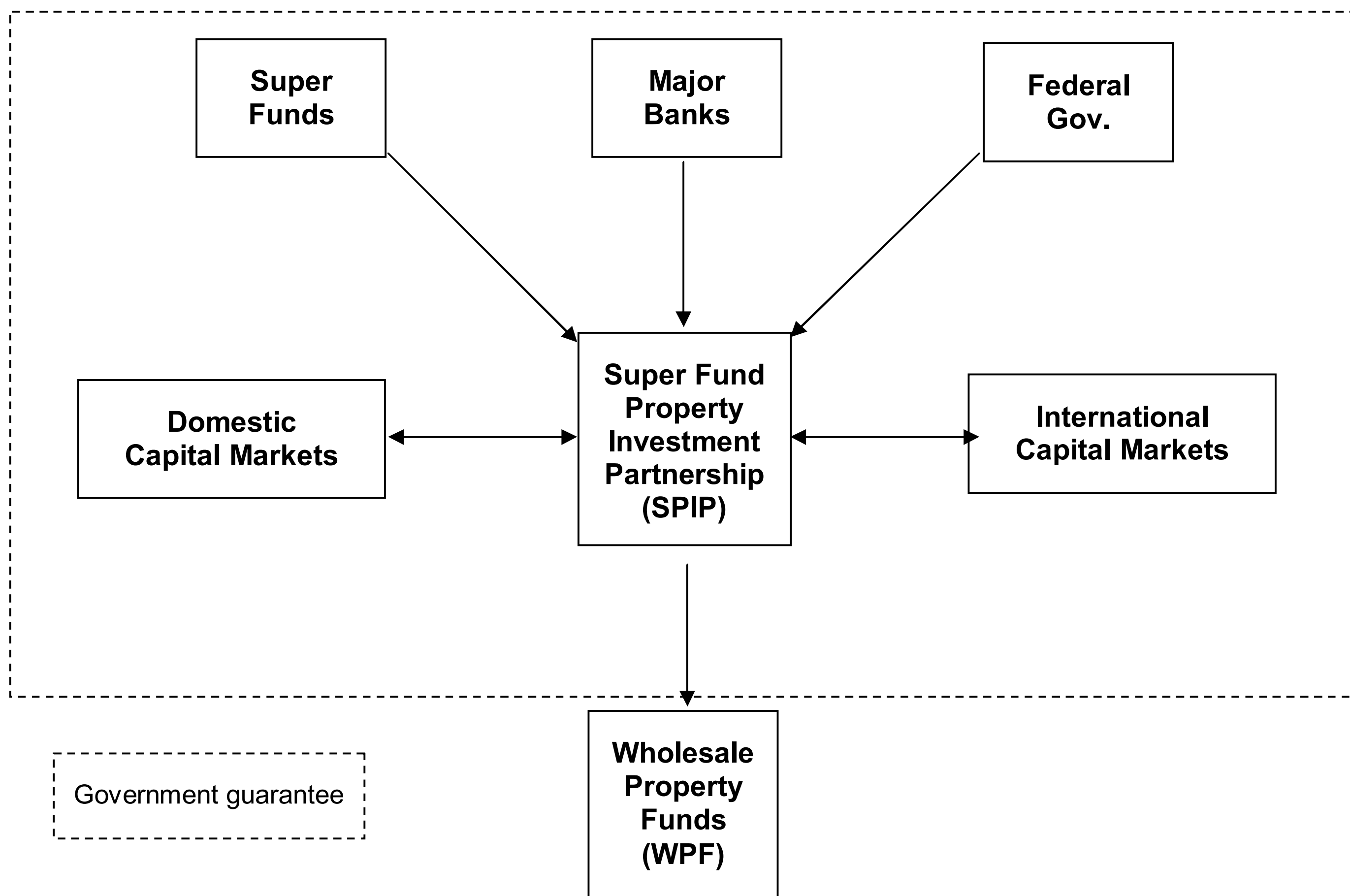
3. The SPIP to raise funds in the domestic and international capital markets on the same terms and conditions as the ABIP for say up to [$20 billion].

4. Super Funds given tax and / or APRA incentives for their SPIP domestic capital markets investments.

5. The SPIP lends to complying wholesale property funds.

6. SPIP encourages energy efficiency improvements where practicable.

The following is a diagrammatic summary of the proposal:



Proposed lending criteria of the SPIP:

1. Only lends to wholesale property funds ("WPF") that are backed by a Super Fund with at least [$10 million] of equity in the WPF.
2. At least one of the Major Banks to jointly lend to the WPF on the same terms and conditions as the SPIP for at least 20% of total outstandings (the "Lending Bank").
3. Debt secured against income producing property assets.
4. Maximum loan to valuation ratios of [60%].
5. Minimum interest rate cover ratio of [1.5 times].
6. Maximum term of [5 years] and a minimum of [2 years].
7. Minimum loan amount of [$10 million].
8. Margin and fees to provide SPIP with commercial returns but linked to fixed rates over SPIP costs of funds depending on the underlying credit rating of the borrower.
9. Approved purposes would include:

a. Refinancing up to [x %] of a domestic bank's exposure to a WPF;

b. Refinancing up to [x %] of a foreign bank's exposure to WPF;

c. Refinancing up to [x %] of a CMBS issue of a WPF; and

d. Funding new Australian real estate investments of a WPF.

e. Funding of energy efficiency capital works programmes.

10. No one borrower able to access more than [x %] of SPIP's total lending book.

Proposed management of the SPIP:

1. Equal representation by the SPIP stakeholders on the SPIP Board under an independent chairman.
2. The Lending Bank would be responsible for all credit related decisions and compliance with the lending criteria established by SPIP.
3. The Lending Bank would be responsible for the day to day credit administration of the SPIP debt.
4. SPIP funding would be outsourced on a cost plus basis to ABIP or one of the Major Banks.
5. Accounting and other financial services to be outsourced on a cost plus basis to a Government department or accounting firm.

7 Summary:

This submission to the ABIP Senate Inquiry has recommended simple amendments to the Australian Business Investment Partnership Bill that will provide major benefits to Australian Super Fund members and at the same time provide job security for direct and indirect employees of the property fund industry. The amendments address the medium to long term funding issues of the wholesale property funds industry which has been faced with serious liquidity and capital management issues arising from the de-leveraging by the domestic Major Banks.

As an alternative to ABIP this submission has outlined a proposal for the establishment of a Super Fund Property Investment Partnership.

Eureka Funds Management Limited
April 2009

Privacy Statement

This submission may be treated as a public document and does not need to be treated as confidential and/or anonymous. The views expressed in this submission to the ABIP Senate Inquiry are the personal views of Eureka Funds Management Limited and it management and should not be taken to reflect the views of any of Eureka's clients or their advisors.

References / Sources:

i Rainmaker Information, December 2008

ii JP Morgan - January 2009

iii Property Investment research Feb 2009

[iv] Bank of America – Merrill Lynch Research, January 2009

[v] CBA IB&M research presentation dated March 2009.

[vi] Bank of America – Merrill Lynch Research, January 2009

[vii] Bank of America – Merrill Lynch Research, January 2009

[viii] Bank of America – Merrill Lynch Research, January 2009

[ix] Standard & Poor's, January 2009

[x] NabCapital; October 2008

[xi] Standard & Poors, January 2009

Eureka Background:

Eureka Funds Management Limited (Eureka) is a boutique Australian fund manager and currently manages some $4 billion of Australian real estate investments exclusively for wholesale and institutional clients. Eureka has an Australian Financial Services License (No. 273320) and 17 of its clients are APRA regulated Australian superannuation funds that together have 3.15 million members.

The Eureka Funds source debt from a range of domestic and foreign financiers. The total debt facility limit relating to the Eureka Funds is in the order of $1.4 billion.

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