



MaxCap

Investment Management

**COMMERCIAL REAL ESTATE DEBT
– A POWERFUL TOOL FOR ENHANCING
INVESTMENT PORTFOLIO RETURNS**

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MAXCAP RESEARCH

In 2020, MaxCap embarked on a research program focused on a quantitative analysis of Commercial Real Estate Debt (CRED) risk and return dynamics, and the effects of its inclusion in a diversified investment portfolio. This research was undertaken in collaboration with a leading economist and a team of researchers from the University of Technology, Sydney. This paper is a summary of the more comprehensive research paper.

KEY TAKEAWAYS

- CRED lowers overall portfolio risk whilst enhancing portfolio returns. Quantitative analysis demonstrates that the key risk/return features of CRED are lowly or negatively correlated with other major asset classes (including real estate), and thereby enhance overall portfolio performance.
- CRED returns tend to improve relative to other asset classes during periods of crisis and sustained economic uncertainty and therefore act as a stabilising force in an investment portfolio.
- CRED has demonstrated resilience throughout market cycles including in the current COVID-19 environment and therefore presents a strategic allocation for investors focused on capital preservation through stable, defensive and asset-backed income.

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THE CASE FOR CRED

The economic impacts of the COVID-19 pandemic continue to evolve on a global scale. Despite heightened risk, return compression still pervades most major asset classes. Increasingly, many investors are seeking alternative investment opportunities which provide a more attractive return-for-risk proposition than what is currently available in public markets.

Private market CRED has several features which distinguish it from other asset classes. These characteristics make CRED a powerful tool for enhancing investment portfolio returns and providing downside protection from volatility during market downturns.

This is true globally, but in the Australian market, the conditions are particularly favourable. Macro-economic fundamentals, banking sector structures and regulatory intervention all combine to create conditions in which informed CRED investors can achieve outsized returns relative to risk undertaken.

Quantitative analysis demonstrates that CRED returns are lowly or negatively correlated with other major asset classes, and thereby enhance portfolio performance. This is because CRED returns tend to improve relative to other asset classes during periods of crisis and sustained economic uncertainty and thereby act as a stabilising force in an investment portfolio.

As a leading local CRED manager, MaxCap understands the way in which CRED reacts to market stress. This has enabled MaxCap to address risk through structure, selectivity and pricing, demonstrating that such risk-adjusted return premiums can endure throughout economic cycles, including periods of market volatility and stress.

Since establishment in 2007, MaxCap has completed in excess of 300 transactions and has returned full principal and interest to investors to date. This distinguished track record reflects MaxCap's disciplined approach to risk management as well as the inbuilt downside protection offered by CRED, which benefits from an 'equity buffer'.

As an alternative asset class, CRED has arguably never been more compelling or more relevant, given the nature of its unique characteristics.

WHAT IS CRED?

CRED is a fixed income instrument, or loan, secured by commercial real estate where the primary purpose of the loan concerns the use and/or improvement of that asset.

Commercial real estate includes industrial land, office buildings, retail centres, logistics assets, vacant land, residential (high and low density) and hotels. It can cover vacant land, assets under construction or transition, and established/operating assets.

Unlike direct investment in real estate (i.e. equity positions), CRED does not occupy a first loss position. This dynamic is captured in the loan to value ratio (LVR) which measures the CRED investor's loan amount as a percentage of the CRE asset's total value. The CRED investor's return is limited to a fixed rate but, through this LVR protection is buffered from downward price movements of the underlying real estate during the term of the loan.¹

Australian CRED typically operates in private (i.e. unlisted) markets, which can be opaque and difficult to penetrate.

Once a loan is written, it is generally held to maturity, and rarely traded in secondary markets.² Once commenced, CRED loans involve intensive and ongoing active specialist management,³ with a high level of time and resources. For all of these reasons, CRED is less liquid than equities and bonds. Because investors value liquidity, those who are willing to hold less liquid assets can earn an 'illiquidity premium' for doing so.

CRED RISK AND RETURNS

Fundamentally, CRED risk is a function of the volatility of the underlying CRE security asset value over the term of the loan. In ordinary circumstances where the asset value exceeds the loan's face value, CRED returns are fixed. However, in circumstances where the CRE security value is subject to high volatility and significant value diminution to the extent that it falls below the loan amount, CRED returns can be adversely affected. For this reason, CRED loans secured by more volatile CRE assets entail higher risk premiums.

To fairly compensate lenders for bearing this risk, CRED returns should reflect the lender's exposure to price volatility of the CRE security asset. By applying established econometric approaches, the investigations have shown that Australian CRED returns generally exceed the 'fair return', or put another way, materially overstate CRE price volatility relative to historical levels.⁴ To the extent that lenders are able to charge borrowers rates above the fair return, they are obtaining a risk-adjusted premium, or alpha.

Graph 1 (below) depicts a situation where despite the CRE security asset value (green line) exhibiting a negative trend with relatively high volatility, the devaluation is ultimately insufficient to cause any loss to the CRED investor, with this value (navy line) moving towards par at loan maturity.

An analysis of Australian CRE volatility and CRED returns over the past 20 years demonstrates a sustained risk-adjusted return premium for CRED investors.

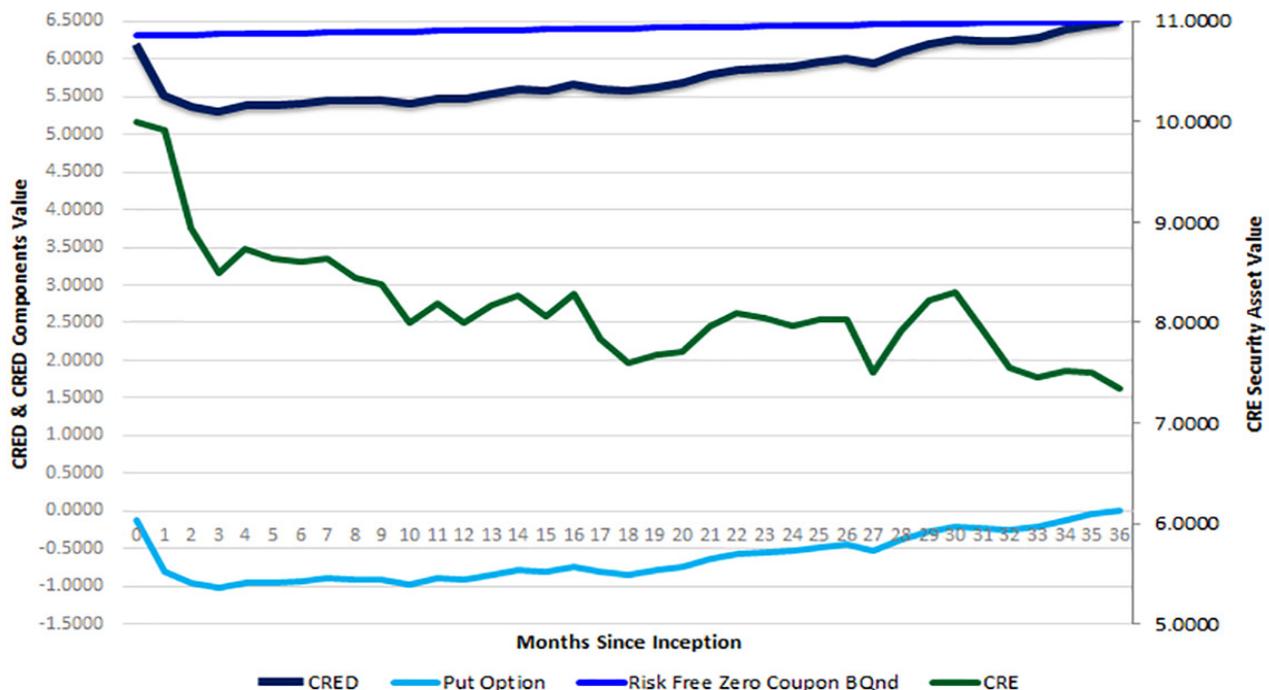
HOW DOES CRED RELATE TO OTHER ASSET CLASSES?

While the strong historical returns generated by CRED provide a convincing argument for investment in the asset class, an equally important feature to consider is the effect of a CRED allocation on a diversified investment portfolio. Not only does CRED improve total portfolio returns on an absolute basis, it can also reduce total portfolio risk, and consequently improve, risk-adjusted returns.

To assess portfolio effects, it is necessary to consider how CRED returns evolve in comparison to other investment exposures. The reason for this is that portfolio level risk/return is driven not only by the returns of each of the constituent investments, but also by how their returns correlate, or vary in relation to one another.

By combining assets whose returns respond differently to certain conditions – assets whose returns are imperfectly correlated – an investor can achieve a higher portfolio return for a given level of risk, or alternatively, a lower level of risk for a given portfolio return.⁵

GRAPH 1: VALUE PATHS FOR CRE, CRED AND ITS CONSTITUENT PARTS



CRED RETURNS

CRED returns are counter cyclical and CRED is therefore an effective portfolio diversifier

The degree to which such benefits can be captured increases as the correlation between assets reduces. This is most clearly observed in asset classes with a negative correlation to the rest of the portfolio.

These investments perform well when the rest of the portfolio is down, thereby exerting a stabilising force which reduces the volatility of overall portfolio returns over time.

For this reason, asset classes exhibiting low or negative correlation with most others are particularly powerful as enhancers of portfolio risk-adjusted returns.

The results of the empirical research illustrated in Table 1 reveal that the correlations between the returns of other asset classes and of CRED are in fact mostly negative.⁶

CRED appears to be a highly effective portfolio diversifier as it tends to perform relatively well during such periods of strain in the economy and financial markets.⁷

TABLE 1: AUSTRALIAN ASSET CLASS CORRELATIONS / CORRELATION OF CRED WITH OTHER ASSET CLASSES⁸

	EQUITIES	BONDS	CASH	CRE
Equities	1			
Bonds	-0.43	1		
Cash	-0.11	0.18	1	
CRE ⁹	0.12	-0.31	0.12	1
Blended CRED portfolio	-0.11	0.13	-0.42	-0.18

HOW DOES CRED ENHANCE AN INVESTMENT PORTFOLIO?

Detailed historical analysis undertaken by MaxCap, in collaboration with the University of Technology, Sydney, demonstrates the portfolio benefits of a CRED allocation including:

1. Enhanced portfolio returns.
2. Decreased volatility.
3. Improvement in a portfolio's Sharpe Ratio which measures return earned in excess of the risk-free rate per unit of risk.¹⁰

These benefits can be seen in the comparative historical performance of investment portfolios before and after an allocation to CRED as shown in Table 2.

TABLE 2: HISTORICAL CRED RISK AND RETURN METRICS

	INITIAL PORTFOLIO	CRED PORTFOLIO
Return (% per annum)	8.05%	8.76%
Volatility (% per annum)	8.07%	7.16%
Sharpe Ratio, ex-post (per annum)	0.44	0.59

HOW HAS MAXCAP CRED PERFORMED?

MaxCap in collaboration with the University of Technology, Sydney, have undertaken an analysis of its CRED loan-book over the past five years. The CRED values in Table 3 (below) reflect a sample of senior and junior CRED loans that are indicative of average/standard risk and return parameters. The fair return is close to the cash rate, and alpha is consequently sizeable. Historical Australian CRED returns exhibit this high alpha across different risk strategies (junior, senior and blended risk positions).

TABLE 3: HISTORICAL FAIR RETURNS AND ALPHA

	TOTAL RETURN (P.A.)	VOLATILITY (P.A.)	ALPHA (P.A.)	ALPHA VOLATILITY (P.A.)
Traditional asset classes				
Equities	9.4%	13.7%		
Bonds	6.2%	3.3%		
Cash	4.0%	0.9%		
CRE	9.9%	2.9%		
CRED Portfolios				
Junior	17.5%	1.2%	13.3%	1.6%
Senior	13.8%	1.1%	9.7%	1.2%
Blended	15.8%	1.3%	11.7%	1.5%

SOURCE: Historical Australian CRED returns exhibit high alpha across different strategies

WHY THE OUTSIZED RETURNS FOR CRED IN AUSTRALIA?

Historically, CRED risk has been under-priced on a sustained basis in Australia, despite the free flow of capital, the strong rule of law, floating currency and a large and mature onshore pool of institutional capital. Ordinarily these factors would be expected to attract capital until any alpha was eroded and fair return was reached. However, the evidence suggests otherwise, and for the reasons outlined below, we expect alpha to persist as Australian CRED markets undergo a prolonged period of transition and maturation.

The Australian banking system is both heavily concentrated and oligopolistic, dominated by the four major domestic banks. In the aftermath of the Global Financial Crisis (GFC), this became more exaggerated with the retreat of offshore banks from the Australian market and major consolidation within the banking sector. It also had the effect of materially increasing the banks' already high exposures to Australian CRE.

Australia has had the highest rate of population growth of any advanced economy and looks set to continue in the future once the COVID-19 pandemic recedes. The property sector has exhibited strong growth over the past decade due to this record population growth, and banks have seen persistent upward pressure on their CRE exposures. This dynamic is partially a result of the natural tendency for the banks' balance sheets to mirror the Australian economy as a whole.

Regulatory intervention

While the banks largely benefit from the concentrated market structure, they are tightly regulated by the Australian Prudential Regulation Authority (APRA).

At their current elevated levels, the banks' CRE exposures are viewed as constituting a systemic risk to the Australian economy.

For this reason, the practical effect of certain regulations is a reduction in the CRE exposures held by Australia's Domestic Systemically Important Banks (D-SIBs). Since Basel III, increased regulatory intervention has led to the imposition of capital requirements on banks, some of which have the effect of limiting their ability to participate in funding a highly active part of the economy, namely, the property sector. As Basel III (and IV) rules and regulations are implemented over the coming years¹¹, regulatory controls such as these are expected to increase.

Notwithstanding the banks' restrictions and restraint, the four major domestic banks continue to dominate Australian CRED lending, with a combined market share of approximately 70%. While this is lower than that previously held¹², it is materially greater than that held by banks in the US (<50%), and the UK (<40%).¹³

Structural dislocation leads to funding gap

As the major Australian banks reduce their exposure to CRED to comply with regulatory requirements, market structures are failing to keep pace. The resulting structural dislocation has been met with high demand for CRED capital, and a substantial funding gap has emerged, presenting challenges and opportunities for non-bank CRED investors and lenders. The Australian CRED market is in a relatively early phase of development and remains more opaque and less liquid relative to more mature examples.¹⁴

These characteristics provide competitive advantages to entrenched local managers such as MaxCap, who has consistently extracted an attractive return premium for its investors.

MITIGATING RISK

Every piece of real estate is unique, and consequently, so is every CRED loan. Commercial considerations should include:

- Asset value volatility.
- Location.
- Market sector outlook.
- Highest and best use.
- Letting status and weighted average lease expiry (for leased assets).
- Interest cover ratio (for leased assets).
- Debt cover.
- Borrower track record and financial capacity.
- Builder financial capacity and reputation (for assets being constructed).
- Loan exit strategy.

Relative to other asset classes, the idiosyncratic nature of each CRED position necessitates specialist knowledge and experience to identify and structure loans appropriately.

Specialist local investment managers transacting frequently in market are best placed to assess and price for risk, and thereby ensure that investor capital is fully optimised and protected.

When CRED loans have entered distress, the circumstances generally fall within the following categories:

- Mispricing and volatility underestimation.
- Concentration risk and outlier CRE assets.
- Speculative assets and valuations.
- Management decisions guided by considerations other than maximising recovery on CRED positions.

Illiquidity

The decision to invest in CRED should be well-considered and informed by CRED investment specialists. CRED positions are generally held-to-maturity, and investors cannot redeem their investment in response to perceived or real negative CRE market movements. The inherently defensive, fixed-income nature of CRED is in this respect of primary importance, and well-structured loans will be designed with a hold-to-maturity mindset capable of weathering current and future conditions.

CONCLUSION

The results of this research demonstrate that CRED's risk-profile is fundamentally defensive, consistent with the fixed-income nature of the asset class. Yet in the Australian context, CRED has developed a track record of consistently strong outperformance not often seen in defensive strategies. How do we reconcile these seemingly counter-intuitive propositions? This is the result of a complex confluence of market and economic forces, which permit Australian CRED's risk-return combination to persist. For astute and informed investors, there is a clear and present opportunity to be seized.

CRED's greatest potential lies in the effects of its inclusion within a diversified portfolio. It is here that CRED's attractive attributes of counter-cyclical returns, and low/negative correlation with other asset classes, deliver their greatest rewards, simultaneously stabilising and enhancing portfolio performance. Crucially, these attributes endure in rising markets, as well as in more challenging economic environments such as the present one.

Australian CRED involves a range of challenges, first and foremost of which is gaining access to quality investments while avoiding those posing a less than favourable risk-return proposition. Private credit markets are characterised by information asymmetries, barriers to entry, and relatively low liquidity. Participating therefore requires a high allocation of resources to source transactions and undertake careful and in-depth due diligence. Experienced investment managers such as MaxCap Group can assist in the successful deployment of funds.

Ultimately, private CRED is still a niche and highly focused space in Australia. As the asset class evolves and matures, its key characteristics will remain alternative in nature, and distinct from those of the traditional mainstays of investment portfolios. Its value proposition is not as a replacement to these, but as a complement, and in this capacity, it delivers the key outcomes expected of a strategically valuable portfolio allocation. For all of these reasons, Australian CRED occupies a highly and increasingly important place in the investment landscape.

REFERENCES

- 1 Where real estate asset devaluation is more extreme, loss may be incurred by CRED investors.
- 2 The research is focused on single-asset higher-yielding CRED secured against un-stabilised assets and does not include any analysis of Commercial Mortgage Backed Securities (CMBS).
- 3 CRE loans generally require ongoing active management, whereas for corporate debt this is generally required only in distressed situations.
- 4 These approaches draw on Black Scholes option pricing theory.
- 5 Consistent with Modern Portfolio Theory - see Markowitz (1959). A portfolio of imperfectly correlated assets will, for a given level of return, involve lower volatility/risk than the weighted average volatility of the constituent parts.
- 6 Other than for bonds where the correlations are weakly positive.
- 7 Conversely, equities and commercial real estate tend to perform poorly during deteriorating economic conditions.
- 8 Correlation factors between CRED (loans managed by MaxCap only), including its constituent fair return and alpha, and the other asset classes are summarised in this table. The correlations are calculated from quarterly realised returns on each of the asset classes for the period 2000- 2020 with the exception of the CRED Alphas, which use data from 2012 onwards (junior) or 2015 onwards (senior and blended).
- 9 Limited to CRE loans managed by MaxCap Group.
- 10 The Sharpe Ratio is commonly employed to assess investment performance, as a way of measuring how well an investor is compensated for the risk borne.
- 11 Currently scheduled for 2023 & 2024: <https://www.apra.gov.au/news-and-publications/apra-announces-deferral-of-capital-reform-implementation>.
- 12 It had risen to above 85% following the post-GFC consolidations.
- 13 https://www.ampcapital.com/content/dam/capital/04-articles/insights/2018/october/AMPCRE0243_US%20Debt_AMPC%20PCCP_insight%20paper_v14.pdf.
- 14 Relative to share and bond markets, but also US/ European CRED markets.

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