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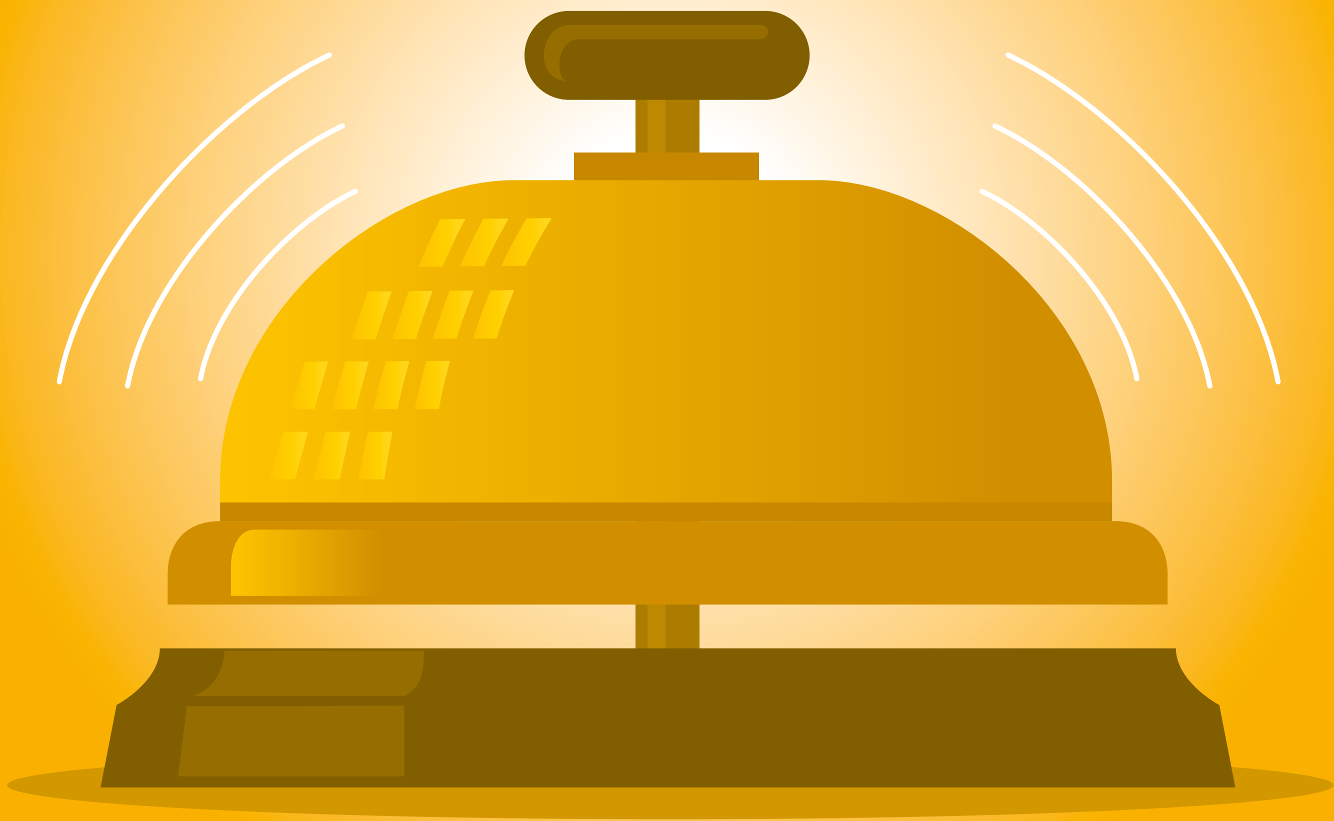

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KEYNOTE INTERVIEW

A stabilizing force in challenging times

Commercial real estate debt returns improve relative to other asset classes during periods of crisis and sustained economic uncertainty, says Wayne Lasky, co-founder and managing director of MaxCap Group

The inclusion of commercial real estate debt in an investor's portfolio delivers enhanced returns without trading off downside protection. This makes the asset class a powerful tool to fight volatility during market downturns like the one the global economy has experienced over the last year. Wayne Lasky, co-founder and managing director of Australia and New Zealand-based debt investment manager MaxCap Group, tells *PERE*'s Alicia Villegas why conditions for property debt investments are favorable in the Australian market.

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Q What is the appeal of commercial real estate debt for institutional investors in times of crisis?

Heightened risk and volatility still pervade most of the major traditional asset classes and return compression is being severely felt by the world's savers. In fact, this has been the case for much of the time since the global financial crisis and this has really come to the fore during the covid-19 pandemic.

For investors grappling with how best to respond to the covid crisis, commercial real estate debt presents a highly relevant, strategic allocation opportunity because it can achieve three important objectives in a well-diversified portfolio – increasing returns, lowering volatility and increasing the Sharpe Ratio, so those returns achieved in excess of the risk-free rate per unit of risk.

The risk profile of commercial real estate debt is fundamentally defensive and is consistent with the fixed-income nature of the asset class. Its returns tend to improve relative to other asset classes during periods of crisis and sustained economic uncertainty – therefore acting as a stabilizing force in an investment portfolio. And yet in the

Australian context, commercial real estate debt has developed a track record of consistently strong outperformance not often seen in defensive strategies. There are a complex confluence of market and economic forces, which permit Australian commercial real estate debt's rare risk-return combination to persist. For astute and informed investors, there is a clear and present opportunity to be seized.

The asset class has demonstrated resilience throughout market cycles including in the current covid environment and, therefore, presents a strategic allocation for investors focused on capital preservation through stable, defensive, asset-backed income.

Q How can commercial real estate debt add value to investors' portfolios?

MaxCap undertook a research study in conjunction with a team of researchers at the University of Technology, Sydney. The findings demonstrated the inclusion of commercial real estate debt in an investor's portfolio delivers enhanced returns, provides downside protection and reduces volatility – thus increasing risk-adjusted returns and the alpha or active return premium. There are very few asset classes that can lay claim to such performance.

By way of example, the findings illustrate commercial real estate debt is an important portfolio diversifier because it reduces portfolio risk and has low or negative correlation to other major asset classes. For instance, it is negatively correlated to equities at -0.11 and similarly negatively correlated to commercial real estate equity at -0.18.

Put another way, commercial real estate debt returns improve relative to other asset classes during periods of crisis and sustained economic uncertainty and, therefore, act as a stabilizing force much the same way the captain of your football team typically does when the whole team is under pressure. In this way, we think the role of this asset class could take on more significant meaning for many investors' portfolios this decade.

Q If interest rates are lower for longer, is there a danger of managers being pushed up the risk curve because returns are modest?

I don't think this is specific to commercial real estate debt, but really the investment industry's Gordian Knot. Experienced and skilled managers that have the ability to maintain focus on their investment philosophy, stick to fundamentals and, critically, they think laterally, and therefore have the ability to untie the knot and navigate these risks best.

This really is the major appeal for investors to increase allocations to commercial real estate debt. Given the lower-for-longer thematic with high volatility, it is more important than ever to allocate to asset classes that deliver consistent returns with higher Sharpe Ratios. I think commercial real estate debt, relative to other asset classes, is far better positioned, specifically in Australia.

The lending opportunity really started when regulatory intervention and structural dislocation commenced in 2017. This was first evidenced in opportunistic real estate strategies – typically land developments – and it has migrated in the past one or two years in the value-add space. But it's also present in long-tenor, core-related investment opportunities. There's a wide spectrum of opportunity in the Australian marketplace.

Q Where do you see lending opportunities in Australia today?

At the moment, I see two very interesting opportunities. One is ESG-related, more specific to the commercial office sector, looking at green-lending strategies. This is part of the value-add opportunity set, which is taking older offices and repositioning them for the times, and in the process, creating a far

more positive environmental outcome.

The other opportunity is what we refer to as transit-orientated developments, which typically and historically have involved major projects of very large scale in primary and secondary central business district locations. What's happening in Australia, though, is our state governments are making these opportunities increasingly available to unlock public benefit and amenity through private investment in suburban locations. This is quite interesting because a response to the covid-19 crisis has been for people to spend more time in the suburbs and less time in the CBDs. How long that remains the case, we'll see. But for the short to medium-term, that remains a sociodemographic feature of the market.

These projects, typically delivered under project development agreements with the state government, are quite complex and challenging. They are very difficult to do unless you're experienced in the space. But we see them regularly and we think they are an excellent opportunity as they provide very resilient, diverse mixed-use developments that are underpinned by ultra-convenient public transportation amenity.

Q What makes Australia an interesting market for commercial real estate debt investors?

There are five forces at play in Australia that support commercial real estate debt as a sustainable and scalable asset class.

One is regulatory intervention. Australia is relatively early cycle in its response to the Basel guidelines compared to continental Europe, the UK and North America.

The second is structural dislocation. In the Australian context, the 'Big Four' domestic banks have historically dominated property lending – we like to refer to that as the 'Aussiegopoly'. But regulatory intervention, the imposition of capital-adequacy ratios on those big four banks, is creating a very large funding gap in the market, which we estimate to be circa A$60 billion ($45.8 billion; €38.5 billion).

"Debt in an investor's portfolio delivers enhanced returns, provides downside protection and reduces volatility"

The third is that commercial real estate debt, by its very nature, is idiosyncratic, and it requires specialized expertise on an asset-by-asset basis.

The fourth point is that these opportunities are typically sourced in private markets and therefore, it's only managers with long track records and deep relationships that are able to access the best deals, which creates a competitive moat for locally based managers.

The fifth is the illiquidity aspect – most commercial real estate debt is illiquid and therefore carries a built-in premium.

In addition, global allocators of capital are drawn to Australia's political stability: our rule of law, a very high level of transparency and relatively high economic growth. If you think relatively to the US or the UK markets, Australia's population was growing at three times the rate of those countries. Now, clearly covid has impacted net migration, which represents about 40 percent of population growth in Australia.

In the medium-term, however, when the rollout of vaccines makes an inflection point, and global borders reopen, skilled migrants will have a few more compelling reasons to consider Australia as an appealing destination to come to. That is, given its impressive performance in containing the virus, a world class healthcare system and, obviously, the actual size of the country itself, which presents pretty unique opportunities to socially distance. From a macroeconomic perspective, the medium- to long-term prospects are appealing.

Q You mentioned a funding gap – when did banks start pulling back from the market?

Bank competition receded in 2020 and has not returned in 2021. This is largely due to their already disproportionate share of the commercial real estate debt market, the regulators capital adequacy provisions and the federal government's direction to focus the big four banks on cashflow lending, supporting businesses through the pandemic.

In any event, it's critically important to have a financial system that seamlessly transmits capital to creditworthy assets and sponsors. To achieve this, we need to have a healthy bank and non-bank market. That's going to be increasingly important for Australia as it has been in other major markets like the US, the UK and continental Europe, where greater of 50 percent of all commercial real estate lending is done by non-bank lenders.

Q How do you expect the Australian real estate debt market to change in the next few years?

The asset class will experience further maturity, with global allocators of capital increasing their allocations. Investors will increasingly allocate into fund programs in order to gain access to the best market opportunities, rather than seeking to transact from afar on a deal-by-deal basis. Historically, this has been a feature for some investors, and has proven to be a very difficult and challenging approach to the market.

I wouldn't expect credit growth to come from the Australian banking sector; it is the non-bank sector that will be doing most of the heavy lifting. I also think we'll see the emergence of this asset class as the 'defensive captain' for many institutional investors by the end of the decade. ■