EXPERT COMMENTARY

In a fast-changing market, Australian commercial real estate debt is ticking plenty of boxes for investors, says Wayne Lasky, founder and chairman at MaxCap

Bringing Australian CRE debt to global portfolios

In today's markets, seeking value and healthy returns is no easy task. Investors don't need to be reminded that close to 14 percent has been wiped off global equities in the year to mid-2022.

At times like the present, when it is particularly difficult to secure attractive risk-adjusted returns for fixed income investments, thinking outside the square – or more appropriately, thinking 'down under' – can deliver critical payoffs.

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Australia's commercial real estate debt market

The combination of healthy returns and reduced risk is elusive, but always the goal for investors. The traditional response has been to build a diverse portfolio.

But as today's investors grapple with heightened risk, volatility and rising inflation, many are rebooting their portfolio strategy away from traditional asset allocations. Australia's commercial real estate debt asset class is delivering the solution investors are looking for.

Commercial property in Australia continues to be a relatively sought-after investment. Local investors continue to compete with foreign investors, reducing the risk of major asset value erosion.

Moreover, supply of new housing stock has dramatically receded and there are few noteworthy developments on the drawing board. Now as borders reopen, there is a very real chance that demand picks up and Australia's population growth story resumes. This will likely lead to a very large undersupply.

This could be creating the 'perfect storm' for the commercial property market. It is also driving demand for Australian CRE debt, and this is providing key opportunities for investors seeking a fixed income replacement and inflation hedging strategy.

Where the value is

In recent years, we have been most active in the high-performing industrial and residential sectors. We have also found that backing non-discretionary convenience retail, particularly those close to transport links, can be a very effective strategy.

In the office sector, Australia is seeing a similar flight to quality experienced in other developed economies. So, there could be a huge opportunity to reposition and perhaps even repurpose some of the B- and C-grade stock as it begins to trade and value is reset over the next 12 months.

We also have a strong focus on the construction sector and are possibly the largest non-bank financier of building activity in Australia. In the context of escalating construction costs, we think it is critical to have contingencies and performance guarantees to protect investors' positions.

What is it all about?

CRE debt is a fixed income loan secured by commercial property. The underlying asset may be anything from industrial warehouses or office buildings, through to retail centers, hotels, logistics assets or residential low to high density developments.

The common thread is that investing in CRE debt earns a fixed rate on a loan that is generally held to maturity. This provides the sweetener of a predictable return for the full term of the debt, most often structured with a strong cash yield.

CRE debt also allows investors to tap into the demand for commercial property in Australia. Yet unlike direct property investors, CRE debt investors are protected from a possible property market downturn by the equity buffer of the loan-to-valuation ratio plus a diverse and robust security suite.

As a guide to scale, MaxCap has placed A$15 billion ($10.5 billion; €10.2 billion) of capital across more than 500 loans since inception 15 years ago. In PERE's 2022 Real Estate Debt 50, ranking the largest real estate debt fund managers by capital raised, we are number one Australia and number two in the Asia-Pacific region, with more than A$7 billion of funds under management and advice.

We are firm believers that Australian CRE debt offers attractive opportunities to global investors seeking more optimal fixed income strategies and a hedge against inflation. There are powerful underlying dynamics driving the development of the local commercial real estate lending market: Australia is the world's 13th largest economy, but in real estate we punch above our weight, being in the top nine nations by value, and the top seven by investment volume.

Why does it appeal?

The OECD is forecasting real GDP in Australia to grow by 4.2 percent in 2022 and 2.5 percent in 2023. According to a recent benchmarking report by government body Austrade, two leading factors underpin Australia's economic resilience – location and diversity.

Fast-growing Asia is set to deliver 44 percent of global GDP by 2026. Australian trade is already oriented toward Asia's economies. In addition, Australia's diverse and highly productive economy provides a buffer against economic shocks.

Overseas migration to Australia has resumed, and we believe the nation's tech-savvy skilled workforce helps to attract global corporations. More than that, Australia has a diversified services-based economy that is not reliant on any one sector. It also has stable and good governance, strong institutions and the rule of law, and is rated among the top three most transparent global markets. It is a very flexible economy and one that I fully expect to attract a lot more capital.

The upshot is that Australian CRE debt offers plenty of scope to deploy capital and is a sustainable investment strategy.

Opportunities for global investors

CRE debt has the potential to deliver impressive returns that outpace equities – and even the underlying

Historical Australian CRE debt returns

	Total return (% p.a.)	Volatility (% p.a.)
Traditional asset classes		
Cash	4	0.9
Bonds	6.2	3.3
Equities	9.4	13.7
Commercial real estate	9.9	2.9
CRE debt portfolios		
Junior	17.5	1.2
Senior	13.8	1.1
Blended	15.8	1.3

Source: MaxCap Group

Note: Based on correlation factors between CRE debt loans managed by MaxCap only, including its constituent fair return and alpha, and the other asset classes summarised in this table. The correlations are calculated from quarterly realised returns on each of the asset classes between 2000-2020 with the exception of the CRE debt alphas, which use data from 2012 onwards (junior) or 2015 onwards (senior and blended).

commercial property market itself. Research conducted by the University of Technology Sydney (UTS) in collaboration with MaxCap Group confirmed that CRE debt provides an attractive return-for-risk combination while significantly reducing portfolio volatility.

The UTS/MaxCap study found CRE debt delivered higher historic returns than cash, bonds, equities and property, but had a very low volatility rate of 1.1 percent per annum, compared to bonds at 3.3 percent. CRE debt is also highly defensive in nature, and its volatility is most comparable to cash, which had a volatility rate of 0.9 percent.

A key factor driving robust returns, and one that is likely to underpin future growth, is the withdrawal of Australia's four major banks from the CRE debt market, largely in response to regulatory intervention. This has led to a substantial funding gap to be filled by specialists such as ourselves.

There is a funding gap of approximately A$70 billion emerging in this space, which the non-bank sector will need to step up and fill. This presents a great opportunity for global allocators of capital, who can invest at scale in a sustainable opportunity with outsized returns. Investors get the benefit of regulatory intervention tailwinds, and real estate credit acts as a stabilising force within an investment portfolio, reducing overall volatility with low correlation to other major asset classes.

> *"Unlike direct property investors, CRE debt investors are protected from a possible property market downturn"*

While CRE debt allocations remain relatively small in comparison to many other asset classes, we believe this will change in the years ahead as CRE debt takes on increased strategic value for investment portfolios.

CRE debt presents a highly relevant allocation opportunity. Faced with uncertainty, there is no doubt that defensive investments with the capability to lower risk and increase portfolio returns will become increasingly sought after by investors over the next decade.

Inflation, interest rates and the CRE debt solution

It is a challenge for global allocators to access the best of breed opportunities, which are managed in a highly professional manner and de-risked to the maximum extent possible. Investors also want to achieve scale while knowing they can allocate consistently over a sustained period.

As in the rest of the world, Australia has experienced a lift in inflation. However, the Reserve Bank of Australia expects inflation to peak later in 2022 and decline back toward the 2-3 percent range in 2023 as global supply-side problems ease and commodity prices stabilize.

While Australia has also experienced several recent rate rises, much of this can be seen as a process of normalizing rates following extreme rate cuts at the start of the covid-19 pandemic. In the current climate, we believe commercial real estate debt is a great hedge.

The base rate applied on loans is a floating rate, using the bank bill swap rate. It rises in step with inflation and with interest rate rises. In an inflationary environment this ought to encourage even more capital into this asset class.

There are very few asset classes that can lay claim to enhanced returns, downside protection, and a reduction in volatility leading to an increase in risk-adjusted returns. Australian CRE debt has not only delivered on these scores, but it has also demonstrated resilience throughout market cycles including the current pandemic. ■