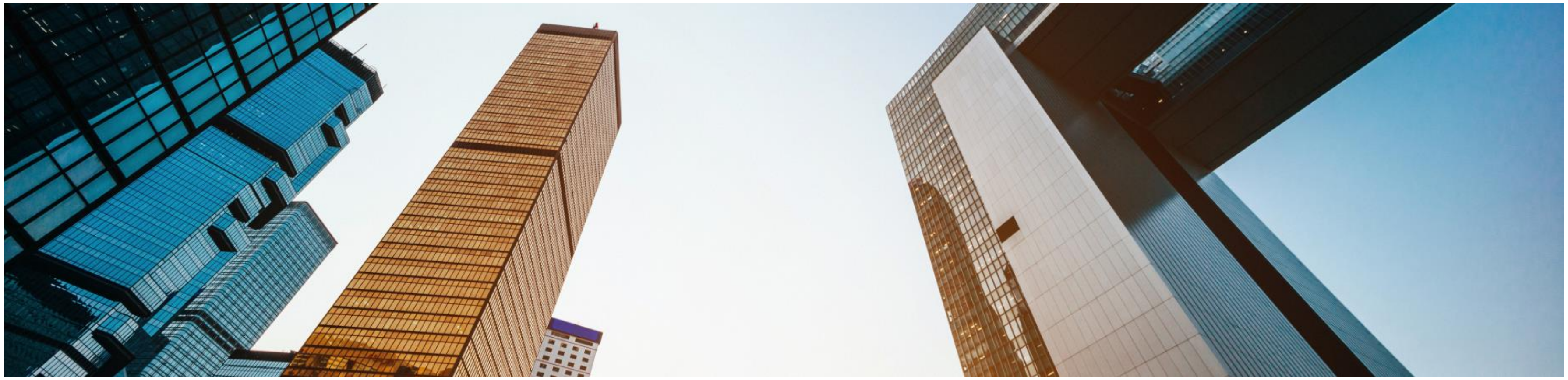
No 1. Lachlan by Golden Age

The Golden Age for Australian Real Estate Credit

MaxCap Group Research - July 2023

A golden age ahead



The end of NICE and driven to WINE. The days of 'NICE' – the Non-Inflationary Consistently-Expanding market – are well behind us, as we move to the world of 'WINE' – Wild Inflation, Negligible Expansion – which requires a marked shift in investor strategy for some years to come.

Faster. Higher. Longer. With inflation remaining well above the official target, central banks are responding with aggressive rate tightening. On current money market expectations, rates are likely to be higher for longer, ruling out the passive levered beta strategies of prior years and driving investors to look more keenly for alpha returns.

Keenly seeking a hedge. Investors are keenly seeking the right hedge, partly to offset the recent weakness in global demand and mostly to hedge the adverse impacts of high funding costs on equity returns. Australian real estate credit is a strategy that is well positioned to provide this hedge.

Deeply divergent sectors. From an equity investor perspective, real estate sectoral market trends are diverging widely across a booming industrial sector, a resurgent residential sector, an uneven retail sector, and a deeply out-of-favour office sector.

Deeper protection in credit. From a credit investor perspective, divergent sectoral trends are not presenting the same degree of risk. Australian real estate values are more resilient, less prone to deep drawdowns that erodes equity capital and exposes debt capital.

A golden age ahead. In our view, Australian real estate credit is well poised to deliver strongly for investors, with resilience across the cycle and a strong hedge to high interest rates. Moreover, we see considerable scope for this segment to diversify portfolios and improve risk-adjusted returns.

A not-so-nice market

For many global investors, the market environment in 2023 is proving to be extremely challenging.

Lingering supply chain delays and elevated energy prices are **slowing growth** and **accelerating inflation**, prompting aggressive **interest rate increases** from most major central banks.

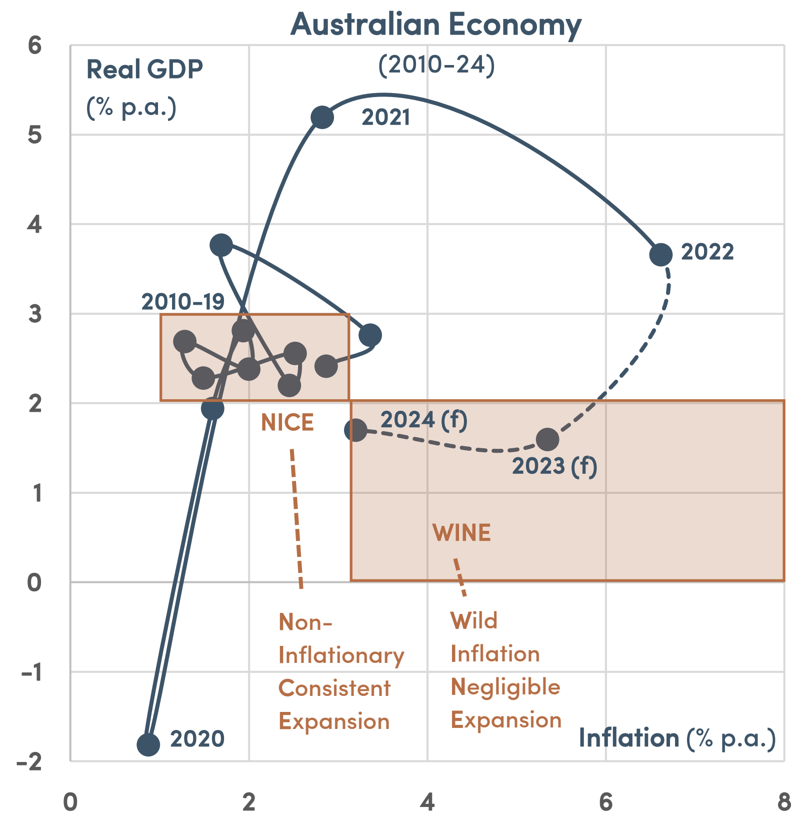
All of which are broadly eroding investment returns for traditional asset classes. Indeed, **listed equities and bonds** are both under pressure, and not delivering their typical offsets in a diversified portfolio.

Even **real estate sectors** are diverging clearly, with residential and logistics outperforming, but office, retail and hotels heavily weighed down by uncertain asset pricing and investor caution.

Meanwhile, we see a golden age ahead for **Australian real estate credit** especially for investors looking for growth, resilience and diversification.

- **Growth in a low-growth world**. Robust population growth – driven by strong migration inflows – stands out as a key point of difference for Australia, supporting relatively firmer housing and economic demand ahead.
- **Hedging in a high-rate market**. With the sustained uplift in consumer price inflation, interest rates are likely to remain higher for longer, supporting returns for floating-rate debt holders, mostly at the expense of equity holders.
- **Resilience and diversification**. In a difficult market environment, Australian real estate credit returns remain notably non-cyclical and relatively resilient, delivering sustained diversification benefits against more cyclical asset classes, in a world where demand growth and beta returns are becoming harder to find.

The end of 'NICE' and driven to 'WINE'. The outlook for slower growth and sustained inflation requires a marked shift in medium-term investor strategy



Source: International Monetary Fund, Oxford Economics MaxCap Group (June 2023)

Rates – higher for longer

The key challenge for investors – aside from slower demand and rising costs – relates to the dramatic uplift in funding costs. The era of cheap money from the prior decade is certainly well behind us, as many central banks move with some urgency to slow demand and curb inflation.

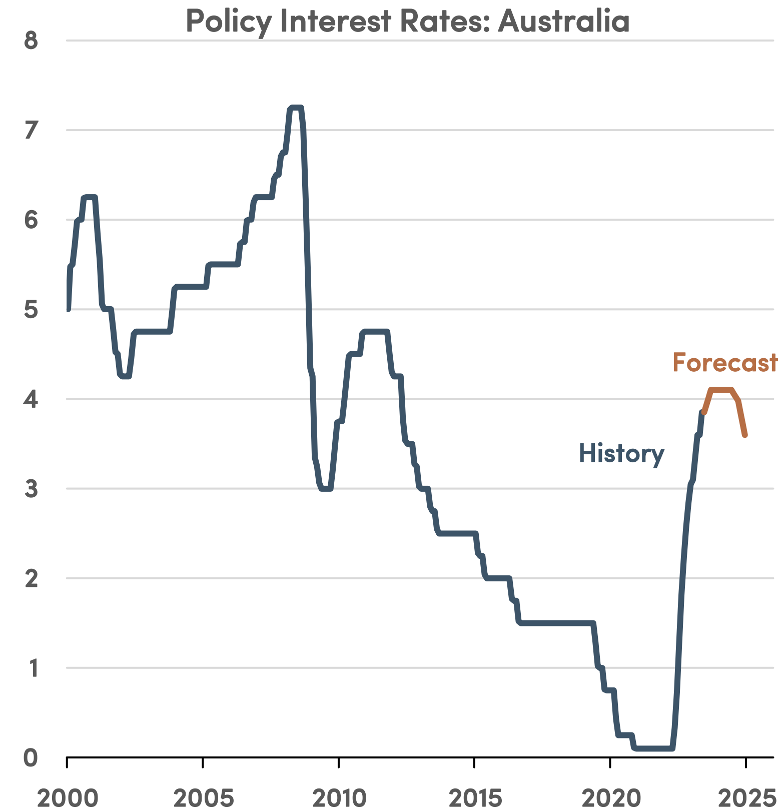
The moves to higher interest rates have substantial impacts on **project feasibility assessments** and **equity returns**. Indeed, real estate asset values have faltered while cap rates have softened, due to the combined effects of higher funding and material costs, even in hotly-contested sectors like industrial and logistics.

Meanwhile, **debt returns** have lifted with interest revenues, particularly as lenders pivot nimbly from fixed- to floating-rate exposures. The sluggish economy does have some indirect impacts for debt investors, driving a higher volume of **loan extensions**, but still not materially enough to increase credit defaults or put senior debt capital at risk.

For now, the **debt market landscape** is clearly shifting. Volatile financial markets offshore are driving greater caution from domestic banks and their regulator, constraining bank debt availability outside of core mortgage lending products. For non-bank lenders, there is **less intense competition** for lending, more opportunity to fill **lending** segments vacated by banks and more scope to select based on **sponsor quality**.

Looking ahead, interest rates are likely to stay **higher for longer**, prompting an urgent portfolio reallocation to deliver an interest rate hedge and sustain returns. **Australian real estate credit** remains a key strategy to deliver that hedge.

Market expectations are for a near-term peak in rates in 2023, before a slow retreat to lower rates in 2024 and beyond. Structurally higher rates are likely here to stay



Source: Oxford Economics, Reserve Bank of Australia, MaxCap Group (June 2023)

Understanding real estate credit exposures

There are some interesting aspects around the current market outlook.

Residential is seeing booming demand led by migration and lagging supply given higher building costs. This is driving a sizeable housing undersupply medium-term and a rental boom near-term.

Office markets are seeing a structural transition as work-from-home arrangements slow down the rebound in net absorption, while investors await more clarity on asset pricing. Future demand is likely to be skewed heavily towards higher-quality, tenant-friendly and climate-friendly office stock.

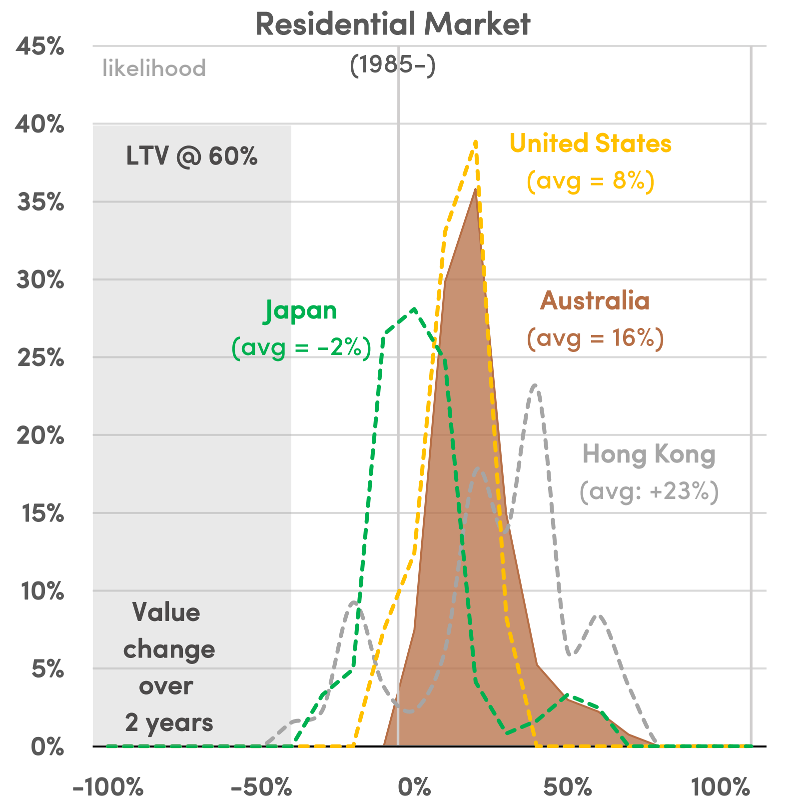
Retail and **hotel** are still adjusting to new market conditions, as higher rates impede consumer and leisure spending for now, amid longer disruptive transitions to e-commerce and post-COVID travel.

Logistics continues a big boom amid the ongoing push for shorter delivery times and better distribution networks. Tenants are rushing for limited warehouse space, driving a sustained surge in rents.

Given all these **divergent sectoral trends**, there is a vital point to make about the nature of real estate credit exposures. In Australia, real estate price movements over the usual loan term are typically positive and narrowly concentrated, notably more so than other markets abroad.

The **historical likelihood** of a sufficiently deep market downturn – that completely erodes equity capital and exposes senior debt capital – is low. Specifically, in a probability distribution of price movements, the 'left-tail' risks of larger price falls are low in Australia, compared to other market peers aboard. Moreover, there is considerable scope for credit managers to adjust **lending covenants** and specifically the loan-to-value ratios, in order to manage capital risks in more challenging market environments.

Over a loan term, asset values are typically trending higher. The likelihood of a long downturn (the left-tail in the distribution) that exposes lenders is low in Australia



Source: Australian Bureau of Statistics, Bank of International Settlements, Proptrack, MaxCap Group (June 2023). Note: this chart plots the probability distribution of residential market price movements over any two-year period, illustrating the relatively low likelihood of a left-tail event or a sustained pricing downturn that would expose credit investors. Past performance is not a guarantee of future performance

Making better portfolios with real estate credit

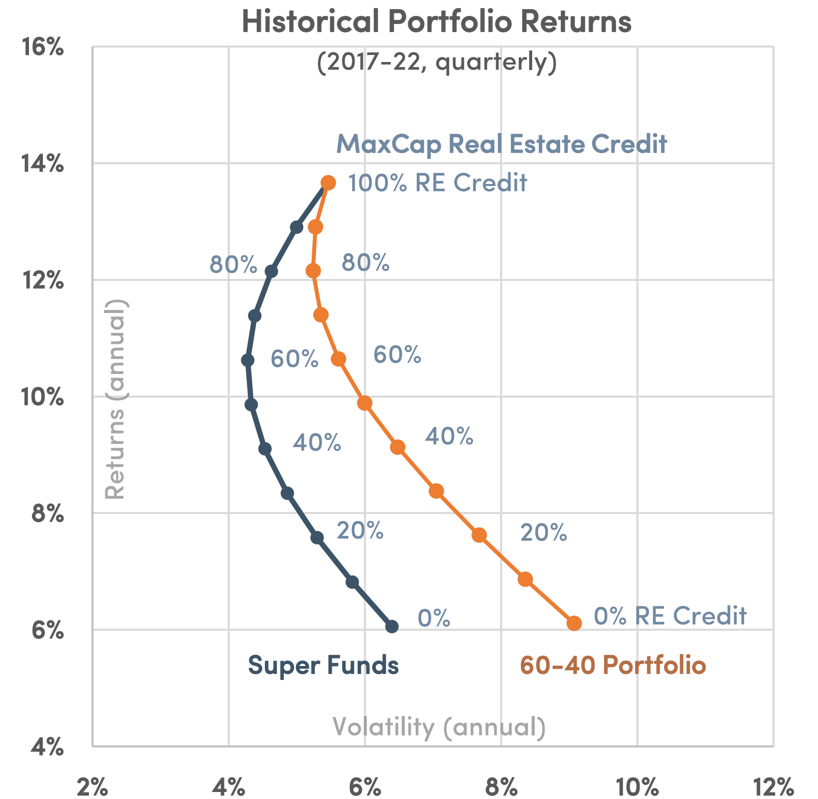
In the context of a highly diverse and competitive investment market, where private and institutional investors face intense pressures to sustain returns or perform to industry benchmarks, there are relentless demands to seek **better risk-adjusted returns**, especially via asset allocation and portfolio selection.

In a 'not-so-nice' investment environment, recent returns have been weak and a little strange particularly last year in 2022, marked by **broad underperformance** in both equities and fixed income segments, asset classes that – together – typically offer some diversification benefits to balance portfolio returns. This is not the case in the low-growth, high-inflation **'stagflationary' market conditions** that we are seeing now and that we expect to persist from here.

From a portfolio perspective, **Australian real estate credit** offers some compelling features, particularly a strong hedge against elevated interest rates. Moreover, this segment has demonstrated robust resilience, with **consistent repayment income streams**, despite the challenging conditions faced by various real estate market segments through the sharp recession and pandemic disruption we have seen in recent years.

Looking ahead, we expect to see considerable **credit opportunities** ahead in specific categories, in the chronically undersupplied **residential** market (both built for sale and built to rent), in the booming **logistics** market to meet the burgeoning demand from online shoppers and the accelerating **brown-to-green transition** for commercial assets already well apparent in Europe and increasingly taking hold in North America.

In our view, there is considerable scope to improve portfolio returns with real estate credit, both enhancing absolute returns and improving income resilience



Source: Bloomberg, Australian Super Funds Association, MSCI, MaxCap Group (June 2023). '60-40' portfolio is a composite portfolio comprising of 60% domestic equities and 40% domestic bonds. Past performance is not a guarantee of future performance

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