30 Pirie Street, Adelaide – Quintessential

Finding Australia on the Credit Compass

MaxCap Group Research - November 2023

Where does Australian real estate credit fit?

The credit compass points to Australia. In a world with elevated interest rates, the case for real estate credit is looking more compelling, supported in Australia by firm population gains, robust housing demand, higher funding costs and good structural resilience.

From brain drain to brain gain. In an unpredictable and volatile world, Australia remains an open island of stability, increasingly drawing larger volumes of immigrants – particularly the young and the highly educated – which provides a welcome boost to economic demand, at a time of challenging demographic headwinds elsewhere.

More resilient real estate markets. Australian real estate asset prices are structurally more resilient, demonstrated over 40 years of history and again in this global downturn. Importantly, milder asset price swings domestically help to moderate credit investment risks.

Vital lending market features. There are key structural market features that work for the lender in Australia. Full recourse loans mean borrowers cannot simply 'hand back the keys' and 'walk away', typically resulting in low instances of credit default and losses.

The tailwinds are not this strong everywhere. Altogether, Australia stands out well relative to other developed credit markets, given very different degrees of market resilience. The sharp market distress currently unfolding in Europe and the US looks more muted here.

Australia warrants an outsized credit allocation. In our view, there is a deep A$500 billion market opportunity that warrants a reallocation out of real estate equity (where we see entrenched underperformance for core strategies) and out of global credit (given more elevated risks of disruptive pricing adjustments in Europe, North America and Asia).

Source: APRA, MaxCap Group (November 2023)

Australia: a land of growing opportunity

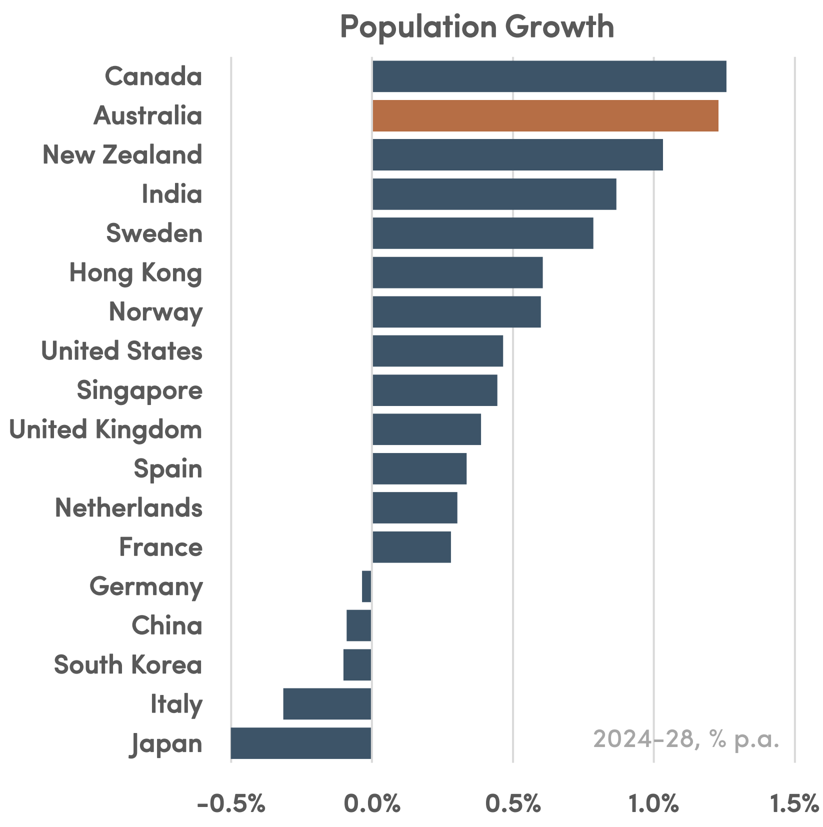
Global markets are looking more uncertain than usual, with **consistent demand growth** and investment returns getting harder to find.

- Widening conflicts in Europe and the Middle East, resurgent oil prices and elevated interest rates are all weighing heavily on the **weakening global growth outlook**. In this context, investors are keenly seeking robust demand growth sufficient to sustain resilient investment returns.
- In this challenging economic environment, **astute market selection** is vital to investor success. In screening markets for their long-term growth potential, demographic factors – the most fundamental drivers of economic and demand growth – sit at the very top of the list.
- Indeed, **demographic shifts** are accelerating after the global pandemic. Birth rates are plummeting on a global basis, diminished by rising costs and uncertainty. Migration trends are also quickening as more people move across borders looking for opportunity and stability.

Population and migration trends point to **a widening gap** in the structural outlooks for economic growth and investment returns over the 2020s.

- There are entrenched **population declines** across many developed countries, progressively reducing economic and housing demand. We have already seen peak population in Japan (2011), Italy (2014), South Korea (2020) and China (2021), with Germany set to follow (2024).
- Moreover, the **ageing population profiles** in these markets are accelerating the reversal of housing demand, as more residents reach the typical age cohorts for downsizing (60+) and assisted living (75+).
- Meanwhile, **Australia** remains one of the strong standouts amongst developed markets, with sustained housing demand at a time of constrained supply additions. The outlook for **housing undersupply** is expected to persist for most of this decade. The market implications are covered in more details in a prior research note Going Up.

There is a widening gulf between the demographic ‘haves’ and ‘have nots’, with stronger population gains driving firmer growth in select parts of the world



Source: International Monetary Fund, MaxCap Group (November 2023)

Looking at risks and returns

Undoubtedly, there is a robust case for **global credit** given higher interest rates and subdued returns for other asset classes. For many investors, the next consideration is working out where to deploy their global or APAC allocations. In other words, where does **Australian real estate credit** fit?

Clearly, there are two distinct investor perspectives to consider here.

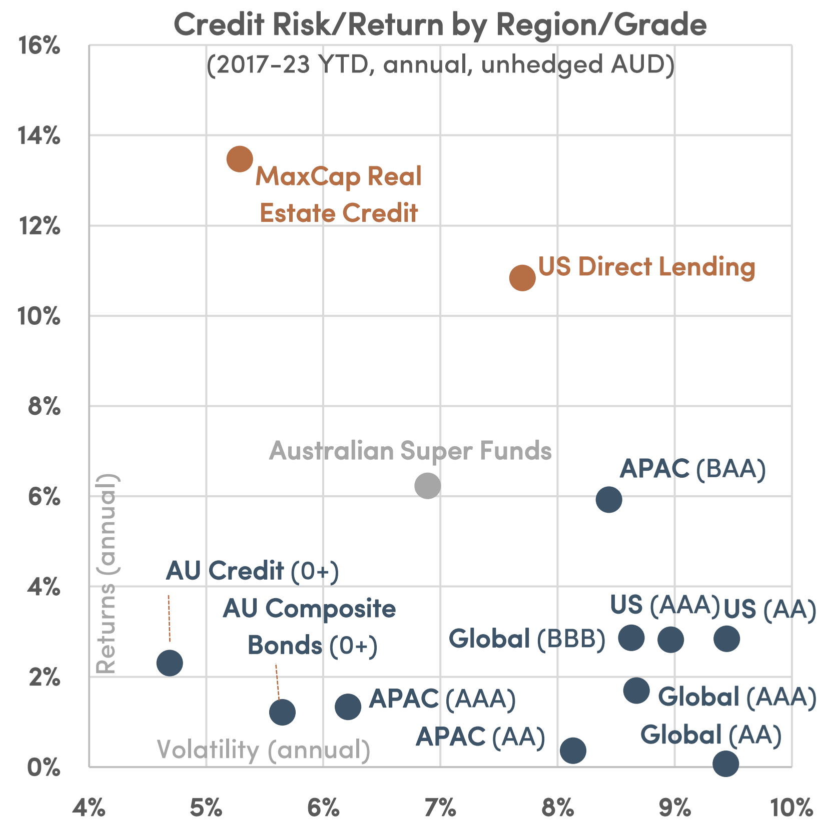
- For **offshore investors** looking into Australia, real estate credit here compares well with other global credit strategies across both risk and return metrics, whether that is on a hedged or unhedged basis.
- For **domestic investors** comparing Australian and offshore options, the home market strategy also stands out in terms of historical risk-adjusted returns, when compared to other credit strategies abroad.

Meanwhile, not all credit strategies are created equal.

- Historically, the risk-adjusted return gap between Australian real estate credit and **investment-grade credit indices** have been relatively sizeable, especially in the context of broad-based public credit losses across many parts of the world in 2021 and 2022.
- Meanwhile, there is a somewhat smaller performance gap between Australian real estate credit and **direct lending** in markets like the US. Indeed, the differences in returns are smaller, with the volatility gap more reflecting currency exposures rather than asset performance.

Cross border strategies come with currency considerations. For most investors, strategic allocations and market selection are conducted through a lens of market fundamentals and expected asset class returns. The **hedging decision** is often an independent choice, done post hoc for risk management reasons. That said, larger diversified investors can benefit from diverse currency exposures and apply more selective currency hedging at a portfolio level. This hedging analysis differs for each investor and is best done on an individualised portfolio basis.

Historically, Australian real estate credit compares well in terms of risk-adjusted returns, when compared with many other private and public credit strategies.



Source: Bloomberg, Cliffwater Direct Lending Index, MaxCap Group (November 2023)

Comparing credit risk profiles

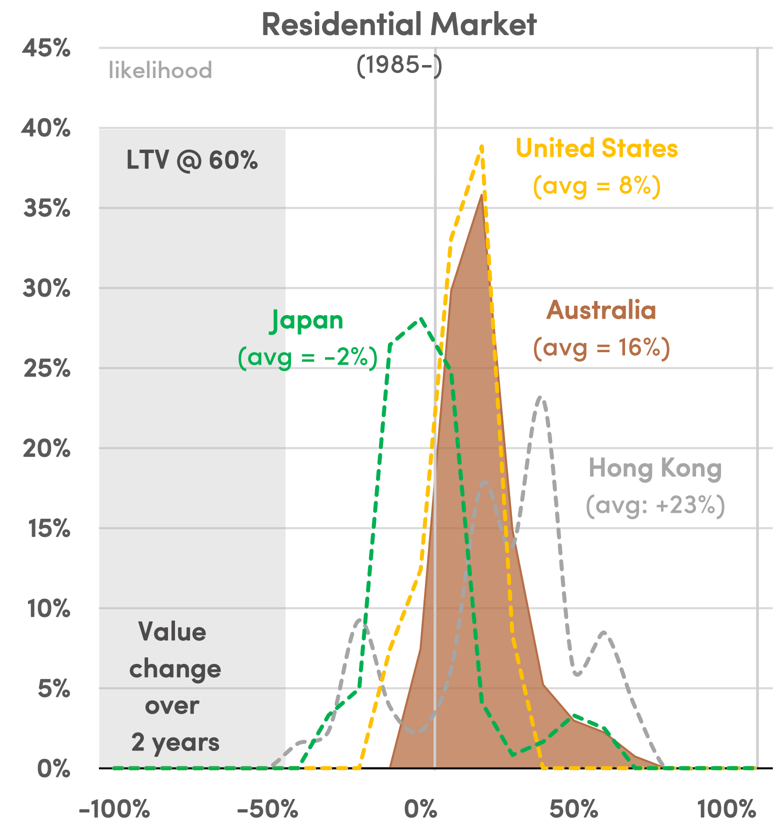
In assessing the real estate credit risk profiles across different markets, we think that the **pricing volatility** of underlying real estate assets is a vital consideration to determining the degree of credit exposure risks.

- From an **equity** perspective, every cyclical downturn presents an immediate impact on the bottom line, with the direct translation of pricing corrections to capital returns, along with any adverse effects from weaker occupancy and vacancies on rental income returns.
- From a **credit** perspective, there are more generous shock absorbers at work. For any given loan-to-value ratio, the credit position is considerably more resilient to pricing cycles, to be exposed only after a sizeable price correction that overwhelms the equity contribution.

Historically, the **degree of credit risk** varies a lot across countries.

- In part, this credit risk profile reflects **structural factors** specific to each country, including underlying economic cycles, local valuation practices and the depth of markets during downturns, all of which greatly affects the realised volatility in asset prices in each market.
- Historically, big downturns during the Lost Decade in Japan (1990-2004), the Asian Financial Crisis (1997-2003) and the US subprime / Global Financial Crisis (2007-09) all triggered long-running real estate price falls and marked distress in both equity and credit markets.
- Importantly, these financial shocks did not hit with the same intensity across all real estate markets. **Australia** fared more resiliently through these globally disruptive episodes, with relatively milder price corrections and credit market impacts. This is evidenced by a smaller left-tail segment in historical price growth distributions.
- In 2023, we are seeing this cycle **playing out similarly** across multiple markets, with significant real estate pricing corrections in the US (regional banking crisis) and China (property credit defaults), amid milder asset price adjustments in Australia.

The risk in real estate credit exposures stem partly from the volatility of underlying markets. Australian markets have proven to be resilient through many pricing cycles



Source: Bloomberg, Bank of International Settlements, Proptrack, MaxCap Group (November 2023)

Keeping the keys

Beyond the long-standing history of macroeconomic and market resilience in Australia, there are some important **structural features** that sustain the relative strength of the local real estate credit market.

- Most significantly, Australian real estate debt are **full recourse loans**, unlike the non-recourse loans commonly found in the US. Full recourse lenders in Australia can claim on other borrower collateral to mitigate the likelihood of loss in the event of credit default.
- In other words, Australian real estate borrowers do not have the same option to **'hand back the keys'** when the equity contribution is wiped out, given the option for lenders to pursue other borrower assets. This type of default cycle is unfolding right now in the US, particularly in the struggling office markets of New York and San Francisco.
- Moreover, Australian commercial real estate borrowers are subject to a range of **risk-mitigating practices** just to access debt finance, with minimum pre-sale and pre-leasing requirements, performance bonds, bank guarantees and greater participation of lenders through tripartite construction agreements between the builder, borrower and lender.
- Meanwhile, the Australian **regulatory and enforcement systems** are highly transparent, well established and tested through a range of cyclical market downturns. Indeed, enforcement is not subject to court judgement or the same degree of litigious disruptions as other markets.

Altogether, the lending framework in Australia – intermediated mostly through an oligopolistic banking system – affords a high degree of **structural protections** for the credit provider and goes some way to explain the historical resilience of the domestic lending market through multiple disruptive episodes. The **lending system** is gradually changing, of course, as the cumulative reforms to the banking system and rising capital requirements (Basel III, 'unquestionably strong' benchmarks) drive the sustained shift of commercial lending towards the non-bank sector.

Looking at construction loan practices across several markets, we regard the Australian market to be soundly structured, well regulated and considerably de-risked.

Factor	Typical market practices for construction loans
Lender types	AU: Mostly concentrated to the four major banks US: Highly diverse bank and non-bank lenders EU: Highly diverse bank and non-bank lenders
Loan structures	AU: LTC 65%-85%, contingencies >5% US: LTC 70%-90%, contingencies 5-15% EU: LTC 40%-80%, contingencies 5-10%
Building contracts	AU: Performance bonds, 5% bank guarantee US: Limited use of performance bonds EU: Performance bonds, 10% bank guarantee
Loan recourse	AU: Full recourse (personal/corp. guarantee, GSA) US: Partial or no recourse to the borrower EU: Full recourse to borrower (guarantee, GSA)
Pre-sale coverage	AU: 40%-100% residential pre-sales, 10% deposit US: No minimum residential pre-sales EU: No minimum residential pre-sales
Enforcement	AU: Enforcement does not require court judgement US: Lengthy process, can be legally disputed EU: Enforcement does not require court judgement

Notes: AU: Australia, US: United States, EU: Europe, LTC: loan-to-cost ratio, GSA: general security agreement. Source: Apollo, APRA, RBA, MaxCap Group (November 2023)

Additional information

#1
in Australia

PERE RED 50

#2
in Asia Pacific

PERE RED 50

This report was prepared by MaxCap Investment Management Pty Ltd (ACN 169 902 005 AFSL 462 086 ACL 395067) (MaxCap). It is intended only for "wholesale clients" as defined in the Corporations Act 2001 (Cth) and you should disregard it if you are not in this category. If you are outside Australia, you must be satisfied that receipt of the report is permitted by the laws of your jurisdiction, and otherwise you should disregard it.

The report is confidential and may not be reproduced or distributed to any other person in any form without MaxCap's written consent.

The information in the report is general in nature and does not purport to be comprehensive or to constitute personal advice. It is not an offer or invitation for any investment product or service.

MaxCap (and its affiliates, directors, and employees) make no representation or warranty about the accuracy or completeness of the contents of the report and, to the extent permitted by law, have no responsibility or liability to you in relation to it. In particular, no representation or warranty is given about any forecasts. Before making any decision regarding an investment, you should review the relevant investment documentation, conduct your own due diligence and obtain advice about your personal circumstances.

The information in this report is current at the date of issue. MaxCap is not obliged to notify you of any changes.

Key contacts

Wayne Lasky
Executive Chairman
wayne@maxcapgroup.com.au

Rob Hattersley
Group Head of Capital
robert.hattersley@maxcapgroup.com.au

Bruce Wan
Head of Research
bruce.wan@maxcapgroup.com.au

Ben Klein
Head of Private Capital
ben.klein@maxcapgroup.com.au

Ben Wollan
Deputy Chief Investment Officer
ben@maxcapgroup.com.au

Penny Tao
Director – Capital
penny.tao@maxcapgroup.com.au

Nicholas Adamson
Associate Director – Capital
nicholas.adamson@maxcapgroup.com.au

Domenic Demaria
Associate Director – Capital
domenic.demaria@maxcapgroup.com.au

Leyla Sacks
Associate Director – Capital
leyla.sacks@maxcapgroup.com.au

Hugh Thomson
Associate Director – Capital
hugh.thomson@maxcapgroup.com.au

Ben Woolley
Associate Director – Capital
ben.woolley@maxcapgroup.com.au

MaxCap Group

REAL ESTATE DEBT AND INVESTMENT

Head office
Level 24, 376-390 Collins Street
Melbourne, VIC 3000 Australia

MaxCap locations

Melbourne
Sydney
Brisbane
Perth
Auckland

maxcapgroup.com.au

@maxcapgroup