Mythbusting in Commercial Real Estate Debt

MaxCap Group Research – October 2024

Tackling common myths

Tackling common myths. The nascent private credit sectors in Australia & New Zealand are not well understood. There are plenty of popular misconceptions regarding how the market works, the degree of investment risks and the consistency of returns delivered over time.

Too small. For global investors, the small size of the local economies often draws comment. However, these markets are highly developed, very transparent and well poised for robust growth, particularly as borrowers continue to pivot from bank to non-bank lenders.

Too risky. There have been a lot of headline news about construction and financing risks. That said, the realised investment risks remain exceptionally low, demonstrated over many years and market cycles. This sector remains attractive for its positive mix of risk and return.

Too opaque. There is a widely-held notion that private credit lacks transparency, and this may draw more regulatory attention with concerns over financial system risks. Industry leaders can address this with a higher degree of disclosures over operations and performance.

Too easy. The apparent popularity of private credit is bringing new capital and managers. New operators will find conditions in the sector very challenging. Disciplined deployment is the key, and this needs deep origination teams and strong internal resources to manage risks.

The strategic path ahead. In this market environment, finding the right private credit manager and partner is the key. This would go a long way to getting clarity on how the sector works and the risks involved. Accessing the right skill set for this sector is vital to success.

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Myth 1: Too Small

In assessing the opportunities in the Commercial Real Estate Debt (CRED) market, a common complaint – more so from offshore investors – concerns its **relatively small market size**, whether that is the size of the underlying economy, its private credit market or the nascent (but growing) segment of non-bank commercial real estate lenders.

- From an **economic perspective**, Australia and New Zealand are indeed small in population (32 million, 0.4% of the global total) and economic size (2% of the world GDP). However, these are relatively mature and well-developed markets, compared to their APAC peers.
- From a **real estate market perspective**, these countries are very accessible and highly transparent, with strong regulatory protections for both lenders and investors. Meanwhile, Australia (4th globally) and New Zealand (10th globally) are both ranked the most transparent markets in the APAC region, and amongst the best in the world.
- From the **private credit perspective**, the commercial real estate debt market in Australia was worth around $491 billion in 2023, presenting deep and liquid opportunities for both institutional and private investors. For now, most commercial real estate loans are written by banks (85%) with a smaller contribution from non-bank lenders (15%).
- Meanwhile, there is **dramatic growth** in the non-bank CRED segment, reflecting stellar population growth, robust housing demand and a structural shift towards non-bank lending. Indeed, this segment is one of the fastest growing in the country, having doubled in size over the past three years, running well ahead of broader credit market growth.

Altogether, the private CRED markets in this region are **well poised for rapid expansion** in the next decade, mirroring what has already occurred abroad in North America and Europe. The growth outlook is driven by the urgent and fundamental need for housing, the associated push for more financial funding and the accelerating substitution from bank to non-bank credit, particularly for land and housing development.

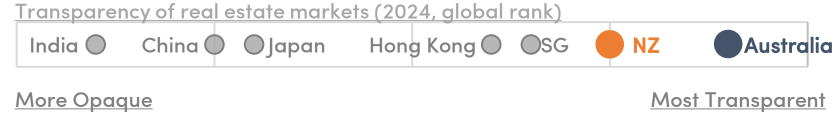
At a glance, the private credit markets of Australia and New Zealand are of reasonable size, compared to other APAC segments, with considerable scope for growth and increased market share ahead.

The region presents well-developed small- to mid-sized economies

Share of APAC GDP (2023, % share)

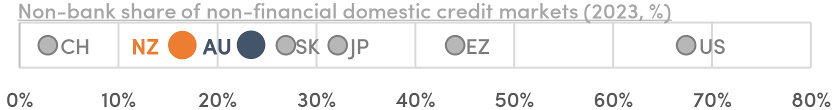
The ANZ real estate markets rank high globally for transparency

Transparency of real estate markets (2024, global rank)



Non-bank lenders have room to grow, given the experiences abroad

Non-bank share of non-financial domestic credit markets (2023, %)



Non-bank CRE lending is quite sizeable and showing rapid growth

Australia's lending landscape (2023, 3-year annualised growth)

Loan market by segment	Banks & ADIs	Non-bank lenders
Commercial Real Estate	$415 billion +11% p.a.	$76 billion +29% p.a.
Corporate / Other	$2.8 trillion +6% p.a.	$112 billion +15% p.a.

Source: APRA, BIS, EY, IMF, JLL, MaxCap Group (October 2024). ADI = Authorised Deposit-taking Institutions, CRE = Commercial Real Estate, AU = Australia, CH = China, EZ = Euro zone, JP = Japan, NZ = New Zealand, SG = Singapore, SK = South Korea, US = United States

Myth 2: Too Risky

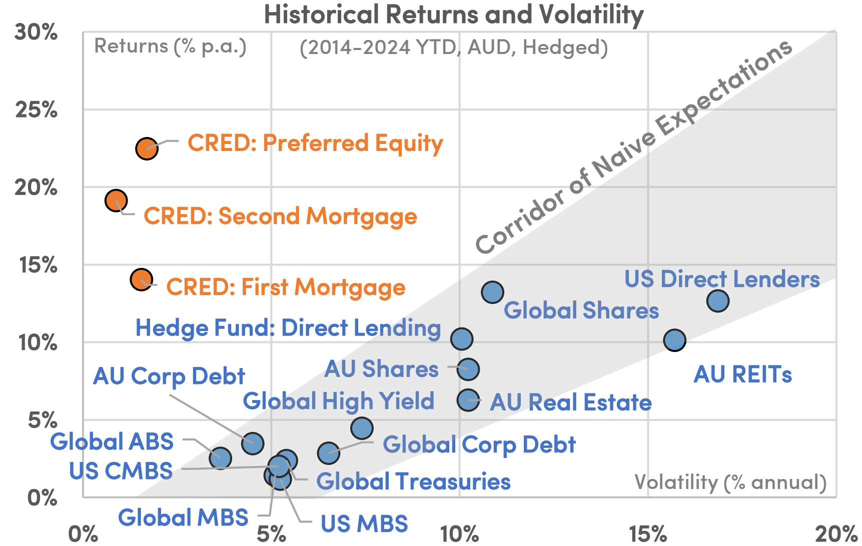
Investors into the private credit market often hear a familiar refrain about risk, specifically that CRED markets are **exposed to too much risk**, stemming from the highly cyclical construction and real estate sectors, to the less transparent behind-the-scene workings of private credit markets.

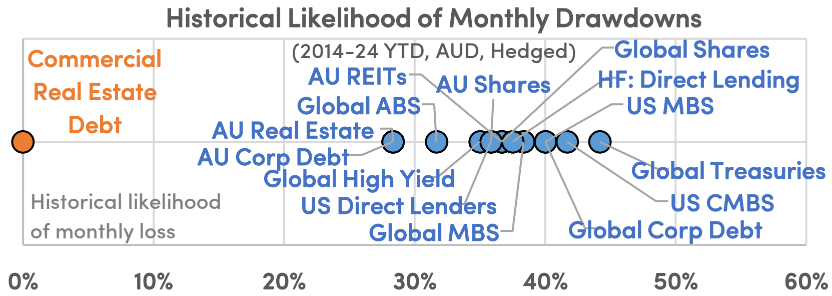
- **Construction risks** have been prominent in news headlines. Builder failures lifted with the sharp spike in building costs in 2022. However, these pressures are now subsiding, as building costs stabilise, selling prices for homes lift, and profit margins widen. Nevertheless, a lagging adjustment is still unfolding in 2024, so far with limited return impacts.
- Meanwhile, **real estate asset values** point to lower levels of credit risks. Residential prices are lifting with excess housing demand. Commercial asset prices are starting to find a floor, and still some way from fully eroding the equity buffer, given conservative lending ratios. Importantly, Australian asset values have been less volatile than their other offshore peers, substantially reducing local credit risks.

All things considered, the **realised risks** for private CRED investments have been somewhat lower than investor expectations and compared to other mainstream asset classes.

- In considering **the balance of risks and returns**, we often see a narrow corridor of naïve expectations, which blindly assumes an elevated risks for CRED strategies. However, realised risks – expressed either through volatility or drawdowns – have been very low, sustained over a long period of time, through deep cyclical downturns.
- Indeed, many **risk metrics** for the private CRED sector are not well understood, particularly relating to its loan duration (~2 years) and liquidity (monthly on a pooled loan basis). Similarly, there are reliable **risk mitigation strategies** for experienced managers, who can bring a highly specialised and refined skillset to oversee construction projects, manage building costs and timelines, and work out troubled loans.

Many types of investment risks are quantifiable. For CRED strategies, we see historically stronger returns, relatively lower volatility and far fewer instances of drawdowns, compared to other asset classes.





Source: Bloomberg, MaxCap Group (October 2024). The reported CRED metrics are calculated from the full loan pool managed by MaxCap. Historical returns are no guarantee of future performance.

Myth 3: Too Opaque

There is a widely-held perception that the private credit markets are **lacking in transparency**, given limited visibility for investors and the risks the sector may pose to the financial system. This call for transparency is drawing greater scrutiny from regulators, along two areas of focus.

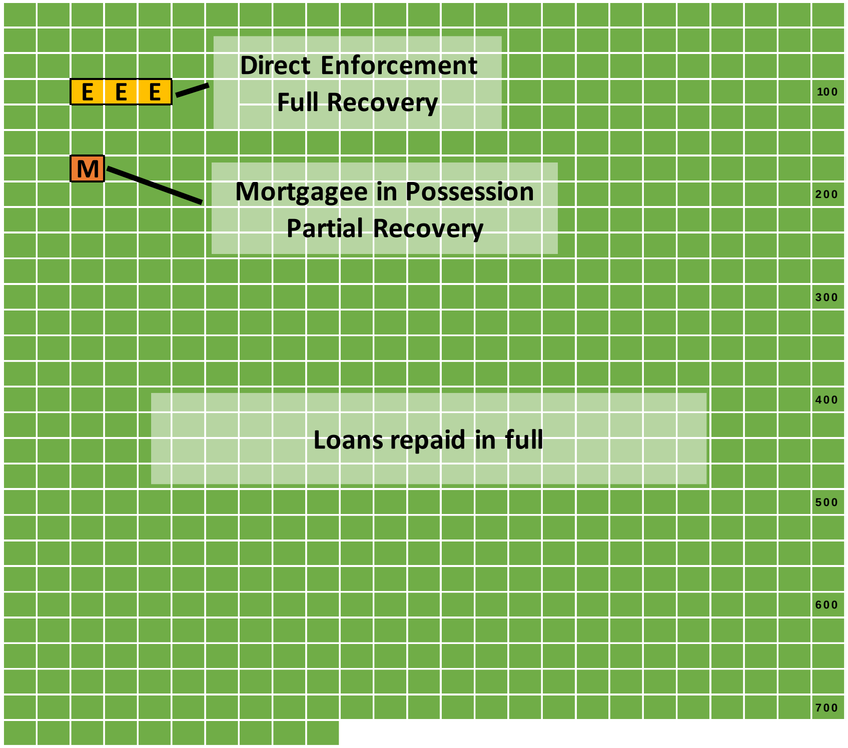
- The main risk relates to **financial contagion,** which we saw during the Global Financial Crisis when failing banks threatened the entire financial system. Private CRED lending does not run the same risks - private loans are backed by >85% of investor capital, while bank loans are backed by just 7% of assets (or 21% of risk-weighted assets).
- The other risk relates to **superannuation funds** and the exposures of individual account holders. For now, private debt holdings are small ($26 billion or 0.85% of investments) and simply do not present the same risks to portfolio returns as more volatile asset classes.

The push for **greater transparency and accountability** is a positive trend for the market, as it improves investor confidence, weeds out weak operators and increases entry barriers for more experienced managers. Increasingly, this higher degree of openness is essential for the private credit sector to become **fully institutionalised**, in order to raise capital from major global partners and tier-1 pension and sovereign funds.

- We can also address this issue with a fulsome accounting of the **historical track record**, progressively built up over 710+ loans, 17 years, and A$17 billion of lending. Over that time, we can show strong results on capital preservation and active loan management, across all real estate sectors and over several economic cycles.
- Certainly, there have been many challenges in that time. There were multiple instances of **builder failures** (and builder substitution). Also, there were several **loan defaults**, which required very active loan management to recover investor capital and interest. The results from all completed loans are summarised here. It is a historical track record that compares very well with major bank and other non-bank lenders.

There is considerable value in greater transparency for the sector. Specifically, it is useful to consider lending risks at the portfolio level, to illustrate the likelihood of adverse events and enforcement actions.

MaxCap Historical Track Record (2007-24 YTD)
Realised CRE loan outcomes over 17 years and 710+ loans



Source: MaxCap Group (October 2024). Past results are no guarantee of future performance.

Myth 4: Too Easy

The apparent popularity of the private credit sector in 2023 and 2024 has brought **an influx of capital and managers**. At last count, there are over 300 managers in this private credit space, with many new to the market, not having seen the challenges associated with a full economic cycle.

- Even in a so-called hot sector – operating conditions are not easy, and there are **many traps and pitfalls** for new managers and investors alike. For the more experienced managers, there are important risk mitigators, applied over many market cycles, which moderate the key risks from operating within cyclical construction and financing markets.
- For construction finance, there is **a specialised skillset** for overseeing development sponsors and contract builders, to ensure strong control on building costs (when costs are rising), timely progress (during inclement weather delays) and dependable valuations (when prices are falling). In this regard, **internal resources** like quantity surveyors, valuers and market researchers are important to provide timely and independent assessments of individual projects and broader markets.

For private credit managers, in the face of more abundant capital inflows, the big challenge heading into 2025 relates to **disciplined deployment**.

- Given the relative underperformance of many asset classes, there is **no shortage of capital** reallocating into the private credit space in 2024. While the pool of viable opportunities is growing, it is not occurring at the same pace, putting the focus on pipeline origination.
- There are **looming pressures** with deployment, as newer managers seek out a first deal and some larger managers are pushed to deploy billions raised and sitting idly as unproductive capital. In this context, it is vital to run big origination teams, able to sustain a high-quality pipeline. At the same time, there are more instances of deals closing at skinnier margins, not appropriately reflecting project risk, committing those investors to lower returns and higher risks. In our view, the key to success is **disciplined deployment at appropriate margins**.

There is a highly specialised and refined skillset that helps managers mitigate risk in this market segment and this phase of the cycle. This creates clear barriers to entry for sub-scale players in private credit.

Key ways to mitigate CRED market risks (or the essential components of a good private credit platform)	
Sourcing	- With more capital, a deeper pipeline becomes vital. - Local origination teams are needed for each city. - Strong repeat borrowers are gold in this market.
Quantity Surveyors	- Critical to oversee builders to get cost transparency. - More important during times of cost uncertainty. - Adds value to builders / borrowers via cost savings.
Valuers	- Book values are not always at market-clearing prices. - Especially vital during periods of falling asset values. - This is an essential cross-check of external valuations.
Research	- Global intelligence from offshore credit markets. - Local insights into specific property markets. - Identify potential macro risks to market valuations.
Partners & Investors	- Institutional capital tends to be more sticky over time. - Good external validation of investment strategy. - Big backers provide invaluable intel on global markets.

Source: MaxCap Group (October 2024).

Additional Information

Senior Lender of the Year, Asia Pacific

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Private Debt Investor AWARDS 2023

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