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**Haley Devine**
director, wealth management
MaxCap Group

# Understanding the opportunity

## Why commercial real estate debt is having its moment

The growth of Australia's private debt market in recent years is nothing short of remarkable, with conservative estimates suggesting it now sits at about $205 billion in assets under management. Of this, about $85 billion is allocated to commercial real estate-related loans, according to analysis by Alvarez & Marsal.

But it is still very much in its infancy – Australia's private debt market pales in comparison to that of the US and Europe. For this reason, it – particularly the commercial real estate debt market – shows great promise; the asset class is currently clocking an average annual growth rate in excess of 20%.

As we know, much of this exponential growth is being driven by regulatory reform, after the big banks scaled back their lending, opening up the space to non-bank lenders.

But there are other tailwinds at play, too – tailwinds that, alongside other structural themes in the broader real estate sector, will be here to stay for some time.

"More tailored, flexible lending solutions compared to bank loans is also important for real estate borrowers with specific requirements," according to MaxCap Group director – wealth management Haley Devine.

"Private markets also offer investors higher rates of return, so that illiquidity premium."

MaxCap Group, which is in a joint venture with alternatives giant Apollo, estimates the size of the commercial real estate debt (CRED) opportunity to be in the realm of $490 billion, largely covered by the banks but with the non-bank portion rapidly growing.

Essentially a fixed income investment, CRED opportunities come with a defined term and rate of return. But the actual quality of these investments hinges on three key factors, Devine says.

The first is the underlying commercial real estate, which can range from residential properties to industrial assets, offices, mixed use developments, and non-discretionary retail.

Secondly, the borrower's profile is also important.

"This includes their experience, financial strength, conduct and capability," Devine explains.

Finally, the third factor is the investment manager's expertise.

"This relates to their ability to source top tier lending opportunities and effectively identify and mitigate risks before starting the investing or lending program, and managing these for the duration of the loan," she says.

Many investors tend to favour first mortgage positions, Devine says, because they act as the bank and hold the strongest security, representing the senior part of the capital stack with the lowest risk. For those interested in taking on more risk in the hopes of achieving higher returns, mezzanine or junior debt investments fulfil this need.

In terms of what makes for a well-structured loan, Devine says it's one that's designed with a whole to maturity approach, fit for purpose in both current and future market conditions.

As for where to allocate, Devine recommends looking for established, mature managers that can meet the strong transparency requirements of the world's sovereign and pension investors.

Investors should focus on track record, scale and capacity management of a private credit manager, she says.

"Select experienced managers who can effectively navigate various economic conditions and manage risks," Devine says.

An exposure to CRED can benefit a portfolio in several ways, including through enhanced returns, providing downside protection, and reducing the portfolio's volatility overall. It can also increase risk-adjusted returns and has a negative correlation to listed equities.

"These characteristics make CRED a powerful tool for portfolio enhancement and risk management," Devine points out.

And the Australian market is particularly favourable, due to the strong macroeconomic fundamentals, the structure of our banking sector, and regulatory intervention, she adds.

"This allows investors to achieve outsized returns, relative to the risk taken," she says.

MaxCap Group has been active in the space for 18 years and has $7 billion in assets under management. MaxCap Group has recently launched its flagship debt fund, the MaxCap Investment Trust.

The fund has an evergreen structure, providing ongoing exposure to diversified pools of CRED with regular liquidity. It aims to provide low volatility and an inflation hedge, which is of great important to investors in the current environment, making it attractive for those investors looking for consistent returns and robust growth potential, Devine says.

It has two product options, catering to investors across the risk and return spectrum – First Mortgage and High Yield products.

The First Mortgage product aims to deliver returns of 9.1% or 5% above the cash rate of 4.1%. Meanwhile High Yield aims to deliver 12.1% or 8% above the cash rate.

Devine says the fund also follows strict guidelines on geography, sponsors and loan types, to manage market conditions effectively. Investors also have access to regular liquidity on an ongoing basis with monthly distributions and monthly applications and redemptions.

**The quote**

*... CRED [is] a powerful tool for portfolio enhancement and risk management.*

In terms of sectors, MaxCap Group has a significant tilt towards residential, with retail opportunities also taking up a sizeable chunk of the portfolio. These assets are primarily located in Victoria, New South Wales, and Queensland. As for what the loans are funding, it's largely site acquisitions and construction.

As at 31 December 2024, the First Mortgage offering achieved a net return since inception of 11.73%, while the High Yield product achieved 12.28%, with both options outperforming the target.

This, despite Australia's real estate markets having famously faced significant headwinds since 2020, some of which still linger today – supply chain disruptions, higher inflation and elevated interest rates.

However, according to recent research from MaxCap Group, there are many emerging themes that indicate the sector may be turning the corner.

For instance, for the residential sector, MaxCap says there is "a better alignment of market drivers, including sustained income growth, buoyant of market drivers, including sustained income growth, activity and lower mortgage rates." All this amounts to the potential for a sustained pricing growth.

With growing confidence of a turning point, MaxCap Group says investors would do well to prepare and position their portfolios for the upswing; sector selection is key.

In terms of leaders, MaxCap says to keep an eye on the living and logistics sectors, as there's still considerable momentum driven by greater credit availability.

When it comes to laggards, the group expects the turnaround in the office space to lag that of other sectors and other parts of the world.

And somewhere in the middle, MaxCap says, will be some of the retail segments which are currently showing relative value, but underlying sales performance is being hampered by high mortgage rates. Given mortgage rates may well fall throughout the year, a bigger recovery is possible. **FS**