FROM LITTLE THINGS, BIG THINGS GROW

THE CASE FOR AUSTRALIAN PRIVATE CREDIT

The Sweet Spot in APAC Investment Strategies

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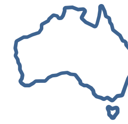
KEY TAKEOUTS:

Australian private real estate credit is now **Australia's number ONE investment class** by annual investment volume

The size of the Australian private real estate credit is forecast to **grow to $154 billion per annum by 2034** – creating a $100bn liquidity shortfall as banks withdraw



Australia represents **35% of the APAC Private RE Credit Market,** making it a core component of a regional portfolio

"Higher for longer" is forcing investors away from beta strategies, to higher performing asset classes like **private credit**

Australian private credit strategies offer solid returns, with **greater downside protection** due to strong economic fundamentals and securitisation

SETTING THE SCENE

SINGER SONG WRITER PAUL KELLY'S TIMELESS "FROM LITTLE THINGS, BIG THINGS GROW" NEATLY SUMS UP THE CURRENT DIRECTION OF THE AUSTRALIAN PRIVATE CREDIT MARKET.

Australian real estate private credit is benefitting from long term structural tailwinds supported by strong domestic economic fundamentals and the ongoing withdrawal of major banks from the commercial real estate lending market. This perfect storm is converging to create an estimated $100 billion liquidity gap over the next decade.

The coming liquidity chasm is occurring at a time when the Australian economy is rotating out of a period of low interest rates, and steady economic growth, into a new era of greater volatility and higher interest rates.

Against a "higher for longer" economic backdrop, incorporating private credit strategies into a diversified portfolio will be critical. Real estate private credit is especially compelling, as it offers higher, risk adjusted returns compared to equity, shorter investment tenure and access to cashflow yield through the holding period.

Our fundamental belief as a house is that growing shortfall in credit liquidity, and the ongoing resilience of the Australian real estate market, will create a positive demand/supply dynamic that will deliver higher overall returns than equity investments in the near to medium term. Reliable and experienced lenders, that actively manage their loan books, will generate a significant investment edge from this environment over the near to medium term.

AUSTRALIA'S FUNDAMENTALS ARE UNIQUELY ALIGNED TO SUPPORT REAL ESTATE PRIVATE CREDIT

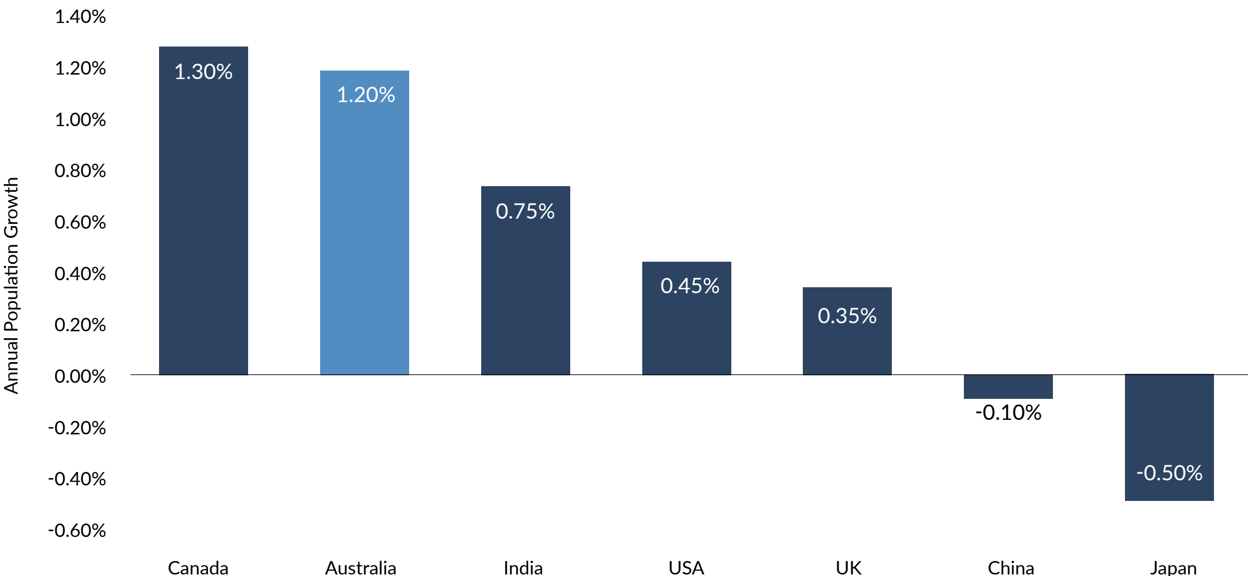
As a higher for longer interest rate environment persists globally, economies with strong underlying fundamentals like high population growth, deep investment markets and well regulated, tax efficient investment structures will stand out for their ability to deliver stronger risk adjusted returns through all cycles.

Australia has a long and distinguished track record of delivering long stable economic growth, a resilient real estate market and a transparent investment environment that is supportive of inbound capital.

The Australian private credit market offers lenders a high degree of structural protections, which explains the relative resilience of this asset class through historical downturns. The returns on offer in Australian private credit are not available in every developed investment market right now. The unique tailwinds driving investment return globally do not land consistently or at the same time in every market. However, Australia now stands out for its performance, showing strong risk adjusted returns, relative to the US and Europe. Some of the core drivers of this success are outlined below in more detail:

Solid and diversified macro drivers: Australia offers investors a stable and growing economy, with resilient real estate markets. This is underpinned by robust population growth, a deep, transparent investment market with best-in-class property rights and a demographic strength attracting a global pool of young, highly educated talent via targeted, growth focused migration policies. According to the IMF, Australia's population is forecast to grow an average rate of 1.2% per annum over the next five years, which will drive sustained long term demand for housing, and support consumer growing spending and employment as the population ages.

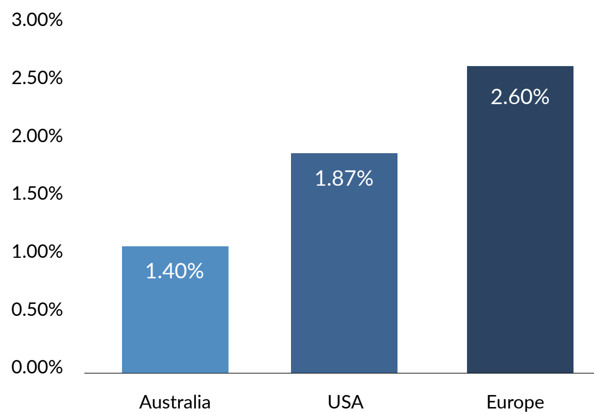
FORECAST ANNUAL POPULATION GROWTH BY COUNTRY 2024-2028



Source: IMF, RW Capital

Unique lending market features: Australian real estate debt is full recourse, unlike the non-recourse loans that are more typically seen in the USA. Australian lenders can call on other borrower collateral such as assets, cash holdings and other securities in the event of a credit default. Unlike the US private debt market, borrowers cannot simply walk away from their debt obligations when their equity is extinguished by falling valuations, avoiding messy, expensive and time consuming litigation.

Q1 2024 MORTGAGE DELINQUENCY RATE

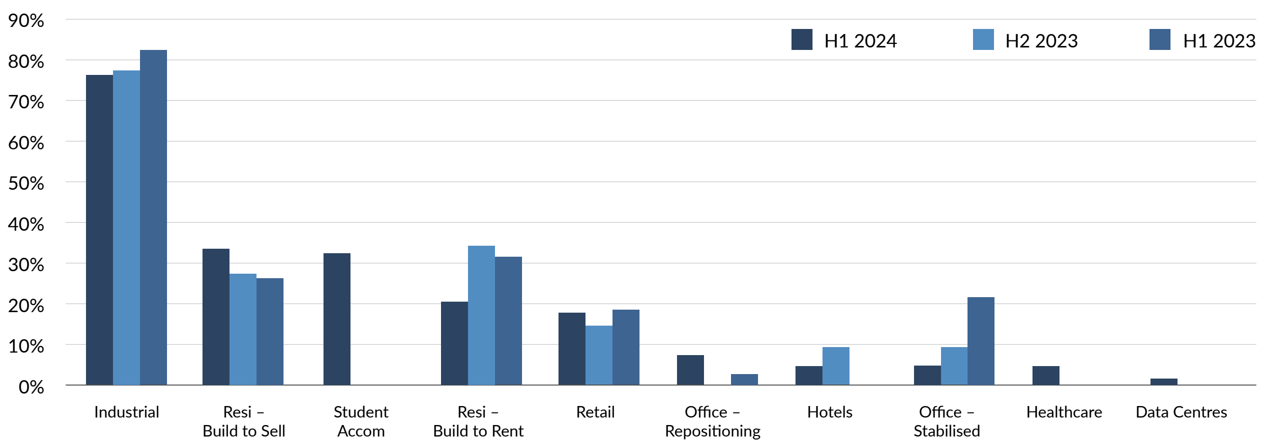


Greater emphasis on risk management: There is no such thing as a vanilla, "set and forget" real estate loan. Australian real estate loans require greater security than their international peers. To access debt financing, borrowers need to demonstrate market traction such as pre-sales of apartments in a residential development, or pre-leasing commitments in a commercial development. Other risk mitigants can include bank guarantees, directors or personal guarantees and other equity assets. In Australia it is very uncommon to see speculative developments financed at high 60% plus LVRs. The quality of the lender is also critical to risk management, with lenders who have a higher participation in the deals through active asset management, seeing better overall returns and lower default rates.

	Australia	USA	Europe
Market Share of Non Bank Lenders %	10%	60%	52%
Loan Structures	LTV 65%-85%	LTV 70%-90%	LTV 40%-80%
Loan Recourse	Full recourse	Partial or no recourse	Full recourse to borrower
Pre-sale Coverage	40%-100% residential pre-sale	No minimum residential pre-sales	No minimum residential pre-sales
Loan Recovery	Enforcement does not require court judgement	Long process can be legally disputed	Enforcement does not require court judgement

Favourable private debt market thematics: Driven by strong demand fundamentals, and resilient pricing, lenders continue to favor the industrial sector out of all the major commercial asset classes. However, there has been strong underlying demand in the living sectors including build to sell and build to rent apartments. Counter cyclical strategies in the office sector are anticipated to drive increased lender interest in the sector over the medium term, as they attempt to time the upswing in the demand cycle for office space, resulting in higher valuations. Despite cyclical headwinds for the major commercial sectors, the rerating of valuations closer to longer term trend yields will ultimately be a benefit for the sector. Australian real estate has proven resilient through multiple downturns over the past forty years, and that looks set to continue as valuations and management pivot to the new hum of this cycle.

LENDER PREFERRED ASSET CLASS FOR NEW INVESTMENT



Source: CBRE Australia Lender Sentiment Survey, May 2024

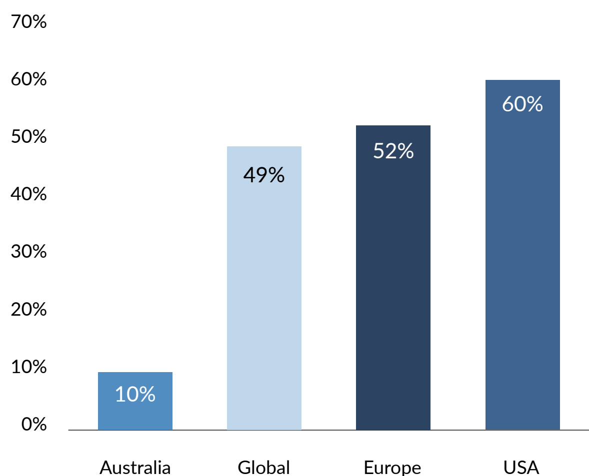
Enhanced downside protection: Australia's real estate markets have shown remarkable resilience over the last 40 years. The deep institutional nature of ownership, transparent and consistent regulations and strong underlying growth drivers have all contributed to a an average total return of 9.7% since 1985. This resilience has underpinned the private credit market to a significant extent, with less volatility and less capital depreciation than other markets such as the US.

Australian real estate provides greater downside protection for investors than the US or Europe. According to MSCI, the average downturn in Australian capital valuations since 1990 saw capital values fall by a maximum range of 10% to 13%, compared to 25%+ observed recently in the US real estate market, which when compared against the average LTV of 65%, shows significant downside protection for lenders. On a typical commercial real estate loan with a 65% LVR, taking into account the deepest recorded drops in capital value, Australia had the highest downside protection versus the US and EU with valuations only falling 13%, against equity security of 35%. Based on historical valuation movements, Australia also looks favourable for higher risk debt strategies that take effective LVRs up to 80% or 90%, and have full recourse or equity conversion rights.

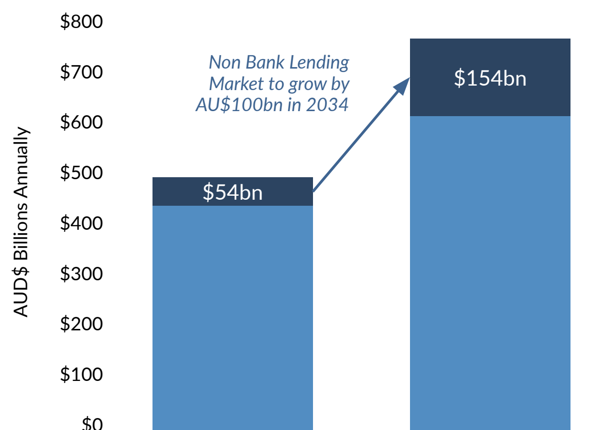
WHAT IS DRIVING THE GROWTH IN AUSTRALIAN PRIVATE REAL ESTATE CREDIT?

The Australian real estate lending market remains heavily dominated by the major Australian and foreign banks, which account for almost 90% of the national loan book. This contrasts sharply against the global average of 49% market share for non-bank lenders, which rises to over 60% in the USA.

ALTERNATIVE LENDER MARKET SHARE BY REGION (%)



FORECAST LONG TERM GROWTH IN NON BANK LENDING

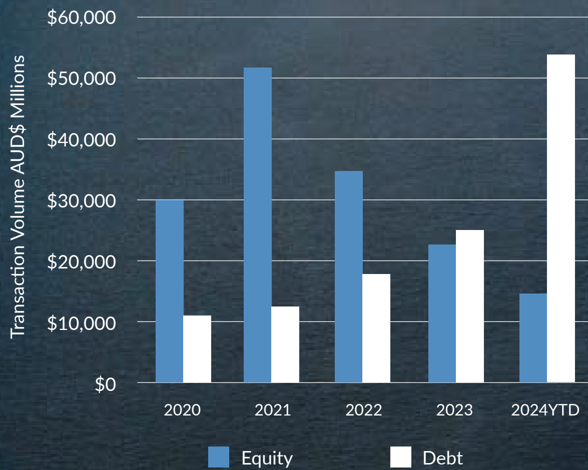


The apparent undersupply of privately sourced credit in Australia, versus the globe, points to a significant long term growth opportunity for the sector. As major banks withdraw from the lending market, this will open up a major liquidity gap in the commercial real estate loan market. Based on the current loan market size of $480 billion, for every 1% of major bank loans that shift to the private credit markets, $5 billion of liquidity needs to be generated in order to plug the gap. Based on our forecasts we anticipate that the commercial mortgage market will grow at a conservative CAGR of 5% per annum. As this market grows, and as the market share of non-bank lenders grows from 10% today to 20% in a decade, the private lending market would need to find an additional $100 billion in private liquidity to meet loan demand.

The recent pricing dislocation in real estate equity markets is driving investment into the sector to record lows, with only $23 billion in gross sales in 2023, down from a peak of $53 billion in 2021 and well below the 10 year average of $35 billion. For the first time since domestic investment sales were tracked, private credit allocations overtook equity investments in Australia. With $25 billion allocated in 2023, and $54 billion allocated year to date in 2024. We are forecasting the size of the non-bank real estate book to reach over $154 billion by 2034.

FOR THE FIRST TIME SINCE DOMESTIC INVESTMENT SALES WERE TRACKED, PRIVATE CREDIT ALLOCATIONS OVERTOOK EQUITY INVESTMENTS IN AUSTRALIA.

DEBT TRANSACTION VOLUMES OVERTAKE EQUITY



Source: Real Capital Analytics, RBA

Non-bank lending has seen remarkable growth in Australia, particularly in the real estate sector. The rise of these lenders can be attributed to several factors:

1 HIGHER FOR LONGER:

The zero rate, lower inflation era is officially over. As central banks battle persistently elevated inflation with higher interest rates, public markets are pricing in rates being higher for longer. In such an environment, this rules out passive, beta focused strategies and a keener focus by investors on alpha led strategies.

2 REGULATORY CHANGES:

In the wake of the global financial crisis, Australian regulators imposed stricter capital requirements and lending standards on traditional banks. These measures were designed to enhance the stability of the banking system but also limited the banks' ability to extend credit, especially to riskier borrowers. Non-bank lenders, not subject to the same stringent regulations, seized this opportunity to expand their market share.

3 MARKET DEMAND:

There is a robust demand for real estate financing in Australia, driven by both residential and commercial property markets. Non-bank lenders have been able to cater to borrowers who may not meet the rigid criteria of traditional banks, providing flexible and tailored lending solutions.

4 INVESTOR INTEREST:

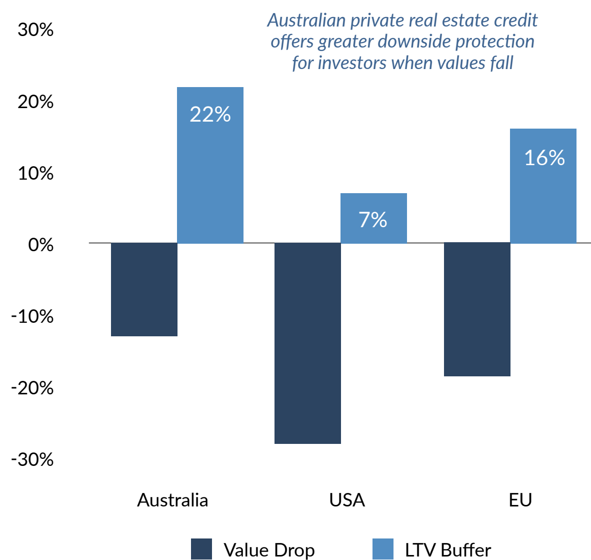
The low-interest-rate environment has pushed investors to seek higher yields, and non-bank lending in real estate offers attractive returns compared to other fixed-income investments. The relatively high yields, coupled with the backing of tangible assets, make non-bank lending an appealing option for income-focused investors.

5 PRIVATE CREDIT AS A HEDGE:

Investors are seeking a hedge against global volatility with inflation and downside risk adjusted returns. Equity investments in Australian commercial real estate still represent over 85% of all capital deployed, however as returns decline and volatility rises in equity markets, private credit as a hedge against investment loss looks comparatively more attractive at this point in the cycle, and beyond.

Real estate private credit is gaining a larger market share of investment capital as investors seek a defensive source of yield and look to diversify away from real estate equity, while achieving strong, consistent, risk-adjusted returns that are secured, and have strong downside protection features. The defensive nature of private debt in the overall real estate capital stack offers enhanced safety, while the floating rate nature of returns provides a positive hedge against inflation.

ANALYSIS OF A DOWNTURN: AUSTRALIAN PRIVATE RE CREDIT OFFERS GREATER DOWNSIDE PROTECTION

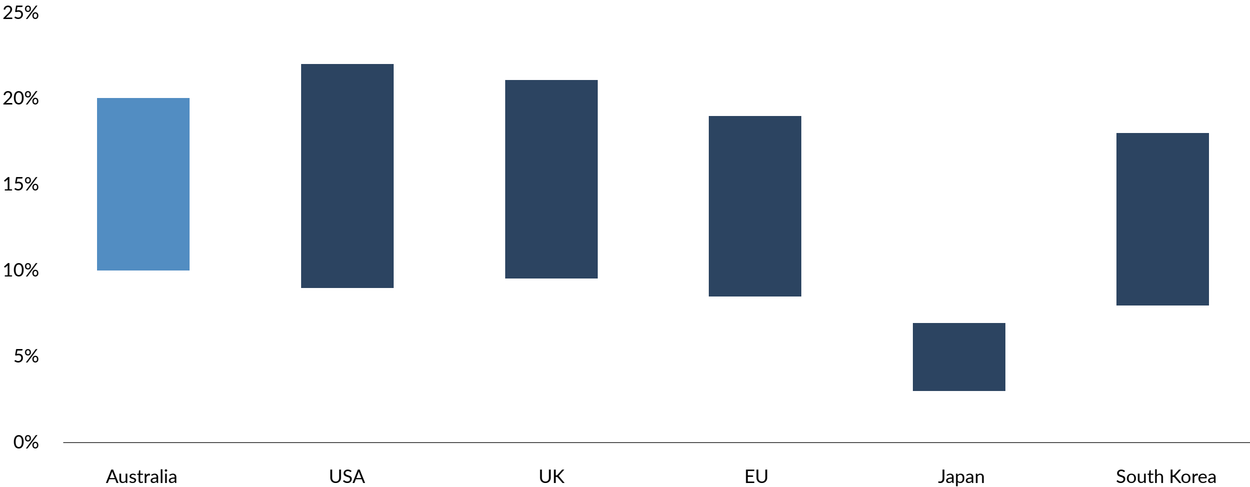


Source: MSCI, RW Capital, Assumption is an average LTV of 65%

HOW DOES AUSTRALIAN PRIVATE REAL ESTATE CREDIT COMPARE GLOBALLY FOR PERFORMANCE?

ON A LIKE FOR LIKE PRODUCT BASIS, WE ANALYSED PRIVATE REAL ESTATE CREDIT TOTAL RETURNS ACROSS MAJOR MARKETS, AND WE ASSUMED NO BACK LEVERAGE ON THESE DEALS (GEARED LENDING) TO GET A PURE LOOK THROUGH AND GAUGE THE TRUE RETURN ON CAPITAL.

PRIVATE RE CREDIT ANNUAL RETURN RANGE BY MARKET AS AT Q1 2024



Source: Cliffwater, DWS, JLL, RBA, RW Capital

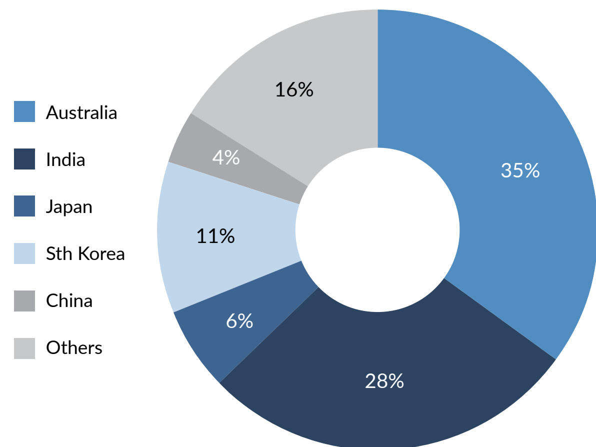
The international return profile tells an interesting story around the synchronicity of the major developed markets, particularly between Australia and Europe. This is unsurprising given the comparatively similar regulatory environment of both markets. However the rumors of an EU rate cut may create greater divergence in return profiles in the coming 12 months.

The US is showing strong returns, reflective of its deep market and accessibility to deal flow. However, the underlying fundamentals paint a weaker, riskier picture as the impact of rapidly falling commercial real estate values increase systemic risk for the non-bank sector due to its no recourse regulations, resulting in protracted litigation and uncertainty. In our view this will result in many debt deals today, converting to equity in the future, leaving lenders holding distressed, underperforming assets. According to analysis by MSCI, there is an upcoming wave of commercial real estate refinancings in 2025-26, which will test valuations and loan pricing in an already increasingly distressed lending environment.

Considering hedging costs, risk adjusted private credit returns for Australia and the other developed APAC economies look healthy averaging 10%+ for senior credit. Higher returns can be found further up the risk curve in junior and special situations where market evidence suggests returns of 20%+ are available in the near term (circa 12 to 18 months).

APAC VS COUNTRY SPECIFIC STRATEGIES

APAC Market Share:
Size of RE Private Debt Market by Country



Source: RW Capital, Preqin

Allocating capital to regions requires a deeper look through to the market opportunity, as each country within that region offers different degrees of depth, risk and sophistication. In the Asian Pacific region, which is home to more than 60% of the world's population, only 10% of global capital for real estate private credit is allocated to this region according to MSCI.

There are several reasons for the mismatch between market size and capital. Firstly many of the economies in this region are still classified as 'developing', they lack prudent regulatory frameworks and a deep, sophisticated talent pool of skilled investment professionals that more developed economies can offer. Another factor is market depth and the size of the investible universe. Deep investment grade real estate markets are more uncommon than not, especially in APAC. Many of the larger markets in Asia Pacific only offer a small number of entry points for investors, looking for higher quality investment grade real estate products, with the larger population markets having a high degree of government involvement or opaque private ownership, with limited rights or protections for investors.

The Asia Pacific private real estate credit market, whilst small compared to the more established markets such as the US and Europe, still offers compelling investment opportunities. In a regional strategy, it is critical that you drill down to the market level fundamentals and consider factors such as transparency, macro-economic conditions, regulations, downside protection and how they all ultimately translate into a return.

Despite being a large market in terms of relative population and size, there are actually very limited allocation opportunities in Asia Pacific. Markets that have best in class regulations, transparency and an appropriate degree of investment grade market size and depth are limited to Australia, Japan, South Korea. Singapore and Hong Kong have potential opportunities, however their smaller size, and relatively illiquid investment markets make it harder to access investments there. China and India whilst very sizable, and fast growing, have regulatory and governance issues creating an opaquer investing environment, increasing risk with limited downside protections for investors.

In line with the global tailwinds propelling private real estate credit, Asian Pacific markets are also seeing a rapid growth in market share of the non-bank lending sector, and rising risk adjusted returns. Longer term, as the share of lending grows for non-bank lenders in real estate in APAC, so too will the maturity of the sector and in doing so widen the available opportunity set for investors. Australia is one of the largest markets for private real estate credit in Asia Pacific, and will need to be a significant component of any APAC focused strategy, due to its depth, safe regulatory environment and support macroeconomic fundamentals.

THE ASIA PACIFIC PRIVATE REAL ESTATE CREDIT MARKET, WHILST SMALL COMPARED TO THE MORE ESTABLISHED MARKETS SUCH AS THE US AND EUROPE, STILL OFFERS COMPELLING INVESTMENT OPPORTUNITIES.

RISK-REWARD PROFILE OF AUSTRALIAN REAL ESTATE PRIVATE CREDIT

LIKE ANY INVESTMENT, NON-BANK LENDING IN REAL ESTATE CARRIES RISKS. HOWEVER, THE POTENTIAL REWARDS OFTEN JUSTIFY THE RISKS FOR INFORMED INVESTORS.

Australia has many unique advantages that assist de-risking the overall investment, including one of the world's lowest default and mortgage delinquency rates. However, there are also risks in the underlying deals, and the way they are structured that can on first appearance look low, but when you dig deeper can expose investors to large and unnecessary downside risks.

1 CREDIT RISK:

The primary risk in non-bank lending is credit risk—the possibility that borrowers may default on their loans. Non-bank lenders often lend to higher-risk borrowers who may not qualify for traditional bank loans, increasing the likelihood of defaults. However, this risk is mitigated by the security provided by the underlying real estate.

2 MARKET RISK:

The performance of non-bank lending investments is tied to the health of the real estate market. Economic downturns, changes in property values, and fluctuations in interest rates can impact the market and affect loan performance. Diversification and prudent risk management can help mitigate these risks.

3 REGULATORY RISK:

Changes in regulations or government policies can impact the non-bank lending sector. While current regulations provide a favourable environment for non-bank lenders, any tightening of regulations could affect their operations and profitability. Staying informed about regulatory developments and adapting to changes is crucial for managing this risk. A relevant example is the upcoming changes to bank capital requirements in Basel III, which will drive banks towards lower risk lending product, and accelerate the liquidity gap. In Australia this will be more impactful, as domestic and offshore banks account for almost 90% of all commercial real estate loans.

4 LIQUIDITY RISK:

Non-bank lending investments are typically less liquid than publicly traded securities. Investors may face challenges in quickly converting their investments to cash without significant losses. However, the relatively high returns offered by non-bank lending can compensate for this lack of liquidity.

5 OPERATIONAL RISK:

Non-bank lenders may face operational risks, including issues related to loan origination, servicing, and collection. Robust operational processes, effective management, and strong governance can mitigate these risks. The experience of the debt manager, and how actively the manage their loan books is critical when assessing funds for risk management.

6 CONSTRUCTION RISK:

One of the starkest challenges facing Australian developers is construction cost control. Inflation impacts on construction pricing have risen sharply in the past five years, with many builders unable to commit to fixed price contracts, resulting in reduced developer margins.

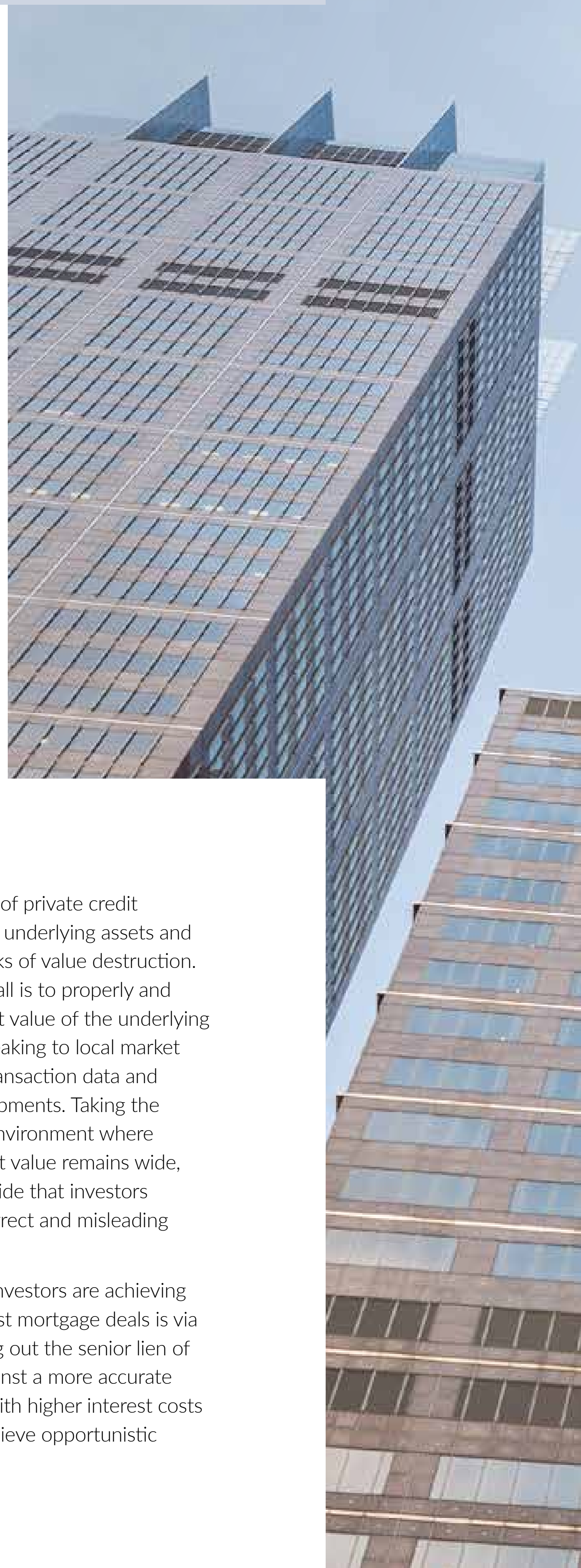
7 BACK LEVERAGE:

Many US private credit funds operate with a high degree of what is called "back leverage". In essence they are borrowing funds from a warehousing facility and those funds are invested alongside their equity to create excess return. This can definitely magnify the returns on offer, however it also increases the downside risk and exposes investors with fewer protections should the underlying loan they are investing in defaults.

8 OPEN ENDED VERSUS CLOSED END FUNDS:

In Australia a significant number of real estate private credit funds offer investors an open-ended structure. Open-ended funds typically offer investors liquidity via seemingly simple and frequent redemption policies that can occur every month or quarter. Whilst this can be appealing to investors initially, the liquidity offered through daily unit pricing can lead to increased fund volatility, as fund managers are sometimes forced to sell assets to fund redemptions or take on significant back leverage which dilutes returns and increases risks of equity destruction. In some cases, closed end funds will free redemptions if there is significant withdrawal from the fund. Closed ended funds offer a greater degree of control and certainty to investors, and in the case of real estate debt achieve a degree of liquidity as loans mature and repayments are made.

MANAGING INVESTMENT RISKS IN AUSTRALIAN PRIVATE CREDIT



ONE OF THE GREATEST CHALLENGES FACING AUSTRALIAN COMMERCIAL REAL ESTATE, AT THIS POINT IN THE CYCLE, IS DETERMINING ITS TRUE VALUATION.

The spread between independent book valuations and market prices remains wide, making it hard for owners of assets to accurately price their assets against market prices, a process commonly known as “marking to market”.

At the time of writing, Australian REITs are trading at an average discount to their book value of 20%, implying further discounting to come or that listed market investors don’t believe their book values, which in some cases is warranted. In some recent case studies of office assets trading in Sydney, they traded at between 17-22% below their peak book valuation, and 9-14% below their most recent valuation.

The key take out from this is that the look through on valuations remains very unclear, potentially exposing investors to elevated, hidden risks in the underlying assets.

Unsurprisingly, the growing spread between market and book valuations has significant implications for debt investments too. Risk is typically gauged by the LVR of a particular deal, with the equity of the vendor providing a buffer for the lender to have recourse in the event the asset or project fails to materialise its full end value.

FROM OUR RECENT TRANSACTION EXPERIENCE, WE HAVE LEARNED THAT LOWER RETURNS DO NOT NECESSARILY EQUATE WITH LOWER RISK.

We are seeing an increasing number of private credit operators mispricing the value of the underlying assets and exposing their investors to higher risks of value destruction. One of the ways of avoiding this pitfall is to properly and independently assess the true market value of the underlying assets. This can be done through speaking to local market experts, looking at a deeper set of transaction data and clearance rates on apartment developments. Taking the valuation at face value alone, in an environment where the spread between book and market value remains wide, is fraught with risk and limits the upside that investors can make on each deal through incorrect and misleading deal pricing.

One of the ways that private credit investors are achieving higher credit returns in senior and first mortgage deals is via restructuring existing loans. By taking out the senior lien of the capital stack, at a higher LVR against a more accurate valuation, adjusting the loan terms with higher interest costs and principal on exit, lenders can achieve opportunistic returns, with greater security.

2023 SENIOR FIRST MORTGAGE DEBT RESTRUCTURE CASE STUDY

In 2023 RW Capital was approached by two lenders and a developer who were looking to restructure their debt arrangements across three projects in Sydney and Melbourne. These loans were originated in 2020, when debt market conditions were generally more stable, and there was more debt liquidity available for large land subdivision projects. The funding facility had been exhausted based on the earlier, existing loan assumptions and required increased funding to enable project completion, to sell down the land lots and achieve repayment of the facility.

RW Capital managed the restructure, bringing multiple parties together and stapling the different loans into one, cross-collateralised facility. Pricing of this facility was increased, reflecting market conditions in 2023 which showed elevated housing market risk and greater volatility in the debt market. During the due diligence process, we prioritised analysing and getting a clearer picture on the quality of the underlying assets and formed the view that despite it being a challenging market, the fundamentals were good but that the loan pricing needed to be adjusted.

RW Capital utilises its deep links and long history of association with the Ray White Group to access market leading intelligence to form a clearer view on market pricing, transaction volumes and other underlying drivers of the economics that these land subdivisions sat within. Our exit strategy was formed early and gave us a clear pathway to realising a our target return. We continuously and actively managed the borrower and their team to repayment timeframes were met. **The result of all this, was that through our restructuring process, we were able to lift the gross IRR on this project to 20%+ with no back leverage.**

THE PRIVATE CREDIT RETURN SPECTRUM – WHERE IS THE PRIVATE CREDIT SWEET SPOT?

	Banks (90% Market Share)	*Alternative Lenders (10% Market Share)*			
	Banks	**RW Capital**	**Domestic Non-Bank Lenders**	**Offshore Credit Funds**	**Distressed/Hedge Funds**
Target LVR[2]	<50%	55-75%	55-65%	55-75%	Flexible
Target Return	6-8% p.a.	12-20%+ p.a.	8-10% p.a.	8-15%+ p.a.	15-20%+ p.a.
Ticket size	$10m-1bn+	$10m-500m+	Up to $1bn+	$10m-1bn+	$10m-1bn+
Focus	First mortgage/ senior loans for core assets	Flexible capital with bespoke structuring	First mortgage and mezzanine loans	First mortgage and mezzanine loans	Distressed/ special situations deals

Looking across the multitude of private credit opportunities on offer, Australian real estate debt ranks highly for both return and security. However, not all real estate private credit products offer equal risk and return, with traditional "core" senior debt in most cases delivering a slim risk premium versus more opportunistic products.

Our thesis is quite simple – in an investing environment with elevated real estate valuation risk, private lenders should price that risk more appropriately and be more selective in their allocations. This is where high volume "core" senior strategies in real estate credit are creating higher risks for their investors. In some recent cases refinancings of these debt deals are being done at discounts to their original value and pricing. This is occurring because the underlying assets are not being properly assessed for execution and pricing risk, resulting in inaccurate deal pricing and distressed exits.

The sweet spot for real estate debt in the near to medium term is accessing senior debt opportunities, with full capitalisation or as we call it "bridge asset finance to stabilisation". This can take the form of a refinancing of an existing project that is close to completion, and backfilling a former lender, but taking the senior position to ensure there is minimal downside risk. We are also seeing increased demand for junior and special situations deals which are often shorter term, and higher yielding. Having a risk adjusted spread across senior, junior and special situations offers diversification benefits and improves the overall return performance of your private credit portfolio.

Difficult to access

Private Equity

RWC Realised Gross Jnr Debt Returns
★
26%

Special Situations

Property Debt

Target Returns
Peer A Peer B Peer C

RECF II Target Return
★
14%

RWC Realised Gross Snr Debt Returns
★
18%

Property –Non-Bank

Senior

Stretch Snr/Mezz

Property – Bank

Investment | Development

Other Private Debt

Infrastructure Debt

Corporate Direct Lending

Senior | Mezzanine

Public Markets

High-Yield Bonds

AU Index:
7.9%

Investment Grade Bonds

AU Index:
5.2%

Easy to access

4% 6% 8% 10% 12% 14% 16% 18% 20%

Estimated Net Return (Indicative)

LOWER VOLATILITY AND HIGHER RETURNS: HOW DOES PRIVATE CREDIT ENHANCE PORTFOLIO RETURNS?

LOW CORRELATION TO OTHER ASSET CLASSES

Private credit historical returns has a low correlation to other asset classes, driven by cyclical shifts

LOWER VOLATILITY

Returns are contractually agreed so generally less volatile for performing assets than equities

ROBUST FUNDAMENTALS

Private markets enable a fundamentals-first mindset, focusing on borrower quality, collateral strength and the likelihood of being repaid as a lender, rather than influenced by sentiment-driven momentum trades

REGULAR AND STABLE INCOME

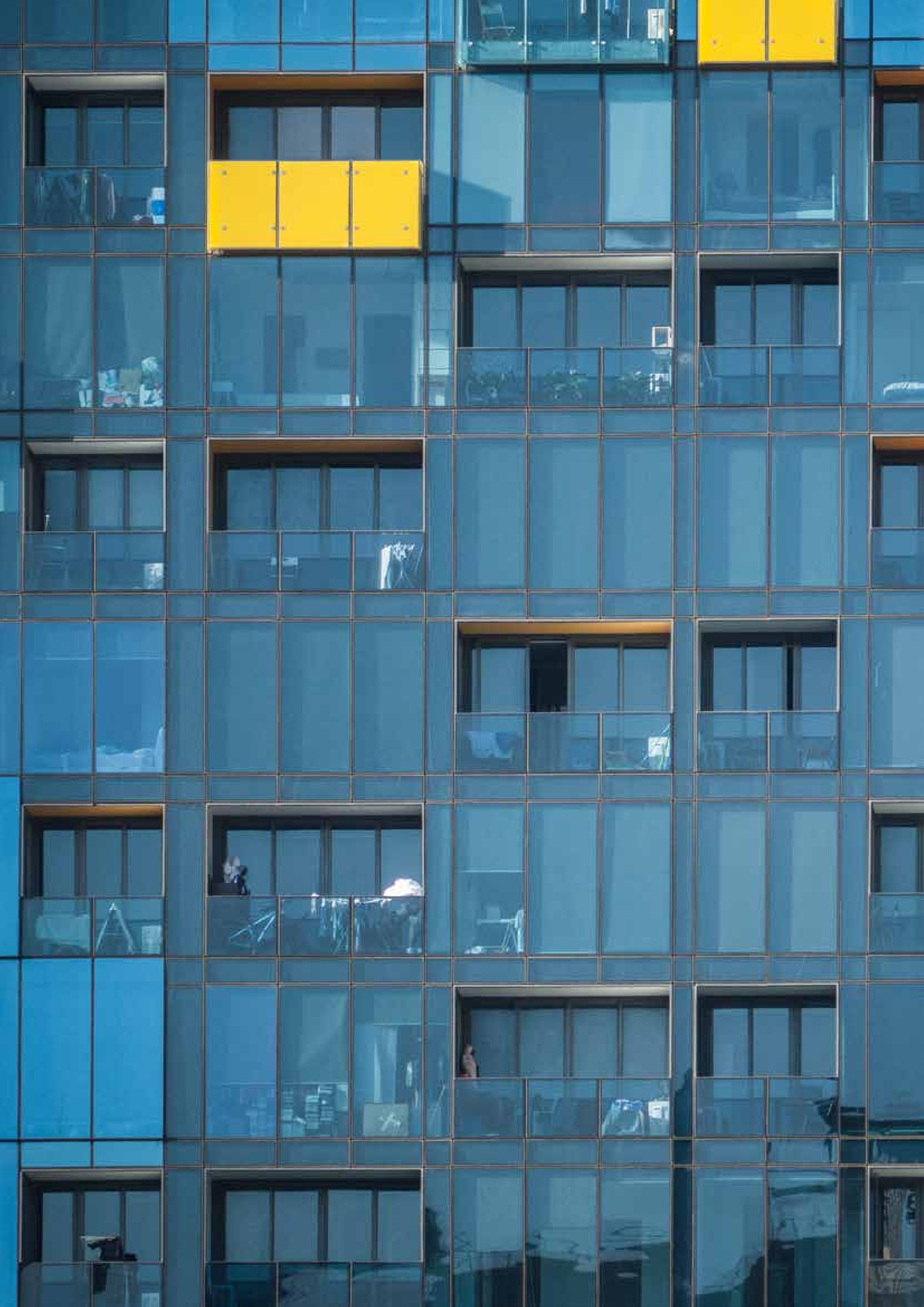
Potential for regular and predictable income secured via contractual borrower agreements

DIVERSIFICATION

Highly granular curated portfolios of loans with exposure to a wide variety of borrowers, assets, industries and geographies

STRONG INCOME YIELDS

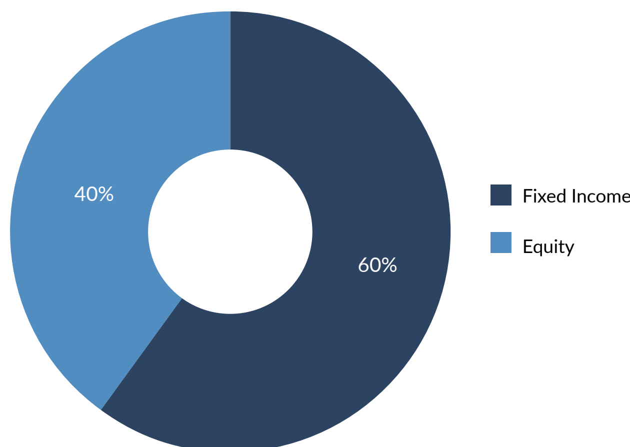
Potential for strong, enhanced yields



WHAT IMPACT DOES PRIVATE REAL ESTATE CREDIT HAVE ON PORTFOLIO PERFORMANCE?

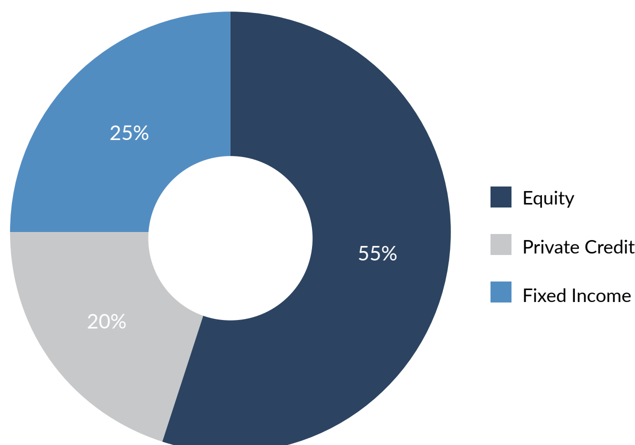
From a performance perspective, portfolios that included private credit saw a higher overall return, with lower volatility over the long term (circa 15 years). In the model portfolio we created, using real historical return inputs, a standard portfolio with a 60% allocation equity and 40% to fixed income achieved a average annual return of 4.7%, with volatility of 12.6%. By contrast, the model portfolio that included private credit, delivered a higher total return of 6.1%, with lower volatility of 11.6%.

REPRESENTATIVE PORTFOLIO



Annualised Return	4.7%
Annualised Volatility	12.6%
Current Yield	2.9%

PORTFOLIO WITH PRIVATE CREDIT



Annualised Return	6.1%
Annualised Volatility	11.6%
Current Yield	4.4%

OUTLOOK FOR PRIVATE REAL ESTATE CREDIT IN AUSTRALIA

THERE ARE STRONG STRUCTURAL TAILWINDS SUPPORTING THE AUSTRALIAN PRIVATE CREDIT MARKET, THAT LOOK SUSTAINED FOR THE MEDIUM TERM TO LONGER TERM.

The continued withdrawal of major banks, the rising demand for capital from a growing number of developers and investors, as equity markets remain tight, will all contribute to strong demand conditions that will ultimately carve out a larger, permanent share of the real estate lending market for the non-bank lenders. Underpinning all this is Australia's strong underlying economic fundamentals and the long-term, proven resilience of the local real estate market.

The major banks currently fund over 90% of the available commercial real estate loan market, but their dominant position is shrinking rapidly. As private lenders step into the fill the void, their role will become more and more vital to the future of real estate development and investment in Australia. One of the key long term risks facing the Australian real estate private credit market is that the gap left by the banks, will not be filled quickly enough by private lenders, resulting in a significant liquidity gap that will stall developments and hold up investment.

Unlike banks, who need to focus on shorter term factors such as depositor liquidity, private credit funds have patient capital, that take a longer-term view on their allocations and risk profiles. Having a longer tenured capital mix in the real estate debt markets will provide more alignment and long-term funding certainty to the sector.

WE FORECAST THAT 20% OF THE REAL ESTATE CREDIT MARKET WILL BE PRIVATELY RUN BY 2030, IF NOT BEFORE.'

But with strong demand growth on the positive side of the ledger, so too comes challenges. When structuring a loan, the exit is as important as the entry. Asset management is critical to the successful delivery and execution of a loan agreement. For example, a senior loan has terms that can stretch out as far as 24 months, placing a greater emphasis on long term asset management to ensure that the borrower meets all of their commitments throughout the loan term. Loan quality, and a true understanding of the LVR, not just accepting a valuer's number at face value, and interrogating the security and repayment strategy of a loan all form critical components of a front-ended exit strategy for real estate loans.

From a returns perspective, the ongoing liquidity gap and sustained higher rate environment will contribute to strong sustained returns for real estate private credit. We anticipate that net IRRs for Australian senior credit in the non-bank sector will continue to range from 10% to 16% (risk dependent) over the near to medium term – 2024-2026.

WHILST THE INTEREST RATE CYCLE IS LIKELY TO SEE SOME CUTS MADE BY THE RESERVE BANK AT THE BACK END OF 2025, CASH RATES WILL REMAIN AT ELEVATED LEVELS FOR THE FORESEEABLE FUTURE WHICH WILL SUPPORT OVERALL HIGHER LENDING RATES FOR THE NEXT DECADE.

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