DRC savills investment management

Australian real estate debt

Opportunities in a growing market

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EXECUTIVE SUMMARY:

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Attractive features of the Australian market include:

Rapid growth and maturity of non-bank lending as the market continues to mature towards the US and European markets.

Conventional lenders likely to remain focused on refinancing existing loans coming up to maturity, resulting in a funding gap where non-bank lenders can take their pick of the best opportunities.

Underwriting of sustainable rental levels is key to protecting income against volatile markets.

Growth in retrofitting opportunities to protect investments against ESG obsolescence.

The headwinds facing the global economy have created a turbulent environment for property investors looking to raise capital. Banks have become more cautious and even seasoned investors with impeccable track records may find it more problematic to raise fresh capital or refinance existing loans.

In this paper on the Australian real estate debt market, we outline why we believe Australia provides an exciting and potentially lucrative market for experienced non-bank lenders who can carefully assess the available opportunities and achieve the optimum risk-adjusted returns.

The retrenchment of the mainstream banks has opened the door for non-bank lenders to step up and help meet demand from this rapidly growing market.

The country's commercial real estate debt market looks as though it will continue its healthy pace of growth as it benefits from the country's rapid post-Covid recovery, inward migration and relatively stable macroeconomic environment.

The commercial real estate market has traditionally been dominated by mainstream banks but is now ripe for non-bank lenders to capture market share and diversify the lender pool.

MAINSTREAM BANKS HUNKER DOWN TO SAFER BETS

The standard response by both domestic and international banks during periods of market uncertainty is to reduce risk. This typically results in their capital being directed towards lower loan-tovalue (LTVs) and better-quality underlying assets and sponsors. Furthermore, banks prefer lending on assets with longer leases in order to reduce vacancy risks. Outside of the industrial sector, average lease lengths have reduced over the last five years and are likely to impact banks' appetite to lend into CRE sector. Therefore, the reduction in CRE market share by ADIs over the last decade, the recent market volatility and subsequent bank retrenchment will provide a greater opportunity to non-bank CRE lenders.

> Over the last decade, non-bank CRE lenders in Australia have increased their market share from 10% to 15%[1].

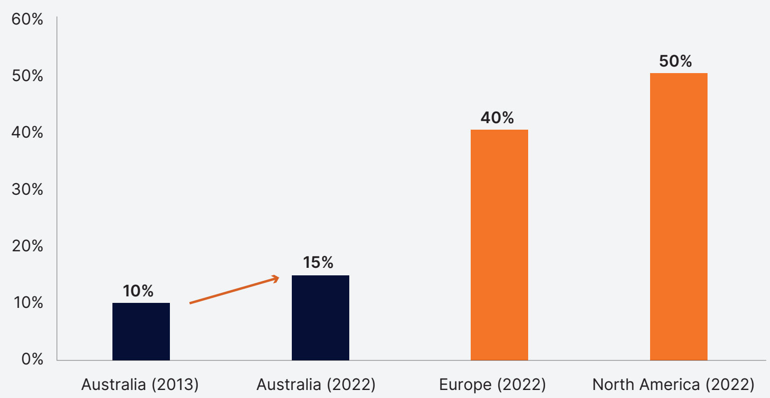
Despite this growth, non-bank CRE lenders' market share in Australia is still below the US and European markets, where non-bank CRE lenders have a market share of circa 50% and 40% respectively.

> Non-bank CRE lenders in Australia are forecast to grow at compound annual growth rate (CAGR)) of circa 17.5%[2] over the next 2-5 years.

At that rate, non-bank CRE lenders will achieve circa 40% market share by 2032. While this seems a dramatic level of growth over the next decade, it is similar to the level of growth experienced by non-bank CRE lenders in Europe, where market share increased from virtually nothing immediately after the GFC, to circa 40% market share by the end of 2022.

FIGURE 1:

Non-bank CRE debt exposure



[1] Source: Estimate based on views from market particpants (February 2023)

THE OPPORTUNITY FOR NON-BANK CRE LENDERS

Non-banks CRE lenders are likely to grow into spaces where traditional lenders have been forced to leave a gap in both acquisition and refinance loans. For example, the majority of banks' annual debt issuance will be absorbed by refinancing existing maturities, so non-bank lenders will have the opportunity to fund new acquisitions.

That said, whilst financial regulators around the world are universally focused on bank's real estate exposure, APRA has a distinctive approach to regulated institutions which includes prescriptive expectations around minimum ICR levels for CRE lending.

Furthermore, the recent increases in interest rates[3] will typically restrict banks to LTVs below 50% as they move to protect their liquidity positions and capital allocation to this higher-risk sector. This will result in a funding gap that must be filled by an equity injection or refinance with higher LTVs.

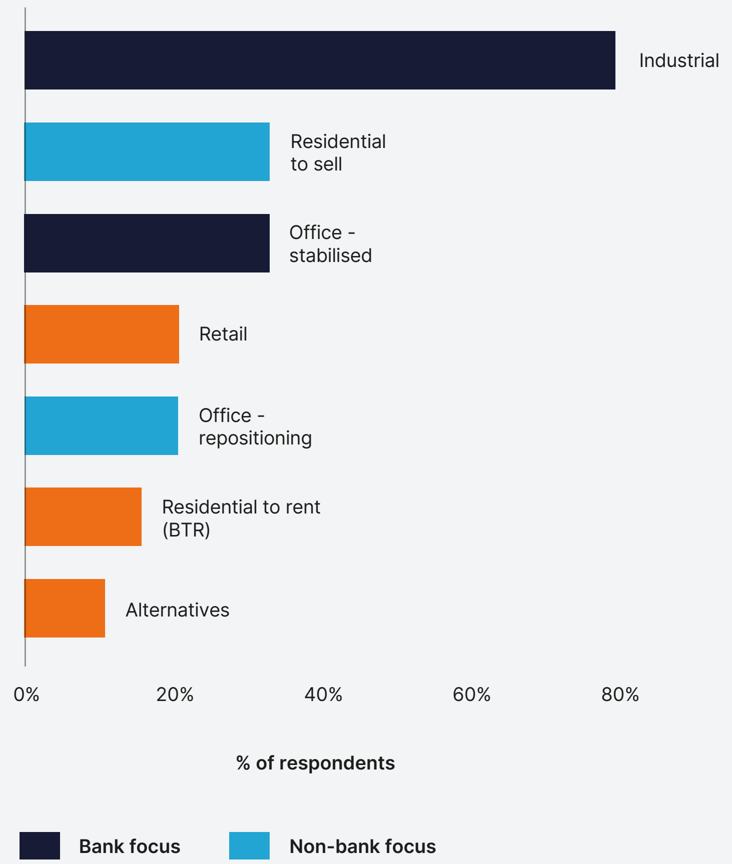
Circa A$75bn[4] of outstanding CRE debt is refinanced annually. Assuming average initial LTVs at 60% with loan maturities of five years, and assuming average new LTVs at 50%, we can estimate a debt funding gap at circa A$11bn annually. This figure takes into account the average all property capital growth over the last five years at 2.13%[5] annualised.

In addition, there is a gap developing between senior lending and high yield debt. At the senior lending end of the risk curve,

2 Average based on views from market participants (April 2023)
3 Interest rates have moved from 0.1% to 3.35% between Feb 2022 and Feb 2023
4 CBRE – Green Finance (June 2022)
5 MSCI Real Assets as at December 2022

FIGURE 2:

Lender asset class preference



Source: CBRE Research, Lenders sentiment survey Q4 2022 (April 2023)

where the ADIs and international banks prefer to operate, competition is high with ample liquidity.

ADIs and senior lenders' investment strategies typically focus on CRE loans to high quality, investment grade borrowers, which are usually either senior unsecured to listed and institutional clients and non-recourse to the mid-market and PERE borrowers.

On the other end of the scale is the mature high yield debt market, with well capitalised non-bank lenders targeting development loans with maturities typically below 24 months. These loans are further up the risk scale, but also enjoy increased yields. Investment strategies are aimed towards speculative residential developments, build-to-sell and land subdivision with loan-to-costs (LTCs) up to 75-80%. Figure 2 shows the preferred assets for these two lender groups.

The lending opportunities that occupy the gap between senior and high yield do not generally offer enough yield to satisfy high-yield debt strategies. They are also unattractive to banks due to their stringent regulatory capital requirements.

As a result, potential clients that fall into this gap represent an under-served market that needs finance for transitional and yet-to-be stabilised assets with LTVs up to 70%. These could be assets that need modernisation, retrofitting or bringing up to required ESG standards, for example.

This is the segment preferred by institutional private credit, with investment strategies focusing on first mortgage and capital protection, while providing attractive returns for investors relative to senior lending.

In summary, Australia represents a relatively exciting market for debt investors with opportunities across the risk spectrum.

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