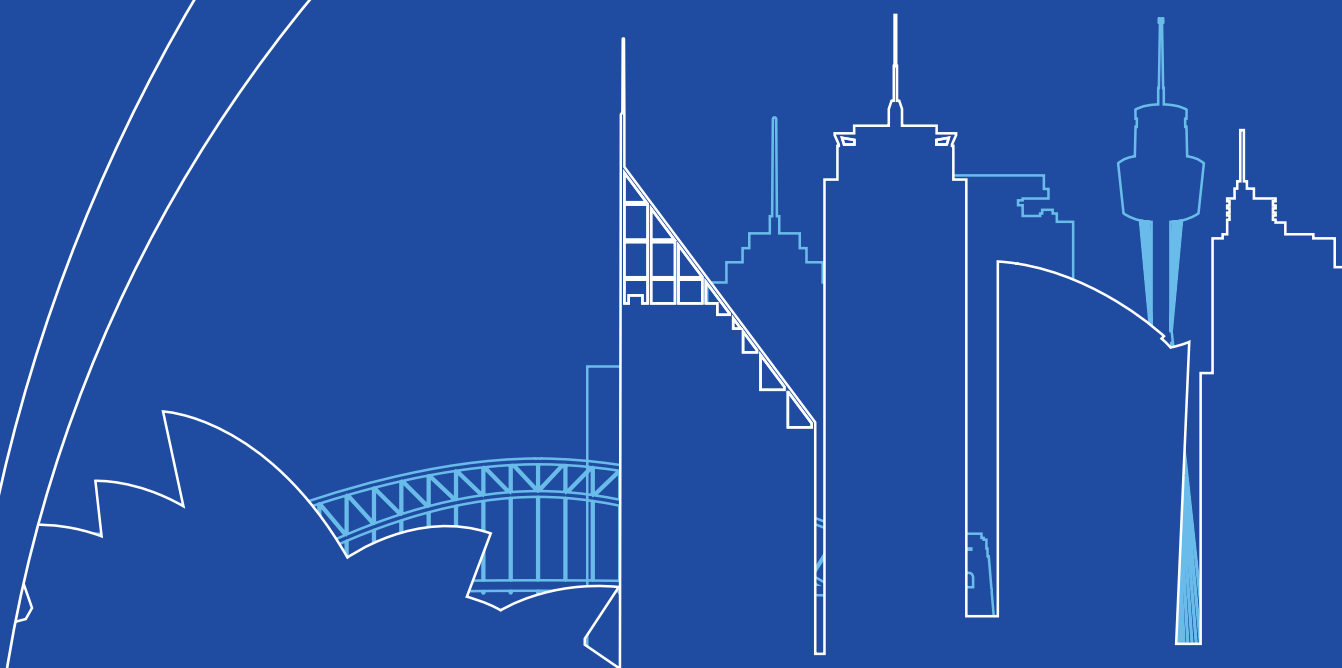


# Real Estate Credit Investment Series

Asset Management



# Real Estate Credit Investment Series

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This series is an introduction to real estate credit, exploring its fundamental attributes and advantages.

1. Interest rising | The case for real estate credit

Provides an overview of investing in real estate credit including its basic principles, defensive nature, diversification benefits and inflation-adjusted, reliable income return.

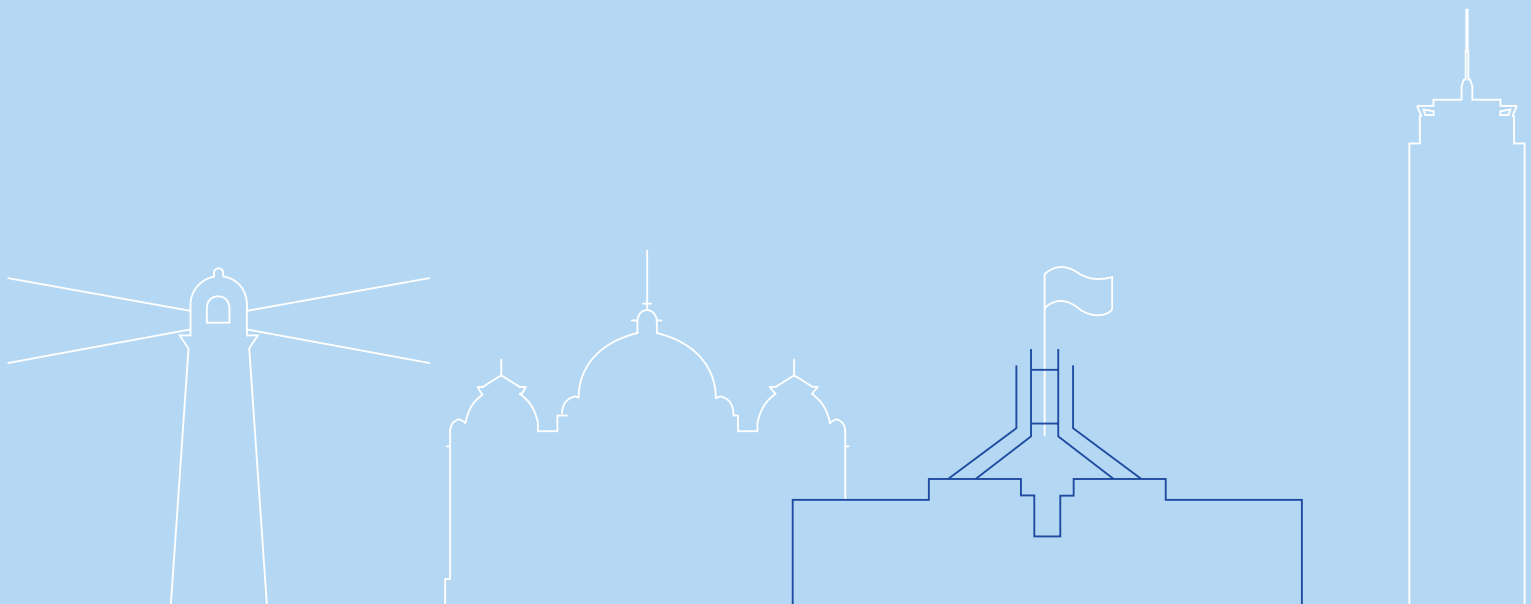
2. Mortgage security | The bedrock of real estate credit

Examines the capital structure and downside protection of investing in an asset class where the underlying investment is secured by a first-ranking mortgage.

3. Avoiding the pitfalls | Choosing a real estate credit manager

Explains the skills and experience required by a real estate credit manager.

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# Real Estate Credit Investment Series



**Drew Bowie**

Managing Director  
Asset Management

## What is real estate credit?

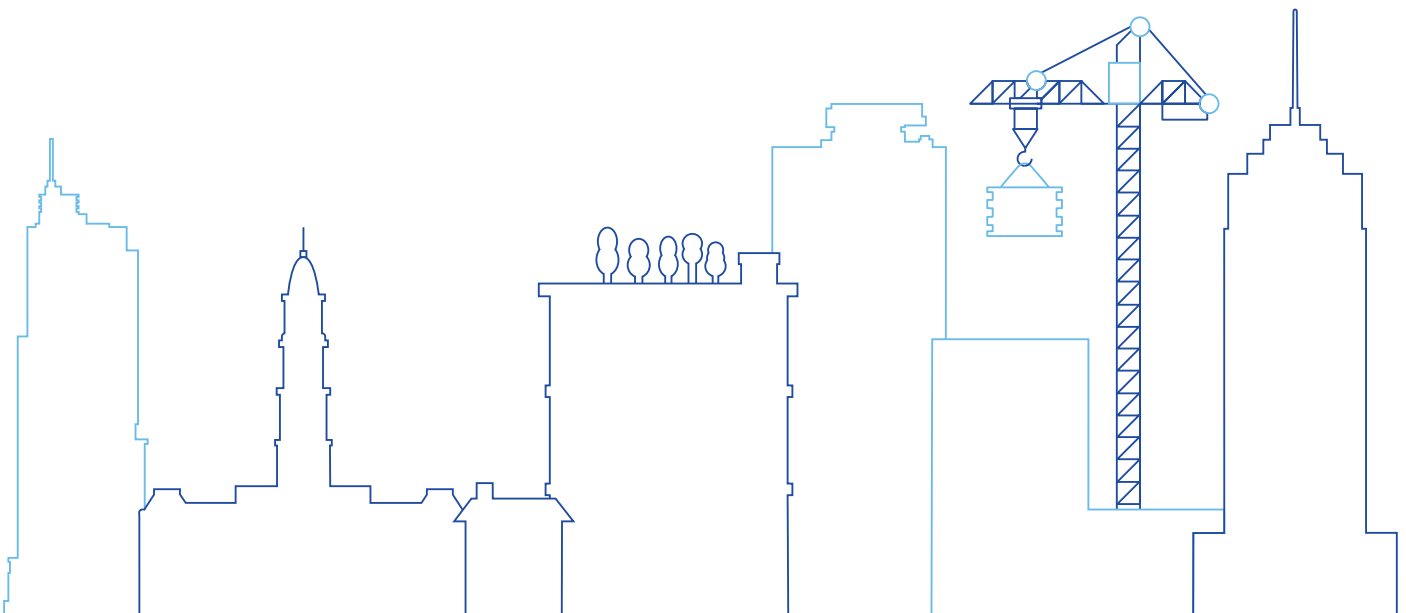
Real estate credit (also known as real estate debt) is a rapidly growing asset class in Australia.

An investment in real estate credit is the provision of a loan to a borrower with the principal security being a first-ranked mortgage over that borrower's real estate asset. The loan gives the lender (the investor) rights to a contracted income return (being the interest on the loan) with significant downside capital protection from the security.

Credit security can take many forms, but one of the most secure and defensive positions is the registered first mortgage. This position in the capital structure gives the lender priority to proceeds when the asset is sold or re-financed. Additionally, the lender can take control of the asset if the borrower defaults.

Through what is often a floating interest rate structure (offering a margin above the RBA Cash Rate), investing in real estate credit has increased in relative attractiveness. It is a defensive asset class, well-positioned to take advantage of a higher inflation and interest rate environment.

Real estate credit, both cyclically and structurally, can offer diversification benefits and compelling relative value. In the hands of an experienced manager with multi-cycle experience, it seeks to provide investors with a reliable income return adjusted for inflation. Importantly, real estate credit also offers the opportunity for capital protection via secure lending structures attached to the underlying investment, the first-ranking mortgage.



# Interest rising |

## The case for real estate credit

Investor interest in strategies offering income stability, downside capital security and protection against higher rates is at an all-time high.<sup>1</sup>

Defensive in nature with a relatively attractive, resilient return profile, by design real estate credit can be shielded from inflation. It can be an attractive through-the-cycle option for investors both cyclically and structurally.

How did this relatively new asset class evolve in Australia? What are its characteristics and how will it deliver for investors through the cycle ahead?

### Real estate credit 101

Valued at \$3.6 trillion, the Australian private credit market has grown by 44% over the last 10 years.<sup>2</sup> To put this into context, the Australian Securities Exchange (ASX) domestic market capitalisation is \$2.7 trillion.<sup>3</sup>

The origination and active portfolio management of loans by a non-bank lender (NBL) secured by underlying real estate assets across a range of sectors and geographies, real estate credit is a specific sub-sector and includes secured loans to fund the purchase of land, commercial or residential properties, either completed or under development.

Real estate credit involves the provision of a loan to a borrower with the principal security being a mortgage over that borrower's property. The most defensive position is a first registered mortgage, which gives the lender (investor) the right to repayment from the value of the asset ahead of any other creditor or the borrower. It is often regarded as the 'last money in and first money out'. It also gives the lender the right to control the property if the borrower defaults.

Other forms of real estate credit, such as second registered mortgages (mezzanine debt), are subordinated to the first mortgage and have more risk.

Its unique lending structure makes real estate credit increasingly attractive in an era of higher interest rates.

### Regulatory changes and changing risk profiles drive growth in NBL

Australia is relatively early in the cycle for NBL, and there is potential for significant growth in the sector due to the changing nature of the lending market and its continuing fragmentation.

To date, regulatory changes have been the engine room driving NBL growth.

Tightened capital requirements for the banking sector introduced by the Australian Prudential Regulation Authority (APRA) post the Global Financial Crisis have shifted deal volume from Australia's Big Four banks to a wide range of NBLs.

Lending by NBLs now represents 8.2% or \$290 billion of the total private credit market, up from 6.7% (\$141 billion) in 2014.<sup>2</sup>

The funding gap in Australia and growth of NBL has been propelled not just through structural change. Strong population growth is one of the key drivers of economic growth, the demand for real estate and real estate credit.

Australia's population growth ranged from 1.5%–2.0% p.a. over the 10-years to the end of 2019 (pre-COVID). This was one of the highest growth rates in the world.<sup>4</sup> Dramatically reduced by Australia's COVID border closures; population growth has returned quickly. The 2022/23 annual population growth rate of 2.4% is projected to remain strong over the next few years. Latest Budget forecasts project an annual growth rate of 1.9% in 2023/24, easing gradually to reach 1.2% by 2033/34.<sup>5</sup>

Along with APRA's capital tightening bank regulations, strong population growth should support Australia's increasing demand for NBL alternatives.

1. Q2 2022 Global Private Markets Fundraising Report, Pitchbook, [www.pitchbook.com](http://www.pitchbook.com)

2. MA Financial Group analysis of Reserve Bank of Australia, D2 Lending and Credit Aggregates (March 2024). Private Credit Market refers to 'Narrow Credit' (ex. Securitisation) in RBA data set, [www.rba.gov.au/](http://www.rba.gov.au/)

3. ASX domestic equity market capitalisation as at March 2024, [www.asx.com.au](http://www.asx.com.au)

4. Annual Population Growth Rate, Australia, Australian Bureau of Statistics, [www.abs.gov.au](http://www.abs.gov.au)

5. 2023 Population Statement, Australian Government, Centre for Population, [www.population.gov.au](http://www.population.gov.au)

## Revised strategies for assessing risk

Economic and financial market variables deviated from long-term historical trends during 2022.

A fundamental building block of asset allocation since the early 1980s has been the 60:40 equities/bonds portfolio. This diversified strategy provided investors with consistent and generous total returns driven by robust economic and earnings growth and low/negative correlation of returns between equities and fixed interest.

Capital market strategies for portfolio diversification and risk management altered over 2022.

Higher interest rates were damaging for both equities and bonds and average total returns from the balanced 60:40 strategy turned negative in 2022 for the first time in 50 years.<sup>6</sup>

## Diversification, inflationary hedge and downside risk | Capital preservation is key

Assets with inflation-adjusted income security and capital preservation are keenly sought by investors.

As the cost of capital increased and liquidity flowed out of the system, alternative NBLs have capitalised on the greater risk premia of traditional asset classes and the unique properties of real estate credit.

Private credit has an historically low correlation to both listed equities and public market debt securities. It provides clear portfolio diversification benefits.

As a floating rate secured asset class, real estate credit provides an inflationary hedge. Rate rises are passed through to investors as cash rates move higher. The payment of historically regular and stable income, adjusted for increases in the cash rate, generates low return volatility.<sup>7</sup>

In addition, a key factor in understanding real estate credit is its relative security compared to alternative investment options. In a secured lending facility, it is equity investors who occupy the first-loss position in the event of a decline in value of the underlying asset. Downside capital protection is provided to credit investors, any change in capital value less than the equity is not passed through, forming an equity shield and cushioning downside risk.

A final layer of income and capital security for real estate credit investors is the low level of loan defaults in the domestic lending market. Australia ranks in the world's top 10 for efficiency in enforcing contracts.<sup>8</sup>

## Where to from here?

Risk is always a critical component of investment and lending.

Real estate credit is no exception, based in part on the nature of the product itself but also from risks in the market in which the facility is operating in. That is why it is important to find a specialist credit manager focused on prudent and disciplined analysis of credit risk on a deal- by-deal basis, with a proven track record of deploying capital at scale and delivering consistent performance through-the-cycle.

In the hands of an experienced manager, the secured nature of real estate credit and its position in the capital structure can minimise income volatility and downside risk.

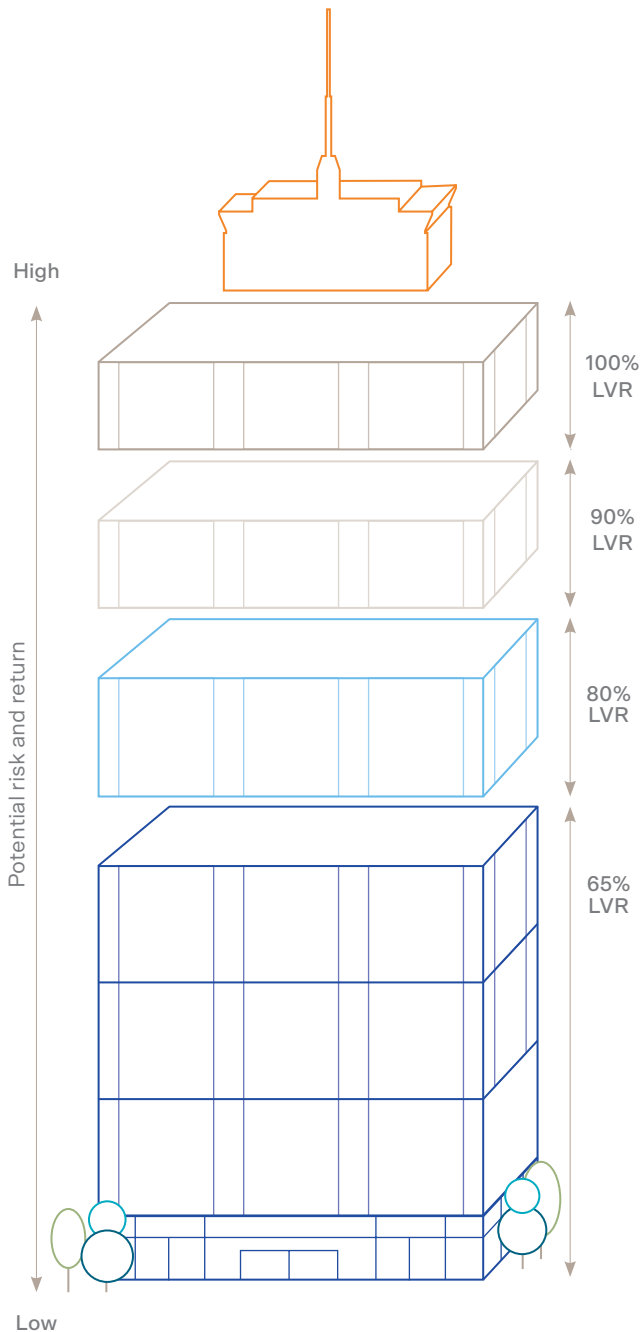
6. Historical total return quoted is the 10-year period ending December 2021. Thoughts on the Market, Morgan Stanley, Allocation – Stock & Bond Correlation Shifts, 17 August 2022, [www.morganstanley.com](http://www.morganstanley.com)

7. Nuveen, 10 considerations for building strategic allocations to alternative credit, Think Equilibrium, [www.nuveen.com](http://www.nuveen.com)

8. Australia ranks sixth in the Enforcing Contracts Rank, above Germany (#13), US (#17), New Zealand (#23) and the UK (#34). Source: The World Bank, Doing Business Archive, [www.archive.doingbusiness.org](http://www.archive.doingbusiness.org)

# Mortgage security | The bedrock of real estate credit

## Real estate credit capital structure



The cyclical and structural case for investing in the private market alternative of real estate credit is strong. As part of a diversified portfolio, it offers reliable and inflation-adjusted income return. Equally important is the defensive strength and clear line of sight for downside capital protection provided by the security attached to its underlying investment – the first ranking mortgage.

## Real estate credit capital tower

Critical in understanding the strength of the downside capital protection real estate credit delivers is the underlying mix of equity and debt used to finance an asset – its capital structure.

Think of the capital structure as a building, with the riskiest position at the top, and the least risky and most stable at the bottom of the building.

Equity holders occupy the top-end of the tower – the riskiest position.

Ordinary equity sponsors manage or control the asset/entity in what is known as the ‘first-loss’ position. An income return, or dividend, is not guaranteed and if the saleable value of the asset decreases, equity funds are the first to be reduced or lost.

Next floor down in the risk/return pillar is preference equity. Installed at the discretion of the sponsor’s partners or syndicate of lenders, this debt/equity hybrid is an optional level that is generally paid a fixed percentage of dividends payable. It sits in a ‘second-loss’ spot after ordinary equity holders.

## The capital foundation | First-ranked mortgages

Further down the risk capital tower is the debt (or real estate credit) foundation.

Topping the debt base is 'mezzanine debt', usually secured by a second ranking mortgage over the asset and positioned above any equity holders in repayment.

Real estate credit issued as 'senior debt', secured by a first-ranking mortgage over the asset, occupies the solid, stable and safest location within the capital tower. The position gives the lender (investor) the right to repayment from the value of the asset ahead of any other creditor or the borrower.

Critically, a registered first ranking mortgage also gives the lender the right to control the property if the borrower defaults. In the hands of an experienced manager, this added security ensures lender's capital can be managed prudently if the loan covenants are breached.

Typically, real estate credit loans are relatively short in duration, the maximum loan term generally 24 months. The shorter-term loan reduces exposure to individual borrowers, sectors or securities and cyclical movements and also ensures the initial due diligence remains relatively current, providing a further protection against capital loss.

## Weathering the storm

Population estimates indicate Australia may experience an annual growth rate of 1.9% p.a. in 2024–25, outpacing many regions in the developed world.<sup>9</sup> Population growth helps create a balance between labour demand and supply, contributing to a stable, growing economy.<sup>10</sup> Increasing activity in the credit (debt) sector of the capital stack will be necessary to fund critical housing and real estate development.

Additionally, as interest rates remain high investors may look to secure an increasingly defensive capital position. The underlying asset in real estate credit (the first-ranked mortgage) is not the only protection offered from the turbulent conditions ahead. Shorter-duration loans (maximum of two years) and low loan-to-value ratios (LVR) combine to further bolster the defensive shield in the event of declining value in the underlying asset.

## Accessing real estate credit

An expanding suite of real estate credit investment products are available in Australia.

Accessing real estate credit is open to institutional, wholesale and retail investors through open and closed-end funds, bespoke mandates, partnerships and separately managed accounts.

Diversified funds typically employ open-ended structures. With a minimal initial investment, open-ended real estate credit funds allow investors in and out of the fund during its life. Distributions are paid on a regular, typically monthly or quarterly, basis and target returns can be linked to official interest rates in line with a floating rate structured loan portfolio. Investments are selected and held at the discretion of the manager.

9. 2023 Population Statement, Australian Government, Centre for Population, , [www.population.gov.au](http://www.population.gov.au)

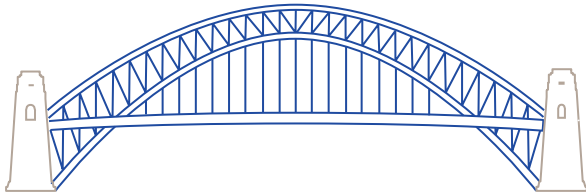
10. The determinants of Australia's future demography, Peter McDonald, Australian National University, [www.pc.gov.au](http://www.pc.gov.au)

# Avoiding the pitfalls | Choosing a real estate credit manager

Through its floating rate structure, resulting in income adjusted for inflation, and the security attached to the underlying investment in registered first-ranked mortgages over property, real estate credit is expanding its reach within the Australian investment community.

In the hands of an experienced manager with multi-cycle experience its secured nature and position in the capital stack can reduce income volatility and downside risk.

As in all investment decisions, the experience and track record of the asset manager is an important factor. So, what are the key questions investors should ask when considering investing in real estate credit?

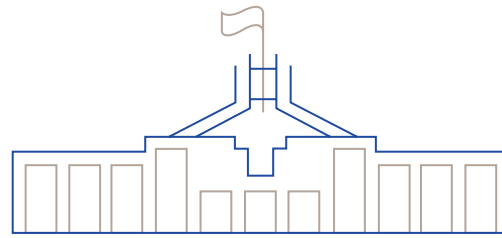


## What is the scale and depth of the platform?

A broad-based platform offering scale and depth provides a competitive advantage in choosing the right investments.

A diversified platform supports careful and timely assessment of the relative risk-reward profile and diversification benefits of individual loans. It also provides support to the lending manager in consistently applying strict loan criteria, particularly when macro conditions are volatile.

Additionally, a robust and varied platform provides greater depth of experience and capability for assessing the value in the underlying asset as well as the potential pool of buyers.



## How is governance embedded in the platform?

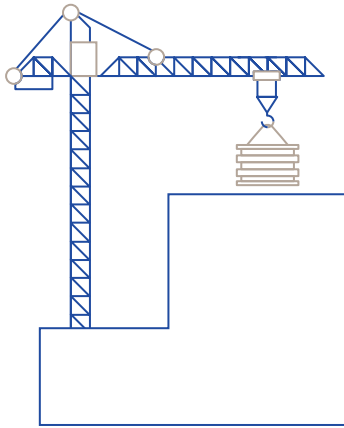
The integrity of the asset/lending manager is critical for investor and borrower confidence.

Strong governance is important to protect the lending portfolio and minimise as many risks and unknowns as possible.

For managers listed on the Australian Securities Exchange (ASX) there is the added security for investors in the requirement to comply with strict corporate governance practices, transparent, timely reporting and industry and peer benchmarking.

Institutional-grade managers have greater scrutiny of ongoing management personnel and operational capability, compliance protocols, environmental, social, governance considerations and financial capacity.





## What is the experience of the lending team?

There are numerous components in assessing experience in the real estate credit universe.

Firstly, construction experience is essential. A real estate credit manager requires a team of inhouse professionals with specialist expertise across all aspects of building and construction, developed across a range of macro environments. This expertise facilitates careful assessment of loan quality and exit scenarios on a case-by-case basis.

Additionally, a broad range of direct borrower, broker relationships and networks provide a distinct sourcing advantage, securing access to a diverse variety of transactions and encouraging discernment in deal selection.

Expertise in owning and managing the underlying asset is central to success. Management experience should include not only assessing point-in-time metrics of the loan portfolio, such as standard appraisals like loan-to-value ratio (LVR), it should also run deeper encompassing an ability to understand market intelligence, analysis of fundamentals, the integrity of book valuations, macro risks and secular trends.

An experienced manager conducts scenario analysis around builder insolvency, time delays, cost increases, pre-sale or lease defaults. A prudent manager will undertake stress testing in all macro conditions, from the most benign through to riskier settings.

Astute lending practice also requires inhouse 'workout' experience. This extends to knowing when to seize control over the secured asset and how to manage the return of capital from that asset.

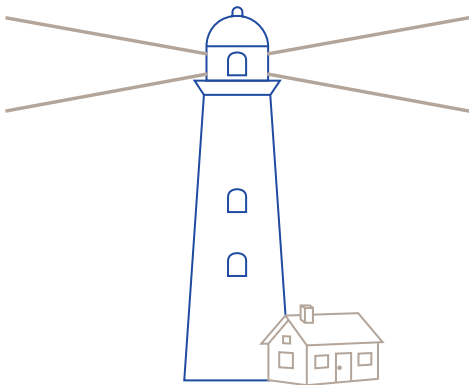
## Navigating choppy seas

Finally, a track-record of investing and managing through multiple cycles is critically important.

The uncertain economic outlook, acute shortages in materials and labour, escalating price shocks, and weather delays across the eastern seaboard have placed builders under significant pressure.

Working through these issues requires pragmatism, genuine conviction and skill in managing the loan on a case-by-case basis in a timely and efficient manner.

In the hands of a disciplined and vigilant manager, real estate credit by design should provide security and attractive risk-adjusted returns across all market conditions. Backed by structural and secular growth drivers with inflation-proofed income and capital risk mitigated by secure lending structures, real estate credit offers compelling relative value.



# About MA Financial Group

## More information

For more information about our real estate credit capabilities and solutions, please get in touch.

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