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I believe every balanced portfolio should include CRE Debt.

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Portfolio
Construction
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Total Value of Key Asset Classes in Australia

Residential Property*	\$9.4 trillion
(Home Mortgages)	\$2.2 trillion)
Bank Deposits	\$3.8 trillion
ASX Stocks	\$2.5 trillion
Commercial Property	\$1.3 trillion
Corporate Bonds	\$2.1 trillion
Government Bonds (State + Federal)	\$1.2 trillion
CRE Debt	\$0.5 trillion

*includes \$2.2 trillion of residential investment property

Source: abs.gov.au, apra.gov.au



Rates of Return – Key Asset Classes

Direct Property	6.3% p.a. after tax
Bank Deposits	1.25-4.5% p.a.
ASX	8.1% p.a. over 20 years
Bank Hybrids	6.9-7.4% p.a.
Treasuries	3.3% p.a.
CRE Debt (SPVs)	8-12.0% p.a.
CRE Debt (Wholesale)	5-12.0% p.a.



Other Asset Classes – Volatility

Rolling 12 Month Return Comparison Since Inception





What is a CRE Debt investment?

- CRE refers to the use of funds – must be a business purpose (i.e., not covered by the National Consumer Credit Protection Act).
- Security property may be residential, commercial, retail, industrial or vacant land.
- Loan types include “pre-DA” loans, construction loans, residual stock and investment loans.
- Most CRE debt is secured by a registered first mortgage, maximum 65% LVR.
- Generally short-term loans (12-24 months).
- Loans written against current valuations (no more than 3 months old) from a ‘panel’ valuer.
- Security property will be transitional (and often appreciating) in nature.
- Typically, interest is pre-paid for the term of the loan or included within the loan itself.



What is a CRE Debt investment? (continued)

- Were mainly fixed rate, now generally variable (BBSW plus) investments.
- May be offered to investors as a single asset/loan SPV or a co-mingled warehouse, containing multiple security assets/loans.
- Warehouses offer diversification.
- Generally open-ended, but trustee may queue redemptions.
- May be listed.
- Often feature first loss capital.
- Target returns (after fees) or contracted returns.



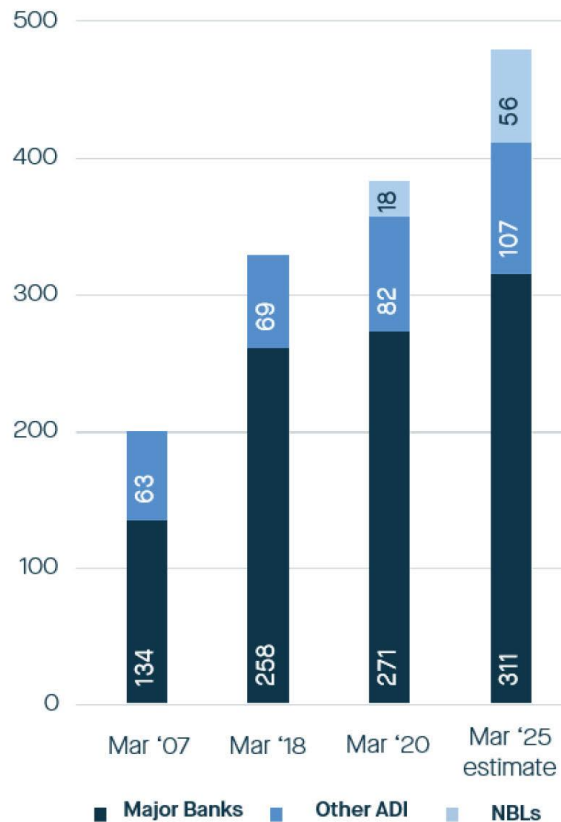
Capital Preservation – My Experience

- Many NBLs have zero or near zero loss rate for investors.
- Pallas has written 419 loan and other investments including 91 construction loans.
- Across the book, default rate has increased from about 0.6% in early 2022 to about 1.1% currently.
- About 40% of defaults are non-monetary i.e., loan term extensions (COVID, rain, construction supply chains).
- A 'case study': three failed builders.



Overview of the CRE Market

- Australia and New Zealand CRE Debt Markets have been overly reliant on the Big Four.
- The total of CRE loans in Australia is forecast to increase to \$475 billion in 2025 (CAGR of 5%).
- The market share held by NBLs is forecast to grow to \$56 billion in to 2025 (CAGR of 25%).
- This growth will take the NBL market share from about 5% to about 12% over this period.
- NBLs represent over 50% of all CRE debt exposures in Europe and over 75% in the USA.



Source: Australian Prudential Regulatory Authority (APRA), Quarterly ADI Property Exposures March 2020, RBA Market Stability Report 2019



NBL Landscape in Australia – by Typical Loan Size



Sub \$2m Loans

- Very competitive.
- Generally automated credit analysis.
- Generally narrow NIM.

The 'Middle Market'(\$2-30m)

- Full recourse loans to SMEs backed by real estate.
- Relatively deep market if security property needs to be sold.
- PGs typically of significant value relative to debt size.
- "Granular" warehouse loan books.
- Generally wider NIM.
- A number of NBLs need to broker transactions to HNW.

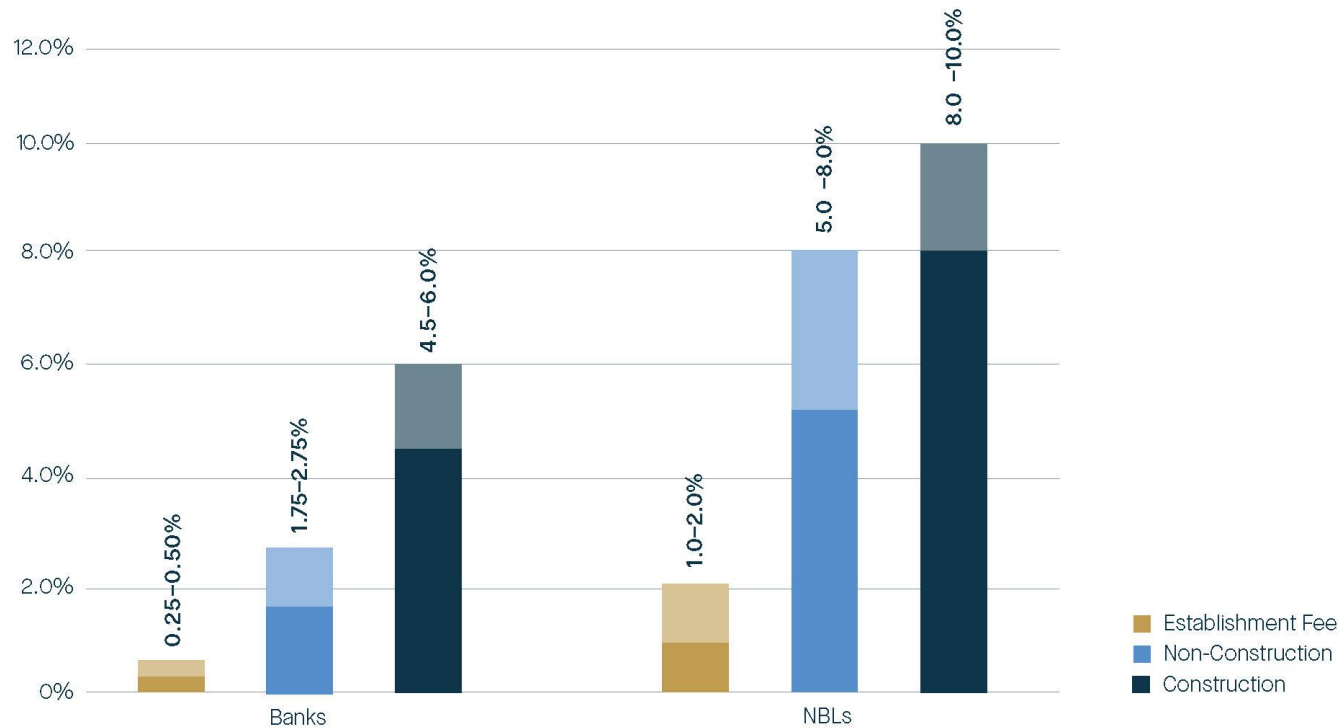
Large loans (+\$30m)

- Size of loans attracts bank lenders and larger credit players.
- Lower interest rates paid by borrowers.
- Often no recourse to sponsors (corporate or offshore sponsors).
- Typically, narrower NIM.



Interest Margins – NBLs vs. the Banks

Variable Rate Lending Margins (over 30-day BBSW)





Competitive Advantages of NBLs

Traditional lenders face many inherent disadvantages in servicing the CRE market, including:

Banks	Non-bank lenders
Slow turnaround times (3–6 months for these loan types).	Turnaround can be 3–4 weeks provided borrower information and current valuation on the security is available.
Typically require pre-sales to cover 40-100% of maximum construction loan balance.	Typically require pre-sales to cover 0-50% of maximum construction loan balance.
Reduction in LVR (loan to value ratio) from (say) 70% several years ago to 50–60%.	Non-banks can still lend to 60-65% of LVR subject to borrower assessment.
Typically require interest cover ratio (ICR) of 1.5x (down from 2.0x in early 2020).	Typically require ICR of about 1.25x.
Inflexible loan terms, e.g., no cash available to be drawn by the borrower to meet other commitments, loans amortising and aggressive 'sweep' of realisation receipts to reduce loan balances.	Flexible loan terms, e.g., borrower can drawdown cash for other commitments, typically interest only with 'bullet' repayment at end of term, borrower may be permitted to retain a proportion of realisation receipts.



How I believe CRE Debt fits within Investment Portfolios

- Until recently, CRE debt was only been available to institutional or family office investors.
- Today, investment in CRE Debt is an established asset class, offering attractive risk-adjusted return.
- Within portfolio construction, private debt is classed into the Fixed Income, Property or Alternatives asset allocation bucket.



In Brief...

- CRE debt offers an attractive risk/reward to investors.
- Investments managed by the best NBLs are ‘institutional grade’.
- CRE debt investments show only a weak correlation to other asset classes (and little or none to underlying property values).
- CRE debt investments can give a high degree of transparency.



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