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Tapping into offshore Real Estate Debt – why now is the time

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Australians have long seen property as the key to building wealth. With consistent price growth, tax perks like negative gearing, and the appeal of tangible assets, real estate has thrived as an investment choice. A stable economy and tight housing supply have only reinforced this trend. So, while Australians may feel very comfortable owning property either as their primary residence or through investment properties, the reality is many will have much greater exposure to the sector than they realise.

A look at an individuals' investment portfolios demonstrates how this exposure can quickly and silently compound across not only residential property but also commercial property. The four major banks account for 20% of the ASX and will feature as a large part of any domestic equity portfolio and in superannuation exposures. These same names also form the largest part of domestic corporate fixed income benchmarks, which deliver the income stream for most clients. The banks not only lend significantly to the residential housing market but to the commercial sector too.

If that wasn't enough property for the average Australian investor, the explosion in Australian Private Credit in the last few years has added yet another source of potential exposure to the list. Further, the majority of this exposure will be confined to just two major cities and the exact composition may not be fully visible. So, while the allure of property is well understood by Australians, they would be well served by looking to diversify their exposure. Rather than adding yet more property exposure through the domestic private credit sector, investors should consider looking overseas where property and credit markets are often broader and deeper, and where the two markets are less correlated.

A great example is the United States, which represents a significantly larger and more diverse market. With a population ten times larger and a significantly greater number of major cities, the US economy offers a broader range of investment opportunities across various sectors. Additionally, the US private debt market, valued at $1.5 trillion, dwarfs Australia's $200 billion market, providing investors with a wider range of options and potentially higher returns. The US real estate credit market is more mature than Australia's market, highlighting the scale and concentration risk involved. Therefore, a diversified investment strategy that includes exposure to the US market can offer significant benefits to investors seeking growth and diversification.

An overview of US real estate debt

U.S. commercial real estate debt ("CRED") has grown substantially as an institutional investment class since the Global Financial Crisis ("GFC") as banks have faced stricter regulations, forcing real estate owners to find alternative sources of financing. CRED investment managers have stepped in to fill the funding gap, offering bespoke and more flexible lending solutions to borrowers. CRED produces predictable and steady income in the form of interest payments, targets higher returns versus most traditional fixed-income investments, provides exposure to the real estate market without direct management responsibility, and offers downside protection with the ability to preserve capital during volatile periods in the economy. CRED represents an all-weather strategy capable of generating attractive, risk-adjusted returns throughout market cycles and is an important component of a diversified real estate portfolio.

What are the benefits of CRED?

Income Generation: CRED investments, including real estate loans and mortgage-backed securities ("MBS"), can provide attractive income-generating opportunities. Investors earn high current yields derived from regular interest payments from the underlying loans.

Portfolio Diversification: CRED offers diversification benefits to investors by providing an alternative to traditional real estate equity investments. The inclusion of CRED in an investment portfolio can help distribute risk and reduce overall volatility.

Capital Preservation: Real estate debt is typically secured by tangible assets that serve as collateral. Conservative loan-to-value ratios can provide downside protection to lenders in periods of declining asset values. If a loan becomes delinquent, a lender has the option of modifying the loan to assist the borrower in bringing the loan current, requiring certain reserves to ensure continued payment from the borrower, or taking over the property with the intent to operate the asset itself or sell the asset to recoup the loan proceeds.

What are some real estate debt strategies used in the US?

Direct lending in real estate

The real estate lending universe is broad and complex, covering residential and commercial real estate with a host of loan and structured finance products. Particularly attractive in the US real estate space are direct lending products that focus on the origination and/or purchasing of senior secured loans. Other attractive lending products include floating-rate bridge loans with short terms (e.g., 3-year terms and two 1-year extension options) that are paid back when a borrower secures permanent financing upon completion or stabilisation of their asset and subordinate debt products, which refers to debt that sits below the senior debt in the capital stack. Subordinated debt can also include stand-alone mezzanine or debt-like preferred equity. Some direct lending strategies close on a whole loan and then proceed to synthetically syndicate the senior component of the loan and hold/control the junior component (note-on-note lending) or provide stand-alone mezzanine debt or preferred equity (in which case a senior loan is originated separately). The note-on-note structure, wherein the lender receives the spread between what is paid to the lender by the borrower and paid by the borrower to the senior lender, is accretive to fund performance as it generates higher returns.

Loan purchases

During periods of distress in the commercial real estate markets, opportunities often arise for real estate credit investors to purchase loans secondarily from banks and other financial institutions who are seeking liquidity and regulatory capital relief. In these situations, sellers of loan portfolios often seek to move quickly as these transactions are typically spurred by an unexpected external stimulus, such as a regulator requiring an improvement in a capital reserve ratio or a sudden need for liquidity elsewhere in their business. Sellers tend to act with discretion in these scenarios to preserve their reputation, often partnering with buyers with whom they have deep relationships and trust to execute quickly and quietly. These portfolios are typically acquired at material discounts to par and offer outsized returns to the buyers, who are often real estate credit funds and their investors.

Freddie Mac K-Deals

The Federal Home Loan Mortgage Corporation (FHLMC), commonly known as Freddie Mac, is a publicly traded, government-sponsored enterprise. Freddie Mac was created in 1970 to expand the secondary market for mortgages in the US and, along with its sister organisation, the Federal National Mortgage Association (Fannie Mae), buys mortgages, aggregates them into pools, and sells them as a mortgage-backed security (MBS) product to select private investors.

Through their K-series program, Freddie Mac securitises pools of loans (typically 30-50 loans) secured by institutional-quality, stabilised, multifamily, seniors housing, and student housing assets with average loan-to-value ratios of 55-70%. The senior 80-95% of a pool (the “A-Piece”) is sold in the open market and is guaranteed by Freddie Mac for payment of principal and interest. The junior 5-20% of a pool (the “B-Piece”) is typically only offered to private investors who have a lengthy, trusted relationship with Freddie Mac. New issuance B-Pieces are placed directly with buyers and are not marketed broadly. The Freddie Mac K-series is characterised by its strong performance, high-quality loan sponsors, and solid property fundamentals. As of November 2023, the K-Series program has issued ~$554 billion across 26,100 loans with less than two basis points in total realised losses.[1]

Commercial mortgage-backed securities

Similar to the Freddie Mac issued MBS described above, non-agency commercial mortgage-backed securities (“CMBS”) are fixed-income investment products that comprise pools of mortgages on commercial properties and are issued by large investment banks or financial institutions seeking to make use of the securitisation market to finance their real estate transactions.

“New issue” CMBS are typically offered to investors by the commercial banks, conduit lenders or investment banks that issue the financing to the borrower. For borrowers, these types of financing arrangements are often used for projects that do not fit agency (Freddie Mac or Fannie Mae) lending standards and typically have faster closing processes. The bonds are marketed to investors and then sold in various classes, or “tranches”, with each carrying its own level of seniority based upon the risk associated with the underlying debt.

CMBS can also be acquired by investors on the secondary market. Secondary purchases of CMBS can be attractive during times of market distress and dislocation, as security holders in these environments face financial stress or require immediate liquidity. For instance, during the COVID-19 market dislocation, many investors were over-leveraged and faced

[1] Freddie Mac Multifamily, as of November 30, 2023.

margin calls when the market went sideways. As a result, many of these investors were forced to sell their CMBS holdings at steep discounts to generate immediate liquidity. The investors who had the capital to acquire these discounted CMBS holdings did so at unprecedented pricing levels and were able to generate outsized returns in a very short timeframe as the market recovered.

Single Asset Single Borrower ("SASB") CMBS
SASB CMBS refers to CMBS secured by loans on multiple properties owned by a single borrower, or CMBS secured by a loan on a single asset. These opportunities are generally broadly marketed, public transactions brought to market by a network of broker-dealers. Two of the main benefits of SASB CMBS investments are the institutional sponsorship backing and the high quality of the underlying real estate assets. Many of the sponsors routinely use the CMBS markets for financing and have substantial net worth and sufficient liquidity to support the deal.

Commercial Real Estate Collateralised Loan Obligation (CRE CLO)
In these types of financing vehicles, short-term floating rate loans are typically issued against a pool of commercial properties. The properties involved in CRE CLO transactions are often transitional assets, such as a multifamily property undergoing a major renovation, or an office building with substantial near-term lease turnover. Unlike traditional CMBS, CRE CLOs are actively managed by an asset manager and have reinvestment periods (typically 5 years) that allow for the addition or removal of loans from the portfolio. Similar to CMBS, CRE CLOs are offered to investors in different tranches that each carry a different level of seniority and risk within the capital stack.

Why is niche expertise on the rise within Real Estate?
As stated previously, the debt sector is wide-ranging, and with the retreat of the traditional banking sector and the rise of the non-bank lending industry, it is helpful to identify lenders that have developed a niche focus, or niche expertise. Even further, as the real estate investing community takes a critical view of the traditional real estate sectors within traditional indices (i.e. office, multifamily, retail, and industrial) based upon their recent relative performance, formerly 'niche' sectors that exhibit strong performance due to demographically driven and non-correlated demand characteristics become more attractive to include in a portfolio, both as an equity and credit/debt allocation.

Demographically driven sectors that have stood out over the past several economic cycles include medical office buildings, seniors housing, and student housing. The dramatically aging population in the US, a phenomenon referred to as the 'silver tsunami' or 'graying of America', has led investors to focus on those sectors that support these significant demographic shifts. There are multiple sectors that will benefit from this phenomenon, namely medical office and seniors housing. Approximately 11,000 people are turning 65 every day, and the 65+ population is projected to increase to 81 million people by 2040 (representing a 45% increase from 2020 levels).[2] This serves as a long-term tailwind for medical office demand as healthcare service consumption typically increases with age, evidenced in part by the 65+ age cohort visiting the doctor approximately 3x more annually than those aged 18-64.[3] This population transformation should continue to bolster healthcare spending, which already accounts for the second largest category, or nearly 20%, of U.S. GDP.[4] The 65+ population is not the only cohort growing rapidly; the 80+ year-old cohort is growing at an unprecedented rate, and is projected to increase by approximately 93% by 2040.[5] Further, the number of households headed by an adult aged 80+ is projected to double from 2021 to 2040.[6] With 80 years old being a prime age for both independent living and assisted living communities, demographic trends point to significant and sustained demand for seniors housing over the next few decades. Student housing has also experienced strong demand; however, this sector is more bifurcated. Large public institutions that present a value proposition to parents and strong academic and cultural programs to students have fared well, yet smaller, expensive private schools have suffered from enrolment declines. Lenders who can ascertain which markets and developments will perform versus where there are more risk are likely to fare better.

Same, same, but different: Aus vs US markets

Market size
As outlined previously, the sheer size of the US economy and its complex financial system creates a vast array of opportunities for private debt investors. This includes a wider range of deal structures, asset classes, and borrower

[2] Administration for Community Living, as of YE 2021.
[3] Center for Disease Control and Prevention, as of YE 2019.
[4] Centers for Medicare & Medicaid Services, as of YE 2021.
[5] Organisation for Economic Co-Operation and Development, as of December 2023.
[6] Joint Center for Housing Studies of Harvard University, as of November 2023.

types, from large corporations to small and medium-sized enterprises. In contrast, the Australian market, while growing, remains more concentrated. Additionally, the US market's depth and liquidity provide investors with greater flexibility and easier exit options.

Regulatory differences

While both the US and Australian private debt markets offer attractive investment opportunities, the regulatory landscape in the US provides a more robust and investor-friendly environment. The US regulatory framework, particularly post-GFC, has undergone significant enhancements. Stricter regulations, such as Dodd-Frank, have increased transparency, accountability, and risk management standards for financial institutions.

This increased oversight ensures that investors are better protected and that market participants adhere to rigorous standards of conduct.

In contrast, Australia has a relatively stable regulatory environment, although the market is still developing and may lack the same level of regulatory scrutiny as the US. This can lead to potential inconsistencies and less stringent enforcement of regulations. Moreover, the US market benefits from a more established legal system and a deeper pool of legal expertise, providing greater certainty and protection for investors. This can be particularly important in complex private debt transactions, where legal issues may arise.

Tax regime

The US private debt market offers a more favourable tax environment compared to Australia. Interest on debt incurred for business purposes is generally deductible in the US, while Australia has specific rules and limitations on interest deductibility. Additionally, the US capital gains tax rates can be lower than ordinary income tax rates, making long-term investments more attractive. State-level tax variations in the US allow investors to choose jurisdictions with favourable tax treatments, unlike Australia's more uniform national tax system.

Experts through a cycle

The US private debt market has a distinct advantage over Australia in terms of its ability to manage market cycles, particularly in times of economic stress.

Firstly, the US market has a proven track record of weathering significant economic downturns, including the Great Recession of 2008. This experience has allowed US lenders to develop sophisticated risk management techniques and workout strategies. In contrast, Australia has not dealt with a sustained default cycle since the 1991 recession. This lack of recent experience may limit the ability of Australian lenders to effectively manage potential defaults and distressed situations.

Secondly, the US market is characterised by a diverse range of lenders, including large banks, regional banks, and non-bank lenders. While this diversity can lead to increased competition, it also enables the market to absorb shocks and maintain liquidity. Smaller regional banks in the US, which often focus on commercial real estate lending, have a history of failing during economic downturns. However, the broader US market has the capacity to absorb these failures and maintain overall stability.

Technology

The US market is leading technological innovation in the financial services industry, particularly in areas such as data analytics, artificial intelligence, and machine learning. These advancements are being applied to private debt to improve credit underwriting, risk assessment, portfolio management, and operational efficiency.

Australia has made strides in technology adoption, but it cannot compare to the scale and sophistication of technological solutions in the US. This technological edge allows US private debt firms to make more informed investment decisions, identify new opportunities, and manage risk more effectively.

What makes a successful US RE debt manager, and what to look for?

The most successful real estate debt investment managers possess deep relationships within the debt markets, maintain flexibility and efficiency relative to traditional debt sources, and focus on specific sectors in which they possess a competitive advantage and the operational expertise necessary to underwrite potential investment opportunities more favourably than their competitors.

Investment managers that can provide efficient, single-lender solutions that reduce transaction costs compared to traditional bank lending place themselves above those with whom they are competing for business. They are able to structure highly tailored/unique debt solutions that are better suited for each particular deal compared to the strict traditional parameters seen from traditional lenders such as banks and other financial institutions, and can do so more cost effectively.

Investment managers that complement their debt platform with an associated equity investment platform and significant operating experience in their target sectors are typically more successful than real estate funds that do not possess the same expertise and operating capabilities. A vertically-integrated real estate platform consisting of both debt and equity teams provides both deeper insights into the specialty sectors in which it invests and the ability to work with borrowers to identify constructive solutions were problems to arise. In work-out scenarios, these lenders are even more confidently able to take ownership of an asset and apply the operational expertise of their equity teams, increasing the likelihood of a successful outcome in the event of a foreclosure. This is an important risk mitigation feature and compelling value-add relative to competitors lacking an operating platform.

Now is the time for diversification

The US private debt market offers a compelling investment opportunity for Australian investors seeking diversification and potential outperformance. Its size, diversity, and robust regulatory framework provide a strong foundation for investment. The market's advanced technology, experienced market participants, and favourable tax regime further enhance its appeal.

By diversifying into the US, Australian investors can gain exposure to a larger, more sophisticated market with the potential for higher returns and lower risk. The US market's depth and liquidity offer greater flexibility and easier exit options compared to the Australian market. Additionally, the US regulatory environment, particularly post-GFC, provides a higher level of investor protection and market integrity.

The US market's experience in navigating economic cycles and managing credit risk gives it a distinct advantage over Australia. This experience allows US lenders to effectively manage potential defaults and distressed situations, which may still be a challenge for the Australian market.

CRED offers a compelling way to achieve strong risk-adjusted returns, gain real estate exposure without direct management, and enjoy stable, recurring income along with portfolio diversification. As the landscape of CRED evolves and nontraditional lenders play a larger role, experienced debt and equity investment managers are well positioned to source and acquire attractive debt opportunities while protecting investor capital.