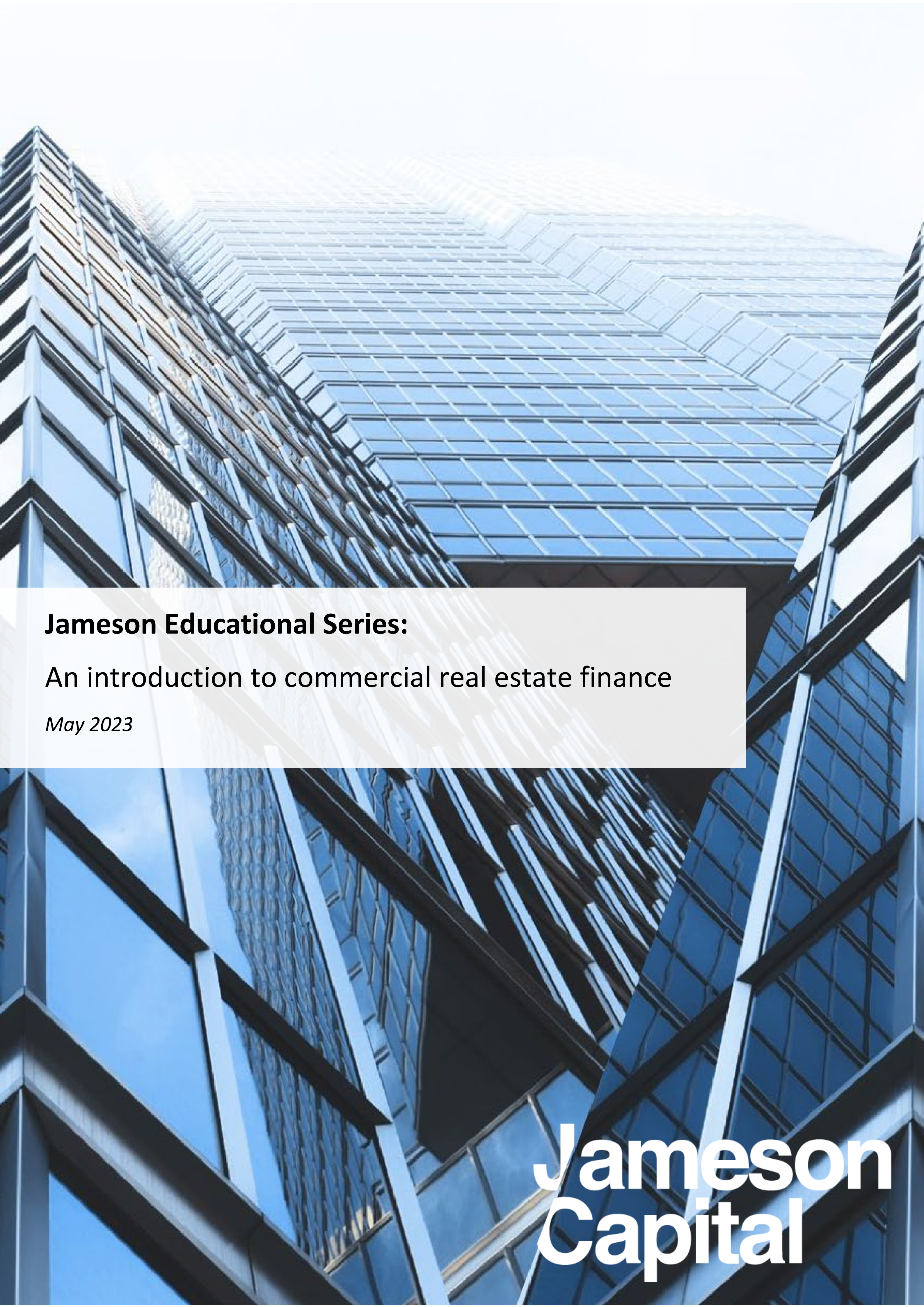

Jameson Educational Series:

An introduction to commercial real estate finance

May 2023

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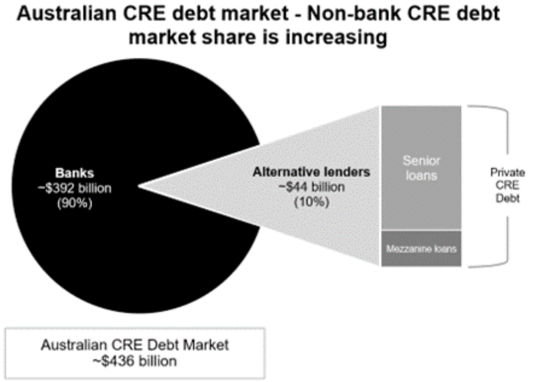
Key points:

- **Commercial real estate (CRE) debt is a growing market in Australia but still lags the rest of the world when comparing relative market shares.**
- **Non-bank lending market growth in Australia is being primarily driven by macroprudential directives designed to limit industry or sectoral concentration risks of traditional banks.**
- **Real estate projects are funded by a mixture of sources of debt and equity capital, commonly referred to as a 'capital stack'. Each component of capital has different risk and return characteristics, which are important for prospective investors to understand.**
- **The addition of CRE debt exposures can bring numerous positive risk and return benefits to a well-diversified investment portfolio.**

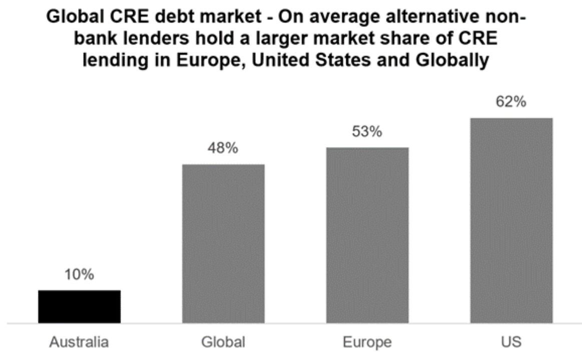
Commercial real estate (CRE) is a vast and complex market, with many different types of investment opportunities for investors and financing available to developers. CRE financing is debt, which can take many forms and plays a significant role in the 'capital stack' of a given project. In this article, we will explore the basics of CRE debt, including the capital stack and why now may be an attractive time to consider this type of investment for your investment portfolio.

Australia's role in the global CRE debt market

CRE debt is used extensively throughout the globe to acquire and develop real estate assets. Australia has been somewhat of a laggard in adopting non-bank real estate finance meaningfully, however this is beginning to change as the non-bank lending market and its benefits for investors and developers are becoming better understood.



Source: RBA Financial Stability Review October 2021; APRA Quarterly Authorised Deposit-taking Property Exposures December 2021; EU Non-bank Financial Intermediation Risk Monitor 2021; FSB Global Shadow Banking Monitoring Report 2021



** Estimates of non-bank lending share relate to total debt market size and are assumed as a proxy for the commercial real estate debt market. Source: RBA Financial Stability Review October 2021; APRA Quarterly Authorised Deposit-taking Property Exposures December 2021; EU Non-bank Financial Intermediation Risk Monitor 2021; FSB Global Shadow Banking Monitoring Report 2021*

A common question that arises from prospective new investors in CRE debt is *'why don't the bigger banks fund these transactions? Is there something fundamentally wrong with the borrowers?'* The answer is **sometimes** *'yes'* if the lending opportunity presented by the borrower is not economically feasible (and good credit managers will elect not to fund these deals), however developers may seek financing from non-banks for a number of other reasons. The other reasons are more nuanced and discussed further below.

Simplistically, large financial institutions generate profits for their shareholders by: (1) approving large volumes of loans; (2) supplying large volumes of credit for each loan; or (3) a combination of (1) and (2). In order for the financial institutions to achieve these profit objectives for their shareholders, the lending opportunities presented to them generally have to be quite standardised and homogenous (eg. standardised 25-year home loans) so as to maximise the number of loan approvals at relatively low cost by achieving operational efficiencies and 'scale'. In a lot of cases, loans that are not standard in structure are typically rejected by large financial institutions as the banks are not inclined to deploy resources, time or expertise on a large array of very bespoke lending opportunities. **A bi-product of this, is that it creates an active and thriving addressable market for non-bank lenders to negotiate customised and bespoke lending solutions for these borrowers seeking finance.**

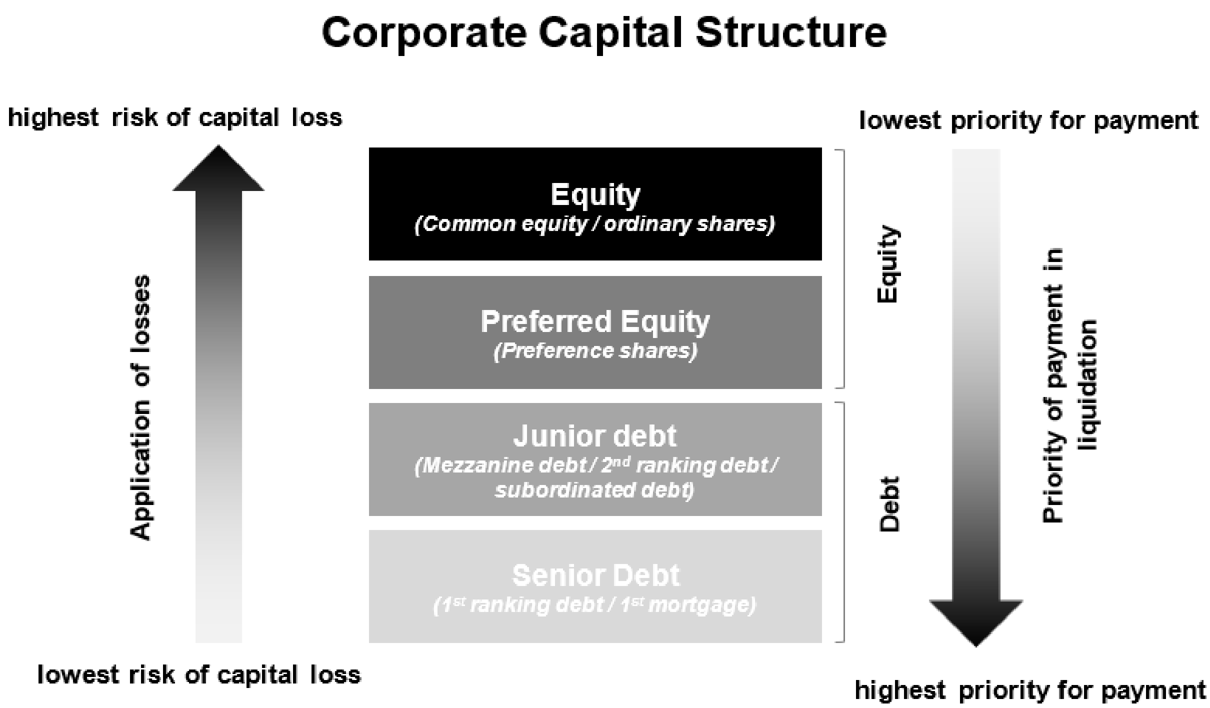
In addition, since 2014 the Australian prudential regulator APRA has provided guidance to limit banks' exposures to the property market to reduce systemic risk and concentration risk in the banking sector[1]. Effectively, this means that each bank has a limited 'pool' of capital that can be exposed or deployed into the property sector at any one time. As such, the banks attempt to secure only the least risky lending opportunities, leaving a large number of very good quality lending opportunities seeking capital. **This unmet demand for credit has led to significant growth in the non-bank lending market in Australia over the past decade.**

The Capital Stack: A Hierarchy of Financing

Before we dive into the specifics of CRE debt, it's important to understand the concept of the 'capital stack'. The capital stack is essentially a hierarchy of financing sources that are used to fund a real estate development through to completion. Each layer of financing attracts different levels of risks and therefore offers investors differing levels of returns based on the risks assumed by the investor.

At the top of the stack is equity, which represents ownership in the project and is capital that is typically provided by the developer or sponsor of the project. The equity holder is entitled to all upside or profit in a project; however, it is also the first capital in the stack to incur losses.

[1] www.apra.gov.au/sites/default/files/141209-Letter-to-ADIs-reinforcing-sound-residential-mortgage-lending-practices.pdf



A graphical depiction of the capital stack highlighting the features of debt and equity.

Beneath equity is debt. Debt is a **legal obligation** for a person or entity (the borrower) to pay a certain amount of money to another person or entity (the lender). When debt is advanced by a lender it is typically secured against a physical real estate asset, and this security interest is typically recorded on title with the relevant state-based land title registry. Debt can be further subdivided into several different layers.

The first layer of debt is typically **Senior Debt**, which is the most secure and lowest-risk (and therefore lowest-yielding/lowest-cost) form of financing. Senior debt is usually provided by a bank or other traditional lender and is typically secured by a first-ranking mortgage over the property. This means that if the borrower were to default, the senior lender would be entitled to the first right to repayment from the sale of property proceeds (i.e. have its loan repaid first). **Most homeowners with a mortgage would be familiar with senior debt as this is the type of arrangement typically entered into with a bank when purchasing a home or investment property.**

Above senior debt are several other layers of financing, including **mezzanine debt**, **preferred equity**, and **common (or ordinary) equity**.

Mezzanine debt is a type of financing that sits between senior debt and equity and typically carries a higher interest rate to compensate investors for a higher level of risk than first-ranking senior debt. Investing in mezzanine debt carries a higher risk than investing in senior debt but is less risky than preferred equity and common (or ordinary) equity. If the borrower were to default, the mezzanine lender would be 'second in line' to have their debt repaid from the sale of property proceeds as it ranks **after** the senior debt provider in the order of repayment.

Preferred equity is a hybrid form of financing that gives investors the right to receive a fixed return before any common equity holders.

Common (or ordinary) equity represents ownership in the project and carries the highest risk and highest **potential** reward/return. You may be familiar with common equity as this is what you invest in when you buy listed shares such as BHP, CBA, CSL etc. **If the borrower were to default, equity investors incur losses first (ie. before any other investor in the capital stack)** as their entitlement to capital and profit repayment is last.

Why now may be an opportune time to consider CRE debt

CRE debt can be an attractive investment opportunity for several reasons, particularly in the current choppy and uncertain economic climate. Some benefits of investing in CRE debt are outlined below:

- **CRE debt may provide investors with a return that exceeds inflation in an elevated-inflation environment** and may allow investors to achieve a **real return** on their capital;
- **CRE debt may reduce or dampen volatility in an investment portfolio** as the value of the CRE debt investment is not directly linked or correlated to investor sentiment and the *'ups-and-downs'* of share markets;
- **A CRE debt investment sits higher in the 'capital stack' than equity** meaning that investors may benefit from higher repayment priority and lower levels of risk and volatility than equity investments such a listed shares or listed hybrids;
- **CRE debt is typically asset-backed and secured by real property assets**. Asset-backed security can be supplemented with personal and/or corporate guarantees and other risk-mitigating mechanisms to improve the security package and the risk-adjusted return equation for investors; and
- **It is anticipated that in the short- to medium-term the CRE debt market will be ripe for attractively priced investment opportunities** as existing lenders reduce the supply of credit and become increasingly risk averse. History has shown time and time again that these fleeting periods of credit 'dislocation' regularly offer some of the best risk-adjusted return opportunities for those opportunistic investors who remain in the market.

Conclusion

CRE debt is a multifaceted market that plays a crucial role in the financing of real estate projects. The capital stack hierarchy, which starts with equity and progresses through different layers of debt, provides a roadmap for investors to consider as they evaluate potential investments. As the market continues to evolve, CRE debt remains an attractive opportunity for investors looking to capitalise and achieve real returns on their capital with real asset-backed security whilst shielding their capital from the risks and volatility of traditional equity markets.

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