challenger

CHALLENGER INVESTMENT MANAGEMENT

A fresh look at Australian CRE Debt

Pete Robinson

Head of Investment Strategy

FEBRUARY 2025

A fresh look at Australian CRE Debt

Learning Outcomes

- a balanced appreciation of both the risks and opportunities in CRE lending
- Tools to identify signs of weakness or stress
- A strategy to take advantage of potential stress

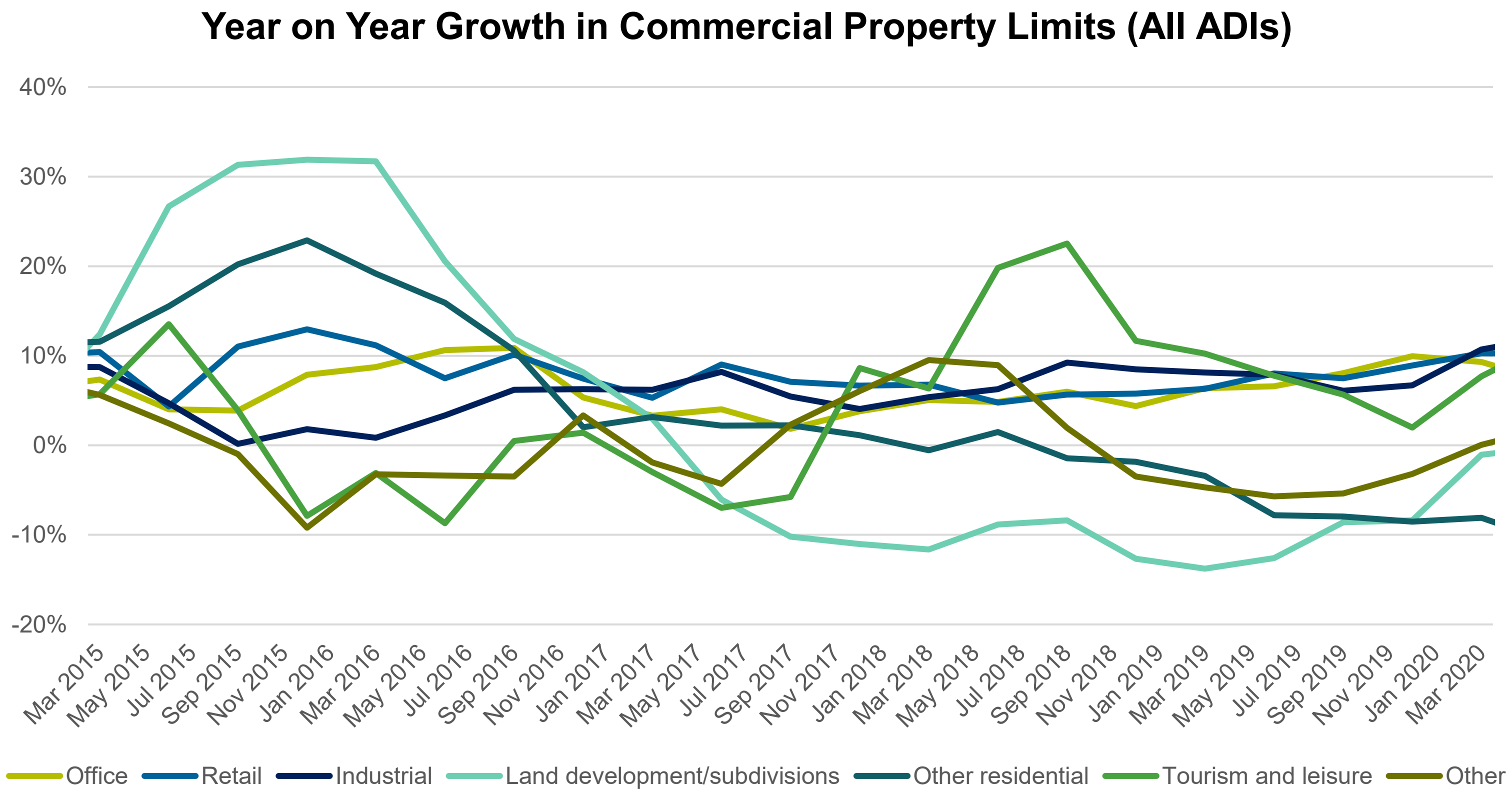
Agenda

1. How did we get here?
2. The post COVID environment
3. Identifying the key risks
4. Seeking out opportunities

The original gap: 2015 to 2020

Basel III reforms created an opportunity for non-banks to replace banks

Bank Don'ts
Residential developments where loan to cost is greater than 75%
Residential developments where <100% of the debt is covered by pre-sales
Income producing real estate where the rental income is insufficient to repay the loan

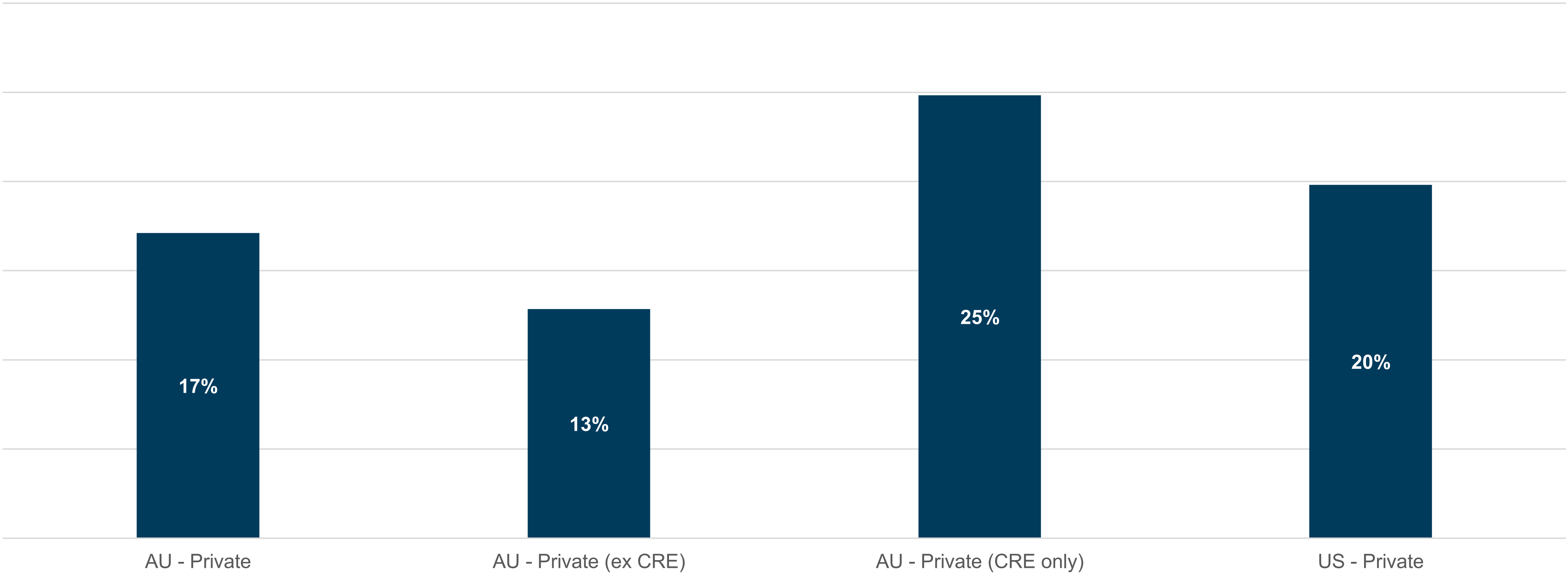


Source for chart: APRA

The emergence of private credit In Australia

A A$205 billion market

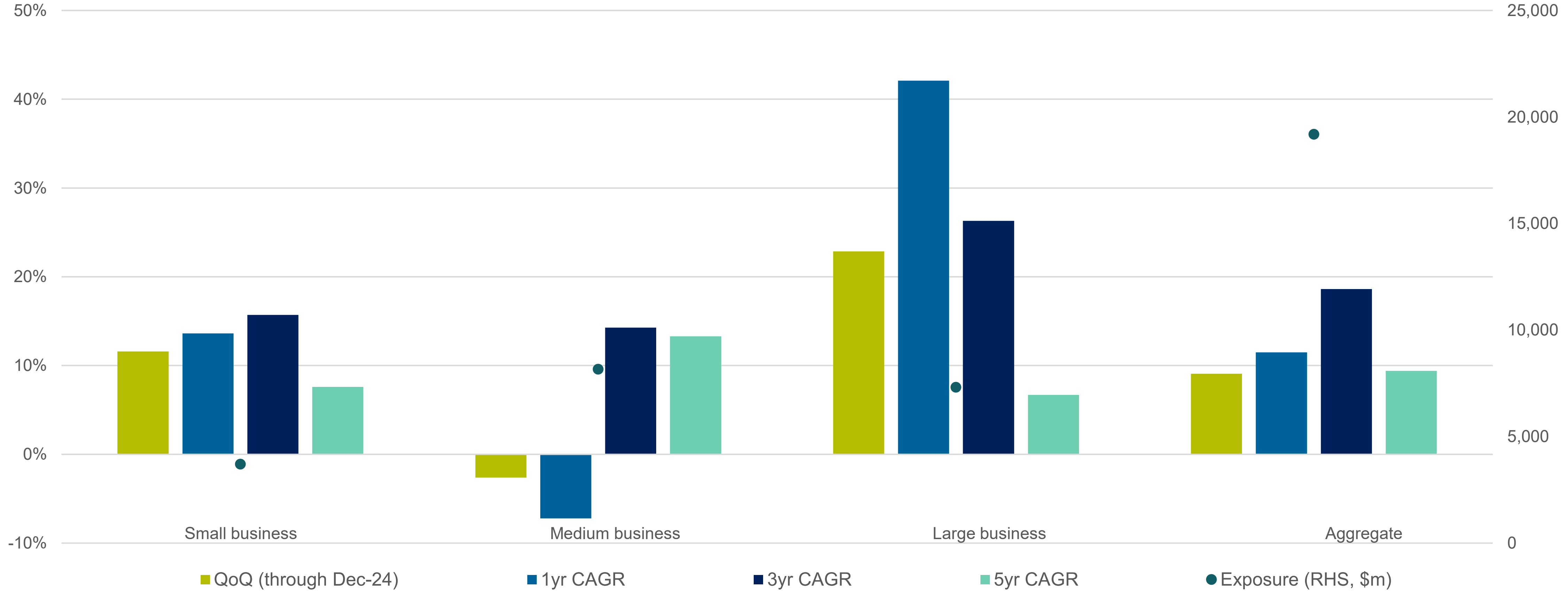
4 Year (2020-2024) CAGR of Private Credit



Source for chart: Ernst & Young, Alvarez & Marshal, IMF

Residential Building Construction Finance

Growth in large business lending mirrors the growth in CRE private lending



Source: RBA Financial Aggregates

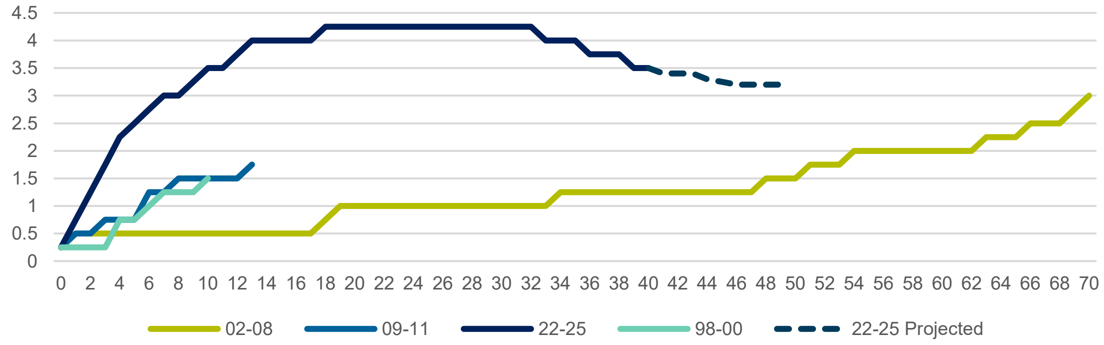
challenger

A New Gap: 2025 onwards

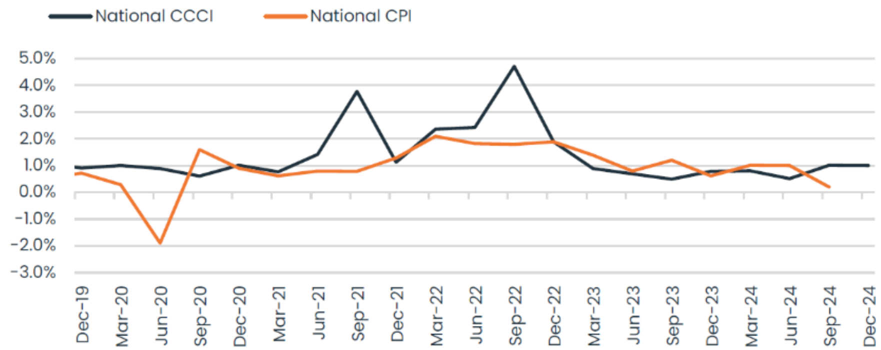
A storm is brewing

With rates coming down, are we through the worst of the CRE cycle?

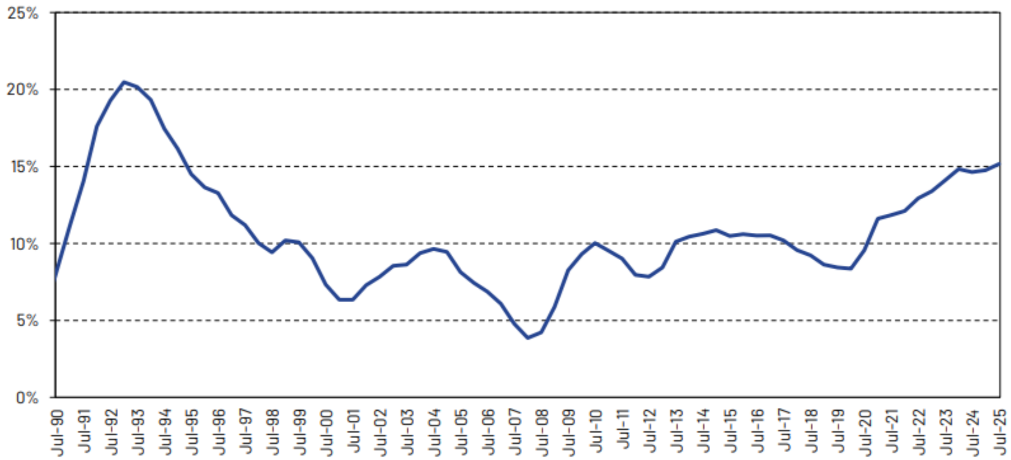
Still the fastest and sharpest rate hiking cycle on record



Residential construction costs up >30% since the start of COVID



Office Vacancy Rates settling in the mid-teens as flexible working holds



Apartment construction projects taking longer to complete

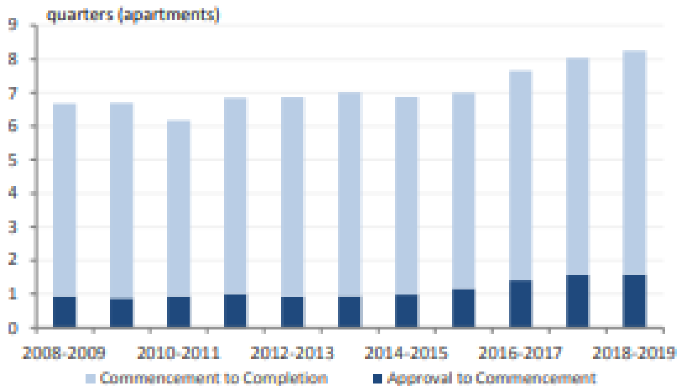
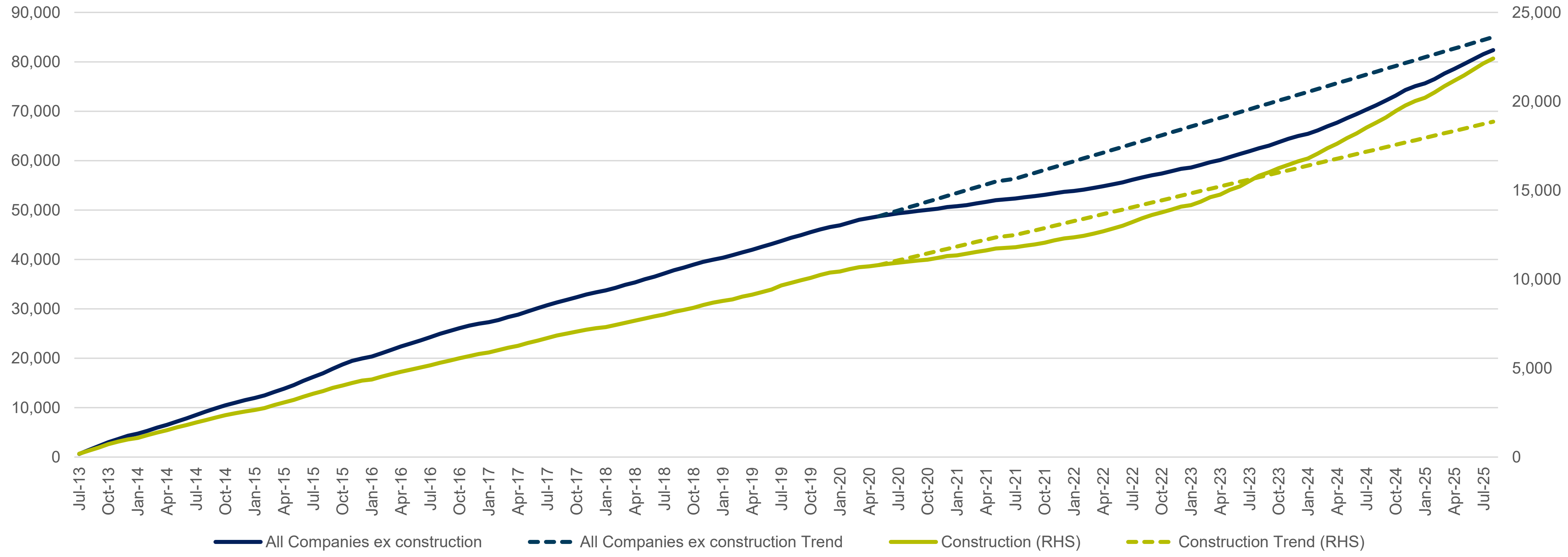


Chart sources (top left, clockwise): 1. Bloomberg, 2: Core Logic, 3: Property Council of Australia, 4: ABS, Morgan Stanley

Insolvencies

Insolvencies in the construction sector have already surpassed pre-COVID trends

Insolvencies versus pre-COVID trends: All companies excluding construction vs construction only

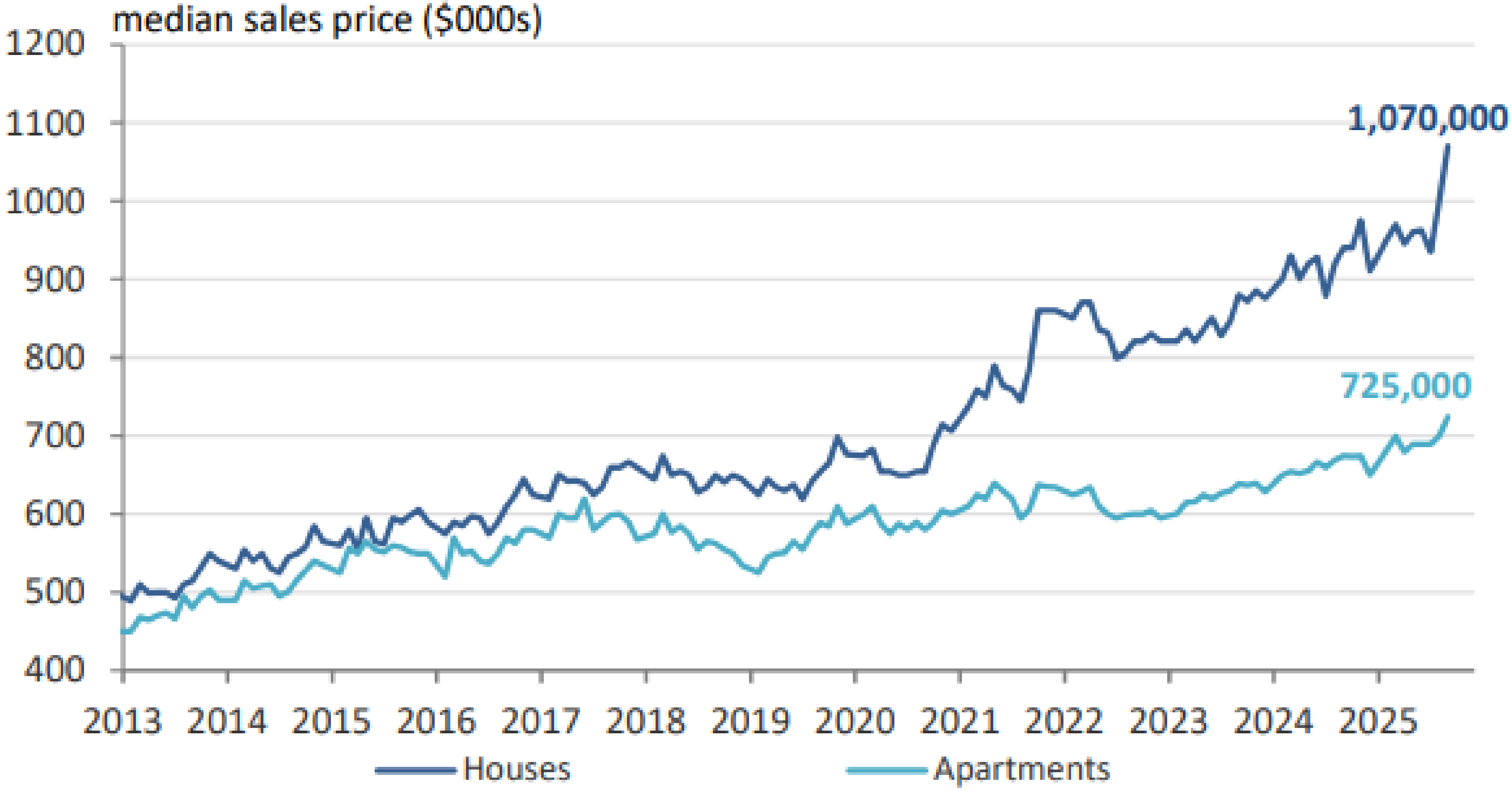


Source: ASIC

challenger

House prices vs apartments

Apartment prices growing at less than half the rate of houses and less than inflation



Apartment prices

- Up less than 4% p.a. over the last 5 years
- In Melbourne, still below post COVID peak of 21/22
- Rental inflation is moderating

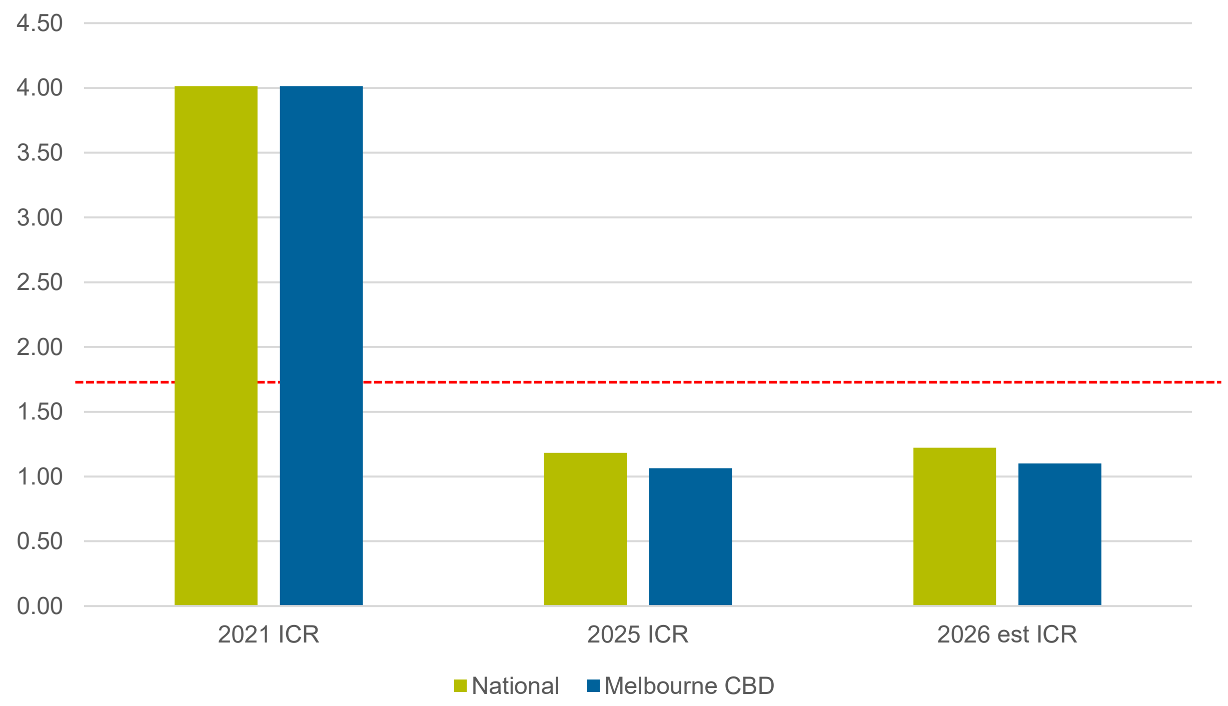
Source: CoreLogic, Morgan Stanley

challenger

The maths doesn't work

Interest coverage ratio of an office loan

**Bank loan balances need to be reduced by >40%
in order to reach a clearing interest cover ratio of 1.75 times**



Borrower options

Modify existing loan

OR

Recap with equity

OR

Recap with non-bank debt

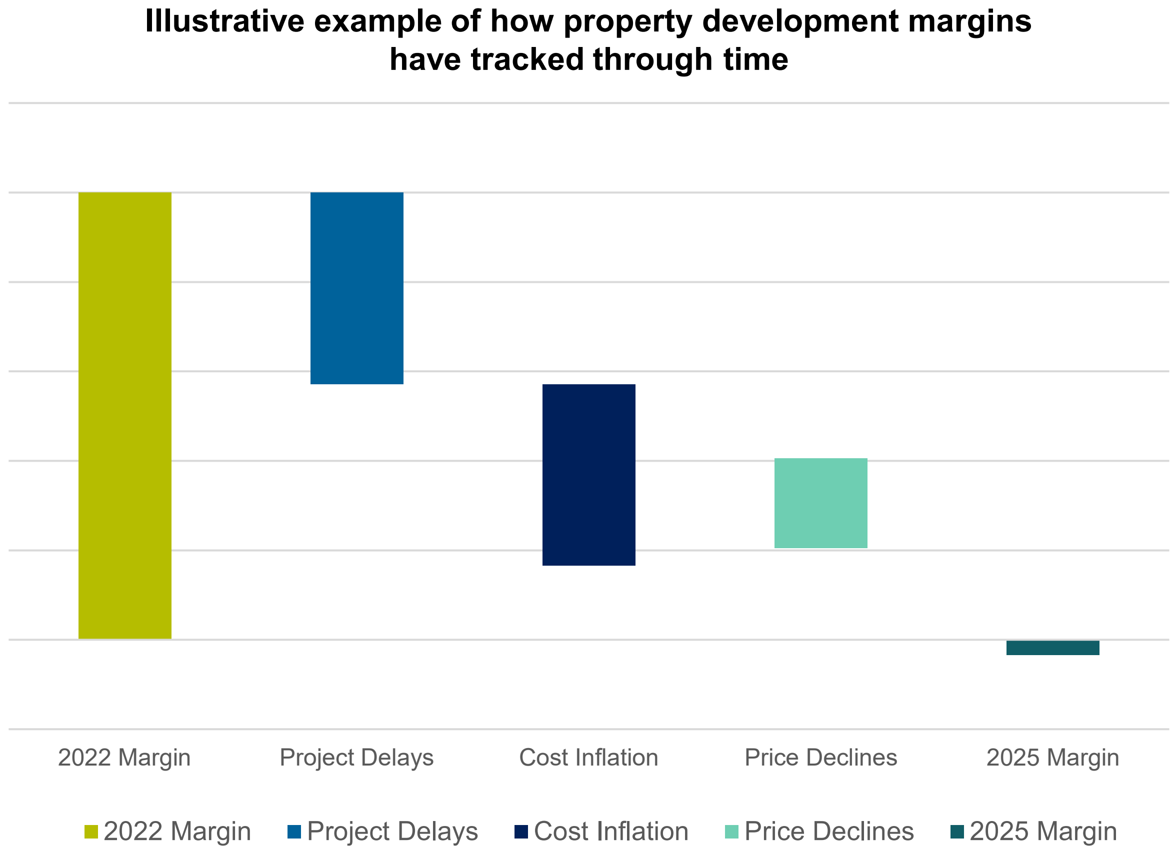
OR

Sell the asset

Source: Challenger Investment Management. Calculations based on a 65% LVR loan on an office with a net yield of 6% and bank margin of 220 basis points. Net effective rents have declined by 10% in Melbourne, flat nationally. 2026 est ICR based on forward curve implied base rate of 3.35%. Non-bank margin of 420 basis points.

The maths doesn't work

Residential property development



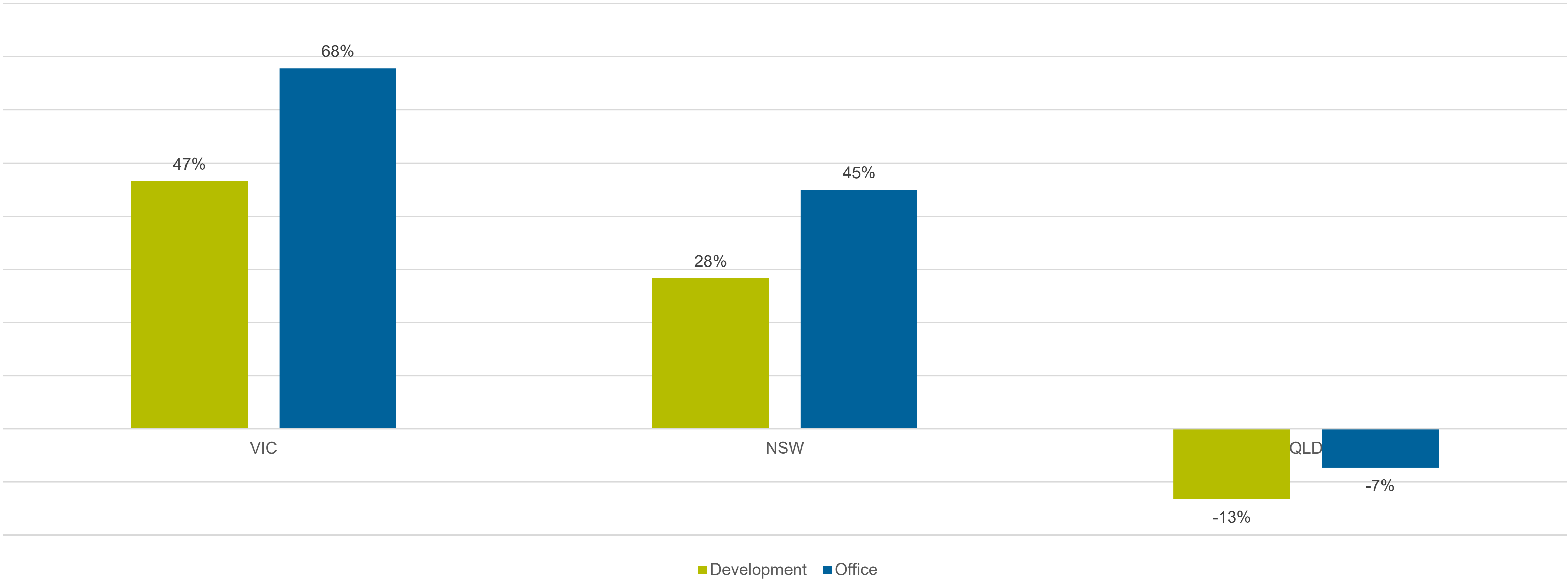
If the maths doesn't work, why isn't there more stress out there?

Developer options
Complete project at loss
OR
Delay sales and hope house prices increase
OR
Restructure the debt
OR
Walk away

Source: Challenger Investment Management.

Gaps emerging

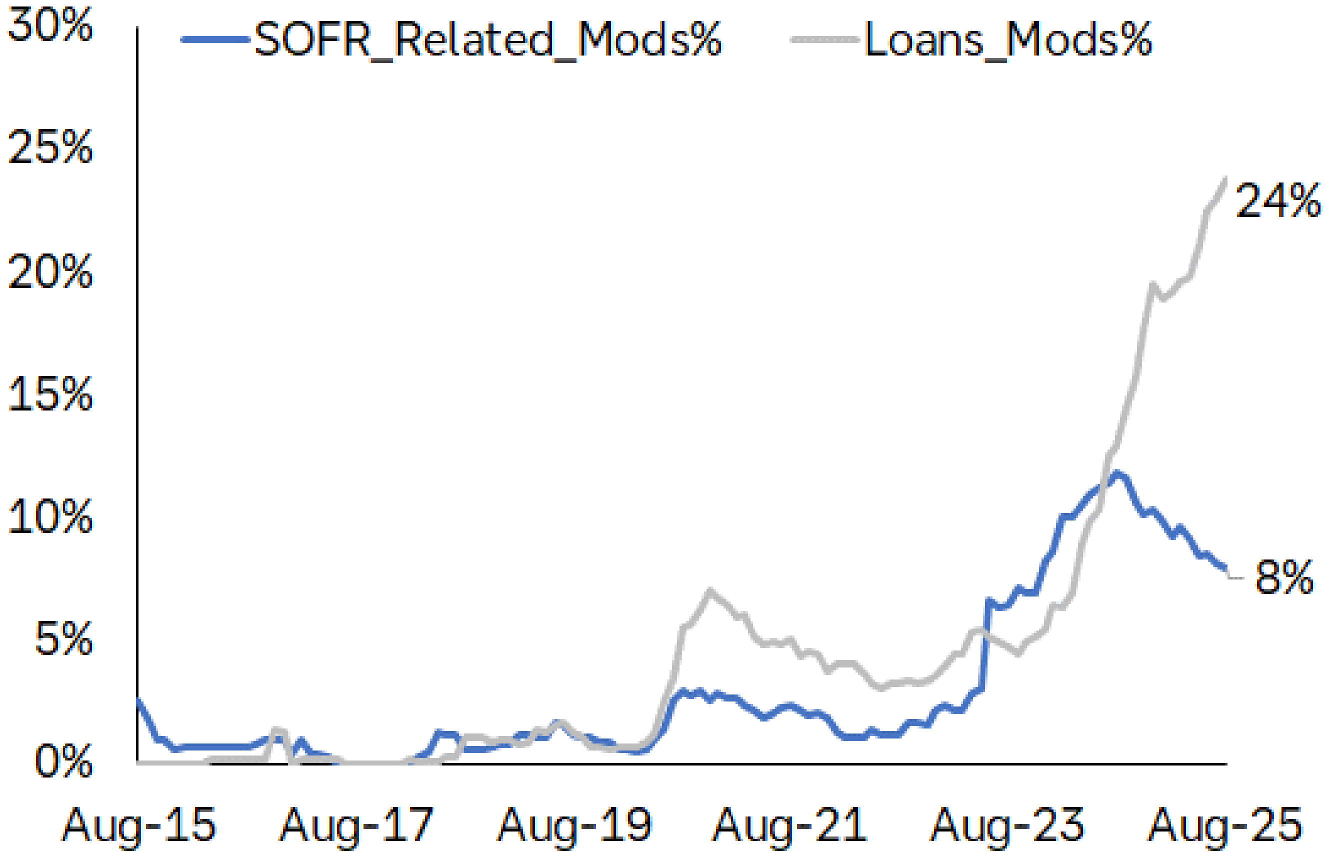
Increase in sites for sale Q422-Q425



Source: realcommercial.com.au

Kicking the can down the road

In the United States 24% of CRE loans have been modified



Is there evidence of extend and pretend in Australia?

Impact of extend and pretend:

- Lower returns
- Lower distributions
- Increased risk profile

Source: JPMorgan

The regulator is watching…

CRE lending is under considerable scrutiny

Will regulatory scrutiny result in reductions to CRE debt allocations?

ASIC has called out…
Inappropriate TMD statements
Disclosure of all fees
Questionable related party transactions
Improper valuation practices
Concentration of risk, especially to real estate
Consistency of terminology

Focus from ASIC could lead to outflows

Outflows could lead to more stress/less extend and pretend

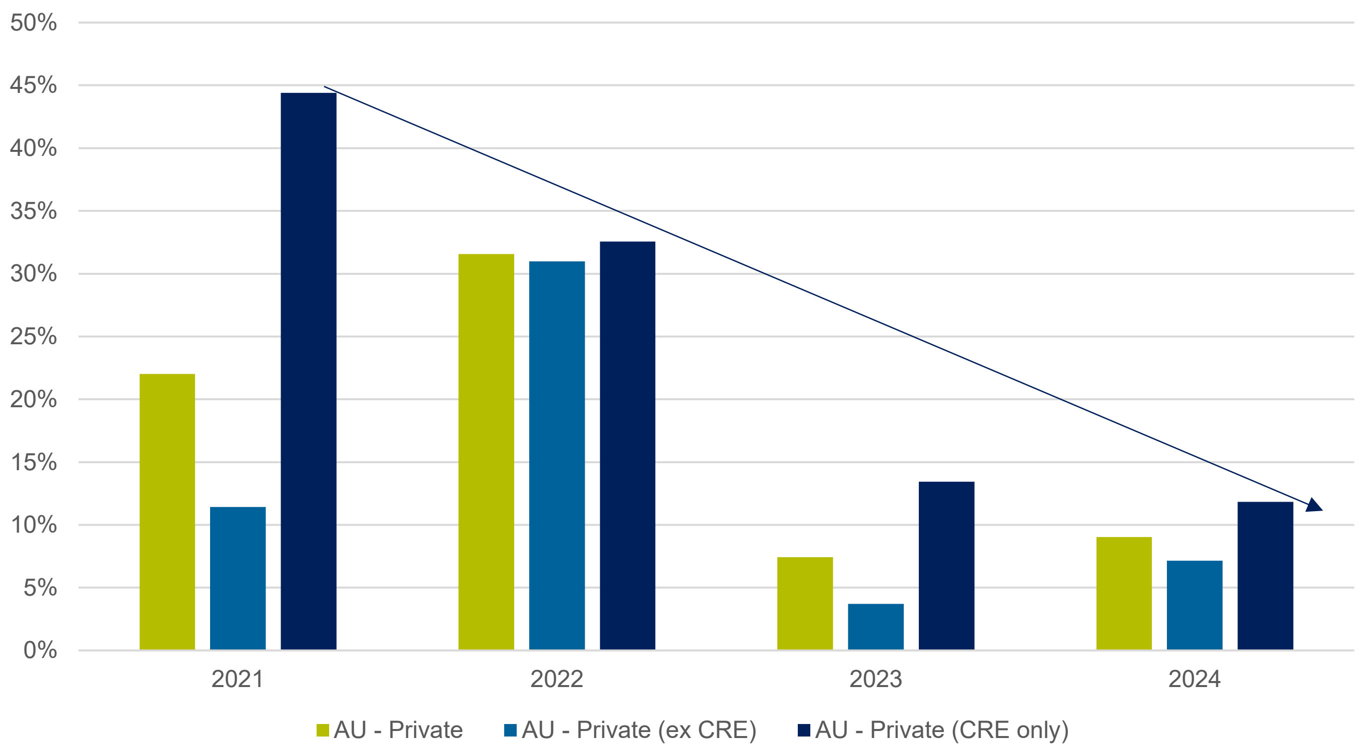
What to watch for
Reduction of portfolio allocation leading to outflows
Full disclosure of fees paid implying much higher fee burden to investors
Less extend and pretend activity as the threshold for RPTs is raised
More pressure to reduce valuations earlier, less extend and pretend
Less capital allocated to real estate lending strategies especially in retail
Higher LVRs reported if based on cost not as if complete

The tide is starting to go out

Managers can only extend loans when they have the capital to do so

Capital flows could turn negative

- Growth in CRE private credit is slowing
- Interest rates are not coming down sharply as hoped
- ASIC is investigating the private credit sector
- Returns are moderating
- Apartment prices are declining
- Negative headlines increasing
  - Lenders enforcing rather than extending
  - Funds suspending redemptions
  - Poor performance
  - Conflicts of interest



Source for chart: Ernst & Young, Alvarez & Marshal.

challenger

The opportunity to step in when others are stepping out

Example transactions for when the tide turns

	Office Loan	Residual Stock Finance
Description	Newly developed Melbourne fringe CBD office • Refinances development loan • Interest reserve account to mitigate sub 1 times ICR • Exit via sale within 3 years	Super senior loan secured over stock of unsold but completed apartments • Refinances development loan when existing financier lacks capital • Conservative loan based on observable sales data
Terms	**Opening Margin:** 5.75% **Upfront Fee:** 1.05% **Term:** 3 years (Bullet) **Rating:** B+ (Internal) **Ranking:** Senior Secured **Covenants:** • Loan to Value Ratio <77.5% • Permitted Distributions: None • Interest Reserve: Fully Funded • Personal Guarantees • Occupancy >75% within 12 months	**Opening Margin:** 5.00% **Upfront Fee:** 0.95% **Term:** 2 years (Amortising) **Rating:** BBB (Internal) **Ranking:** Super senior secured **Covenants:** • Where LVR>50%, 100% of sale proceeds to lenders, otherwise 60% • Max LVR 65% tested every 180 days • Interest reserve: 6 months

A fresh look at Australian CRE Debt

Action Items

- Assess existing exposure to CRE debt
- Determine how to identify stress in existing exposures or the wider market
- Develop a plan to take advantage if stress emerges

Key Takeouts

1. CRE debt is at the centre of the private credit boom in Australia
2. CRE debt has been hit by inflation and higher interest rates with many issues unresolved
3. Regulators have turned their focus to CRE debt which increases the risk to investors
4. Opportunities could emerge for investors with patient capital

challenger

Further reading

1. What We're Watching December, 2024: our quarterly round up across markets (including CRE): https://www.challengerim.com.au/what-were-watching-quarterly-report-december-2024/
2. Podcast with Gerard Hargraves, Head of Real Estate Lending: https://www.investordaily.com.au/podcast/55042-exploring-private-credit-trends-with-gerard-hargraves-from-challenger-investment-management
3. What We're Watching April 2023: a look at the maths of commercial real estate lending: https://www.challengerim.com.au/what-were-watching-the-maths-of-commercial-real-estate-lending-april-2023/
4. What We're Watching September, 2024: a look back at how governance risk can impact performance outcomes in private credit: https://www.challengerim.com.au/what-were-watching-lessons-from-the-noughties-fooling-some-of-the-people-all-of-the-time/

Disclaimer

Unless otherwise specified, any information contained in this material is current as at date of publication and is provided by Challenger Investment Partners Limited (Challenger Investment Management or Challenger) (ABN 29 092 382 842, AFSL 234678). Fidante Partners Limited ABN 94 002 835 592, AFSL 234668 (Fidante) is the responsible entity and issuer of interests in the Fund. Fidante and Challenger Investment Management are members of the Challenger Limited group of companies (Challenger Group). Information is intended to be general only and not financial product advice and has been prepared without taking into account your objectives, financial situation or needs. You should consider whether the information is suitable to your circumstances. The Fund's Target Market Determination and Product Disclosure Statement (PDS) available at www.fidante.com.au should be considered before making a decision about whether to buy or hold units in the Fund. Past performance is not a reliable indicator of future performance.

Investments in the Fund are subject to investment risk, including possible delays in repayment and loss of income or principal invested. Accordingly, the performance, the repayment of capital or any particular rate of return on your investments are not guaranteed by any member of the Challenger Group.