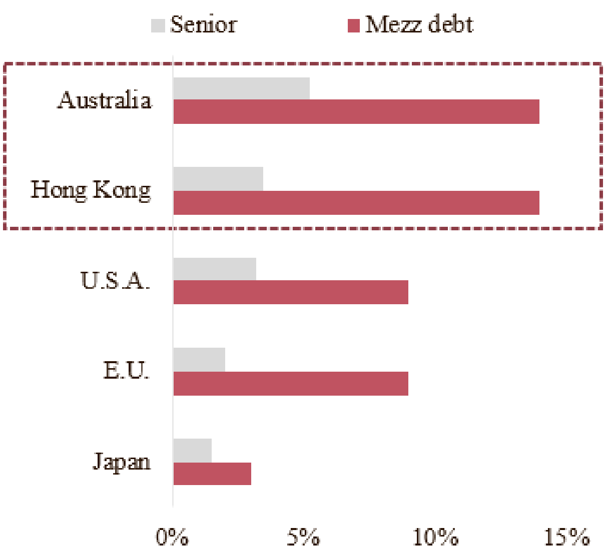
Government regulation is creating high risk-adjusted returns for Asian Real Estate Debt – June 2022

by Milan Khatri, Director, Head of Research

Key Asian markets are offering debt returns significantly ahead of Europe and the US

- As of Q2 2022, mezzanine debt returns were reaching mid-teens in Australia and Hong Kong, reflecting the ongoing impact of stringent government regulation of bank lending to the real estate sector (see chart 1)
- As central bank borrowing costs are rising, real estate debt returns could potentially rise to reflect higher risk-free interest rates in both Hong Kong and Australia
- Adjusted for inflation, junior loan returns are expected to be c.10%, which we believe is particularly attractive for real estate debt in developed markets
- Within APAC, Australia stands out as a particularly attractive market due to it relatively low real estate market risk, and given its high level of transparency and strong legal process
- In the US and Europe, mezzanine loans on average yield less than 10%, reflecting relatively high liquidity in these markets – – in this context Australia and HK stands out with respect to available returns

Chart 1: Senior and mezzanine commercial real estate loan returns, Q2 2022[1]



[1] Source: Phoenix estimates, CBRE, Wüest Partner, 2021/2022

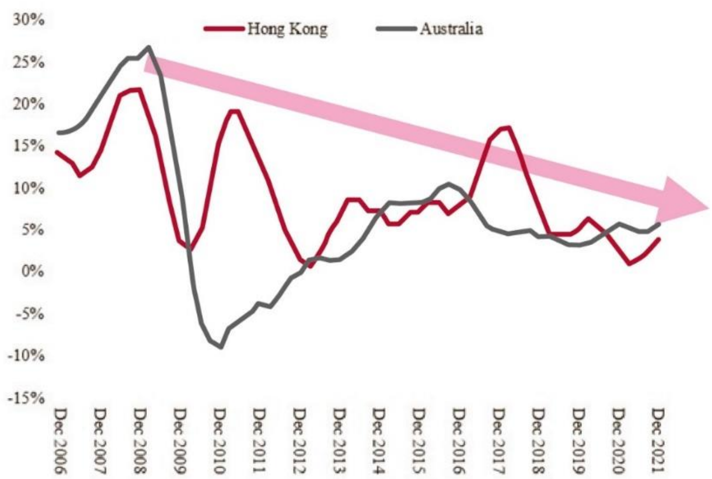
Capital raised for private Asian debt funds is much smaller than in the US or Europe

- Over the past 4 years (2017-2021), APAC credit funds have raised US$ 1.2 bn per year against US$ 8.1 bn and US$ 10.2 bn for European and US private real estate credit funds respectively
- This suggests that Asia's relatively high yields are more sustainable due to less liquidity, and therefore should remain relatively attractive for the foreseeable future compared to the US and Europe
- We estimate that the overall size of commercial real estate lending markets in Asia Pacific is US$ 3.4 trillion (across China, Japan, Korea, H.K. and Australia), and larger than the US and Europe which are US$ 3.25 trillion and US$ 2.1 trillion respectively

Why are Australia and Hong Kong so attractive for credit investments?

- Australia and Hong Kong face restrictions on domestic real estate lending as regulatory authorities seek to reduce potential systemic risk to the banking sector - the result is that relatively high private credit returns are achievable in these markets as domestic banks have curtailed lending (see chart 2)

Chart 2: Bank Lending to Real Estate, % p.a. growth[2]



- Returns are elevated in China but the risk surrounding the real estate market, and particularly to development projects, is also high. This reflects the ongoing deleveraging campaign to reduce the debt of large developers, and the subsequent spillover to the broader industry. Opportunities are likely to arise though in the short-term we are cautious on this market.
- In other Asian markets such as Japan and Korea (see chart 3), ample domestic bank liquidity means that opportunities for non-bank lenders are relatively limited, or only available at very high loan to value ratios (80% plus).

[2] Source: APRA, HKMA. April 2022. Figures are rolling 12-month averages. Excluding residential mortgages.

- As interest rates rise, potential returns in select markets are also likely to rise – we note that interest rates have risen in both Hong Kong and Australia in 2022

Chart 3: Asia: Senior and mezzanine commercial real estate loan returns, Q2 2022[3]

	Senior debt up to 65% LTV	Mezzanine debt up to 75% LTV
Japan	1-2%	2-4%
South Korea	4-7%	6-10%
Australia	**3-8%**	**10-18%**
Hong Kong	**3-4%**	**10-16%**
China	5-6%	12-17%

- We also note that the underlying economic fundamentals of Australia and Hong Kong are robust, reflecting medium growth potential that arises from:
    - **Australia:** Robust population growth which we see resuming, and border controls have already relaxed significantly as the pandemic reduces in impact
    - **Hong Kong:** Ongoing economic integration with mainland China will fuel further growth in financial and business services in H.K. (e.g. robust mainland IPO activity in H.K. to the end of 2021)
- These two economic drivers for Australia and Hong Kong are evident in long-term employment growth that has trended above the average for developed Asia, the U.S. and the eurozone (see chart 4) for over a decade

[3] Source: Phoenix estimates, 2022

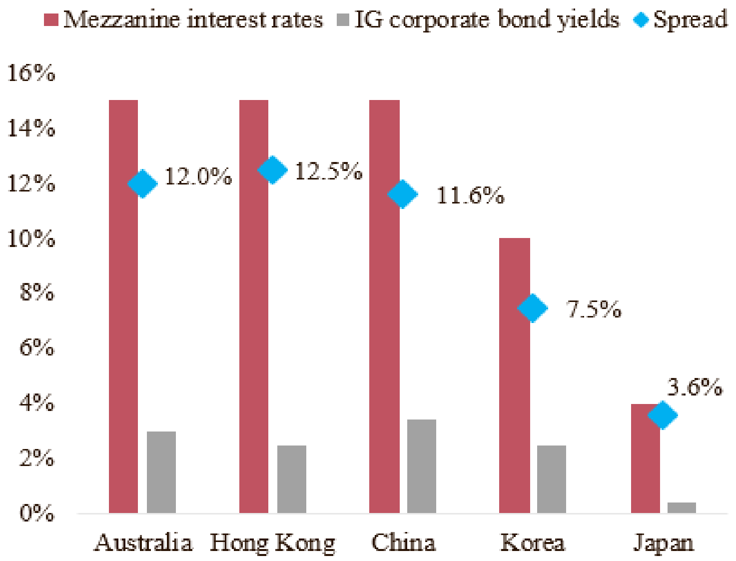
Chart 4: Long-term employment growth (pre-COVID) 2006-2019, % p.a. [4]

Australia	1.9%
Hong Kong	1.0%
Developed Asia	0.9%
United States	0.7%
Euro area	0.5%

Real estate debt can offer a significant return premium over liquid fixed income investments

- We estimate that for the target investment markets of Australia and Hong Kong, mezzanine returns are approximately 12% above that of investment grade corporate bonds as of Q2 2022 (see chart 5).
- In the US and Europe, the yield premium for mezzanine debt over investment grade corporate bonds sits at 7-8%

Chart 5: Mezzanine loan yield premium over investment grade corporate bonds, 2021/2022 [5]



[4] Source: OECD, National Statistics (2006 to 2019)
[5] Source: Phoenix estimates, CBRE, Wüest Partner, S&P, 2021/2022

Asia's return premium is attractive on a risk-adjusted basis

- Phoenix believes that a risk premium of c.12% in key Asian markets (i.e., Australia and Hong Kong) is likely to offer attractive risk-adjusted returns, particularly when benchmarked against available returns in Europe and the USA
- From an investment risk perspective, both Australia and Hong Kong can be regarded as relatively low risk as they share many similar fundamentals to other western economies – such as high sovereign credit ratings, high income per capita, and offer strong, tried, and tested legal institutions that support the safeguarding of investor capital (see chart 6)
- In a rising inflation environment, the expected returns on junior debt in HK and Australia are likely to be comfortably above expected inflation - as of April 2022 inflation in HK was only 1.3% while in Australia inflation reached 5.1% in Q1 2022 – hence junior debt returns in real terms could potentially be in excess of 10%
- Also, this risk premium for Asian mezzanine debt appears attractive in the context of the historical average risk premium for U.S. mezzanine loans of c. 6% against investment grade corporate bonds from 2010 to 2020[6] (historical mezzanine loans return data is not available in other markets such as Europe or Asia Pacific)
- Finally, we also note that unlike liquid fixed income instruments, private real estate loans (senior and junior) have security packages granting direct access to physical real estate in the event of default which can significantly help to mitigate downside investment risk

Chart 6: Macroeconomic risk profile[7]

	Credit Rating	GDP per capita (US$ '000)	Rule of Law Ranking
Australia	AAA	63	13
Singapore	AAA	66	17
Hong Kong	AA+	49	19
South Korea	AA	35	20
Taiwan	AA	33	20
Japan	A+	40	15
China	A+	12	98
India	BBB-	2	79
Germany	AAA	51	5
United Kingdom	AA	46	16
France	AA	45	24
Spain	A	30	22
Italy	BBB	35	34

If you would like more detail on the questions above and Phoenix Property Investors' market views please get in contact (ir@ppinvestors.com) and we would be happy to help.

[6] U.S. mezz loans achieved a return of 10.6% p.a. from 2010 to 2020 which compares with investment grade corporate bond returns of 5.1%. Source https://jpm.pm-research.com/content/early/2021/08/23/jpm.2021.1.269 and S&P, 2021
[7] Source: S&P, IMF, World Justice Project Rule of Law Index, 2022. Rule of Law ranking is out of 140 countries.

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