# APAC Real Estate Debt Market Update

July 2023

IN A NUTSHELL

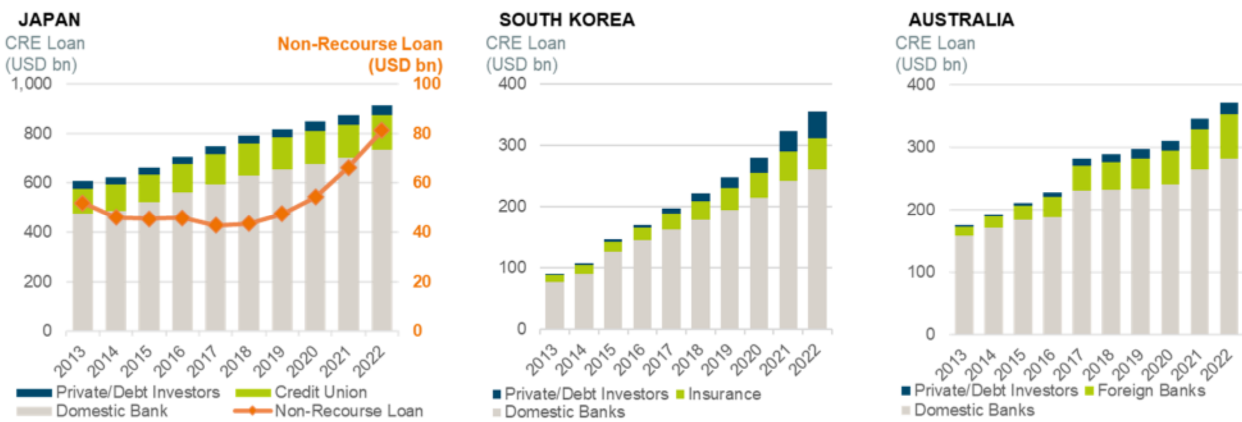
- Compared to the US market, APAC market share of private/debt investors remains small but is growing rapidly.
- As successive rate hikes since 2022 have led to the negative spreads between cap rates and lending rates, a window of opportunity has opened up for real estate debt investments.
- Construction loans and mezzanine financing, as opposed to senior lending, will likely provide attractive risk-adjusted returns, especially in South Korea and Australia.

## Structural Shift of CRE Lending Market

Amidst rapid interest rate hikes over the last two years, the U.S. regional bank failures in early 2023 raised questions on the banking exposure to commercial real estate (CRE) loans, with U.S banks under pressure to de-risk by reducing exposure to CRE lending to cut their capital requirements and raise liquidity buffers, in turn shrinking credit availability for CRE borrowers.

Over the last ten years, the APAC CRE lending market has been dominated by traditional local banks. The size of the market remains nascent but fast-growing compared to the more mature U.S. and Europe private debt markets. In particular, three developed markets in the Asia Pacific region, i.e., Japan, South Korea, and Australia, saw continuous growth in CRE lending along with the rapid growth of the CRE transaction volume. Japan remains the largest among the three key markets, while the non-recourse loan or asset-level financing market remains relatively small as prominent developers in Japan tend to prefer cheaper options like corporate finance. On the contrary, South Korea and Australia primarily depend on asset-level financing, which has grown two-four times over the last ten years. As the APAC region has also seen similar successive rate hikes since 2022, and the traditional local banks who have been dominant in the sector started to tighten lending, an unprecedented window of opportunity has opened up for new CRE debt investors.

EXHIBIT 1: COMMERCIAL REAL ESTATE LENDING BY COUNTRY IN ASIA PACIFIC

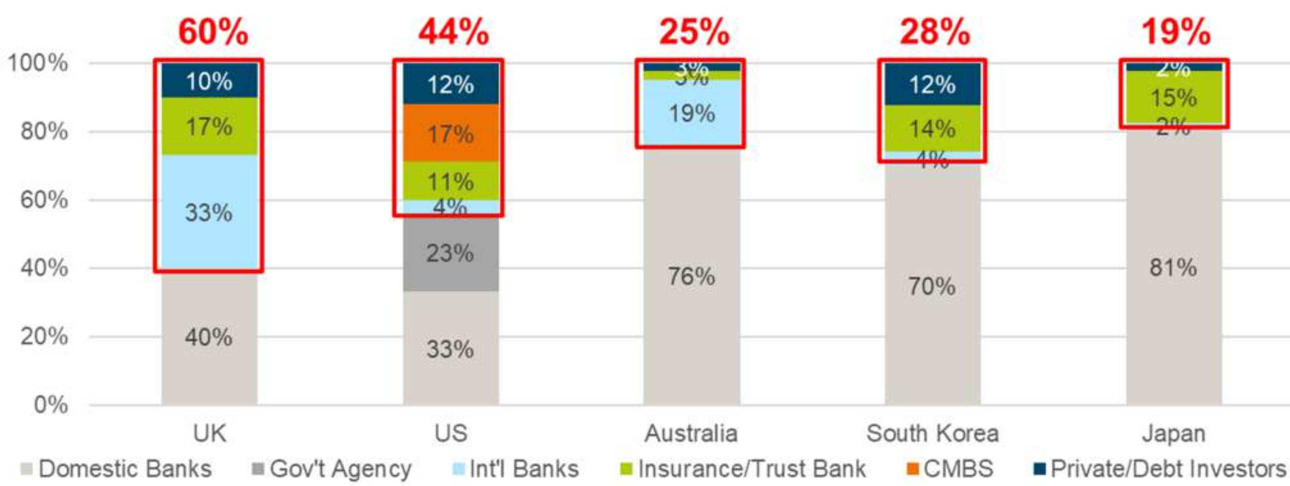



Source: Real Capital Analytics, Bank of Japan, FISIS, APRA Quarterly ADI Property Exposures, DWS. As of July 2023.

## Share of Non-Bank Lenders in APAC

CRE lending markets in APAC remain dominated by local banks and lenders, thus less diversified compared to U.S. and Europe. For example, U.S. and U.K. have high diversification with non-domestic bank lenders comprising 44-60% of overall lending in 2022-2023, compared to 19-28% in key APAC markets. Moreover, APAC markets lack established financing channels such as CMBS, Mortgage REIT, or pan-regional debt funds, limiting senior debt borrowers to direct lending from local banks or insurance companies. There has been the emergence of several single-country-focused debt funds in the region, particularly in Australia and India, mostly funded through local capital and focused on the residential sector. However, most were small-scale and slow in deploying capital, as structuring debt deals in Asia is less straightforward and competition had been severe with local banks.

EXHIBIT 2: SHARE OF NON-DOMESTIC BANK LENDER BY MARKET



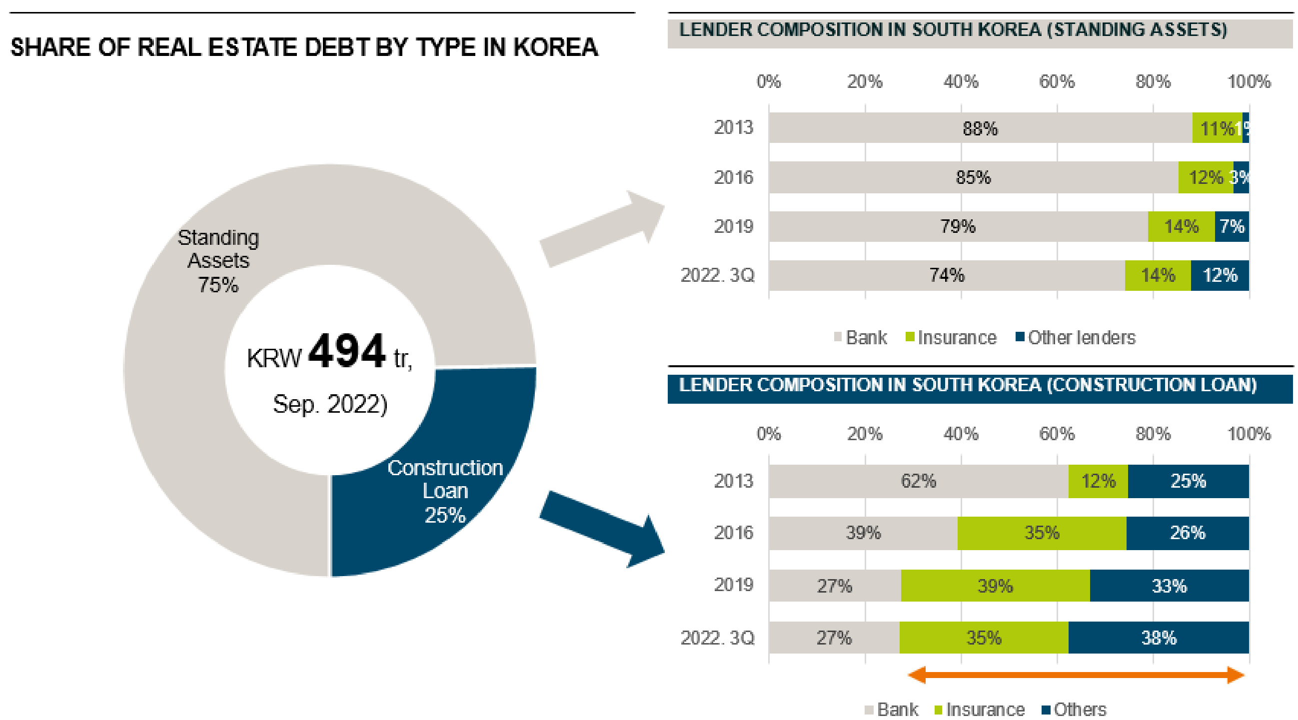

Source: Real Capital Analytics, Bank of Japan, FISIS, APRA Quarterly ADI Property Exposures, DWS. As of July 2023.

## Increasing Attractiveness of Construction Loans with Regulation Changes

Compared to senior lending, construction loan markets have more diversified lending sources in APAC due to banks' diminishing lending appetite and the roll-out of stronger capital regulations for the banking industry, or Basel III[1]. This has varying impact in APAC, with Japan less affected due to the lower proportion of non-recourse borrowing. On the other hand, in South Korea and Australia, higher reliance on non-recourse lending to development projects impose higher-risk scores or capital reserve requirements on the banks. Consequently, local banks in these markets have gradually retreated from the construction loan market since 2013, yielding their share to the non-banking lenders, including insurance, securities, and mortgage companies with a tiny presence of real estate lending funds or institutional lenders.

Exhibit 3 shows that while local banks still dominate lending to standing assets in South Korea, their market share in construction project loans dropped dramatically from 62% in 2013 to 27% in the third quarter of 2022, while insurance companies and other non-bank lenders have expanded their market share of construction financing to 35% and 38% respectively.

**EXHIBIT 3: COMPOSITION OF REAL ESTATE DEBT BY LENDER GROUP IN SOUTH KOREA**



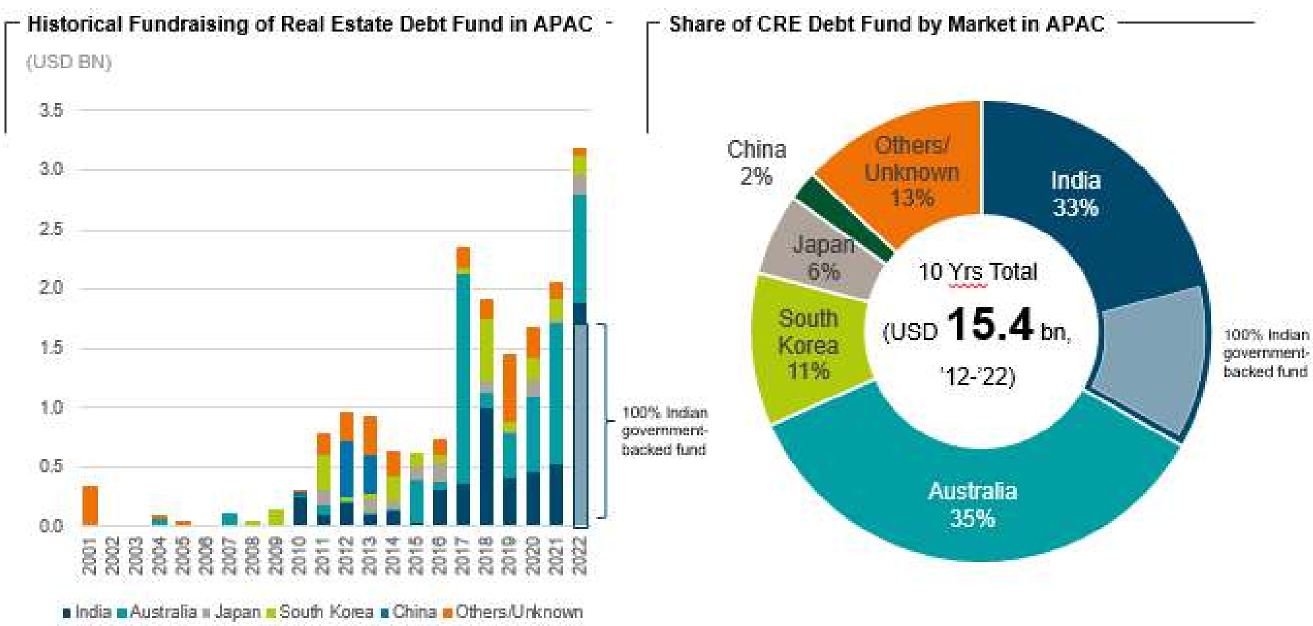

Source: FISIS, DWS. As of July 2023.

[1] Basel III is an international regulatory accord that introduced a set of reforms designed to mitigate risk within the international banking sector by requiring banks to maintain certain leverage ratios and keep certain levels of reserve capital on hand. The capital requirement is based on a risk assessment for each type of bank asset, when construction loan gets

## Fast-Growing but Still a Tiny Existence of CRE Debt Fund in APAC

Among lender groups, APAC CRE Debt funds remain nascent but have grown rapidly in the last ten years. Fundraising volumes tripled from c. USD 1 billion in 2012 to c. 3.1 billion in 2022, mostly targeted at mezzanine development loans in Australia or development finance in India (mainly non-performing loans or government-backed funds for condominium development projects). In 2023, CRE debt fundraising increased further throughout the region, while South Korea saw record fundraising of c. USD 2 billion from a couple of funds, by far the largest and more than ten times larger than the historical average of the country's annual fundraising amount in the last ten years. With the lack of other established financing channels, single-country-focused CRE debt funds are expected to continue to drive the expansion of the CRE lending market along with increasing investment demand from institutional investors.

**EXHIBIT 4: HISTORICAL FUNDRAISING OF COMMERCIAL REAL ESTATE DEBT FUND IN APAC**

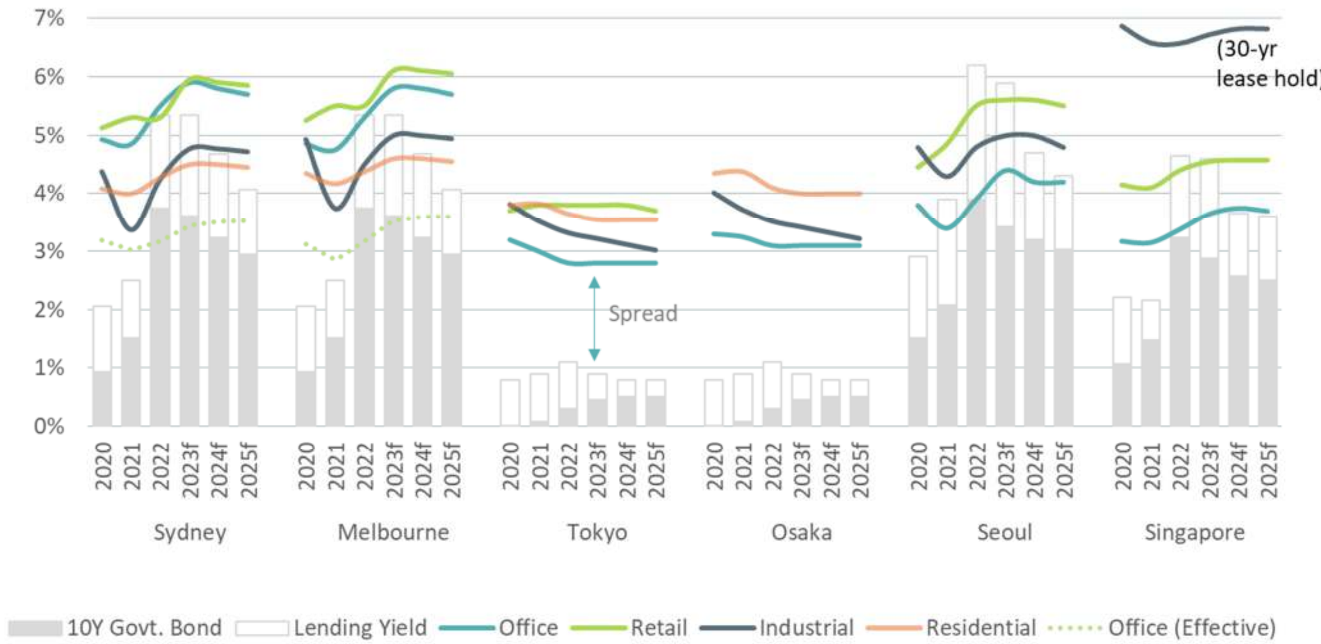



Source: Preqin, DWS. As of July 2023.

## Market Developments with Interest Rate Hikes since 2022

Since 2022, the APAC CRE debt market has faced an unprecedented turning point for market expansion, with key central banks rapidly hiking their base rates to fight surging inflation. Most traditional lenders in the region significantly tightened lending conditions and even stopped new real estate lending. Even for the small number of the successful financing transactions, higher financing costs have resulted in negative carry for investors reliant on external financing. The negative spreads between the cap rate and the lending yields have expanded to the record level of around 200-300 bps in Australia and South Korea, increasingly putting downward pressure on property valuations and eroding cash yields of stabilized assets for equity investors. In other words, it has transferred the income returns of landlords and development margins of developers into dividend returns of debt investors. This has the potential to open up an extraordinary investment window for debt investors to garner more attractive risk-adjusted returns than equity in the coming years.

**EXHIBIT 5: CAP RATE AND BORROWING COST TRENDS IN ASIA PACIFIC**



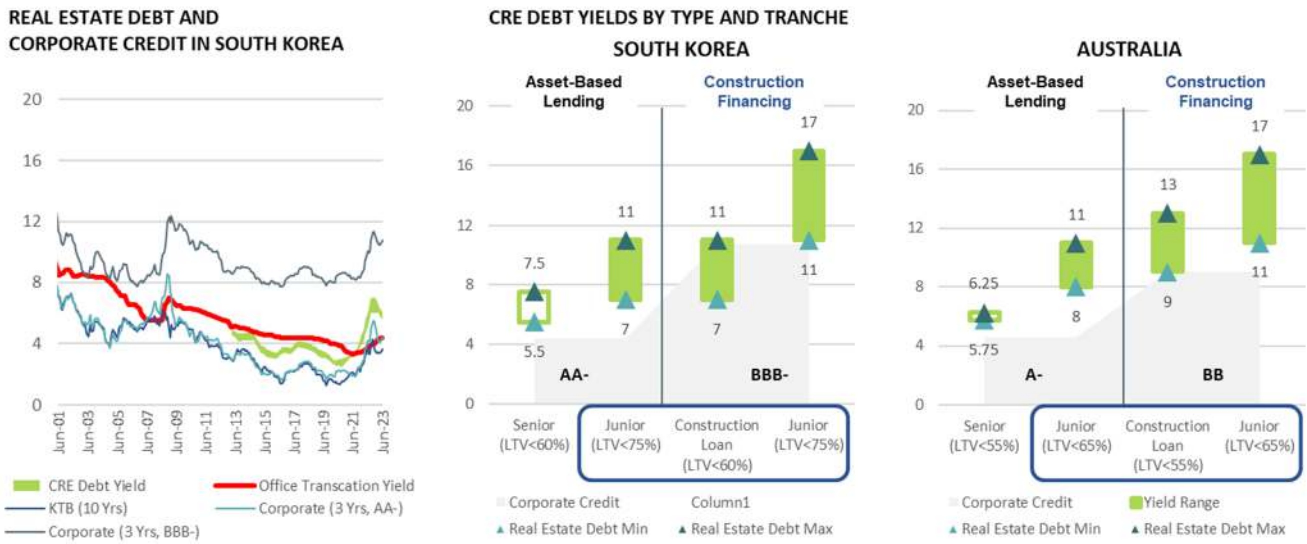

Source: DWS, Oxford Economics. As of July 2023

## Indicative Lending Yields by Tranche in South Korea and Australia

Indicative lending yields quoted from traditional lenders show that the recent illiquid return premium of CRE lending has recently expanded to an attractive level in South Korea and Australia, especially for junior debt and construction loans. For example, asset-based lending yields in South Korea stood at around 5.5-7.5% for senior debt and 7-11% for junior debt in June 2023, showing a remarkable risk-adjusted return premium. Construction loans have also provided attractive premiums with lending yields currently around 7-11% (senior) and 11-17% (junior). Similarly in Australia, lending yields for completed assets stand at around 5.75-6.25% (senior) and 8-11% (junior), and yields of 9-11% (senior) and 11-17% (junior) for construction loans.

Notably, loan availability for construction loans remain more scarce, as existing lenders struggle with the potential write-offs of existing loans and remain cautious towards all new construction loans, regardless of the financial feasibility of these projects. On the other hand, senior lending for existing assets has gradually stabilized with the return of traditional lenders anticipating the end of the interest rate hike cycle.

**EXHIBIT 6: REAL ESTATE DEBT AND CORPORATE CREDIT IN SOUTH KOREA**




Source: DWS, Colliers, Oxford Economics, Reserve Bank of Australia, Bank of Korea, As of July 2023.

## Investment Considerations

While the senior lending market remains dominated by local banks, construction loans for prime assets and high LTV loans present potentially attractive opportunities with less competition and the ability to offer good risk-adjusted returns. Especially, in the next 6 to 12 months, we believe constraints in the credit markets have the potential to create attractive debt investment opportunities for alternative lenders across the capital stack.

For construction loans, reduced appetite among lenders for construction loans has created opportunities in lending to transitional and development properties in prime locations with high ESG certificates, which has the potential to lead to the growth of private debt investors across the capital stack. We believe that key South Korean and Australian markets could become the most attractive in the APAC region with their relatively big market size and less institutionalized CRE lending market circumstances. By sector, office, logistics, and residential sectors, including built-to-rent and built-to-sell, appear to be well poisoned to provide attractive risk-adjusted returns to debt investors. Notably, we believe that high LTV whole-loan or mezzanine financing could potentially provide good entry points to debt investors who prefer high visibility on the mid-term cash flow of existing assets.

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