# APAC Real Estate Debt Market Update

October 2024

## IN A NUTSHELL

- CRE debt yield spreads have remained relatively wider in 2023 and 2024 from a historical perspective. Discussions are ongoing regarding the extent to which central banks could lower rates even after the pivot in September 2024.
- In stark contrast to a significant decline in overall fundraising of real estate funds globally, the APAC region experienced record fundraising activity for debt strategies, primarily driven by Australia and India, followed by Japan and Korea.
- In Australia, CRE private debt markets have become an increasingly important source of debt for borrowers, particularly for refinancing and development/capital works funding. For investors, a shift from 'fixed' to 'floating with a floor' rate structures tied to the 90-day BBSW could potentially provide a significant inflation hedge to mitigate interest rate risk.
- Indian CRE lending has seen a structural shift of dominant lenders from Non-Banking Financial Companies (NBFCs) and Housing Finance Companies (HFCs) to the banking industry and private lenders. Mumbai, Delhi NCR, and Bengaluru collectively account for 80% of the entire CRE lending region-wide.
- With the resilient CRE lending market in South Korea over the last 18-24 months, there are two divergent trends in fundraising: local asset managers focusing on senior loans with a 6% target return, and foreign managers targeting higher risk profiles with 10-15% target returns.

## Looking Back 2023-2024 from Commercial Real Estate Lending Perspective

2023 was marked by a strong focus on inflation, particularly in developed markets. While Japan and China were exceptions, the rest of the markets in the US, Europe, and APAC were primarily concerned with inflation and the actions of central banks. The year saw numerous loan maturities in the commercial real estate (CRE) market, many of which were amended and extended where possible, leading to the recapitalization of some loans. At the same time several instances of loan default took place, especially in the distressed US office sector, though this did not lead to the full devastation of the CRE lending market.

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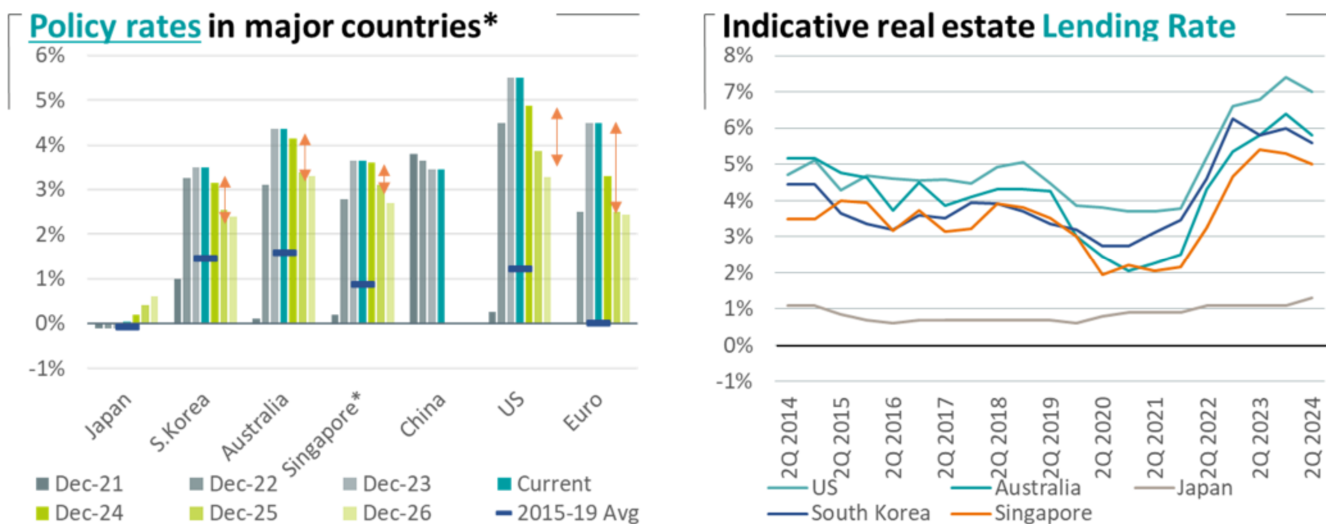
We began 2024 with relative optimism that central banks would reduce interest rates by mid-year. However, there has been a divergence between the US Federal Reserve's projections and market expectations. While market participants anticipated earlier and sharper movements, the Fed has consistently communicated a slow pace for rate reductions, with inflation higher than anticipated. This has also impacted the pivot schedules of other central banks. Consequently, CRE lending yield spreads have remained relatively wider from a historical perspective, reflecting the continuous elevated risk in the CRE market. The situation varies significantly by sector and market in APAC.

In September 2024, we finally saw the pivot with the US Fed's rate cut of 50 basis points, while discussions are ongoing regarding the timing and extent to which central banks could lower rates or adjust their strategies toward 2025. At the same time, we have witnessed a continuous wave of CRE debt fund launches in APAC over the last 18-24 months, driven by attractive risk-adjusted returns and structural shifts in domestic banking conditions. At this critical juncture, it is an opportune time to reassess the CRE debt strategy to determine its attractiveness and sustainability in the mid to long term.

EXHIBIT 1: POLICY RATES AND INDICATIVE REAL ESTATE LENDING RATES IN MAJOR COUNTRIES




Source: Bloomberg, DWS. As of October 2024.

## APAC CRE Debt Fundraising

Despite the growing appeal of the CRE debt strategy within institutional investor portfolios, 2023 saw a significant decline in overall capital commitments to private real estate funds at the global level. This decline overshadowed the momentum for debt strategies also globally, as institutional investors faced challenges such as weak performance, limited liquidity, and the impact of the denominator effect on their portfolios.

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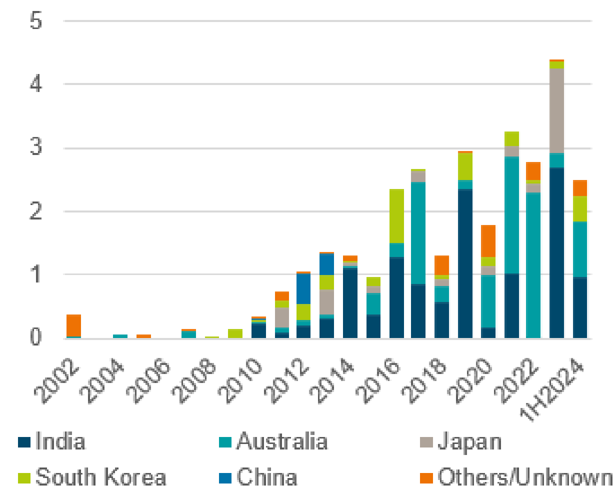
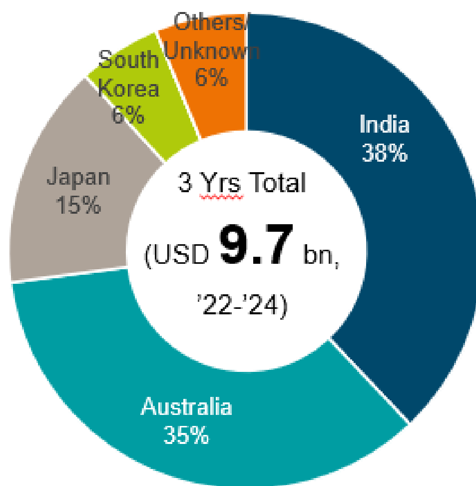
However, the APAC region experienced record fundraising activity for the debt strategy, amounting to USD 4.5 billion in 2023 and USD 2.5 billion in the first half of 2024. This surge was primarily driven by Australia and India, followed by Japan and Korea. Notably, 4 out of 5 CRE debt funds with a fund size exceeding USD 1 billion in the region have been launched since 2021, bringing the total fundraising amount to USD 9.7 billion between 2022 and 2024.

This coincides with ongoing structural changes in the banking system in key APAC markets, where regulators are pushing for traditional lenders to reduce exposure in the CRE space. Although the pressure for immediate debt liquidation is much lower in APAC compared to the US, this is a long-term trend which we expect to lead to the institutionalization of private credit lenders in the CRE lending market. However, it also requires global alternative lenders to localize their operations to remain relevant through economic cycles, given the symbiotic nature of the lending business.

It is noteworthy that the main targets of newly launched debt funds vary significantly by market, with a weaker common focus across the region. For example, recently launched CRE debt funds in India are primarily focusing on distressed BTS residential development projects struggling with liquidity shortages. In contrast, in Australia and South Korea, these funds are more targeted towards refinancing whole loans for existing assets or providing construction loans for new development projects. Lending opportunities remain rare in Japan, although some funds are actively seeking opportunistic lending opportunities, including assets under distress or those with extremely high LTV profiles up to 80%, referred to as deep mezzanine.

EXHIBIT 2: HISTORICAL FUNDRAISING ACTIVITY OF REAL ESTATE DEBT FUNDS IN APAC




Source: Real Capital Analytics, Bank of Japan, FISIS, APRA Quarterly ADI Property Exposures, DWS. As of October 2024.

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## Australia

The private debt market in Australia has experienced significant growth over the past couple of years increasing from $33bn (2016)[1] to $188bn (2023)[2]. While Commercial real estate (CRE) lending accounts around 40% of the total private debt market, it is within its infancy in the CRE lending space at a 16% market share[2], well below the UK and US markets.

There is a mutual benefit in the CRE private debt market for lenders, borrowers and investors which support the fundamentals of the overall sector. The introduction of international banking reforms post GFC has led to increased capital requirements, tighter lending, and greater risk aversion amongst traditional bank lenders, which act as a high barrier to entry for mid-lower rated borrowers. This has opened a gap in the market for non-bank lenders within the Senior, Junior/Mezzanine, and construction loan segments. For lenders, Australia's insolvency laws further support the attractiveness of the CRE private debt market with a 'prioritisation' of creditors interests over debtors, which allow for a greater degree of control in the event of a default/insolvency scenario.[3]

For borrowers, CRE private debt markets have become an increasingly important source of debt to assist with tighter ICR scenarios and leverage shortfalls, particularly for re-financing and development/capital works funding. Non- bank lenders operate outside the restrictions which govern traditional banks, which allows for more favorable lending conditions for borrowers. In Australia non-bank lenders generally accept an LTV of 65%+ and ICR of 1.1-1.25x compared to traditional banks which typically require 50-60% and 1.5-1.75x respectively[4]. Today lending conditions within the residential and industrial sectors are more favorable given market resilience and tailwinds. While non-bank lending margins are typically higher between 5-6% for a senior loan compared to traditional bank lending between 1.5-1.7%, the ability for borrowers to draw down on 'cash' allows for a greater degree of flexibility throughout the loan term.

The CRE private debt market presents an attractive opportunity for investors. The CRE private debt market has seen a shift from 'fixed' to 'floating with a floor' rate structures to the 90-day BBSW, could potentially provide a significant inflation hedge to mitigate interest rate risk. Over the past 12 months, increased demand from institutional capital has seen Senior investment lending margins tighten, particularly for core locations, favorable sectors, and higher quality sponsors. Estimated target return of private lenders for senior loans currently sit between 9-10%, with the investment loan segment seeing more stretched-senior lending[5] compared to Junior/mezzanine[6]. For construction lending, margins have increased reflective of construction industry challenges, however, provide an attractive risk/return opportunity for investors. Their estimated target returns for construction loans currently sit between 10-15% and closer to 20% for the Junior tranche[7].

The outlook for the private debt market in Australia remains positive, with a turn in the economic cycle likely to see a pickup in commercial real estate transaction and lending activity. Increased capital allocation is expected into the CRE private debt space particularly from super funds, potentially by high risk adjusted returns with a lower correlation to fixed income and equities.

[1] EY Australian Annual Private debt market update 2024
[2] ROC Partners Private Credit: An Australian Perspective 2022
[3] Foresight Analytics Strategic Research Insight March 2023
[4] Foresight Analytics Strategic Research Insight March 2023
[5] Stretched senior loans are typically up to 75% LVR with some mandates up to 80%, which include a revenue share at the back end.
[6] DWS, as of October 2024
[7] DWS, as of October 2024

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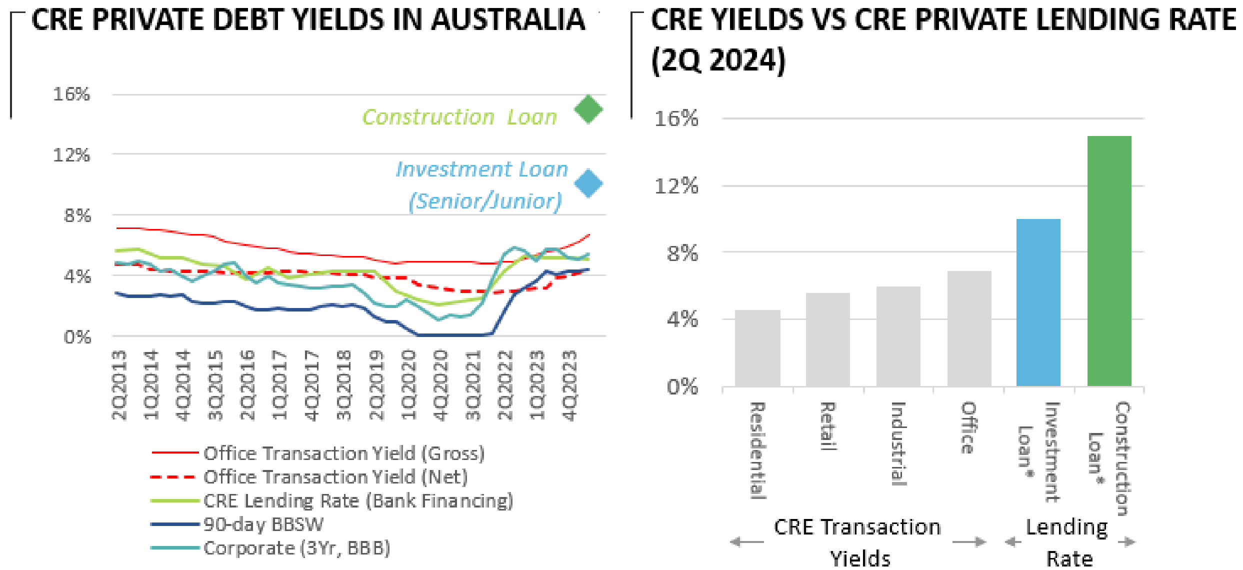
EXHIBIT 3: CRE PRIVATE LENDING RATES AND COMPARISON WITH TRANSACTION YIELDS IN AUSTRALIA (2Q 2024)




Source: Bloomberg, RBA, Colliers, DWS. As of October 2024.

ource: DWS. As of October 2024. *Indicative of a lending yield of Senior Loan

## India

India's real estate sector is experiencing significant growth, driven by the country's robust economic performance, with a projected GDP growth of 7% for FY24. The increasing demand for real estate development funding presents substantial opportunities for lenders, while the biggest difference between India and other markets is that the Indian CRE debt market had been led by Non-Banking Financial Companies (NBFCs) and Housing Finance Companies (HFCs), with other lender groups including banking sector and private lenders accounting for less than half of the entire lending market until recently.

The shift in debt lending from NBFCs and HFCs to banking and private credit was primarily triggered by the IL&FS crises in 2018[8]. These events led to a significant reduction in the exposure of NBFCs and HFCs to the real estate sector, prompting developers to seek alternative funding sources. Also, multiple regulatory reforms[9] have enhanced transparency, boosted investor confidence, protected consumer rights, and created a more efficient and trustworthy market.

Post the COVID-19 pandemic, the real estate sector has seen a resurgence, with banks now leading the market with 68% of debt approved in 2023. Additionally, the share of Alternative Investment Funds lending has increased from 7% to 13%, reflecting the

[8] IL&FS crisis: Infrastructure Leasing & Financial Services (IL&FS) is a non-banking financial company (NBFC). Established over 30 years ago, the conglomerate funds infrastructure projects across India, while it fell short of cash and defaulted on several of its obligations in 2018. It significantly impacted ongoing infrastructure and real estate development projects, as banks became reluctant to release finances for those projects and investors withdrew substantial sums of investments from NBFCs, especially housing lending institutions.
[9] Real Estate Regulatory Authority (RERA), Goods and Services Tax (GST), and the Insolvency and Bankruptcy Code (IBC)
All data and forecasts in this "India" section per JLL (Decoding Debt Financing: Opportunities in Indian Real Estate) as of 06/20/2024 unless otherwise noted.

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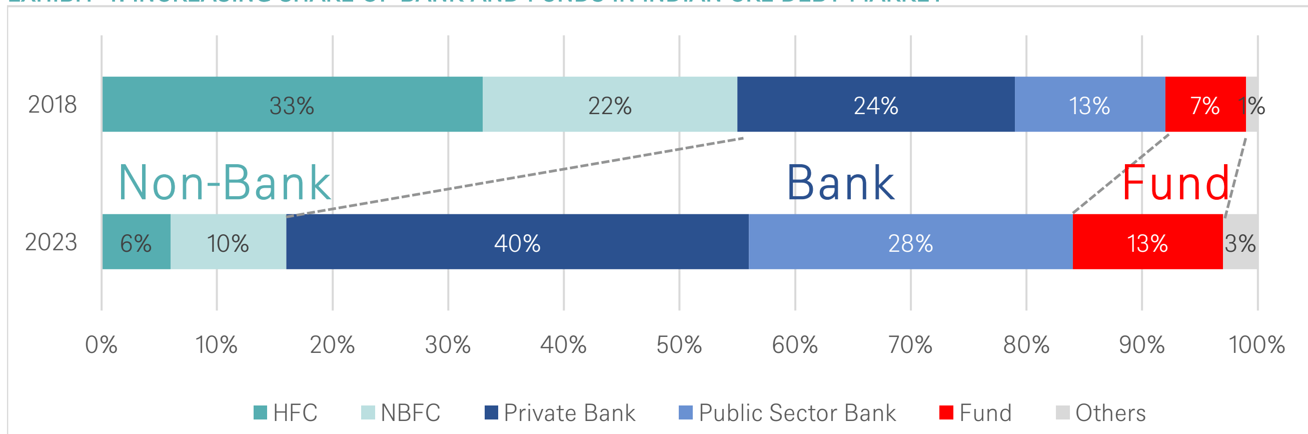
growing role of private credit in the sector. Region-wide, Mumbai, Delhi NCR, and Bengaluru have collectively accounted for 80% of the debt allocated in India's real estate sector, totaling $115 Bn. Mumbai leads with a 40% share of the debt, followed by Delhi NCR at 21% and Bengaluru at 19%.[10]

According to JLL, India's real estate debt market is projected to reach USD 170 billion between 2024-2026. This growth is primarily driven by construction finance and distress sales dubbed as "Lease Rental Discounting (LRD)." The residential market alone is slated to require nearly USD 52 billion in long-term debt by 2026, while the overall real estate construction market is expected to grow by 35-40%, totaling USD 66 -72 billion. There is a gap of approximately USD 18 BN between required and approved debt in construction finance, primarily in the residential sector. The LRD market in the commercial segment is projected to exceed USD 96 BN by 2026, with a 30% growth in the commercial office segment.[11]

EXHIBIT 4: INCREASING SHARE OF BANK AND FUNDS IN INDIAN CRE DEBT MARKET




Source: DWS, JLL, As of October 2024.

## South Korea

Despite rumors of a potential credit crunch among vulnerable lenders, the CRE lending market in South Korea remained resilient throughout 2023 and the first half of 2024, with no notable losses in the senior debt of existing core assets. However, there have been some de facto defaults in development projects, particularly in the logistics sector. This has led lenders to allow unexpected extensions of maturity or even write-offs of the original valuations, keeping traditional lenders on the sidelines for construction and bridging loans. Also, traditional lenders, such as banks and insurance companies, are facing headline issues and changes in accounting standards. Since 2022, tightened BIS banking regulations and IFRS 17 accounting standards have made it more difficult for them to participate in construction loans, creating opportunities for alternative lenders.

In the last 12 months, indicative lending yields from lenders show that the recent illiquid premium of CRE lending has peaked but remains attractive in South Korea, especially for construction loans. For example, senior loan interest rates for prime core office properties have decreased to 4.8%-5.5% in the third quarter of 2024 from 5.5%-7.0% a year ago, compared to an average office cap rate of approximately 4.3%. Nonetheless, CRE lending remains more attractive compared to equity investments due to its lower repayment risk.[12]

[10] JLL, DWS. As of October 2024

[11] JLL, DWS. As of October 2024

[12] DWS. As of October 2024

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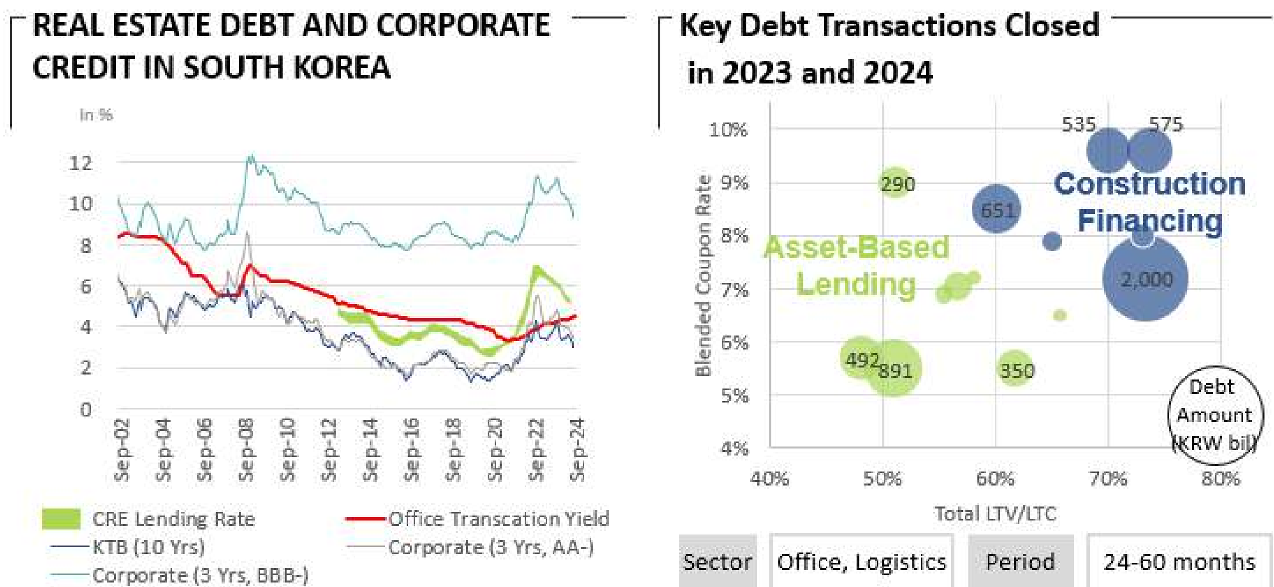
Recent CRE debt fundraising activities focusing on senior loans have been led by local asset managers sponsored by large financial groups with strong business networks in the core space, targeting returns around 6%. In contrast, foreign asset managers have been focusing on higher risk profiles, including construction, bridging, or structured loans, with estimated target returns of 10%-15%.[13] The National Pension Service (NPS) is currently selecting a manager for its first domestic CRE debt blind fund since 2019, which is expected to be followed by other domestic institutional investors.

In terms of pipeline and sector, upcoming development plans and increasing investment volumes in the office sector could create attractive debt investment opportunities, supported by a tight office vacancy rate below 2% and Seoul's strong office utilization rate which is the highest globally. The logistics sector has seen oversupply, but demand remains strong. Generally, there is an equalization of yield in these markets, offering high-quality assets for first mortgage lending, potential for high cash-on-cash returns, and total returns.

## EXHIBIT 5: REAL ESTATE DEBT YIELDS AND RECENT DEBT TRANSACTIONS IN SOUTH KOREA




Source: DWS, Oxford Economics, Bank of Korea, As of October 2024.

[13] DWS. As of October 2024

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Counterparty risk – A financial institution or other counterparty that underwrites, distributes, or guarantees any private credit investments or contracts that the strategy owns or is otherwise exposed to, may decline in financial health, and become unable to honor its commitments. This could cause losses or could delay the return or delivery of collateral or other assets.

Prepayment and extension risk – When interest rates fall, issuers of high interest debt obligations may pay off the debts earlier than expected (prepayment risk), and the strategy may have to reinvest the proceeds at lower yields. When interest rates rise, issuers of lower interest debt obligations may pay off the debts later than expected (extension risk), thus keeping the strategy's assets tied up in lower interest debt obligations. Ultimately, any unexpected behavior in interest rates could increase the volatility of the strategy's yield and could hurt performance. Prepayments could also create capital gains tax liability in some instances.

Debt securities risk – Debt securities are subject to the risk of the issuer's or a guarantor's inability to meet principal and interest payments on its obligations and to price volatility.

Default risk – The issuers or guarantors of debt securities may fail to make payments or fulfil other contractual obligations.

Secured debt risk – Although secured debt generally will be secured by specific collateral, there can be no assurance that liquidation of such collateral would satisfy the borrower's obligation in the event of non-payment of scheduled interest or principal or that such collateral could be readily liquidated.

Second lien and subordinated loans risk– Second lien loans generally are subject to similar risks as those associated with investments in senior loans, and, because they are subordinated or unsecured and lower in priority of payment to senior loans, they are subject to additional risks, including the risk that the borrower may be unable to meet scheduled payments, price volatility, illiquidity, and the inability of the originators to sell participations in such loans.

Private investment risk – Private investments are highly competitive, less transparent, and illiquid.

PIK interest risk – Loans with a payment in kind ("PIK") interest component generally represent a significantly higher credit risk than coupon loans; may have unreliable valuations requiring continuing judgments about collectability and the value of any associated collateral; and the borrower could still default when the actual payment is due at maturity.

Direct Lending risk – The lender in privately offered debt is responsible for the expense of servicing that debt, including, taking legal actions to foreclose on any security instrument securing the debt. This may increase the risk and expense compared to syndicated or publicly offered debt.

Interest rate risk – In general, rising interest rates in the market will negatively affect the price of the direct lending investments. Sensitivity to a change in interest rates is more pronounced and less predictable in instruments with uncertain payment (or prepayment) schedules. Central bank monetary policy, rising inflation rates, and general economic conditions may cause interest rates to rise.

Illiquid portfolio investments risk – Private credit investments generally will be long-term and highly illiquid.

Valuation risk – There is no central place or exchange for private credit investments to trade. Uncertainties in financial market conditions, unreliable reference data, lack of transparency and inconsistency of valuation models and processes may lead to inaccurate pricing and other market participants may value direct lending investments differently.

High yield debt risk – High yield debt securities have historically experienced greater default rates than investment grade securities and are subject to additional liquidity and volatility risk.

Reinvestment risk – During periods of declining interest rates, an issuer of debt obligations may exercise an option to redeem prior to maturity, which could result in new investments with lower-yields.

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