Is Private Credit the New Megatrend in Australia? (Part 2)

[1]

Is Private Credit the New Megatrend in Australia? (Part 2)

BY PAUL MIRON

At the beginning of 2022, I posed the following question to an audience of sophisticated self-directed investors:

Is Private Credit the new megatrend in Australia?

It is important to remember these were carefree times when the official cash rate was at a historic low of 0.10%, and terms such as 'cost of living pressure', 'mortgage stress', 'inflation' and 'recession' were not part of our vernacular.

I learnt a few lessons that day:

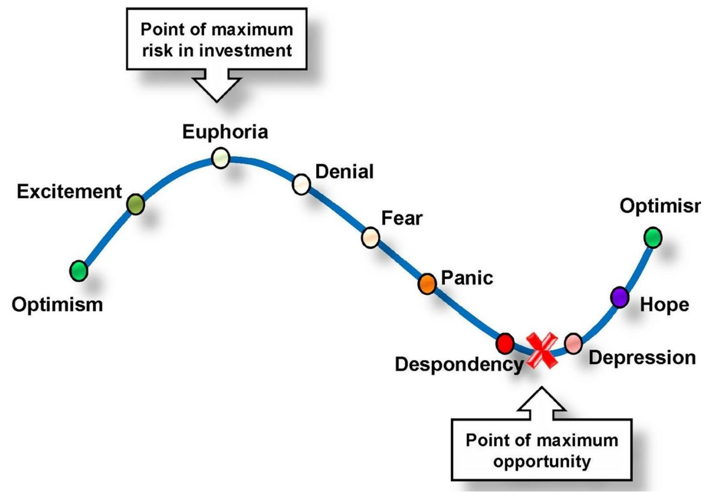
1) **Howard Marks' philosophy regarding market cycles was once again on the money!**

It should not be a surprise that most investors want to avoid hearing words of caution in good times. We conducted a survey in which most attendees believed that the equity and property markets would continue their stellar

post-COVID economic trajectories without investors having to adjust their portfolio for future risk.

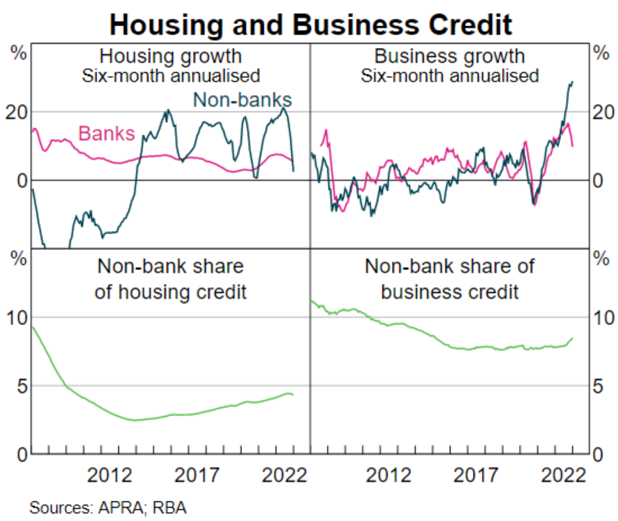
However, the premise of Howard Marks' proposition is that market cycles are better correlated with the collective mood of the market participants than pure economics.

[1] https://www.australianlendingcentre.com.au/pros-cons-dealing-private-lenders/.



2) Private credit is at an embryonic stage in Australia.

Despite private credit funds being so dominant in both the US and Europe, it is still at the embryonic stages of its evolution here in Australia constituting circa 8% of all business debt.[2] By comparison, in 2019, 50% of business debt in Europe was financed by private credit.[3] The biggest traction however, is in the US where in 2020 private credit providers took a 68% share of the mortgage market (residential and commercial).[4]



There is no question that there needs to be more awareness and understanding of private credit funds in Australia the — the benefits, the variety of options, the attractive risk-reward relationship, and most importantly, the diversification away from Australian equities.

3) There is a poor understanding of the market.

In Australia, only a few truly understand how commercial (Small to Medium Enterprise, SME) loans work combined with the true value proposition of private credit funds.

4) The revolution has already started within the Australian debt Market.

It is no longer a matter of **IF**; it is a matter of **WHEN**. It is only a matter of time before private credit funds will be recognised as a mainstream asset class and not labelled ambiguously as an alternative investment class.

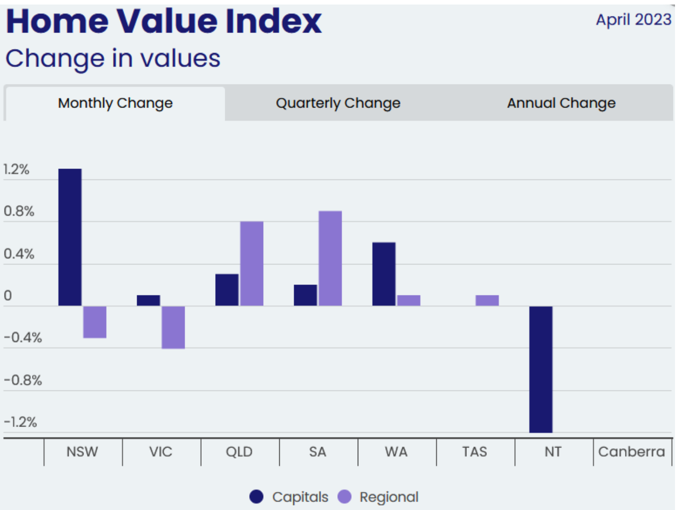
Upon reflection, over the past 18 months there has been a significant increase new interest in the sector; a day does not go by without a fresh news article regarding a new entrant into the industry or a new mandate from either a superannuation fund or another financial institution, specifically focusing on allocating funds towards private credit.[5]

Current Economic Environment

Market expectations on whether we are going into recession or not, or whether interest rates will stay in place, go down or continue to go up this year, are in limbo. Not to mention the even larger questions, such as whether monetary policy will be enough to bring inflation at bay, or whether Trump's next move will be going to prison or back into the White House. Expectations regarding these events change daily.

Perhaps the biggest surprise despite the chaos and 11 official interest rate increases is that property is emerging as quite a resilient asset class, recently bucking the negative trend. According to CoreLogic, nationwide median house prices rose by 0.6% in March and 0.5% in April.[6] As many economists, politicians and media have now concluded, the reintroduction of net migration and a slow planning system are contributing to keeping prices high, coupled with an overall lack of supply.[7]

[2] Non-bank Lending in Australia and the Implications for Financial Stability | Bulletin – March 2023 | RBA
[3] Financing-European-Business-NBL-and-the-Economic-Recovery.pdf
[4] Nonbank Lenders Are Dominating the Mortgage Market - WSJ
[5] Big super wakes up to private debt | Investor Strategy News (ioandc.com).
[6] https://www.corelogic.com.au/news-research/news/2023/corelogic-home-value-index-further-evidence-australias-housing-downturn-is-over.
[7] https://www.realestate.com.au/news/whos-to-blame-for-australias-exploding-property-prices-and-housing-affordability-crisis/.



[8]

What is Private Credit?

Private credit covers various strategies spanning the capital structure and borrower type – from first registered mortgages against established residential, commercial, and industrial property, to corporate debt secured against goodwill, unsecured credit cards and mezzanine construction loans.

Different loans carry different types and levels of risk and can generate a range of returns to compensate for that risk. Secured loans offer relatively stable yields and are lower on the risk and return spectrum than other private credit strategies. In theory, unsecured, subordinated and mezzanine strategies provide financing further down the capital structure, with higher yield to compensate for the additional credit risk. This assumes that the investor understands the debt stack and invests based on risk-reward.

The variety of private credit strategies and their features means that a private credit portfolio can be structured to target a wide range of objectives and can be tailored to an investor's individual goals.

Structural Changes in the Debt Market

The Big 4 Banks have dominated the Australian lending market for decades.[9] Nevertheless, recent years have shown a rapid rise in an often-overlooked part of our country's financial market: private credit. Australia's private credit market represents a relatively untapped part of our economy, with non-bank lenders accounting for approximately 5% of Australia's financial system (inclusive of all types of lending: residential, commercial and unsecured).[10]

Private credit has grown rapidly in recent years, driven primarily by growth in mortgage lending. Mortgage lending growth has averaged 15% on a six-month annualised basis – more than twice the rate recorded by banks.[11] 5.37% of housing finance came from private credit in 2022, up from 4.88% in 2021. Even before the onset of COVID-19, lenders owned by the big banks saw their market share slide from 77% to 67%, while non-major lenders increased their market share by 42.4% year-on-year to $1.77b.[12] The numbers do not lie. Private credit is on the rise.

Regulatory Environment

The aftermath of the GFC brought stricter banking regulations across the globe, including in Australia. As a result, banks have become more selective in terms of borrowers, preferring either larger companies or simple home loans rather than SMEs, opening a door for private credit.[13] Even the perception that finance is more challenging to obtain from the major banks has seen even some higher quality borrowers shifting to non-bank lenders; it has been found that this is due to borrowers being attracted to quicker and more likely to be obtained loan approvals.[14]

In addition, the striking 2019 report from the Banking Royal Commission did not bode well for the public's trust in our traditional financial institutions, with a survey conducted following the report's release finding that 94% of Australians surveyed agree that banks do not act in their best interests.[15]

---

[8] https://www.corelogic.com.au/news-research/news/2023/corelogic-home-value-index-further-evidence-australias-housing-downturn-is-over.

[9] https://www.theadviser.com.au/lender/37823-analysis-how-big-are-the-non-bank-lenders.

[10] https://www.rba.gov.au/publications/bulletin/2023/mar/pdf/non-bank-lending-in-australia-and-the-implications-for-financial-stability.pdf.

[11] https://www.rba.gov.au/publications/bulletin/2023/mar/pdf/non-bank-lending-in-australia-and-the-implications-for-financial-stability.pdf.

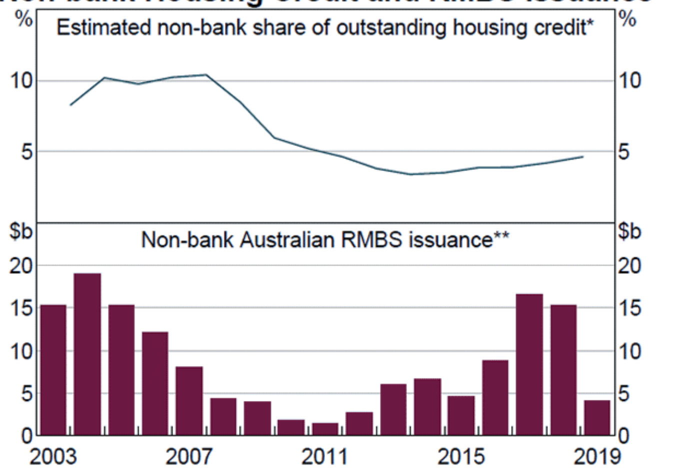
[12] https://www.loans.com.au/home-loans/market-share-improves-for-non-bank-lenders.

[13] https://www.afr.com/wealth/investing/investors-reap-the-spoils-as-banks-pull-back-20220913-p5bhqi.

[14] https://www.rba.gov.au/publications/fsr/2019/apr/box-d.html.

[15] https://www.savings.com.au/news/bank-xious-94-of-australians-dont-trust-their-banks.

Non-bank Housing Credit and RMBS Issuance



* As at year-end
** 2019 year to date
Sources: APRA; RBA

[16]

In addition, the global economic headwinds are catching up with reality. As the saying goes, if the US sneezes, the rest of the world catches a cold. Financial markets are factoring in a likely chance of a US-led recession,[17] combined with the fragility of both US and European banks recently being exposed, and several banks needing to be rescued from collapse, an inevitable further credit crunch is headed. With credit becoming harder to get, the demand for private credit will inevitably only increase. This will further exacerbate regulators' high capital adequacy hurdles on global banks.

The last time we entered this cycle, it was a once-in-a-lifetime opportunity for private credit providers in the US as they took significant market share permanently and became mainstream lenders, with names such as Blackstone, Apollo, and Oaktree Capital, who went from managing a few billion to hundreds of billions in a relatively short time. The flow of investment was not constrained by regulations and instead, a flight of capital flowed from investors into the private lending sector as a haven against volatility and for the preservation of capital.

Where is the Opportunity?

Relative to other countries, private credit is much less competitive here in Australia. As a result, the relative margins above the cash rate enjoyed here are at a premium. In the US, an investor tends to take a margin of 2-3% above the official cash rate, whereas the equivalent risk in Australia will give a margin of 4-5%.

Superior Returns and Diversification

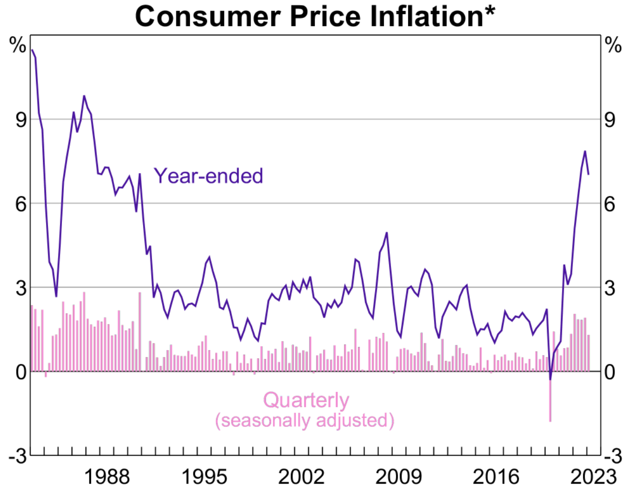
When managing money in a world full of uncertainty, diversification is more critical than ever. Private credit provides investors access to superior portfolio diversification and lower levels of volatility, which typically increases the likelihood of achieving an investor's objectives over the long term.

Private credit does not correlate highly with traditional asset classes.[18] To reiterate the earlier point, private mortgage investments are not directly influenced by price fluctuations in other markets, such as equities and bonds.

Private credit also acts as an excellent inflation hedge. This is especially important given the high 7.00% inflation we are currently experiencing in Australia.[19] The main point here is that interest rate rises made by the RBA in response to higher inflation can be passed onto borrowers at the beginning of each interest rate roll period. This is yet another benefit of private credit over traditional investments.

There should be no doubt that it is time that the nature of consistent regular income and asset preservation qualities all result in a significant compounding impact of investors funds. As Albert Einstein once said, "Compound interest is the most powerful force in the universe".

Consumer Price Inflation*



* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000.
Sources: ABS; RBA

[20]

[16] https://www.rba.gov.au/publications/fsr/2019/apr/box-d.html.
[17] https://www.statista.com/statistics/1239080/us-monthly-projected-recession-probability/.
[18] https://www.abrdn.com/en-gb/institutional/insights-and-research/the-role-of-private-credit-in-defined-benefit-endgame-portfolios.
[19] https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/consumer-price-index-australia/latest-release.
[20] https://www.rba.gov.au/chart-pack/aus-inflation.html.

The Years Ahead

There is no question that private credit can thrive, as evidenced by its success in the US and Europe. The tailored solutions for borrowers, high returns for investors, regulatory favour and strong growth in recent years all point towards a bright future for private credit and investors in Australia, irrespective of market uncertainty and volatility.

Msquared Joint Venture

Msquared is excited to announce a strategic joint venture with EG Funds (EG). EG has a track record spanning over 23 years and currently has $5.1b under management. They are well known as a property fund manager but they also develop technology which aids in the risk assessment of macro and microeconomic factors affecting property. With our combined expertise and technological overlay, we wish to expand the current offering to investors to allow them to access opportunities within the private credit market.

Msquared Capital is a private credit provider with investment opportunities backed by quality property along the Eastern Seaboard; we ensure that all investment opportunities are based on risk-to-reward as our core offering and performance. Mortgage funds perform well during volatile times, and capital preservation is regular, with a reliable monthly income that gives our investors peace of mind. If you would like more information, please feel free to contact myself or our dedicated team of professionals at our office with the following details:

Phone: (02) 9157 8608

Email: info@msqcapital.com.au

Address: Level 12, 88 Pitt Street, Sydney NSW 2000