

Centuria

Understanding loans in real estate debt funds

Real estate debt funds have become increasingly popular given their potential to provide attractive income, capital protection and diversification.

While many funds have successfully delivered these outcomes, investors shouldn't fall into the trap of thinking all funds are alike.

The loans underlying real estate debt funds vary, exposing investors to different levels of risk and return. Before investing in a real estate debt fund, it's a good idea for investors to understand the underlying loan, or loans, it invests in. By understanding the different risk and return characteristics of each type of loan, investors will be able to make informed decisions that align with their investment goals.

Loan types vary by capital structure

A factor that sets commercial real estate debt funds apart from other types of private debt funds is that underlying loans are secured against tangible real estate assets in most cases. This affords investors a high level of protection, as lenders have the right to possess and subsequently sell assets to recover the loan balance if a borrower defaults on a loan.

However, even if all loans in a real estate debt fund are secured by property, they do not have the same repayment priority.

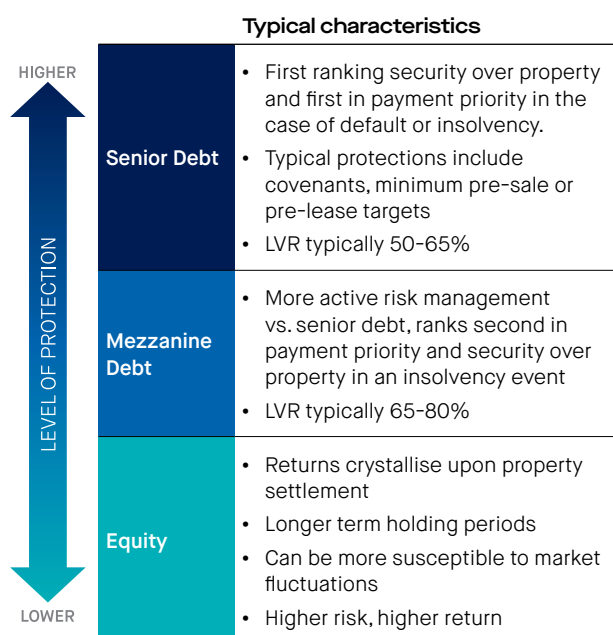
A loan's repayment priority is determined by its position in the capital structure. Also known as the capital stack, the capital structure refers to how a property or project is financed. Each position in the stack has a different level of risk, return and repayment priority during repayment or in the event of a loan default.

At the top of the capital structure is senior debt, also referred to as senior loans or first mortgage secured loans. This is the safest and lowest-risk position in the stack as these loans are secured by real estate assets and repaid first in the case of a default.

Positioned below senior debt in the capital stack are mezzanine loans. These loans are repaid after senior debt, but before equity, and because they are subordinated to senior loans, they are considered riskier than senior debt.

Equity loans sit at the bottom of the capital stack. Typically unsecured and subordinate to senior and mezzanine debt, equity loans are the riskiest position in the capital stack. Equity loans are repaid last and only after all debts are settled, however they can benefit from capital appreciation.

Capital structure



Loans vary by stage of real estate project

Commercial real estate loans also vary by different stages of a property project, with each one having its own unique characteristics, risks and expected returns.

Early-stage loans, such as construction loans, tend to have higher risk/return profiles than late-stage loans, such as residual stock loans. That said, the risk profile of each type of loan depends on various factors, such as the specifics of the loan, position in the capital structure, borrower strength, market conditions, and loan-to-value ratio (LVR).

Bridge loans



Bridge loans provide a borrower with temporary financing until a long-term funding source can be secured and are typically short-term (6-12 months). These loans may be utilised as investment loans to refinance cash flowing properties, or between development phases of the underlying property. During the term of bridge loans, construction is not intended. Bridge loans carry the lowest risk profile of all real estate debt but provide the lowest return.

Construction loans



Construction loans are used to fund residential and commercial building projects, typically lasting 12-30 months. Construction loans include loans to build dwellings but also include land development loans which involve site preparation, infrastructure installation which is aimed at dividing bigger blocks of land into smaller parcels. Throughout the term of the construction loan, there is an underlying uplift in capital value of the property because capital works are being completed on the site which provides a benefit to the investor. Despite this, construction loans carry higher returns due to the increased project risks, such as project delays and cost overruns which may result in a deterioration in project feasibility.

Residual stock loans



Loans secured by unsold, completed properties (0-12 months). These loans typically offer lower returns at face value compared to construction loans due to the reduced risk associated with completed properties (i.e. saleable product). However, residual stock loans carry risks related to the volatility of the underlying asset (i.e. market risks). While returns at face value are lower than construction loans, the investors internal rate of return (IRR) is elevated as residual stock loans typically include provisions for the settlement of the completed properties which pays investors back early to redeploy on other investments.

Key investment considerations

When evaluating different types of loans in commercial real estate (CRE) debt funds, investors must consider a range of factors to effectively assess the risks and potential returns.

This includes broad factors, which focus on market and economic conditions, and specific factors, which focus on the specific characteristics of an individual loan.

Broad factors



Interest rates

Rising or falling interest rates can play a significant role in the performance of real estate debt investments as they influence both the value of the underlying assets and the creditworthiness of borrowers.



Inflation trends

Inflation can impact both asset values and the cost of construction materials.



Supply and demand

Imbalances between supply and demand can impact asset prices and the ability to sell properties. If demand outpaces supply, loan repayment becomes easier, however, in an oversupplied market the risk of unsold assets increases.



Regulatory environment

Obtaining building permits or changes to zoning can delay or prevent projects from moving forward. Uncertainty around the approval of development projects is an especially critical risk factor for loans in the early stages of the project (e.g. construction loans).

Specific factors



Loan-to-value ratio (LVR)

The LVR measures the loan amount relative to the appraised value of the asset. A lower LVR indicates that the borrower has more equity in the property, which offers a cushion for investors if the property value declines.



Borrower creditworthiness

The financial health and track record of the borrower are critical in evaluating the risk associated with a loan.



Loan terms

The terms of the loan itself, such as interest rate, duration and covenants, also influence the risk and return. For example, shorter duration loans carry less exposure to market fluctuations, while longer duration loans are more vulnerable to changes in interest rates, property values and market conditions.



Exit strategies

The exit strategy refers to how the lender expects to be repaid at the end of the loan term and it impacts both the timing and certainty of repayment.

Key takeaways

Real estate debt funds can provide investors with attractive levels of income and capital protection where underlying loans are secured and/ or prioritise repayment over equity in case of default.

However, given different types of loans have varying risk and return profiles, investors should assess the risk/return profile of real estate debt funds before making investment decisions. Diversifying across different types of loans can help investors reduce the overall volatility and risk in their portfolios. This can be achieved by investing in a mix of real estate debt funds, ensuring a blend of higher-risk loan types with more stable, lower-risk options.

An experienced management team, who actively oversees and manages the loan throughout its entire life cycle, helps ensure optimal performance and risk mitigation. By using their skills and capabilities to assess market trends, economic conditions and asset performance, a skilled manager can help maximise returns and mitigate risk.

FURTHER INFORMATION

For information on Centuria's listed and unlisted commercial property funds visit centuria.com.au or contact the Centuria Investor Services team on **1300 22 44 24** or contactus@centuria.com.au.

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