PERE

# Asia Debt

February 2025 • perenews.com


PEI

KEYNOTE INTERVIEW

# Real estate lending in the world's most diverse market

*Navigating risks effectively across Asia's diverse economies requires skill, experience and teams on the ground, says PAG's Chris Gradel, as not all markets are created equal*

Investors seeking risk-adjusted returns can find compelling real estate lending opportunities across the diverse economies of Asia-Pacific, argues Chris Gradel, chief executive and co-founder of the Asia Pacific-focused alternative investment firm PAG, one of the world's largest real estate-backed lenders.

Within the region's developed markets, Australia's booming housing market, fueled by high immigration and a persistent supply shortage, underscores strong demand for credit. Meanwhile, in developing Asia, India has become more creditor-friendly, which has significantly increased its attractiveness, delivering some of the region's most promising returns.

SPONSOR
**PAG**

**Q What is the current state of real estate lending in Asia-Pacific?**

The private debt market has been driven by a combination of bank regulation and cyclical factors, such as higher interest rates, which have increased financial stress and made banks more reluctant to lend. Regarding regulation, all major Asian countries with robust real estate markets are signatories to Basel III, which imposes uniform capital restrictions on banks, with most countries adding their own regulations on top.

Unlike the homogeneous US market, Asia consists of diverse countries with varying legal systems, regulations and economies at different stages of the cycle. Additionally, sourcing tends to be very relationship-driven, with less intermediation, making it a very local business. Consequently, many active firms in the region tend to be smaller and local rather than large and regional.

**Q Many investors view Asia as carrying developing market risks. What is the key to managing these risks while still delivering strong returns?**

It's important to disaggregate the region. Some people when they think of Asia just think of China and India, but not all Asian markets are developing. Countries like Japan, Australia, South Korea, Singapore, New Zealand and Hong Kong are mature markets with effective and well-tested legal systems. Developed markets in Asia carry developed market risks, while developing markets in Asia have developing market risks.

Over the past 20 years in private debt in the region, we've learned a lot. Picking markets with strong legal systems, staying senior with low LTV ratios, working with reliable borrowers: these factors are key. We've also built a strong asset management team, which is crucial for monitoring and intervening when problems arise. In terms of enforcement, in case of default, most of Asia's developed markets are arguably better than the US, as enforcement tends to be easier.

On the developing side, some Southeast Asian markets still lack creditor-friendly legal systems, which we avoid entirely. In others, like China and India, the legal systems are decent, but there is still some policy tail risk. India was challenging but has improved significantly since 2018, yielding some of our best returns in the past five years. China was stable until 2022, when some policy errors unintentionally created a massive property crisis.

Selecting the better markets is important, as are choices around structuring, collateral and counterparties. However, ultimately, it's about sizing the emerging market risk appropriately to account for the greater tail risk versus developed markets. We've decided to keep over 80 percent of our investments in developed Asia and limit exposure to developing markets to manage these risks. Some clients don't want any developing market risk, and we can accommodate that too.


**Q How is competition to source debt deals in the region?**

There's a natural barrier to entry, as building out infrastructure in multiple locations is essential to servicing local markets. So far, the big US firms have not done this. Among local firms, very few have invested in creating institutional-quality infrastructure or expanding across multiple markets. This has kept the competitive environment relatively favorable.

We try to offer the best of both worlds. We've been in these markets for over 20 years, running local teams from 12 offices. Across our private debt business, we've done about a thousand deals since 2006, worth about $40 billion.

Over 80 percent of these loans are originated bilaterally by us. It's all about being on the ground. For instance, in Australia, we have people in places like Brisbane, not just in the major markets of Sydney and Melbourne. We've found that being close to the Brisbane market has provided much better access for sourcing opportunities there.

**Q What makes Asia appealing for real estate lending?**

According to Savills, the combined real estate value of Japan, China, Australia, India and South Korea exceeds $120 trillion, compared to $65 trillion in the US. These markets are huge. China and Japan make up a significant portion, but in both countries the cost of capital is currently too low to be attractive from a lending perspective.

We estimate our target market to be around $30 billion-$40 billion annually. This is a fraction of the US market but we find this sufficient to keep us busy. The local relationship-driven nature of these markets creates barriers to entry, and the lack of competition allows us to generate attractive returns with safe structures.

Also, the fact that there are multiple markets at different stages of their

economic cycles means there are always some markets where there's an opportunity. For instance, China and Japan are at very different stages of the economic cycle compared to Australia, which is more aligned with some Western markets.

**Q How do demographic shifts in Asia influence the attractiveness of the region for real estate lending?**

I think demographics is more of a factor in the equity story than in the debt story. The debt story is more about the supply and demand of credit and ensuring a safe, low loan-to-value ratio that can cover market fluctuations.

Naturally, we prefer certain types of collateral and markets over others. For instance, Australia has a significant housing shortage, driven by high immigration with very tight planning restrictions. It will take years for Australia to fill this housing gap. That creates natural support to the market, which we find appealing.

**Q Which markets do you consider most attractive, and which would you avoid?**

Our key target markets are Australia, New Zealand, South Korea and India, where we can still generate mid-teens returns for senior-secured risk. We like all these markets. Australia, which has been one of the most attractive markets, is expected to see an increase in demand for credit in 2025.

One issue in Australia, as I mentioned, has been a significant planning bottleneck in getting new residential projects approved, leading to a substantial housing shortage that needs to be solved. However, this year we anticipate some de-bottlenecking, with improvements in the planning process that could unlock more supply and help alleviate the housing shortage. This will also drive more demand for credit, making it a busy year in the Australian market.

In Japan, the cost of capital remains too low. Even though rates have increased to 25 basis points, and we might see rates going up a little bit more, we don't expect this to significantly impact the cost of capital for real estate debt. Similarly, Singapore is very well-banked.

*"Our key target markets are Australia, New Zealand, South Korea and India, where we can still generate mid-teens returns for senior-secured risk"*

China is largely still in balance sheet repair mode. We haven't made any loans in the country since 2021, although we've been active opportunistically on the distressed side. Interestingly, some credit is slowly returning to residential real estate in China in the form of super senior completion financing.

However, with Chinese interest rates continuing to decline and a strong hunt for yield, anything credit-worthy can get financing very cheaply. New debt in China is going in at single-digit pre-tax levels, which is not appealing for US dollar capital.

We also anticipate continued activity in New Zealand, South Korea and India, with opportunistic prospects in Japan, Singapore and Hong Kong.

**Q How does the current real estate debt environment compare with previous market cycles?**

We do a lot of development financing, and recent years have experienced what we have been calling "peak pain" for the development finance industry. Cost overruns due to building material cost inflation, supply-chain bottlenecks, higher funding costs given higher rates, etc. We have managed this by remaining disciplined and not chasing marginal deals. We have a strong track record in distressed investing that allows us to manage our existing book and source interesting transactions for new vintages.

Otherwise, I think it's going to be a continuation of what we've been seeing, although we need to be cautious. In Australia, for example, property prices have gone up a lot. We need to be careful with our LTVs and make sure that we have plenty of headroom in case of market fluctuations. Other markets, like New Zealand, have already corrected more. Perhaps there's slightly less downside risk there.

Overall, we focus on reducing two major forms of risk. One is market risk, which we try to reduce through low LTVs, careful selection of collateral, and pre-sales – we want most of our debt ready to be covered through pre-sales.

The other is delivery risk. We want to ensure that our borrowers are experienced developers working with stable and experienced builders. We spend a lot of time on that. I think market fluctuations will happen, but if we really focus on low attachment points and mitigating these risks, we should be in a good position no matter what the market throws at us.

**Q You mentioned lower LTVs to reduce risk. Is this a measure taken from lessons of previous market cycles?**

Yes. We've seen a few different types of markets over the past 20 years, and we spend a lot of time looking at how prices have moved over previous cycles to make sure we can absorb those fluctuations. If we look at our Australian loan portfolio, for example, our average LTV for the portfolio is about 35 percent. We believe we're well insulated from some pretty major moves. ■