KEYNOTE INTERVIEW

Seizing the moment

PAG's Chris Gradel considers the expanding opportunities for private real estate debt in APAC

SPONSOR
PAG

Non-bank lenders are well-positioned to emerge as crucial players in financing real estate in the Asia-Pacific region, as they capitalize on the confluence of economic growth, regulatory changes and, more recently, spiking interest rates. Chris Gradel, chief executive and co-founder of APAC-focused alternative investment firm PAG, says now is the time to take advantage of an attractive risk-reward profile.

Q Non-bank lenders are gaining traction in Asia-Pacific. What factors are driving the growth of the real estate debt market in the region?

There are really three factors, one of which is the macro situation. Asia-Pacific accounts for 40 percent of global GDP and has accounted for about 50 percent of global GDP growth over the past 10 years. It is a large region which is growing fast, and the need for capital is obviously growing as well.

Secondly, there is the global tightening of banking regulations – which, to a large extent, has really created this private debt world. Since 2008, after the global financial crisis, bank regulation has only been going in one direction, and that has created the gap for non-bank lenders.

We are seeing that in Asia as well as in Europe and the US. A big part of that is Basel III and IV, of which there are many adopters in the region. But local regulators have also implemented their own restrictions on banks, which has created a large and growing gap that is being filled by private lenders.

And thirdly, there are cyclical factors. Outside of China and Japan, rates have been going up, and that has increased the cost of debt. Rates going up has also created more stress and, whenever there is stress, the banks tend to pull back. Relative to the US and Europe, banks account for a larger part of the credit markets in Asia-Pacific, so any pull back is acutely felt by borrowers in the region.

Q From a pan-Asian perspective, are private real estate debt returns attractive versus the risk taken?

Yes. It depends on the deal structure, of course. There are good and bad deals possible under all environments. But overall, we are seeing a large and growing lending gap, and not a lot of players who can really compete.

In our target markets, we estimate a $20 billion-$25 billion gap, creating a growing need for non-bank credit. At the same time, these are markets where you really need to have strong local teams and good on-the-ground knowledge.

We are by most metrics the largest private debt investor in Asia-Pacific. We have over 100 people across 12 offices in the region sourcing, executing and monitoring private debt opportunities locally. That scale, combined with the lending gap, creates an environment where we can generate an attractive risk-reward.

Q How does the risk-return profile of real estate debt in the region compare with corporate debt?

There are two parts to private debt: primary lending and distressed/special situations. On the distressed side, both corporate and real estate can throw up good opportunities. Historically, going back to previous crises, people including ourselves made very good returns from those opportunities. But there is capped upside in real estate distressed debt. And in corporate debt, traditionally there has been higher return, albeit with higher risk.

On the lending side, it is really about the size of the gap from traditional lenders and then the amount of capital focused on it. And there I think the real estate opportunity is better than corporate.

In terms of the amount of capital, corporate private debt is far bigger than real estate private debt. Globally, there is probably four to five times more capital for corporate than there is for real estate.

It is similar in Asia-Pacific, but we think the lending gap here is larger on the real estate side, and there are few non-bank lenders who can compete. So, when we look at the terms you can get on the real estate side, they are more attractive.

For instance, in the senior space, it is possible to generate mid- to high-teen returns. On the corporate side, you are probably looking a few points lower than that.

Q In Asia-Pacific, which markets present opportunities and, conversely, which ones may pose challenges for investment?

We currently like Australia, New Zealand, Korea and India, in particular.

Q How have financing terms changed in markets affected by rising interest rates, such as South Korea, Australia and Singapore?

We have seen rates go up in all markets except China and Japan – and obviously lending rates have gone up as well. But the spread is driven by the supply of credit and the demand for that credit, and that does vary by market.

In South Korea, rates have gone up. Historically there has been a lot of liquidity in this market, which has kept spreads quite low. Traditional lenders had really captured most of the market. But now, with a bit more stress, we are seeing banks being more cautious, pulling back, and we see a bit more of a lending gap appearing. Spreads are starting to widen to more interesting levels for us.

Australia has a good-sized lending gap. Rates have gone up and spreads have stayed fairly constant. So overall, the rates you can charge have gone up.

Singapore is slightly different. There is a lot of liquidity, so rates have gone up, but spreads are very thin because there is a lot of traditional capital available. In Singapore, there is not really much of an opportunity for a non-traditional lender, at least in the senior space.

The benefit of having a pan-Asia platform is that we can pivot to different markets depending on the opportunity set. In India, for example, there have been three key changes that have recently made it much more interesting.

The first of those is the legal system. The bankruptcy regime implemented post-2017 has made the market much more creditor-friendly. The law has teeth and has also very much changed borrower behavior.

Secondly, there is a large lending gap currently. India is now the fastest-growing major economy in the world, but bank lending has been flat, mainly because the banks are very conservative. And thirdly, we think India has probably one of the best macro stories in the world currently.

In Japan, the cost of capital is still very low and we are not seeing so much stress, so there isn't so much on the distressed side. Japan is opportunistic, as is Singapore.

In Hong Kong, there is some spillover from some of the problems in China. There are some borrowers with issues that are creating some rescue financing type opportunities.

In China, we are playing opportunistically on the distressed side, looking at dislocated property developer bonds and opportunistic distressed situations. On the primary lending side right now, the developer defaults have been so widespread that really most borrowers are in balance sheet repair mode and there are very few clean assets.

And then in Southeast Asia, we are generally cautious, primarily because the legal systems are a bit less creditor-friendly at this stage.

Q When underwriting debt, have you been more cautious on sectors like office?

Most of our activity has been on the residential side, where we feel it is easier to underwrite the asset values. We have been generally cautious on commercial real estate. Having said that, there are office markets around the region which are pretty strong.

"In the senior space, it is possible to generate mid- to high-teen returns"

"These are markets where you really need to have strong local teams and good on-the-ground knowledge"

In Korea, for example, the Seoul market has slightly over 1 percent vacancy; there is a real lack of supply. That is why I say we must take things on a case-by-case basis. Generally, though, we have been cautious on assets valued on a cap-rate basis – particularly office, where both rent occupancy and rates can result in big moves in valuations.

Q How have you seen the space changing across market cycles?

PAG has been active since 2004 in the private debt space and we have invested over $40 billion in Asia-Pacific private debt. I think the biggest change we have seen has been the regulatory environment. Bank regulation has historically been good for our business, and it doesn't look like that is going to dramatically change.

Basel IV – or Basel III Endgame, as some people call it – has generated some pushback, so we will see whether that has much impact on slowing regulation. But even Basel III, as it stands, created a lot of room for the private debt business to really develop.

The competitive landscape has also changed. Leading up to 2008, a lot of our strongest competitors were the prop desks at the banks, which obviously disappeared after the global financial crisis. We still see hedge funds come in, play a bit in the private debt space, sometimes get burned and then exit again.

You then have global funds, especially US funds, which come and go. But this is a market where you need to be on the ground for the long term, as I have said. You need to invest in the infrastructure, in the market, in the relationships to play these markets properly. I think that is very important. ■