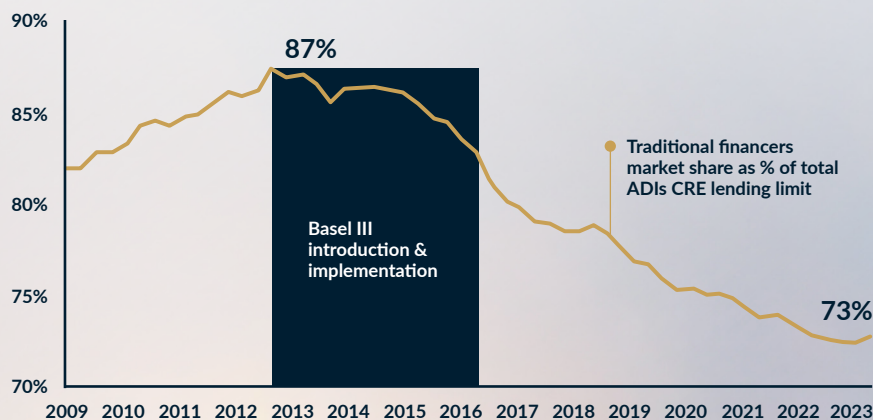


The capital stack unpacked

Following the Global Financial Crisis (GFC), Australia has seen a permanent structural shift in the lending environment for commercial real estate (CRE).

This shift, due to the rigorous capital provisioning requirements enforced by the Australian Prudential Regulation Authority (APRA), means traditional financiers, typically banks, can no longer participate as they used to and their share of CRE lending has declined considerably.

TRADITIONAL FINANCIERS REDUCED SHARE OF COMMERCIAL REAL ESTATE LENDING SINCE GFC^{1,2}



Authorised deposit-taking institutions (ADIs) total CRE lending limit^{1,2}

\$450bn

Qualitas' real estate private credit allocation³

\$7.2bn

Real estate private credit lenders, such as Qualitas, have stepped in to fill the gap by providing flexible senior and mezzanine financing solutions to meet borrowers' needs. This doesn't necessarily mean higher risks for private credit lenders. In many instances, the profile of the lend is relatively low risk, however, the terms agreed upon may simply not align with the risk and capital allocation models that banks are now required to use.



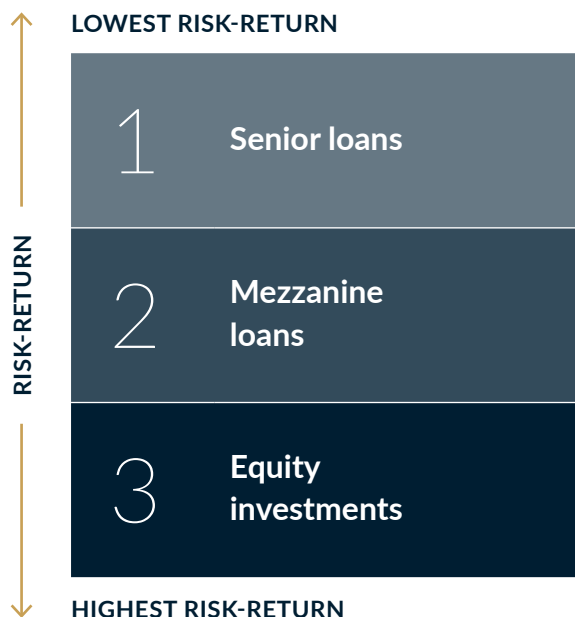
The capital stack unpacked

COMPREHENDING THE CAPITAL STACK

There is a hierarchy for the different types of financing used to fund real estate or other investments, called the capital stack. As it relates to property, it outlines the order of claims on a property's income and assets, with each layer representing different levels of risk and return.

Qualitas invests across the entire capital stack and offers a range of private credit and private equity funds that eligible investors can choose from, depending on their risk-return appetite.

By investing in a real estate private credit fund, an investor gains exposure to the growing property market (through senior loans, mezzanine loans or both) without the risk of owning property in the form of equity, which is repaid last in the capital stack.



Let's look at the different types of financing.



1. Senior loans

Senior loans offer the lowest risk and return profile in the capital stack because they rank first in the capital stack. If the borrower defaults, the senior lender is first in line to claim the assets provided as security. These assets are often the physical property that the loan is secured for and a personal guarantee by the borrower. If a default were to occur, the lender can either take possession and sell the property or hold the property and rent it for income.



2. Mezzanine loans

Mezzanine loans are second ranking in the capital stack. These loans have the same protections as senior loans however, the repayment of the mezzanine loan follows the senior loans. The risk is higher than senior loans and the rates that are charged to borrowers and by extension, the returns provided to investors, reflect this.

These loans are also an important source of funding for borrowers and are typically used alongside senior loans.



3. Equity investments

Equity investments are repaid last in the capital stack. When property values increase, equity investors receive direct upside however, unlike senior and mezzanine loans, investors are directly exposed to any downside if property values decrease. Due to the greater risk undertaken, equity investments typically achieve greater returns.

The capital stack unpacked

HOW IS CAPITAL PRESERVED?

Real estate private credit lenders require borrowers to have equity in a project. This ensures that the borrower has a vested interest, plus it provides an equity buffer to protect against potential downside.

LOANS ARE TYPICALLY PROVIDED WITH A LOAN-TO-VALUE RATIO (LVR) OF 60%, PROVIDING SIGNIFICANT PROTECTION TO THE LENDER IF THERE IS A PRICE CORRECTION.

For example, the property value underpinning a loan with a LVR of 60%, would need to fall by more than 40% before the lender makes a loss. This is a worst-case scenario. It is not something that Qualitas has encountered in the 16 years we have lent to commercial real estate.

It is also worth noting that real estate private credit loan values do not fluctuate like property values. This provides opportunities for investors to reap the benefits of Australia's growing property market without the risks of owning property.

OPPORTUNITIES TO INVEST IN REAL ESTATE PRIVATE CREDIT

A range of real estate private credit investments are available to meet different investor needs or investment goals.

For investors aiming to receive regular monthly income and who are focused on preserving capital, credit-based investments such as the Qualitas Real Estate Income Fund or the Qualitas Private Income Credit Fund may be suitable.

For investors who are interested in the asset class but prefer to invest in the listed market, the Qualitas Real Estate Income Fund (ASX:QRI) is an option. QRI invests primarily in senior loans (86% of the portfolio⁴) with the remaining allocation to mezzanine loans (14% of the portfolio⁴).

For wholesale investors, Qualitas has an unlisted fund – the Qualitas Private Income Credit Fund – which only invests in senior loans.

As with any investment, manager selection is always critical – it's a specialised asset class that requires a specialist manager with experience through multiple cycles, deep borrower relationships and a core focus on risk management.

ACCESS SMART INVESTMENTS MADE SIMPLE WITH ASX:QRI

FIND OUT MORE →

Notes: 1. APRA Quarterly ADI Commercial Property Exposures March 2024. 2. APRA Monthly Authorised Deposit-taking Institution Statistics March 2024. 3. As at 27 June 2024. 4. As at 31 July 2024.

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