IS PRIVATE CREDIT

THE NEW MEGATREND IN AUSTRALIA?

IS PRIVATE CREDIT THE NEW MEGATREND IN AUSTRALIA?

BY PAUL MIRON

In this modern-day world, we are living through a high-tech, ever-increasing fast-paced, and ever-changing world. Investors are undoubtedly faced with much more pressure, decisions, choices, and information than ever before.

Many years ago, investor semi-gods, such as Warren Buffet, at the start of their careers, sent out handwritten letters to listed companies requesting financials and prospectuses, which took weeks to receive. They would proceed to seek investment opportunities and invest at remarkably low share prices (Price-earnings ratios of 2 as opposed to 14- 30 today) where a little bit of discipline, hard work, and dedication would enable them to amass fortunes over time.

In today's efficient markets, where we all have equal access to an abundance of information at our fingertips, new information is instantly distributed and analysed virtually instantaneously by all market participants, thus making it near impossible to gain an advantage over the market.

What techniques are investors turning to today to gain meaningful peeks into the future with the hope of investing more confidently and enjoying the thrills of making superior returns?

Investors are turning to Megatrends

Megatrends are long-term trends transforming the way we live, work, and play. The driving forces are caused by macroeconomic changes, technological gains, a shift in migration, and social changes.

To understand the full power of Megatrends, one must learn from past historical lessons.

As an example, many historical sceptics did not believe that Coca Cola Amatil would last long at all, but we find today that Coke is an international monopolistic conglomerate of the beverage market.

They could not see past the product being merely carbonated boiled water with added sugary syrup presented in a fancy bottle. However, with the proper marketing and changing emergence of changes to social tastes, it would become one of the most successful investments that one could have made at the time, similar stories of McDonald's, General Electric, Boeing, Starbucks, to name a few.

Another example is Bill Gates' vision that a personal computer could be a powerful tool used by everyday households. Interestingly Gates was not the only visionary with the same idea at the time; the difference was his superior business acumen and the pivot in building the Microsoft operating system to enable this technological transition from concept to reality. In this, he led the way for others to forge forward, such as Apple and IBM, propelling the settings for the information age to emerge.

Investors should not have a false sense of security just seeking the insights of Megatrends for success. It is critical to acknowledge that the market is a collective of people, and as a result, markets tend to boom and bust while inevitably moving in traditional cycles.

My favourite Mark Twain's saying that best describes the ups and downs of the market is, "History does not repeat itself, it Rhymes." It is impossible to predict the timing of the next boom or bust consistently. Still, you can prepare yourself through diversification and understanding that certain asset classes will follow predicted behaviour over time. One must always consider asset preservation within their portfolio. This is the key, as losing your hard-earned money should always be avoided.

So, what are some of the Megatrends that Msquared can see on the horizon being a specialist direct commercial mortgage fund manager?

Interest rates internationally

Indeed, we are living through uncharted territory regarding low-interest rates globally near-zero official interest rates set by most Central Banks globally, primarily to combat the negative economic impacts of COVID -19 now and into the foreseeable future.

In Australia, the Reserve Bank's primary role is to set official interest to a level to stimulate both consumers and business activity while not allowing for the market to overheat with higher inflation. The bank's traditional targeted inflation band is 2%-3%. If longer-term inflation increases beyond 3%, interest rates will reluctantly need to increase to place downward pressure on asset values.

That said, with the official cash rate at 0.10% p.a., the by-product of cheap credit has pushed up the value of assets such as real estate and shares, far beyond most expectations, despite being in the middle of one of the most economically challenging times due to the COVID-19 pandemic.

The five and ten-year bond rates are presently sitting at circa 0.63% and 1.18%, respectively. The combination of the most brilliant economists and bond traders believe that the official cash rate over five years may only go up by 0.5% in five years and, possibly, 1.1% over ten years, which is essentially negligible.

The current bond rates infer that we will be operating in a very low-interest environment for a very long time. Accordingly, the expectation is that asset prices will likely keep going up until they become unaffordable or investors stop seeing any value in holding those assets. Therefore, the Megatrend that we envisage is a continual and gradual yield compression (decrease in returns) for property, shares, and other tradable assets. The free cash flow from these investments will continue to contract further, making it even harder for investors to generate the appropriate level of income required, especially for SMSF trustees and self-funded retirees.

The main two events that would change this outlook would be higher inflation, thus pressuring Central Banks to increase interest rates sooner, or an out of sequence market correction/crash bringing about loss of confidence due to an unexpected event.

Property

Regular readers will know my view regarding property's resilience and its contribution to the overall health and stability of the economy.

The Australian love affair with property and homeownership is now at 67%, due to the highest net overseas migration for the period leading up to the COVID -19 outbreak and together with the supply constraints that have been added due to an inefficient planning process. As discussed in my June article, 'It Is Confirmed - Australia Is The Lucky Country', Australians are now the wealthiest people per capita globally. Not surprisingly, it has been the best-performing asset class one could participate in, as per the graph below.

Due to COVID-19, a short-term trend has recently emerged:

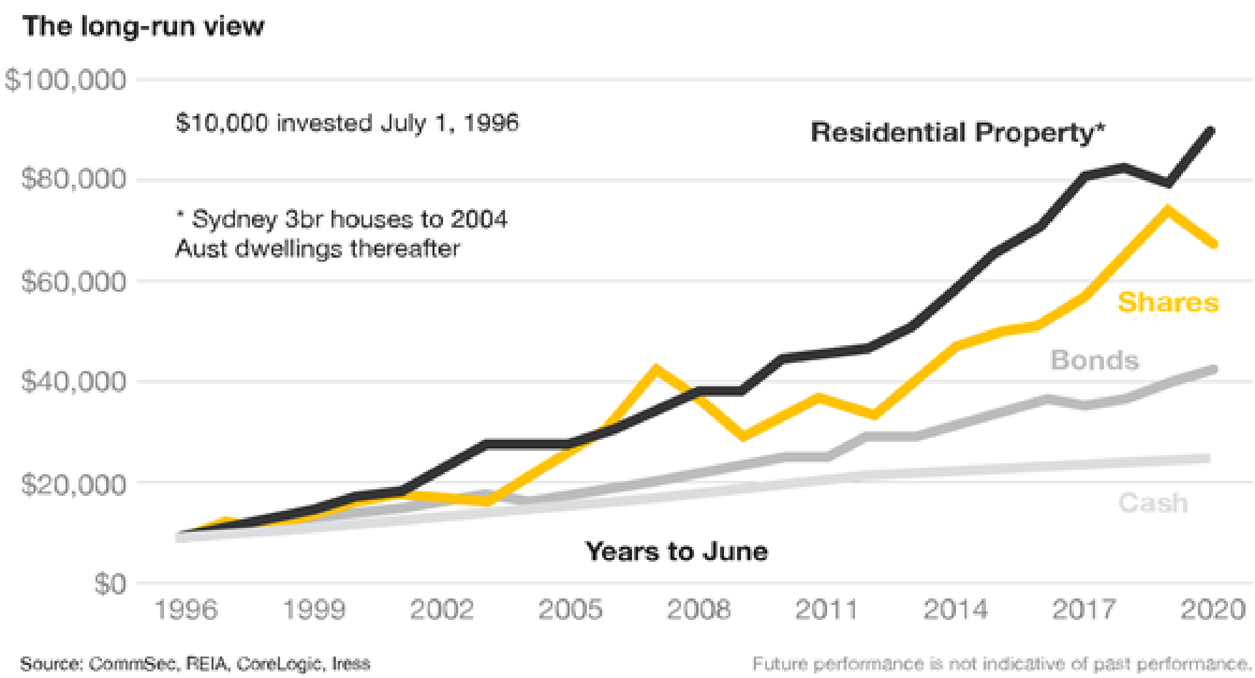
The price gap between units and detached houses has widened to the most significant gap in recorded history.

The Megatrend is that we believe that this will be reversed, however, with a twist. It is our view that the demand and price growth for the luxury, larger apartments that offer superior amenities will not only be highly sought after but will also become the best performing type of property within its asset class. With baby boomers' increasing requirements for downsizing accommodation in combination with the proposed restart of skilled affluent migrants coming to Australia at the end of the year, the demand for the high-end luxury apartments segment will only increase.

Australian Private Credit coming into Vogue

Australia, compared to the US, European, and other Asian counterparts, is lagging substantially behind when it comes to these ongoing global Megatrends.

Just over 70% and 46% of all commercial loans are written in the US and Europe by private credit providers, also known as non-bank lenders; In Australia, it is a mere 8%. This class of investment offers the ability for investors to have ownership of the mortgage, earn more than 6% p.a. while having the security against real property. This investment generates regular income with a proven track record in preserving investor capital in any market cycle and volatile markets.



The investors in US receive returns of circa 3% p.a. due to the maturity and competitive nature of the overseas private credit market. In comparison, this is less than half of what is offered by Msquared for a similar style of investments, as our returns start from 6.50% p.a.

Considering we are operating with the same close to zero interest rate environment globally, this is significant.

We believe that demand from Australian commercial borrowers to have options other than funding through our major banks will continue to grow as reflected by the funding Gap, last reported to be over $119b. Due to ongoing government regulations and interventions, the ability of private credit providers to offer bespoke solutions, ease of capital, service and speed, private credit providers will continue to grow.

Investors are slowly learning the benefits of investing in direct commercial mortgages andseek out these opportunities. Institutional investors weigh their support into the sector both due to the lack of ability to generate consistent regular income from other investment classes and due to recognition ofresilient qualities offered by real property, enabling asset preservation within the portfolio.

As the market matures, the appreciation for contributory funds will increase. Savvy investors will seek higher transparency, ethical investment requirement, and a direct line of sight of the underlying security on offer while having the added benefits of superior returns rather than a pooled fund.

Contributory funds allow more control to the investor by having these choices. The function of a contributory fund is that each investment is a separate ring-fenced opportunity, whereas pooled fund, as its name indicates, has many mortgages within one investment vehicle.

The contributory fund places the investor in the driving seat, allowing them to create their personalised unique investment portfolio in this asset class.

The Megatrend is that there will be a structural change on how and who will provide commercial loans in Australia, reflecting the path experienced in the US and European debt markets. Msquared Capital is excited with the prospects of meeting the needs of more investors while servicing the funding needs of quality borrowers in their commercial pursuits for many years to come.

If you would like to know more about how Msquared Capital can be a part of your investment portfolio and the added benefit of our unique structure, platform, and offers. Please feel free to contact Paul Miron on +61 2 9157 8608 or sending an email to investor@msqcapital.com.au.

PAUL MYLIOTIS

Managing Director

e. p.myliotis@msqcapital.com.au
p. 02 9157 8608
http://msqcapital.com.au/

PAUL MIRON

Managing Director

e. p.miron@msqcapital.com.au
p. 02 9157 8608
http://msqcapital.com.au/

REFERENCES

1) https://www.bloomberg.com/markets/rates-bonds/government-bonds/australia

2) https://www.linkedin.com/pulse/property-continue-resilient-paul-miron/

3) https://www.abc.net.au/news/2015-05-06/fact-file-housing-in-australia/6442650

4) https://www.linkedin.com/feed/update/urn:li:activity:6818001616608874497/

5) https://docs.preqin.com/quarterly/pd/Preqin-Quarterly-Update-Private-Debt-Q1-

6) Australian Prudential Regulatory (APRA) December 2020

7) https://www.theadviser.com.au/breaking-news/41345-sme-funding-gap-sees-5-jump

8) https://www.financialadvisor.com.au/contributory-mortgage-funds-explained/