Property insider stares down $2.2trn debt cliff
By Nick Lenaghan Property editor

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From his office in New York, David Kruth has become an eyewitness to the next big shakeout in the commercial property sector.

Major landlords in the Big Apple, such as Scott Rechler's RXR, are already preparing to hand back to the bank keys to office towers that are no longer producing viable returns. Other major investors are caught up in the turmoil, too, including Brookfield and Pimco's Columbia Property Trust defaulting on commercial mortgages.

And the storm clouds are gathering. An estimated $US1.5 trillion ($2.2 trillion) of commercial real estate debt falls due by the end of 2025 in the US market. Will it be refinanced? With rising rates, increased office vacancy and the work-from-home trend showing no sign of abating, finance for office towers especially will be under threat.

Mr Kruth, a former portfolio manager at Goldman Sachs Asset Management, now oversees Dexus' Global REIT Fund. He says the instability in the sector is not new. "This has happened in cycles and cycles over time," he told *The Australian Financial Review*. "I want to be very clear that for the majority of that $1.5 trillion, there will not be issues."

Fortunately for Mr Kruth, most of the disruption now being felt in the

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David Kruth is confident big US landlords will survive a trillion-dollar wall of debt facing commercial real estate. PHOTO: ANN-SOPHIE FJELLO-JENSEN

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direct market was anticipated more a year ago in publicly traded real estate investment trust markets globally, including Australia's, which plummeted as central banks moved to tame inflation, jacking up interest rates and sending long bond yields jumping higher.

As REIT prices slumped last year, absorbing losses in a jittery market, so did returns from the $20 million Dexus Global REIT Fund, whose launch in April 2020 coincided with the COVID-19 pandemic. On the upside, as Mr Kruth highlights, even as the fund dipped it outperformed its global benchmark by a respectable 2.64 per cent in the past year and by 1.59 per cent since inception. Currently, it is returning a 4.2 per cent dividend yield.

While those results will be good news to his investors, Mr Kruth is also remarkably sanguine about further upheaval in commercial property and the prospect of writedowns in value.

He says there will be situations where investors in some office towers will not be able to refinance their assets properly as loans expire. "The [owner] of the asset and the bank are going to have to work out some plan to recapitalise or kick the can down the road and eventually work out the issue.

"There will be some assets in that sector, older offices, that will need to be repurposed into apartments or something else. What's going to happen is the owners of those assets are going to suffer some writedowns until somebody will buy that asset to repurpose it into other uses."

As observers of the US market worry about what happens if and when the finance tap is turned off, analysts here have turned their attention to stress-testing how Australia's REITs would fare during a US-led credit crunch in the sector. There's plenty to consider, given among 22 listed stocks analysed by Morgan Stanley, there is $75 billion in debt, with the bulk of that sourced from the capital market. The report card was good; in the main, Australian REITs have enough liquidity to sail through a credit squeeze.

Mr Kruth says REITs learnt the lesson of the global financial crisis and now run their balance sheets on conservative gearing levels. The likelihood of a sharp drop in values in the direct market – in Australia, some pundits warned of a 20 per cent tumble in office tower values – does not faze Mr Kruth either. That's because the property stocks took their medicine well before distress arrived in the direct market.

"Valuations of all asset classes have fallen pretty dramatically from their peak during COVID, like 12 months ago, mainly on the fact that the risk-free rate has gone up substantially," he said. "The public market – in Australia, whatever stock you want to look at, the public market in the US, the public market in Canada, et cetera, et cetera – has largely ripped the Band-Aid off the valuations, repriced everything.

"The private market historically takes longer to do that. It's just the way it works. The appraisal process is not in lockstep to the public market. It hadn't been that way since the early 1990s," he added. "The public market led us up in this recovery a couple of years ago, post-pandemic. Now we are repricing the equities, the value of the publicly traded companies, the private market is following down slowly. By the time it gets to a fair valuation, the … market is most likely going to be going up again."

Mr Kruth has good reason to be cheerful, given the relative outperformance of the Dexus fund he oversees.

A closer look at the composition of that fund is an eye-opener for Australian REIT investors, whose horizon is largely restricted to a traditional mix of offices, malls and warehouses, along with residential developments built to sell. Although logistics comprises almost a quarter of the fund, multifamily residential – known in Australia as build-to-rent – accounts for 22 per cent.

Healthcare, data centres, telecom towers and single-family residential also feature prominently.

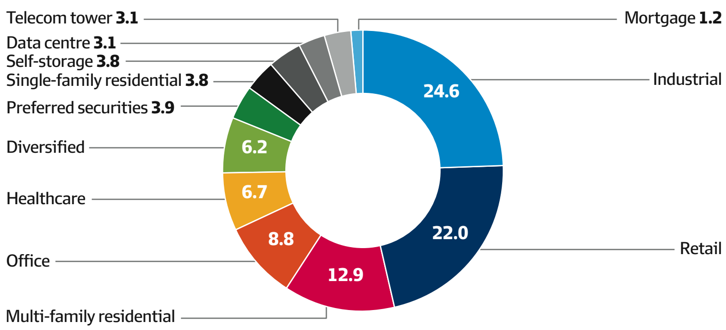
So, what then is the secret of the fund's relative success? Mr Kruth's advice involves a mix of taking a "proactive approach" to risk and "selecting strong companies with good growth prospects at relative value prices".

It's also pretty simple.

"Sometimes you win by avoiding mistakes," Mr Kruth says.

Carefully curated

Sector exposures of the Dexus Global REIT Fund (%)



SOURCE: DEXUS GLOBAL REIT FUND