

remara.

Private Credit Quarterly

A comprehensive look into the markets
& what may lie ahead.

Q3-2023

• Welcome

Welcome to the 'Private Credit Quarterly,' an in-depth resource for investors to explore the inner workings of the markets and what may be in store moving forward.

Despite the markets having faced headwinds for a prolonged period, capital is still readily available for borrowers. With further challenges expected as we move into 2024, we take a detailed look at our core-sub markets and how 'sticky inflation' could mean that we are in for additional interest rate rises over the coming months.



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● Insights

The 'war' on inflation has prompted some of the most significant rate hikes in the US and Australia in more than 20 years.

By Andrew McVeigh & David Verschoor

Some time ago I was given a book written by Sun Tzu called the "The Art of War". Written over two millennia ago, the book aims to provide insights into achieving victory in warfare by emphasizing the importance of strategic thinking, meticulous planning, and understanding one's opponents.

It delves into various aspects of warfare, including terrain analysis, assessing the enemy's strengths and weaknesses, and exploiting opportunities for success. Sun Tzu's central thesis revolves around the concept of outsmarting the enemy rather than engaging in direct conflict, highlighting the importance of diplomacy, deception, and careful manoeuvrings to secure favourable outcomes.

I reflect on the juxtaposition of the books title, 'Art and War.' One is usually aligned to beauty and the other an ugliness of human conflict. The book's title came to mind as I thought about where we are at currently and how we got here. Early last year, the war in Ukraine started a fierce march upwards on inflation. Food scarcity and oil (out of Russia & Israel) were the main initial drivers. But other pressures were already there.

Very low interest rates (near zero through Covid), helicopter money being pumped through the system (and even here in Australia via the RBA) and supply chain disruptions (think limited supplies of chips etc). So what started as a physical war erupted into a war on inflation and now we have a second conflict to add to the equation. What will this mean?, most likely more inflation specifically in the energy sector, which as an input into everything, will surely drive further inflation and keep us in this high inflationary environment for longer.

The "war" on inflation has prompted some of the most significant rate hikes in the US and Australia in more than 20 years. US rates have risen by 5% since early last year. The US economy is now slowing and recent indicators suggest that economic activity is potentially flatlining. US housing sector activity remains weak, largely reflecting higher mortgage rates. Higher interest rates and slower output growth also appear to be weighing on business fixed investment.

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But offsetting this is a very tight labour market. Over the first nine months of the year, job gains averaged a robust ~200,000 jobs per month. The unemployment rate moved up remains low at September, at ~3.7 percent. There are some signs that supply and demand in the labour market are coming into better balance.

The labour force participation rate has moved up in recent months, particularly for individuals aged 25 to 54. Nominal wage growth has shown some signs of easing, and job vacancies have declined so far this year. While the jobs-to-workers gap has narrowed, labour demand still substantially exceeds the supply of available workers.

We think the efforts by the Fed and RBA are delivering exactly the outcomes needed to moderate demand and it seems there is a much more measured pace of employment growth, with inflation starting to appear more under control. However with a target inflation rate of 2% and US inflation currently at 5.3% there is still a way to go to moderate. Some of this will be time. Some of this will be higher rates.

With our rates sitting at 4.1% and inflation remaining high, interest rate parity arguments most certainly will push the AUD further down in the near term future, which further adds to inflationary pressures already felt.

The RBA recently released the Financial Stability Review for the September period, outlining that home borrowers have been surprisingly resilient in the face of rising interest rates and their ability to increase their nominal and real income to combat the sharp rise in rates. This commentary leads Remara to believe we are in for a longer period of higher rates and rates are likely to further increase to allow the RBA the confidence to claim they have dealt with inflation.

As the impact of higher rates starts to bite, we expect to see a decline in credit quality in other lenders, with some arrears appearing through portfolios. Although the RBA might add a couple more rate hikes, we think this cycle is done even if we are expecting to see rates higher for longer.



● Insights

So year to date we have had S&P500 up 11.68%, ASX200 up ~ 2%. DAX is up 3.5% and Nikkei is up a whopping ~ 19%. VIX has been stable for the summer holiday period, we are starting to see a trend higher as we move into Christmas. Equally credit indices have done well.

Overall, in our market we are 19bp tighter on the year with Credit indices at 130. European (main) index is 13bps tighter on the year at 77 and XOver (the high yield CDS index) is tighter by 68bps to 406.

Current arrears rates are still well below 2012 levels (with SPIN data showing Prime at 0.96% and low doc of 3.72%). We have seen both cohorts largely in-line with the same period last year and below long-term average. For our own part, arrears through our portfolio are healthy and in fact have fallen into September 23 vs Dec 22. Our market leading asset finance pool has 30days+ on our asset finance pools of 0.39%.

Which brings my note to our views going forward. The war of the central banks is not over, we will most likely see more rate hikes and if you believe in interest rate parity, we have some room to catch up to the US. We're starting to see arrears on mortgages (both prime and low doc) edge higher but nothing to worry about.

"In the battle against inflation, one must wield the sword of prudence, strike with the shield of fiscal discipline, and maintain an unwavering focus on the enemy within - the unruly forces of excess demand."

So, what would Sun Tzu have said about the war on inflation?

Perhaps a witty response might have been "In the battle against inflation, one must wield the sword of prudence, strike with the shield of fiscal discipline, and maintain an unwavering focus on the enemy within - the unruly forces of excess demand. Only then can victory be achieved, ensuring a stable economic landscape where prices march in harmony."



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● Market Overview

The market has faced significant headwinds for what is now a prolonged period...What has been the impact?

In data, not much, but the data is a lagging indicator and what we are seeing in market is a different story. Capital is still available for borrowers, however, each of the markets that we operate in are facing distinct impacts that will lead to challenges as we move into 2024. Let's look at our core sub-markets.

01 Small & Medium Enterprise (SME)

SME borrowers have been extremely resilient during the rate rise process. There are signs starting to emerge that "Prime" borrowers have identified the changed market conditions that they are facing and we have seen a drop in the underlying demand for credit. The quality of borrowers already in-debt has continued to be strong, with limited movements in arrears and losses through the portfolio being experienced.



02 Insurance

Well, costs have gone up, about 20% overall. We have seen through our financing activities for SME's and Corporates an overwhelming increase in the underlying cost of increase year on year. This has led to a ~56% increase year on year in our funding of Insurance Premiums, it is also places substantial inflation pressures on business. The good news is the higher rate environment, should be beneficial for insurers and attract more capital from them and may halt future increases for a period of time.

03 Real Estate

The Real Estate market is at an inflection point, with each sub-class experiencing alternate issues. Let's quickly explore each class quickly:

Residential

Demand has trended sideways, with a national increase of 0.8% YOY in total sales listings resulting in a rather buoyant period on reduced activity. We believe residential real estate [overall] will benefit from two main factors both working in tandem. Significant positive net migration into Australia will provide continued



demand for dwellings, while poor state development planning and policy incongruent with federal migration policy will continue to limit new supply. These factors should provide a floor to the market. If we start to see declines in interest rates, we will be off for a further bull market in prices. Without any rate changes or nominal increases, we anticipate a market that will continue to trend sideways and oscillate between +/- 2% growth.

Industrial

We anticipate a continued strength in industrial property, however caution must be noted given the environment and prior commentary on the SME market. If we see further degradation in the SME market, this will flow onto Industrial tenants and then property values. It should also be noted, capitalisation rates are not reflective of a 4.15% base rate market. While not our base case, if stress is incurred and forced selling is needed, Industrial could be materially impacted.

Commercial

We have had a negative view on commercial spaces for the last 18 months. This view has not changed. We continually see a lower demand for office space and a flight to quality assets, limited transactions have occurred, but they have all occurred at a discount to book, reflecting a higher RBA rate and readjusting values lower.

The office sector is well capitalized and learnt from the GFC period, so the expectation of significant declines in Prime through to B grade is unlikely. The challenge of Office will be the C class and below. These buildings need significant capital expenditure and require repositioning. This is not a cheap task and money is relatively expensive. We may see further lower quality office buildings be repositioned to residential apartment buildings as that will form highest and best use for the foreseeable future.

04 Development Finance

Remara participates across the equity and debt stack of Real Estate. A core aspect of operations is development and construction finance. Through our activities as both a principal and financier we have seen a continued challenge in the market, driven by a few key factors:

Planning & Approvals

Planning policy and approvals continues to be a challenge, this was exacerbated by COVID and has unfortunately progressively worsened. We are seeing projects being delayed due to a lack of available staff and an inefficient approval model.

The impact of these delays is significant, prior to the RBA increases, valuations were increasing and the ability to refinance at end of term was available, this is no longer the case.

This is leading to undercapitalised developers (a significant portion) struggling to maintain their projects and creating issues for most development financiers, which in turn, limits the availability of capital for new projects, placing further upward pressure on prices through limited new supply.

Construction

A lot has been made of the price escalations that occurred during COVID. While the increases have eased, there is a baseline that is higher than previous. This readjustment has been brutal for builders as many have fixed price contracts and therefore needed to absorb the price increases on their own balance sheet. We are seeing more and more construction firms going under, placing further risk on projects. We expect a period of further instability for construction firms of all sizes. This leads us to caution on the construction side of our lending activities and the appointment of builders on our principal development activities.

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Remara has focused its financing activities on projects that it can complete, if required, via our principal development team. We have limited the financing of built form (apartments) to residual stock or land financing only as we believe smaller developments with lower construction risk will be critical during this period. The resulting lower competition on finance is allowing positive risk/reward opportunities to be available on sub-division & smaller multi-family developments (duplex and townhouses).

05 Dealer Finance

Remara currently funds several strategic primary asset dealers across motor, yellow goods, agriculture and recreational equipment. We have seen continued strength for good quality equipment that is well priced. We are starting to see challenges in dealerships with higher end second hand goods such as European motor vehicles and we anticipate the market to correct from the highs experienced through COVID.

Tailwinds and shifting market dynamics have increased demand for floorplan and inventory finance products. A correction to the mean for dealers, as stock turn normalises toward pre pandemic levels as a result of OEMs mobilising their production lines with key components and shipping delays reducing its impact across the supply chain. Remara remains bullish on floorplan product.





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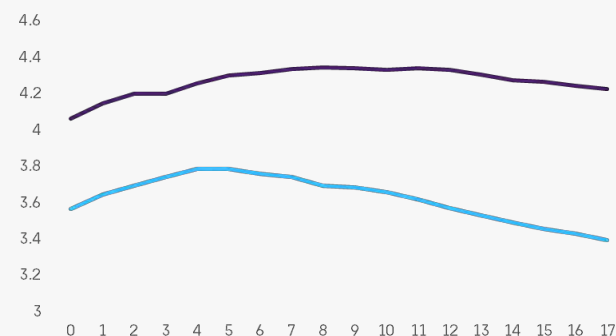
Tight financial conditions continue to be maintained through restrictive monetary policy by the RBA. The RBA left the cash rate unchanged in October at 4.1% as expected by the market. However recent CPI indicators point to sticky inflation – particularly in relation to Services, driven by wages inflation by employees. Underlying inflation (as measured by trimmed mean CPI) has fallen from recent highs [from an annualized 6.9% 4Q2022 to 5.9% 2Q2023].



However, the RBA have recently stated that 'In making its decisions, the board will continue to pay close attention to developments in the global economy, trends in household spending, and the outlook for inflation and the labor Market.' The developing risk of a wider war in the Middle East could lead to an inflation shock through higher oil prices [currently 30% higher than June 2023 levels].

Accordingly, short term market expectations are that there could be additional rate increases in the coming months.

ASX 30 Day Futures



Current | 6 month

● Economic Outlook

ASX 30 day futures, which indicate short term rate expectations regarding the cash rate, show that over the past 6 months that expectations for a higher terminal rate and for a longer restrictive period of restrictive cash rates have been factored by the market.

Despite the tight financial conditions, the labour market continues to remain resilient. Unemployment remains slightly above 50 year lows at 3.7% nationally, however the strength of the employment market is beginning to wane. Spare capacity within the labour market showed signs of softening which could indicate a turning point.

Output growth (GDP) has also shown resilience with the RBA adjusting their 2023 calendar growth by 0.5% (to 2.1%). Other factors contributing to the strong result was rapid population growth and high capacity utilization.

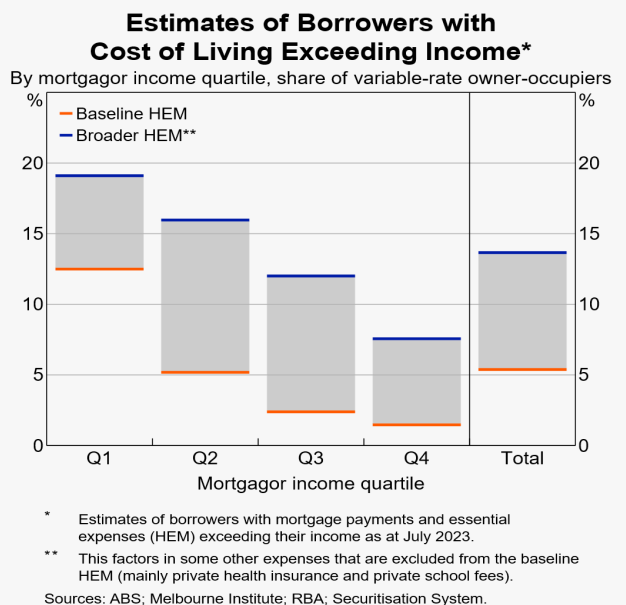
There has been considerable debate in the financial press regarding the resilience of the Australian housing market in the face of such a steep and fast rate hike. On average, mortgagors face payments 30 – 50% higher than mortgage repayments at the start of the hiking cycle (April 2022). Additionally, those who fixed their mortgage during the COVID-19 pandemic at very low rates faced even higher increases to mortgage payments. The RBA, in its biannual Financial Stability Review, stated that “a growing number of households are in early stages of financial stress but a very small share are currently unable to service their debts”.

The RBA cited spare cashflows and savings buffers as a chief source of support for households facing higher repayment costs (in addition to increased cost of living expenses). The central bank examines the stress levels of fixed rate mortgages that are rolling into much higher variable rate mortgages and finds that the cohort has similar savings buffers to typical mortgages. They find that an estimated 8-18% of borrowers will not have an income able to meet the cost of living. The RBA estimate the ability of a borrower to use Mortgage

Buffers to meet the income shortfall to paint a strong picture of the resilience of the Australian Consumer.

This segment is particularly important as 1.92 million fixed rate mortgages were taken during the COVID-19 pandemic. The transmission of monetary policy has been delayed by the fixed rate loans. By the end of 2023 approximately three quarters of these loans will have rolled off. We think therefore the pain for mortgage holders will only really start in Q3, 2023.

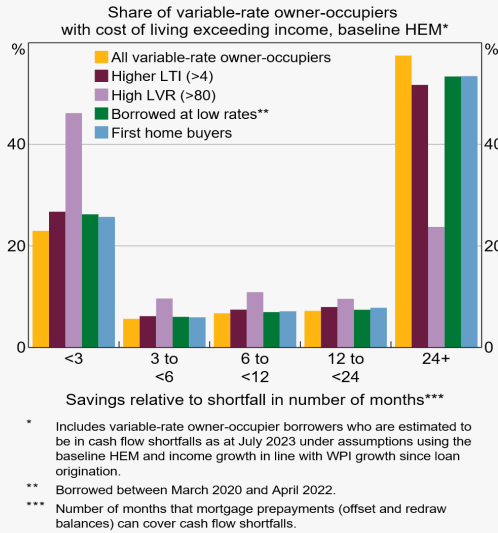
Recent performance of Australian Housing (1% below previous highs of April 2022) gives a strong ability of mortgage holders to ultimately sell the collateral to repay the loan should they not be able to persevere whilst the RBA returns Inflation to the stated target of 2-3%.



Source: Financial Stability Review October 2023, RBA

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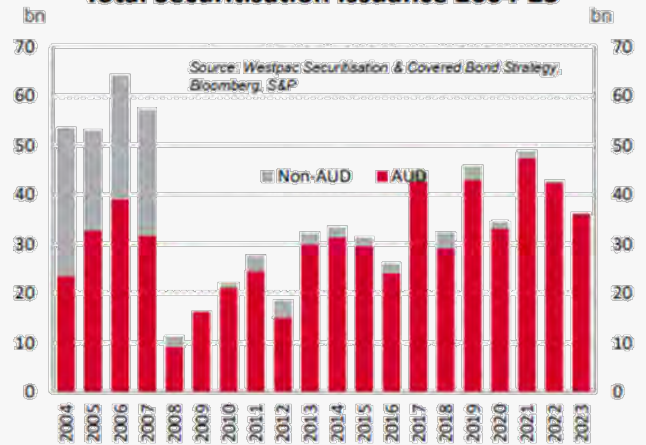
Mortgage Buffers Relative to Cash Flow Shortfalls



Source: ABS; Melbourne Institute; RBA Securitisation System

Securitisation markets remain resilient with 36.1bn [56 transactions] ABS placed in public term markets in 2023 to date including a flurry of issuance from new issuers (or new asset classes for the issuer) including Grow Finance, Judo Bank, MA Financial, BC Invest (Coventry Program), Angle Auto Finance and Shift Financial. Issuing spreads tightened throughout the calendar year – AMP's Prime RMBS Progress's 2023-1 deal price at a weighted average margin of 160bps/ bbsw1m across all classes during March 2023. AMP revisited the market during September and achieved a weighted average margin of 128bps/BBSW1m.

Total Securitisation Issuance 2004-23



Source: Westpac Securitisation & Covered bond strategy, Bloomberg, SP

This trend was observed down the credit spectrum and for all securitized asset sub-markets with the exception of non-conforming subordinated IG RMBS – spreads for these notes moved from the 300bps/1mbbsw area to 400bps/bbsw1m. [comment on S&P spin].

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