Why zig when you can Zagga?

COVID, crisis and catalysts:

the rise and rise of alternative lending

Zagga | your secured alternative

The past is another country. They do things differently there.

- L.P. Hartley, The Go-Between, 1953

On one hand, it seems dramatic to apply this quote to a paper that marks a four-year anniversary. And yet, Zagga's launch year of 2017 feels unrecognisable in many ways.

Such is the experience of people who live through major events; many already think of pre-COVID-19 times wistfully. We shook hands with strangers, were confused by QR codes and commuted to offices five days a week.

And in 2017, interest rates seemed about as low as they could go.

Hovering at 1.5% for close to three years[1], the Reserve Bank of Australia's (RBA) cash rate target seemed low but manageable for savers and investors alike. The economy was neither roaring nor sputtering. In fact, it wasn't until 2019 that the RBA first lowered the rate by 25 basis points, concerned about international trade tensions abroad and anaemic wage growth.

Just over a year later, the cash rate was at 0.10% and the RBA was engaged in 'unconventional' monetary policy as it sought to steer the Australian economy through choppy COVID waters.

During 2020, the ASX200 experienced both a precipitous 37% drop and a dramatic recovery by year's end[2]. In the meantime, investors faced significant dividend cuts thanks to lower earnings and regulatory intervention.

Investors experienced whiplash as they watched their fortunes rapidly fall then rise over the pandemic. However, the events of the past 18 months have not sparked new trends, they have simply acted as a catalyst for existing ones.

1 RBA Cash rate target September 2016 - May 2019
2 ASX 200, February – December 2020

A world remade

The decade following the Global Financial Crisis was a new era for investors. Ultra-low interest rates, increased Central Bank intervention, and higher capital requirements for banks created far-reaching and diverse flow-on effects. Three key effects were:

1. Asset price inflation - buyers accessed cheap capital to invest in property and shares, sending valuations up across a range of asset classes
2. Investors increased their risk appetites - income-focused investors moved up the risk curve to capture returns in the face of the low rates available from cash and bonds
3. Banks reduced their risk appetites - especially for commercial lending, to ensure they met regulators' capital requirements[1], which were designed to avoid another GFC

Taken together, these trends had a significant impact on the alternative lending sector.

Rethinking risk and return

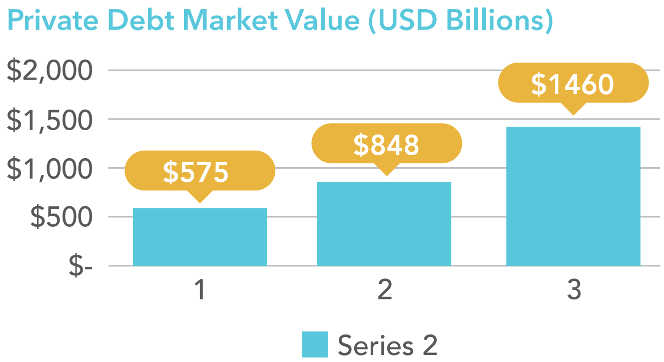
Since 2020, asset prices have soared across everything from residential homes to tech stocks. Interest rates for cash and term deposits aren't keeping up with inflation.

Investors are continuing to look beyond traditional barbell approaches of cash/bonds for safety and equities for risk in order to meet their lifestyle costs.

In this context, the growth of alternative lending has been remarkable - but not surprising. In particular, Commercial Real Estate Debt (CRED) has been boosted by investor interest and borrower demand as the property sector maintained strong momentum. Zagga has been a beneficiary of this trend, as a relatively early entrant to the market, with a strong reputation and solid origination pipeline. This paper explains how the CRED market works, why it is growing and how it can benefit investors seeking attractive, predictable income in an unpredictable world.

Going Private: a global boost for alternative lending

CRED provided by alternative lenders is a subset of the broader Private Debt asset class, which is experiencing strong growth globally.



One of the strongest tailwinds behind this asset class is the low-return environment. Consider, for example, that 10-Year Australian Govt Bonds (Chart 1 below) are providing yields of around 1%, even as they take on the significant duration risk of a 10-year horizon.

Investing in corporate bonds, which traditionally pay a higher yield than government, is no simple solution either. The conventional thinking is that lending to corporates is riskier, so investors receive a premium for that risk. But in today's low-rate world, such bonds are only paying yields of around 2%, as shown in Chart 2.

Chart 1
10-year Australian Government Bond Yield

Sources: RBA; Yieldbroker

Chart 2
Australian Non-financial Corporate Bond Yields

Sources: Bloomberg; RBA

It is no wonder, then, that investors are looking to options like private debt. With higher yields hard to find elsewhere, two thirds of global investors surveyed intend to increase their investment in private credit, according to a PREQIN survey in August 2020[3].

3 Private Credit Outlook, JP Morgan Asset Management, 14 Jan 2021

Commercial Real Estate Lending: on a growth trajectory

Lending to commercial real estate has always been big business in Australia: the CRED market for Authorised Deposit-taking Institutions (ADIs) is currently worth more than $305 billion, an increase of around $15 billion since December 2019[4].

Such numbers only represent the traditional banks. There is a growing loan market provided by foreign banks and privately-funded alternative lenders such as Zagga. In fact, private lenders are predicted to provide more than $50 billion in CRED lending by 2024[5].

This growth is driven by two key factors:

1. **Reduced lending appetite from banks.** Given their strict capital requirements[6], banks have narrower parameters for providing loans to commercial customers. For borrowers seeking flexibility and certainty of funding, private lenders offer a more tailored approach to assessing creditworthiness.
2. **Investors seeking income.** With equity markets arguably overvalued, and cash returns hovering close to zero, sophisticated investors are allocating their capital to investments that fall broadly in the 'fixed income' space but provide more flexibility and higher returns than traditional bonds.

Australia: an outlier in lending

The CRED asset class has long been a mainstream option for investors in markets such as the US, Europe and the UK, where banks have had a lower market share of commercial lending. For example, US banks only have a 39% market share of CRED lending[1].

In Australia, the long-established dominance of the 'Big Four' banks (complemented by smaller, second-tier banks) means ADIs have controlled around 85% of the CRED lending market. However, this has been undergoing a shift.

The four biggest banks have shrunk their share to around 72% – the lowest level since the Global Financial Crisis[1].

4 Quarterly authorised deposit-taking institution property exposure statistics, APRA, March 2021
5 Non-bank lending to hit $50b by 2024 as major banks cut back, AFR, 5 Oct 2020
6 RBA Financial Stability Review, April 2021

A different pathway to property investment

A key attraction of investing in CRED is that it provides exposure to the property sector, but without the potential volatility of listed Real Estate Investment Trusts (REITs).

The S&P ASX200 AREIT Index fell significantly in 2020, reflecting the performance of the broader equities market[7]. CRED also avoids the high cost of buying and owning an investment property, and the limited liquidity such an asset offers.

Another reason for the popularity of CRED investments is their ability to be secured by underlying property assets. This means that if the borrower defaults on their loan, the lender has recourse to the property against which it is secured. This provides investors with peace of mind regarding risks to their capital.

There are generally two ways to invest in CRED:

Individual loans: investors are matched to specific loans, based on their risk profile and return preferences. The investor reviews the loan details to ensure it fits their needs and provides approval to proceed with the deal. These loans usually require multiple investors, essentially creating a loan syndicate.

Discretionary funds: Investor capital is pooled in a fund and the firm managing the process allocates capital to a range of loans that align with the fund's mandate. This provides investors with regular income based on a target return, as well as diversification across a portfolio of loans.

7 S&P ASX 200 AREIT Index fell from 1730 points in Feb 2020 to 877 in March 2020

Zagga provides both of these options, in response to investor preferences. Given the risk profile, predictable returns and focus on capital preservation, these products are viewed by investors as an alternative to bonds, cash or cash-enhanced products. The structure is also transparent: unlike investing in a unit trust or special purpose vehicle, Zagga investors directly own a fractional share of the loan assets with a clear value and can access the underlying security, which is seldom the case with other traditional structures.

Zagga's key numbers at a glance

LAUNCHED IN 2017 First loan of **$7.50M** written on 26 June 2017	Total originated portfolio of **$0.50B+**	**130+** loans funded
300+ registered investors	Average loan term **10.1 MONTHS**	Average loan-to-value ratio **62%** (historic)

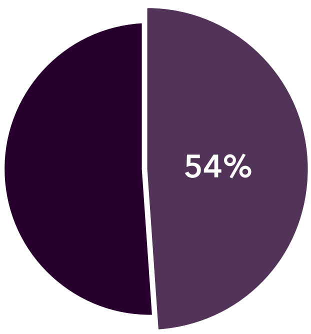
As at 30 June 2021

The impact of COVID: A flight to safety

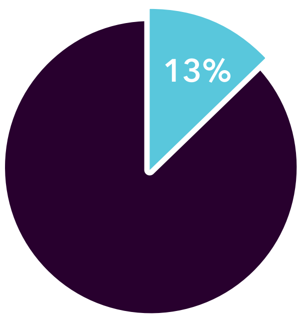
The market disruption caused by COVID-19 has led to strong growth for Zagga. There was a notable uptick in the numbers of both investors and borrowers looking for opportunities on the platform since COVID disrupted markets.

In any crisis, people have a tendency to take money out of equities and look for less volatile alternatives. In the midst of a pandemic, where volatility became the new norm, investors realised they needed to have a range of assets that could deliver against unprecedented market movements.

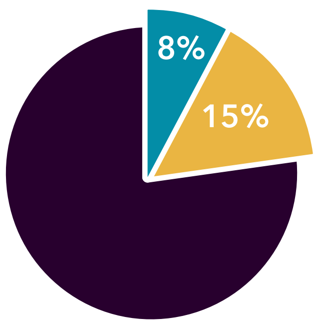
This shift was reflected in research conducted by the Australian Securities Exchange (ASX) in May 2020[8]. Asking investors about their behaviour during the pandemic downturn, the ASX found:



54% of investors made changes to their portfolio due to COVID



13% increased their allocation to cash



8% of retirees (defined as those aged 60 and over) switched from risky investments to more secure options while 15% increased allocation to cash

8 ASX Investor Study, ASX, May 2020

Reliance on dividends: a rethink

The ASX research also found that post-COVID, sustainability of dividends is now an issue for 38% of retirees.

This is unsurprising, given the rough ride many of them experienced. In March 2020, the banking regulator, APRA, asked banks to either cut or delay their dividends in order to preserve capital. At the same time, falling revenue prompted several companies to do the same.

A Realindex research paper from May 2020 noted that historically, 60% of the ASX200 benchmark's total return is due to dividends and for Financials, that rises to more than 70% of the total return (including dividends and buybacks). The paper's authors were concerned that limiting dividends could both reduce investor incomes and affect valuations[9].

As events played out, it became clear that most of the dividend cuts were short-lived. However, it was a stark reminder for many investors that dividends are always discretionary, and those who rely on equity income for their living costs need to factor this into their planning.

By contrast, debt-based investments can provide a more sustainable and predictable income stream, generated by regular loan repayments.

The appeal of CRED in this context is clear, as it provides a more middle ground between ultra-low government bonds (or bank deposit accounts) and the higher volatility of equities (or private equity).

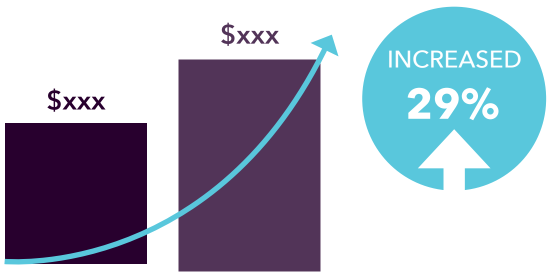
9 Capital retention will shake dividends in 2020, Firstlinks, May 2020

Banks turn off the taps to borrowers

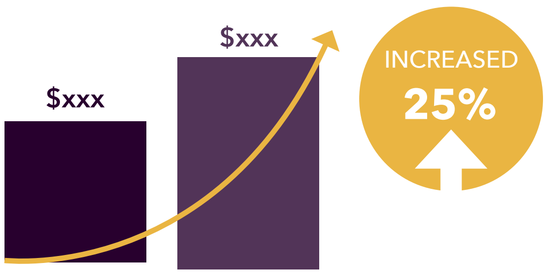
On the borrower side, COVID saw the banks reduce the flow of lending as they sought to 'batten down the hatches' in case of a prolonged economic downturn.

But the real estate sector didn't grind to a halt – in fact, many participants saw opportunities among the chaos, and needed access to funding. They looked to alternative lenders to fill the gap. With their increased flow of investor capital, such lenders were able to work closely with borrowers to understand their projects and provide much-needed funding, as shown below.

Zagga's loan originations increased significantly between 2019 to 2020:



DOLLAR VALUE OF LOAN ORIGINATIONS



AVERAGE LOAN SIZE

Comparing H1 to H2 of 2020:

DOLLAR VALUE OF ORIGINATIONS

NUMBER OF NEW LOANS ORIGINATED

Zagga's lending appetite is focused on quality borrowers with quality assets to provide as security. The key difference, compared to a bank's credit assessment, is flexibility and a tailored approach. Zagga looks at each opportunity on a case-by-case basis to ensure it meets the lending criteria, and then matches a successful application to the risk and return appetite of investors.

The road ahead

As uncertainty now defines our lives and is reflected in investment markets, Zagga expects the trends outlined in this paper to continue apace:

A growing private debt market in Australia
Restrictions on bank lending
The increasing need for alternative commercial real estate lending
The continued flight to safety for investors
A reduced reliance on dividends for income

Moreover, both investors' and borrowers' experience of working with alternative lenders has opened their eyes to an arguably better way to do business.

Many previous bank customers have now experienced the ease and flexibility of borrowing through a boutique lender who can work with them, look at the bigger picture and provide a bespoke solution. They are not a number and they are not forced to fit into a box.

For investors, once they experience the ease of investing through the Zagga platform, they not only invest again, they tell others. Investors in Zagga will, on average, refer 3 to 5 of their friends/family to the platform. They are attracted by the regular, reliable income it provides, the robustness of the loan assessment process, and the detail that is provided with each investment opportunity.

With the broader market trend of a low-return world set to carry on for years, and the CRED lending market continuing its healthy growth trajectory, Zagga believes that both investors and borrowers will benefit from the rise of the alternative lending model.

Testimonials: What Zagga's investors are saying

"Zagga is my first exploration of the 'alternative investment' market. When reviewing the opportunity, I looked at the combination of the product offering, the integrity of the people in the business, and the capacity to execute, and I was happy to invest.

Once I started to invest, the business' thoroughness and due diligence was clear. When reviewing other investment opportunities, there tends to be a lot of hype, which I'm wary of. This is not the case with Zagga; you feel comfortable in what you're doing.

It surprises me the breakneck speed people try to get mortgages on the platform, there's huge demand and interest for deals.

You know your money is stable, and there's a level of comfort with Zagga. I've got property, equity and this is my fixed income, interest producing component. My Zagga investments are in the order of 10% of my available investment portfolio.

I like that the deals are relatively short-term for fixed income investments. You're not locking your money away forever.

I've recommended it to half a dozen people to invest in, including my family.

Alex, Sydney."

In my four years of investing with Zagga, there's never been a problem. I don't have any sleepless nights. You know exactly what your returns are going to be; they don't dimmish. What you sign is what you get.

Alternative investments like Zagga are an important addition to my investment strategy. I consider my Zagga investment part of my cash portfolio. The beauty of it is you get consistent, above market returns, and there's flexibility in the offering. If you are looking for a long-term option, you can put your money into the fund, whereas if you know you'll need your money in the next 6 to 12 months, you can look on the platform and find a deal that aligns with that need.

It's a bit like having a rental in a property, your rental payments are ongoing, the market can fluctuate, but that doesn't impact your payments. With Zagga, you're getting your returns/interest upfront, or ongoing, it's not affected by unpredictable market events.

Alan and the team's due diligence on deals is outstanding. There is a lot of cover and security on the opportunities. I would recommend Zagga to others, and in fact I have done so many times before.

Paul, Sydney.

Zagga offers efficiency, transparency and steady returns.

My investments on the platform are property secured syndicated loans. During a time of uncertainty aggravated by Covid-19 Zagga provides stability.

I have confidence in Alan and the entire team. It's important for me that it's not just the online platform. At all times I have access to, and face-to-face contact with the individual team members.

The team is trustworthy and reliable-essential criteria.

Robert, Sydney.

"I've been developing boutique residential, retail and commercial property for 8 years now, and historically I used to work with banks to source funding. However, since the Royal Commission into banking, approval processes became slow. So I started to look at non-bank lending options.

I now use non-bank loans regularly as part of my funding mix, especially when I need a quick turn-around of funding for land purchases. In fact, non-bank loans make up 65% of my current funding.

Zagga is quick, efficient, and transparent; I've used them for numerous transactions. The team is easy to deal with and fair with their LVR ratios. I still use the banks too, but they're much slower, and since the pandemic it's been vital for me to access funds quickly to take advantage of various opportunities in the market. I've currently got two developments underway, one in Sydney and one in Melbourne, both with loans sourced using Zagga, around the $5M and $10M mark. I wouldn't hesitate to recommend them."

Borrower, Property Developer.

Why zig when you can Zagga?

Contact us

zagga.com.au | info@zagga.com.au | 1300 1 ZAGGA
(1300 192 442 or +612 8378 7176 from overseas)

Zagga | your secured alternative