

Special Report

# Commercial Real Estate Lending

October 2020



## Contents

Executive Summary	2
Australian Private Debt, a New Asset Class?	3
Commercial Real Estate Credit Concepts	7
<i>Seniority and the Capital Structure</i>	7
<i>Loan Valuation: Setting the Credit Spread</i>	8
<i>Risk Mitigation: Structuring and Covenants</i>	10
<i>Worst Case: Restructuring and Workout Process</i>	11
<i>CRE Debt in Practice</i>	12
The CRE Debt Cycle	15
<i>What Has History Shown Us?</i>	15
<i>The Current Climate</i>	18
Commercial Real Estate Debt Risk & Return	21
Important Information	22

## Executive Summary

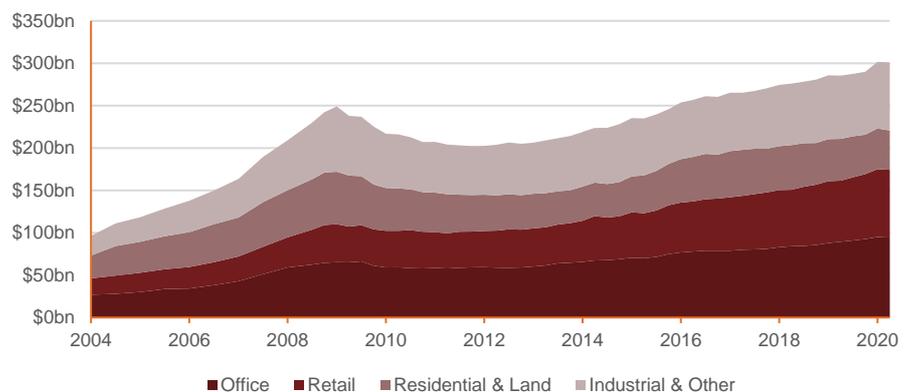
Despite being one of the largest and more diverse asset pools domestically, the Australian private debt market is largely unknown to most investors.

Historically restricted to the nation's banking system, current regulatory pressures mixed with robust demand for credit mean that the market is growing into an institutional asset class. A key driver of the market's increased activity and uptake in recent years is its unique risk profile, namely, senior secured, floating rate, corporate credit which coincides with ideal positioning within both the interest rate and credit cycles.

A major and specialised subset of the Australian private debt universe is the commercial real estate (CRE) loan market, which represents approximately a fifth of the aggregate corporate loan book of the domestic banking system (domestic ADIs). In contrast to typical corporate lending, CRE debt funding will revolve around a particular commercial property asset (rather than a company) which can vary in terms of stages of development, seniority, geography and use of the underlying asset (Figure 1).

Consequently, significant experience is required to operate within the market to ensure origination and subsequent monitoring processes are robust enough to prevent capital losses. Australian banks found this out the hard way when loose lending practices, elevated leverage and deteriorating economic conditions resulted in significant impairments to CRE loan books during the global financial crisis (GFC).

**Figure 1. ADI CRE Exposure by Sector**



Source: BondAdviser, APRA.

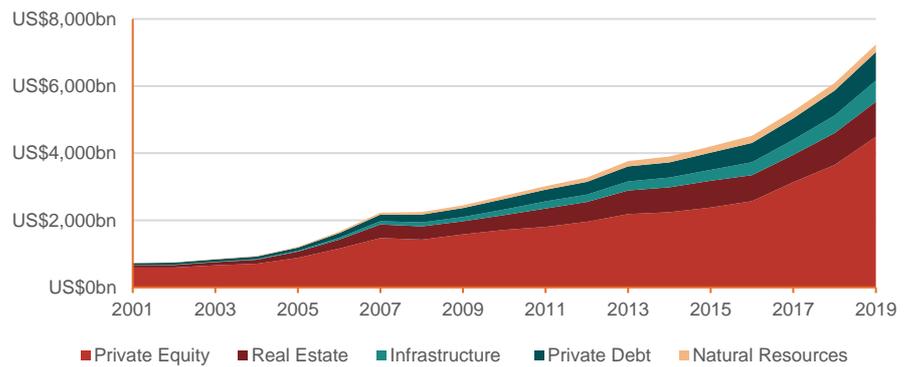
Nonetheless, if appropriate risk management is applied, CRE lending can generate lucrative returns with limited capital volatility; **this is currently being achieved by a number of non-bank CRE lenders**. While the broader asset class will always remain cyclical, the risk profile of CRE has improved materially in the past decade with debt (versus equity) being our preferred investment strategy.

Although the direct and indirect (funds) purchase of CRE has been a popular investment strategy for decades, we believe investor knowledge of the CRE debt market is fairly limited. As a result, this primer is designed to be a useful reference for investors, detailing key concepts, historical examples and analysing its risk / return profile. Overall, this market represents an attractive investment opportunity and will continue to be a material pillar of the emerging Australian private debt institutional asset class.

## Australian Private Debt, a New Asset Class?

Despite its longstanding existence, private debt has only become globally recognised as a separate asset class in the past decade. Although it has always been difficult to quantify the size of this market due to its inherently confidential nature, worldwide institutional investment has grown substantially to US\$845 billion (Figure 2) as investors have sought out income alternatives in a historically low interest-rate environment. As the underlying investments are typically illiquid, funds will generally be closed in nature, meaning capital will be drawn down with investor liquidity provided periodically or within an extended time frame.

**Figure 2. Global Alternative Assets Under Management<sup>1</sup>**

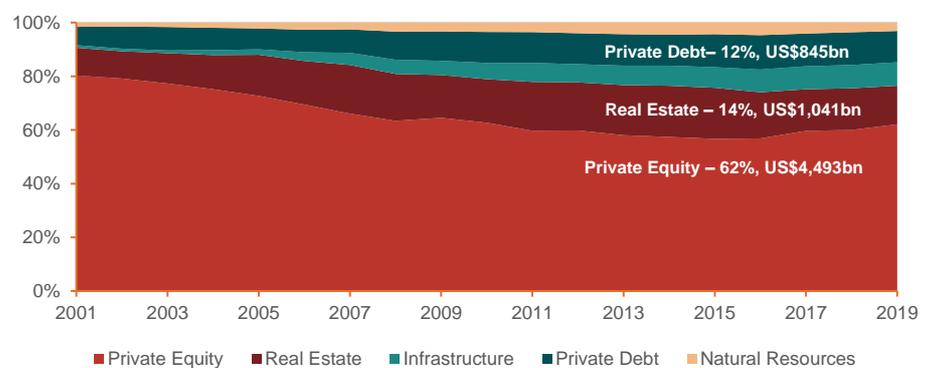


Source: BondAdviser, Preqin Pro.

<sup>1</sup>To avoid double counting of available and unrealised value, funds of funds and secondaries are excluded.

According to Preqin, a leading data provider for the alternative assets industry, private debt comprised 9% (US\$103 billion) of all private institutional capital raisings in 2019, making it a material pillar of global private capital markets. Preqin estimate that private debt and real estate (equity portion) now comprise 12% and 14% of the global total of US\$7,237 billion alternative assets under management. Within the private debt asset class there are many strategies, spanning from venture capital financing to distressed debt, but direct lending has consistently been one of the most popular. This has largely been catalysed by a changing regulatory environment, which has made traditional commercial banking activities less profitable on a return on equity basis. This capital vacuum is now increasingly being serviced from non-bank lenders.

**Figure 3. 2018 Global Alternative AUM Breakdown**



Source: BondAdviser, Preqin Pro.

<sup>1</sup>To avoid double counting of available and unrealised value, funds of funds and secondaries are excluded

In the private debt market, lending is generally undertaken on a direct basis between the single lender and single borrower. These are known as bilateral loans and can be tailored and customised to suit the underlying borrower's situation and / or business model. This contrasts with syndicated loans, where multiple banks will lend to a single borrower to divide risk exposure either directly with the borrower or via an agent / arranger.

Due to the bespoke structure of bilateral loans, they are relatively more illiquid when compared to syndicated loans and will generally involve a buy-and-hold strategy. As there is only a single lender, these loans will generally be made to smaller borrowers (the middle-market) with loan commitments typically less than A\$100 million. As the market is private, usually overlaid with multiple confidentiality agreements and does not have an active secondary market, data is non-standardised and fragmented. While some of Australia's largest buildings will involve loan syndication, most domestic CRE financing arrangements are conducted on a bilateral basis, especially given the unique circumstances and attributes of CRE assets.

**Table 1. Bilateral v Syndicated Loans**

	<b>Bilateral Loans</b>	<b>Syndicated Loans</b>
<b>Loan Size</b>	\$2-\$100 million	>\$100 million
<b>No. of Lenders</b>	Single: loans are made on a one-on-one basis with a single borrower and a lender.	Multiple: Multiple banks will form a 'syndicate' and collectively lend to a single borrower.
<b>Public Information</b>	Lower: Bilateral contracts are highly confidential with the terms generally giving the lender significant non-public information about the borrower.	Higher: As syndicated loans typically involve large public companies, there is some public disclosure with collection from a number of self-reported data vendors.
<b>Covenants</b>	Due to risk concentration for the lender and usually bespoke requirements of the borrower, bilateral agreements tend to have more robust covenant packages.	As syndicated loans are generally made to the largest borrowers and for common purposes, contracts typically have a greater degree of standardisation and less restrictive covenant packages.
<b>Credit Spread</b>	Higher: Bilateral loans are usually made to smaller and relatively riskier borrowers. As a result, lenders will usually require a greater risk premium.	Lower: Syndicated loans are usually made to larger and relatively less risky borrowers. As a result, lenders will usually require a lower risk premium.
<b>Liquidity</b>	Lower: As there is less standardisation and only a single borrower, bilateral loans have a very limited secondary market.	Higher: Syndicated loans have some degree of liquidity either between syndicate participants or other large banks.
<b>Non-Bank Participation</b>	Higher: Due to the attractive risk profile which can be tailored to the lender, confidentiality of agreements and lower capital requirements, there is a greater participation from non-bank lenders.	Lower: Banks usually offer loans at competitive rates due to additional ancillary attached to a particular borrower (bank accounts, hedging) making the return profile of syndicated loans unattractive to non-bank lenders. Greater capital requirements also impose a barrier to entry.
<b>Fee Structure</b>	Although the all-in cost of funding may be higher, bilateral agreements are usually subject to a limited number of fees.	Syndicated loans typically involve syndication fees and agent / arranger fees. However, the all-in cost of funding will generally still be lower due to smaller capital spread.

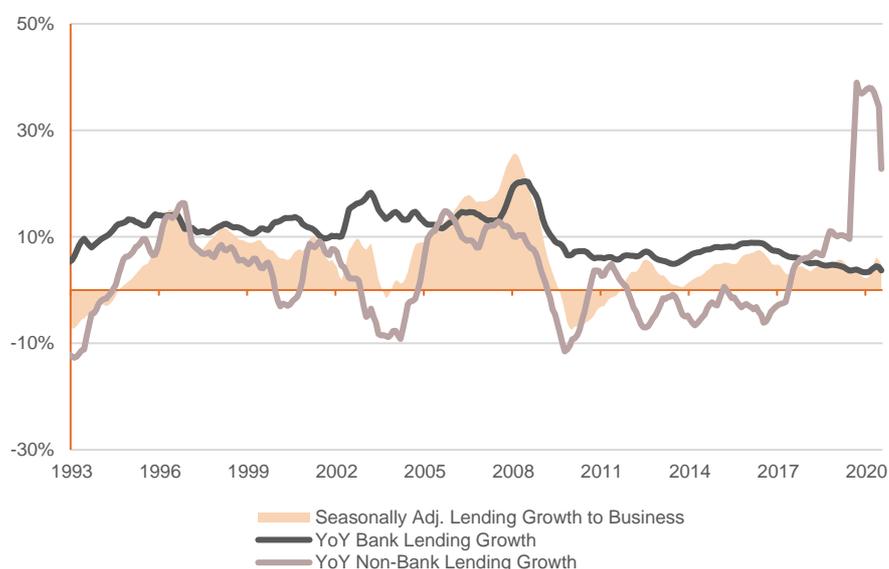
Source: BondAdviser.

In Australia, the private debt market broadly refers to ‘middle-market’ corporate lending which mostly comprises all borrowers too small to receive large, syndicated bank loans, yet too large to receive small business loans. As this segment does not require the high capital requirements needed to participate in large loan syndications while also allowing lenders to tailor loan contracts, there has always been a material non-bank presence due to attractive, customised investment opportunities.

Historically, this participation has been cyclical with the domestic corporate loan landscape remaining a major bank-dominated market with APRA figures indicating that the majors represent 70-80% of all domestic corporate lending. As illustrated in Figure 4, from 2017 until early 2020 non-bank lending experienced strong growth and substantially outperformed bank lending on a growth basis. In our opinion, this is supported by underlying drivers which are changing the composition of lenders in favour of the non-banks. In recent years, **tighter banking regulation** has seen a healthy influx of non-bank institutional lenders versus the surges in corporate debt we have seen in previous cycles. This period (2017-2020) may have marked the beginning of a permanent shift in market structure supported by a greater focus on risk management.

In response, there has been a **growing appetite for various loan funds**, but given the relative opacity of underlying assets, education and data is a direct function of investor confidence – which is gradually improving. Ultimately, all of these factors are contributing to the case of the emerging private debt asset class in Australia. Although growth significantly tapered off in early 2020, this sudden shock is a consequence of the COVID pandemic. Although the COVID health and economic crises present risks to these supportive conditions, the **muted lending growth may benefit corporate lenders** regardless, as they can charge higher premiums on a scarcity basis.

**Figure 4. Australian Corporate Lending Growth**

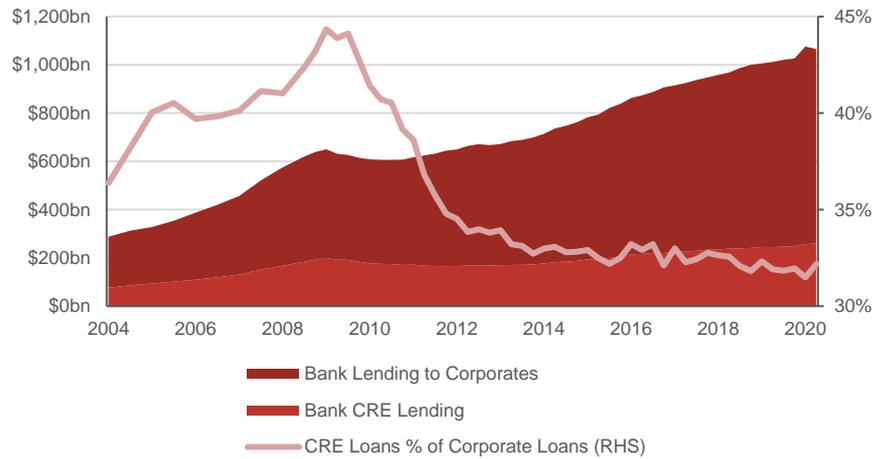


Source: BondAdviser, RBA.

CRE lending, is a specialised, yet major component of the middle-market corporate loan universe where lenders participate in the development of new or established real estate across office, industrial, retail or residential developments. In addition to this development-based lending, residual stock lending, where a developer borrows as they sell left-over apartment stock, is an increasingly important aspect of the CRE market at this point in the cycle.

As loans made by non-bank lenders are private and hence, data is decentralised, it is difficult to quantify the complete size of the universe. However, as a general indication, total domestic CRE exposure is estimated to be ~A\$300 billion according to APRA, demonstrating the size and breath of the market. As Figure 5 illustrates, this exposure has proportionally declined within the corporate loan books of banks, highlighting the inverse trend seen across the broader Australian private debt market.

**Figure 5. Australian Banking System Domestic CRE Exposure**



Source: BondAdviser, APRA.

## Commercial Real Estate Credit Concepts

Unlike traditional bottom-up credit analysis across a wide range of assets and sectors, the CRE loan market has a greater degree of correlation due to a strong influence from top-down macroeconomic variables. As a result, investment managers can utilise diversification across sub-markets and geographies, but the **extent of diversification will always be limited**. In other words, it is difficult to achieve negative correlations to protect capital within the CRE asset class (Table 2). Consequently, asset-level strategies such as covenants, clauses and other conditions together with substantial expertise, are of utmost importance when investing in the space, which will vary significantly across transactions with each loan asset typically having its own unique risk profile. As capital price appreciation for loan assets is rare, emphasising the natural skew in credit investing (i.e. limited upside), credit risk management is two-fold, requiring all capital is retained and all income is received in a timely manner.

**Table 2. Australian Sub-Sector Capital Value Correlations (2004-2017)**

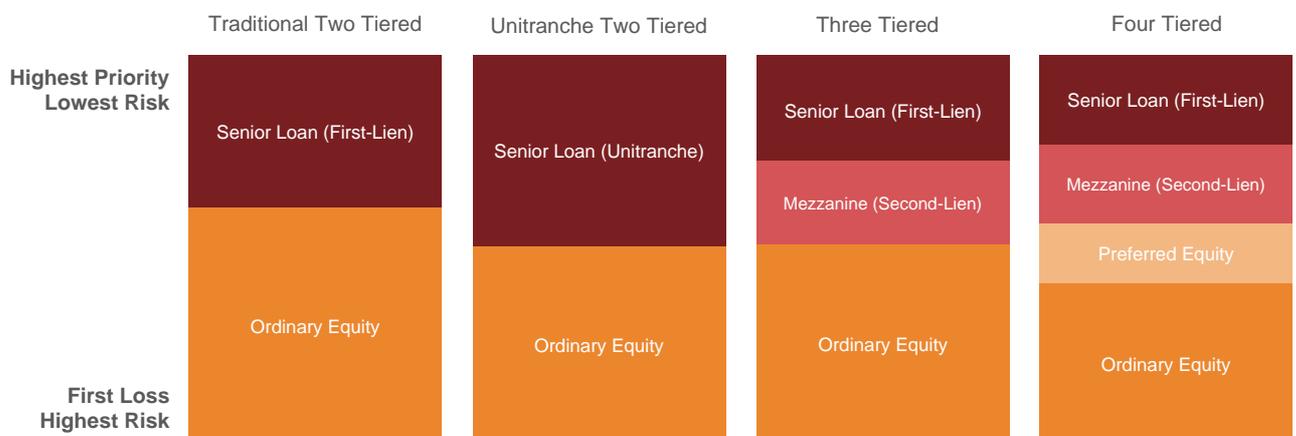
	Residential	Retail	Industrial	Office
Residential	1.00			
Retail	0.22	1.00		
Industrial	0.26	0.91	1.00	
Office	0.29	0.78	0.88	1.00

Source: JLL Research, ABS as at December 2017.

### Seniority and the Capital Structure

When deciding on CRE funding requirements, assets are generally financed from a mix of debt and equity capital. However, within each class, investors can be subordinated depending on the specific funding composition of the underlying asset which forms the 'capital structure'. The types of capital structures for a given CRE asset are illustrated in general terms in Figure 6. While CRE lending can be conducted on an unsecured basis, this is rare with most loans secured to the underlying real estate/project. Equity forms the residual value of the asset once the debt is subtracted from its value and can be raised externally or contributed internally by the borrower.

**Figure 6. Examples of CRE Capital Structures**



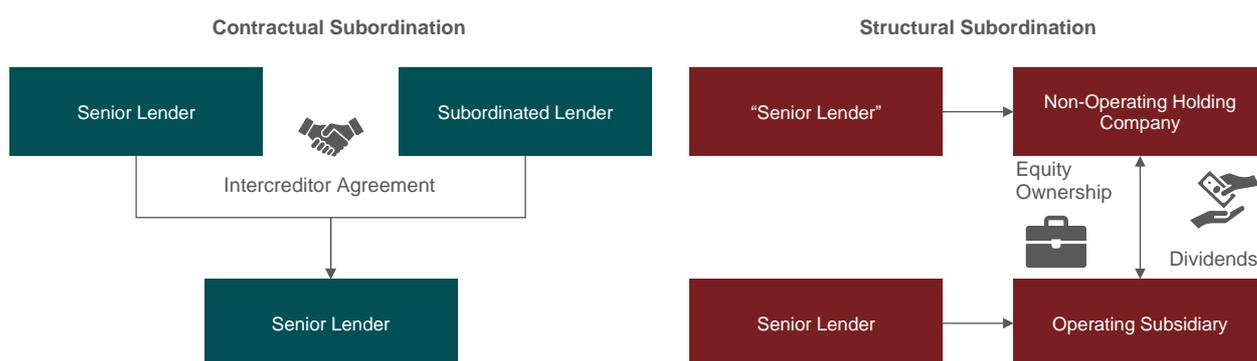
Source: BondAdviser.

A first-lien loan is a type of senior debt where debt holders have the **highest priority claims to the collateral of the loan in the event of default**. Claims on the collateral of second-lien loans (also known as mezzanine financing) rank behind claims of first-lien loans. Due to the implied risk in a wind-up scenario, second-lien loans usually price at a premium to first-lien loans. As both obligation types are typically structured as secured arrangements, CRE loans almost always rank ahead of other investors in the capital structure.

Senior secured (first-lien) and subordinated (second-lien / mezzanine) lenders can share the same security package with an intercreditor agreement stating that senior lenders are subject to priority application of assets and cash flows towards their repayment. This is known as contractual subordination. The deployment of mezzanine debt (higher risk stage of development / project) will precede the deployment of senior debt (lower risk stage of development / project) but the inter-creditor agreement will typically restrict repayment unless certain credit conditions have been met by the borrower.

A lender can also be structurally subordinated but this is rare in CRE lending. In this scenario, the lender will usually be counterparty to a non-operating holding company (NOHC) which will hold equity in the downstream operating subsidiaries. While the loan will be structured as senior secured, it will structurally rank behind senior secured lenders of the operating subsidiaries. This will result in a risk premium for the NOHC lender but can be mitigated if the operating subsidiaries guarantee the obligations of the NOHC.

**Figure 7. Forms of CRE Loan Subordination**



Source: BondAdviser.

### Loan Valuation: Setting the Credit Spread

In an active market (i.e. equity and bonds), the value of an asset is its traded price. However, where an asset is less actively traded or a traded price does not exist, the value of an asset for the purposes of calculating its Net Asset Value (NAV) is determined in accordance with applicable accounting standards (fair value hierarchy Levels 2 or 3). The largest risk for any loan asset is its embedded credit risk, meaning the probability of credit migration and / or loss of capital. Credit risk is always the largest variable when pricing and subsequently valuing any loan, and the credit quality of an asset will usually be represented by a credit rating or in the case of CRE debt, by a loan-to-value ratio (LVR) which describes the proportion of debt used to fund an asset or other project-specific measures.

The **credit spread paid should reflect the borrower's credit risk** and will be contingent on many factors such as facility size, term, equity buffer, credit risk (and associated covenant package), purpose, the demand / supply dynamics of the market (business credit availability, alternative funding sources), liquidity and can also be linked

to certain conditions (credit deterioration or prepayment triggers). Material shifts in the perceived credit risk of the borrower from the loan’s credit spread will impact capital value and can be driven by many factors (Figure 8).

Due to the partial liquidity of the secondary market, large corporate loans can be categorised as Level 2 assets and include a subjective element in the valuation process. As there is limited transactional data, market participants utilise multiple channels to compile valuation sources to determine capital value. However, the private debt market comprises mostly Level 3 assets from an accounting perspective, meaning **observable inputs for fair valuation are very limited**. As a result, assets are recorded at the amount drawn on the valuation date and will be tested for impairment on a periodic basis driven by the expected loss (the product of the probability of default and loss given default). If impairment occurs, this will directly impact the NAV of the portfolio.

Given the nature of the assets, the decision to impair is fairly binary and will usually involve a number of external parties and opinions. It involves tracking the performance of key ratios versus their initial base-case scenario and stressed thresholds (this will likely be accompanied by a downgraded credit assessment). In fact, loan structures are manufactured in this way to ensure experienced lenders can participate and act before an Event of Default materialises. While assets will typically be valued around par value, potential valuation write-downs are dependent on underlying probability of default as well as recovery rates at the point of default.

**Figure 8. CRE Loan Valuation Elements**

<b>Qualitative Factors</b>	<ul style="list-style-type: none"> <li>• Macro environment</li> <li>• Property conditions</li> <li>• Management</li> <li>• Alternate uses</li> <li>• Geographic area</li> </ul>
<b>Quantitative Factors</b>	<ul style="list-style-type: none"> <li>• Credit spreads</li> <li>• Default probability</li> <li>• Recovery rates</li> <li>• Credit metrics</li> <li>• Covenant package</li> <li>• Property valuation</li> <li>• Cost-to-Complete</li> </ul>
<b>Profitability</b>	<ul style="list-style-type: none"> <li>• Interest rate</li> <li>• Other fees</li> <li>• Undrawn portion</li> <li>• Fixed / floating</li> </ul>
<b>Facility Characteristics</b>	<ul style="list-style-type: none"> <li>• Collateral</li> <li>• Loan term</li> <li>• Size</li> </ul>
<b>Market Factors</b>	<ul style="list-style-type: none"> <li>• Demand / supply</li> <li>• Reference rates</li> <li>• Banking</li> <li>• Regulation</li> <li>• Alternative capital sources</li> <li>• Refinancing</li> <li>• Economic conditions</li> </ul>

Source: BondAdviser.

## Risk Mitigation: Structuring and Covenants

While an issuer's fundamentals, underlying industry and valuation can make a potential transaction attractive, a covenant package can alter this significantly, and can even make a loan uneconomical (i.e. too much can go wrong). **Covenants are a balancing act between operational flexibility for the company and mitigating downside risk for the investor.** They are crucial to the investment process and allow loan managers to benchmark the credit quality of an asset against the covenant requirement or scenario analysis to assess if credit is improving or deteriorating. Importantly, documentation is not standardised and arguably an advantage for lenders (increased flexibility).

Asset covenants play a crucial role in lender protection and serve as a major contributor to the credit analysis process. While financial institutions such as banks and insurance companies are subject to regulatory requirements, the covenant package is instrumental to downside protection when investing in corporate loans. Covenants are legally enforceable conditions that borrowers and lenders agree upon in the origination process. These conditions are legally binding, require the issuer to operate within certain limits and are defined in the loan documentation such as the facility document or inter-creditor agreement.

Covenants can be either affirmative (positive) or negative. Affirmative covenants are clauses that require a borrower to perform specific actions. Examples are complying with certain laws, maintaining assets and / or submitting certain reports beyond typical disclosure requirements. On the other hand, negative covenants are established to restrict the issuer from certain actions that would reduce its ability to service its obligations regarding the loan. These limits can be specified in the form of financial ratios which are tested on a periodic basis. The objective of these ratios generally involves capping leverage while creating floors for earnings, cash flow and overall liquidity. These are known as financial covenants.

Negative covenants can be subject to maintenance or incurrence tests. Maintenance tests require the issuer to maintain compliance with a metric to avoid a technical default. For example, a maintenance test could be a maximum loan-to-value (LVR) ratio of 70%, which if the borrower (or underlying asset) exceeded, would result in default. However, using the same example, an incurrence test would only be breached if the company actively incurred additional debt to the point where the LVR exceeded 70% but not if total capital declined and caused gearing to increase.

**Table 3. Common CRE Loan Covenants**

Limitation	Example of Covenant
Indebtedness	Gearing ratio, LVR
Liquidity	ICR, Debt Serviceability, Cost-to-Complete Test
Secured Indebtedness	Secured Gearing Ratio, Negative Pledge
Asset Sales	Minimum Valuation, Debt repayment linked to sale
Transaction with Affiliates	Minimum cash balance of borrower

Source: BondAdviser.

If a specified limit or condition is breached by the lender, the legal documentation may also specify cure periods and remedies to the lender. Covenants can also be subject to a Review Event provision that allows lenders to alter covenants should a material event

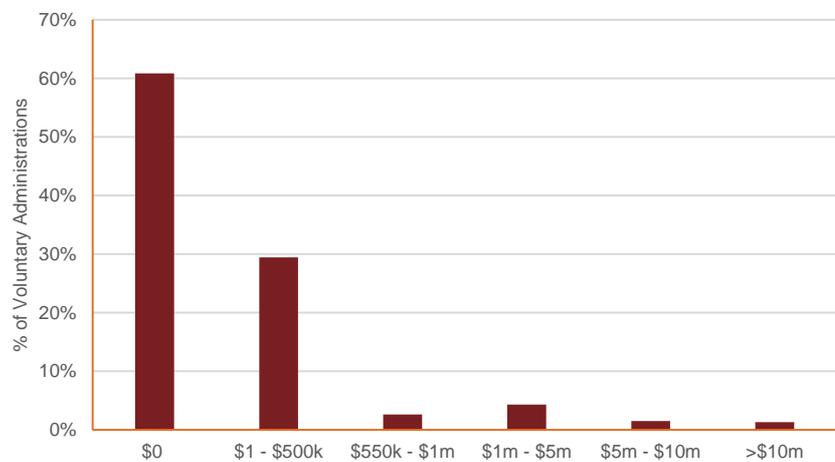
occur such as large asset sales, changes in management and / or loss of major customers. In general, financial covenants are set at a level where there is sufficient headroom for lenders to act before there is a risk of capital loss. This ability to be hands-on is what differentiates the corporate loan market from other asset classes where individual investors have minimal influence on a company's actions.

### Worst Case: Restructuring and Workout Process

The domestic insolvency landscape for corporate lending gives lenders significant flexibility in terms of recovery, with sufficient protection embedded in the domestic legal framework to ensure recovery rates remain high (Figure 9). As a result, default does not automatically mean loss but rather, restructuring, and subsequently, potential recovery. This is of significance to CRE lenders given the underlying asset will generally be the first line of defence in an Event of Default for a secured loan. However, knowing what the optimal restructuring strategy is in such an event is critical and requires substantial expertise.

Importantly, as there is usually only a single lender (bilateral loans) who will be counterparty to a large proportion of the company's liabilities, lenders can have significant power and influence in the workout and restructuring process. This is evidenced by global recovery rate data from Moody's where on average (from 1970-2019) loans have experienced a recovery rate of 76.9% while senior secured bonds have experienced a recovery rate of 59.1%. Subordinated bonds experienced a recovery rate of 31.8% over the same period. However, most of the time, lenders will try and avoid insolvency proceedings as it is a lengthy and resource-consuming process with complex legalities.

**Figure 9. Amount Owed to Secured Creditors in Construction Industry**



Source: BondAdviser, ASIC, calculated for 2018-2019.

A technical default relates to the scenario where a borrower breaches a covenant as specified in the documentation. In this situation, the borrower may still be able to meet interest payments and / or repay principal but due to the breach, the borrower will usually be subject to some form of remedy. Usually, the borrower can agree on a solution and / or amendment to waive the violation in exchange for compensation to the lender (i.e. one-off penalty fee, increased spread and / or amended loan terms).

Payment default is the traditional and more severe concept of default where a borrower fails to make a scheduled payment of interest or principal. If this event occurs, the borrower will be usually subject to a 'cure' period where it has 30 days to rectify the

default. Following this period, if the borrower has ‘not made’ good on the missed payment, the lender can take appropriate action (contingent on the circumstances). Usually, this either involves calling the loan (and potentially forcing the lender into bankruptcy and / or liquidation) or giving the borrower further time under strict controls and oversight. Under each option, there are a number of restructuring techniques that can be utilised by the lender to ensure loan value is recovered (Table 4).

**Table 4. Workout and Restructuring Techniques**

<b>Recapitalisation</b>	A recapitalisation is a common form of restructuring and will usually result in the borrower raising fresh equity capital to repay debt. This would ultimately lower the LVR of the asset.
<b>Divestments</b>	Another common option is to force the borrower to divest the asset or project (i.e. liquidate) to repay debt immediately. Assuming a sufficient equity buffer, the lender should recover 100%.
<b>Amendment of Terms</b>	In a technical default, a lender and borrower can simply agree to amend the terms of the contract. This can take many forms but will typically involve waiving the breach. Further amendments may include increasing the term of the loan in exchange for a higher credit spread, charging penalty fees, rescheduling interest payments and / or imposing harsher covenants. Lenders will usually favour this outcome to avoid resource-consuming bankruptcy proceedings
<b>Debt-for-Equity Swap</b>	A debt-for-equity swap refers to the situation where lenders cancel their debt claims in exchange for equity in the restructured company on favourable terms. This will usually involve significant dilution of current equity investors and the new shares issued to the lenders may be defined by a superior class (dividend preference, voting rights etc.).
<b>Distressed Refinancing</b>	There are a number of global firms that specialise in distressed debt. As a result, these firms may refinance existing lenders or simply buy the outstanding loans, usually at a discount to par. This strategy is commonly utilised by banks due to regulatory constraints. This was common for CRE bank loans during the GFC.

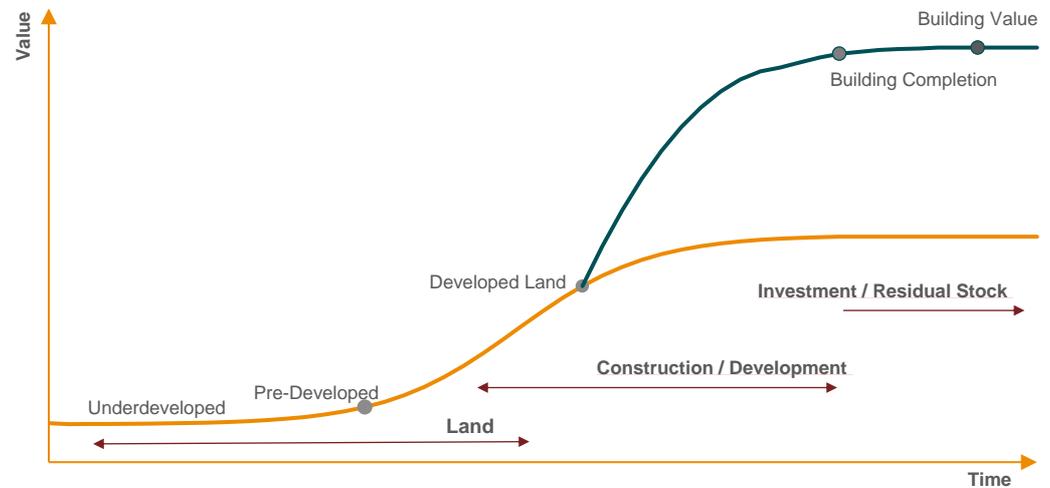
Source: BondAdviser.

While the goal of any workout period is to recover 100% of loan capital, a debt-for-equity swap can allow for a recovery rate exceeding par value. Specifically, lenders can implement “loan-to-own” structures where debt claims are converted to equity in the underlying borrower on significantly favourable terms and control. This allows the lender to partially-or-wholly own the recapitalised and / or restructured asset / project with significant upside potential. This strategy is typically employed by non-bank lenders who are not subject to the same regulatory constraints as banks (high cost of capital for equity holdings) and is a popular strategy for distressed and deeply undervalued CRE assets.

### CRE Debt in Practice

CRE lending involves a bespoke approach as each situation is generally unique to the underlying asset or asset. Each transaction can vary by sector (office, residential development, industrial or retail) and can be funded by senior debt, mezzanine debt or preferred equity. However, all CRE broadly undergoes the same asset cycle (Figure 10) and as a result, loans will generally fit into one of three categories: land, construction or investment.

Figure 10. The CRE Asset Cycle



Source: BondAdviser.

For development projects, Cost-to-Completion tests and other metrics will be tested each time new funds are advanced. For example, for a residential development project, the lender may require drawn debt be covered by pre-sales before each stage of funding will be released to the borrower. Loan terms are kept relatively short to match the development timeline and are highly controlled by the lender over the development period.

In contrast, if the loan is secured by an established CRE property (i.e. brownfield projects), an Interest Coverage Ratio (ICR) and Loan-to-Value Ratio (LVR) will be determined in the origination process and monitored throughout the loan's tenor, capturing the debt servicing ability and asset value of the underlying asset.

**Residual stock loans**, broadly considered to be a class of investment lending, involves the borrower accessing the equity embedded within unsold stock and the lender securing the loan against the asset. Especially in periods of high supply and longer selling periods for left-over stock, the loans can provide a cushion for developers and assist in steadying cash flow. The lender will generally structure the loans on an LVR basis during funding and will seek to reduce LVR exposure over the selling period. However, loan servicing, and thus reduction of LVR exposure relies on the developer being able to sell the stock, which attaches material risk to the loans.

**Table 5. Generalisation of CRE Funding Structures**

	<b>Investment / Residual Stock</b>	<b>Development</b>
<b>Asset Base</b>	Established single assets such as commercial office, industrial or retail.	Unestablished single assets.
<b>Funding Structure</b>	Senior (30-60%), Equity (40-70%).	Senior (30-50%), Mezzanine (0-20%), Equity (30-50%).
<b>Security</b>	Secured against established assets.	Secured against underlying land, borrower's assets or project.
<b>Funding Use</b>	Senior debt is used to fund the acquisition of the asset, with the remainder utilised for redevelopment.	Funding facilitates initial purchase of site, with progressive drawdown as the development progresses.
<b>Primary Covenants</b>	LVR and ICR.	Cost-to-Complete and Debt Service tests.
<b>Debt Repayment</b>	Asset rental stream, settlements or refinancing.	Pre-sales, settlements, deposits, refinancing or asset sales.
<b>Yield / Risk / Control</b>	Lower.	Higher.

Source: BondAdviser

## The CRE Debt Cycle

As with most asset classes, real estate is cyclical (Figure 11) and will prosper in periods of economic expansion while declining in subsequent downturns. Consequently, property values will fluctuate throughout a complete cycle, which will in turn impact the owner's equity. **Default probabilities will rise as economic conditions deteriorate** but assuming a sufficient equity buffer is in place, and swift active management is undertaken, the recovery rate for secured debt investors can be 100%. However, as the following sections show, this is not always the case.

**Figure 11. GDP Growth v Private Non-Residential Building Approvals**

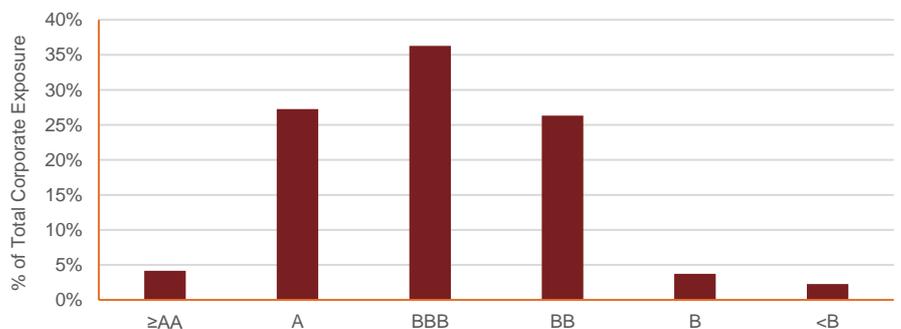


Source: BondAdviser, RBA as at September 2020.

## What Has History Shown Us?

For most economies, the real estate loan market is largely controlled by its banking system, making the asset class challenging to analyse on a risk / return basis, especially with limited publicly available data. A useful gauge of domestic market characteristics are the four major Australian banks, which dominate both the corporate lending landscape and more specifically, the CRE loan universe; with the major banks holding ~75% of all domestic ADI exposure to CRE lending according to APRA data. Loan-level data from the banks is limited but historical risk metrics regarding their broader corporate loan books can be derived from regulatory disclosures. While credit quality across the major banks' aggregate corporate portfolio is diverse and ~30-40% non-investment grade on average (Figure 12), loss rates have been muted throughout the last economic cycle (Figure 13).

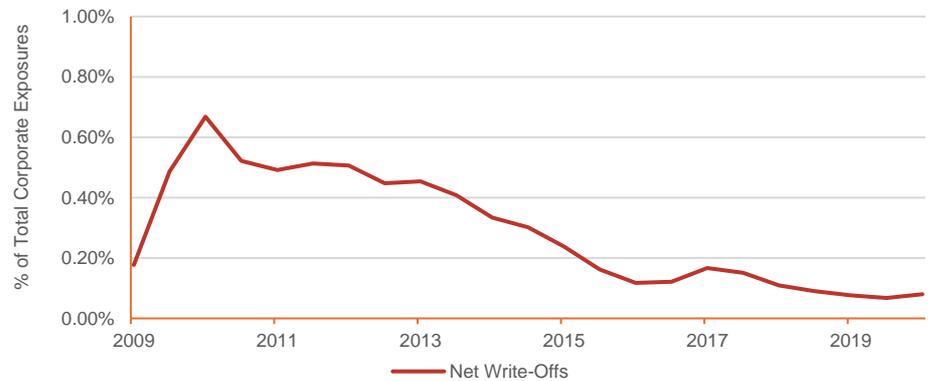
**Figure 12. Major Bank Rating Distribution**



Source: BondAdviser, Pillar 3 Disclosures as at 30 June 2020.

In terms of domestic CRE debt, the best objective data of distressed assets would most likely have occurred during the nation's recessionary periods. However, given Australia's last experience with such conditions (excluding current conditions) was in the early 1990s and information regarding CRE from this period is limited, it is more appropriate to analyse the market from 2000 onwards, since more data is been publicly available for this period.

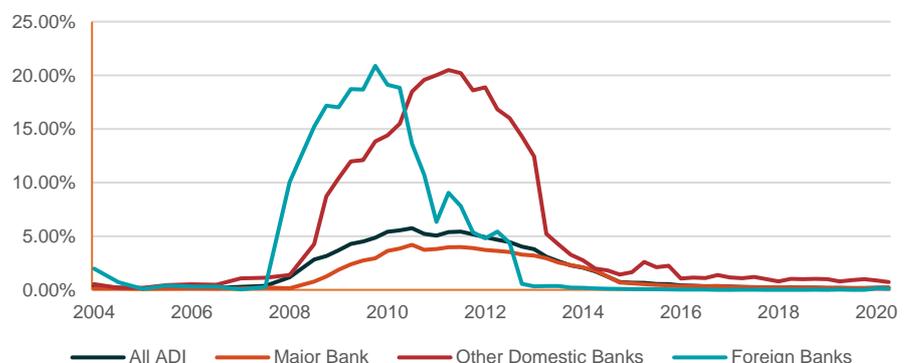
**Figure. 13 Major Bank Historical Loss Rates**



Source: BondAdviser, Pillar 3 Disclosures as at 30 June 2020.

On this basis, considering the fallout of COVID remains unknown, the global financial crisis (GFC) is the best example of distressed real estate debt despite Australia not technically experiencing a recession. According to APRA, impaired assets as a percentage of total exposures peaked in 2010-2011 with a strong divergence between the major banks (~4%), other domestic banks (~20%) and foreign banks (~28%, though peaked earlier in 2009). Interestingly, the latter resulted in the vast exodus of UK and European banks from the Australian corporate loan market while a number of small banks consolidated and/or restructured to arguably remain viable. While actual losses (write-offs) are hard to estimate with conviction, US data (Figure 15) suggests there is usually a notable difference in arrear rates that widens in challenging economic conditions (albeit using a slight change in terminology with charge-off and delinquency rates).

**Figure 14. Australian CRE Debt Impairment Ratio by Type of Lender**

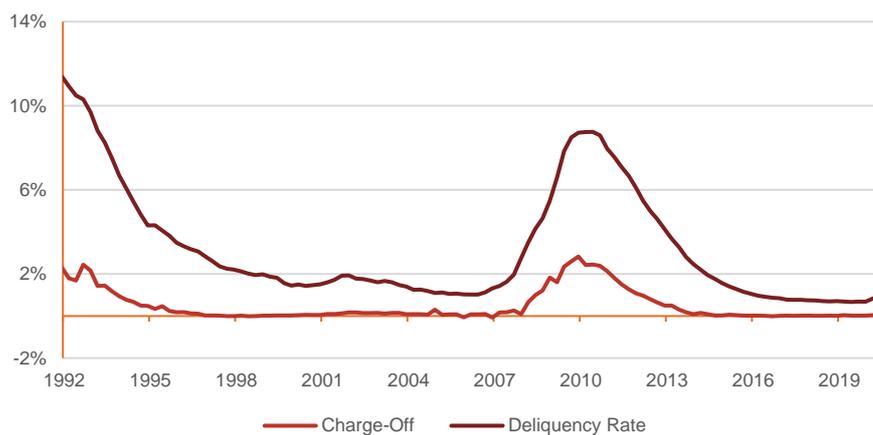


Source: BondAdviser, APRA.

Overall, Australian CRE debt impairments fared relatively better during the GFC, declining by 25% from peak to trough according to information compiled by the RBA. In comparison, some countries amidst the depths of the global recession recorded declines

of more than double those seen in Australia. For example, the US and the United Kingdom experienced contractions of 43% and 44% respectively while Ireland's market lost greater than half its value, falling by 56%. While these figures are substantial and demonstrate the cyclical nature of CRE assets, it is important to note that these are passive capital losses. In other words, typical CRE loan contracts give lenders significant control and ability to intervene in such scenarios. Therefore, in reality, action is usually taken (or borrower default would likely occur) far before a particular CRE asset reached its trough in value.

**Figure 15. US Charge Off v Delinquency Rates for CRE Debt at Commercial Banks**



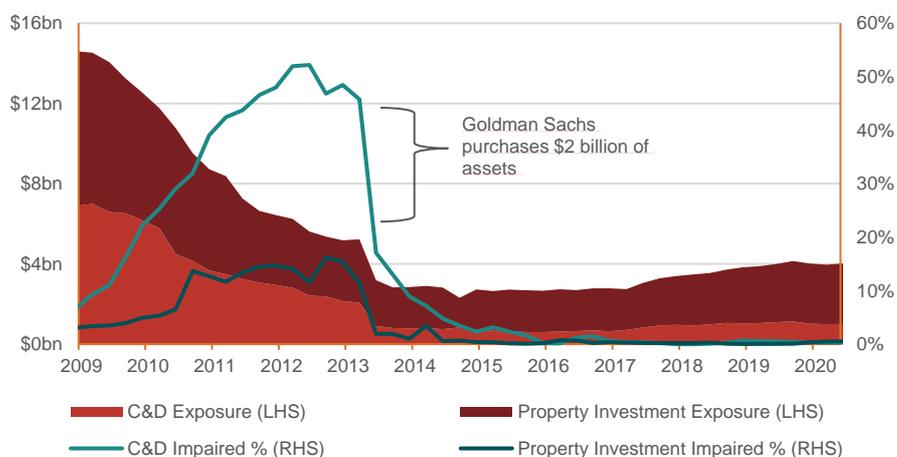
Source: BondAdviser, Federal Reserve.

In such an event, there are a number of strategies that could be undertaken to protect debt capital, such as recapitalisation of the borrower, ownership of the asset (i.e. swapping debt for equity) and/or the forced fire sale of the asset (albeit this is less ideal). However, we note that due to construction lag and the default risk associated with pre-sales, **development projects generally perform worse in distressed environments versus established assets**. Underlying land value, alternate uses and cost-to-completion, combined with significant lender experience, are important variables for development projects to avoid sub-par recovery rates. Ultimately it is challenging to quantify with accuracy actual cumulative losses that were experienced by all the domestic CRE lenders in the aftermath of the GFC but it is well known some fared far better than others. In 2012, the Royal Bank of Scotland received just 48% of par value for most of its Australian commercial property exposure, while in 2013, Suncorp sold A\$1.6 billion of damaged commercial property loans at a 60% recovery rate.

In 2009 when the financial crisis hit, Suncorp opted to set up a non-core or 'bad bank' to run-off ~\$17.5 billion of loans consisting of commercial property loans (65%) and corporate loans (35%), that soured after the GFC due to "inappropriate risk settings". When these loans were 'carved out' of the Group's more stable regional banking franchise, the non-core loan book equaled about 20% of group assets, which was dangerously high. Suncorp's regulatory disclosures in the years that followed depict the deterioration in credit quality for the CRE portion of the 'non-core portfolio' with Construction & Development (C&D) book reaching a gross impairment ratio of 50% and the Property Investment book (i.e. established assets) experiencing a gross impairment of 15% (Figure 16). This reaffirms that development projects are subject to greater credit risk in a downturn. It is also important to note that while these figures are concerning, banks are naturally levered vehicles (Suncorp had a leverage ratio of ~9x in 2009) which compounds a sharp deterioration in assets. On an unlevered basis (a key attribute of

non-bank institutional lenders), impairments would have been below ~6%. In 2013, in a move designed to 'de-risk' the Group, Suncorp sold a portion of this non-core or 'bad debt' book to Goldman Sachs for ~60 cents on the dollar.

**Figure 16. Suncorp's C&D and CRE Property Investment Loan Book Run-Off**



Source: BondAdviser, Suncorp APS300 Reports.

## The Current Climate

The current CRE climate is dominated by the developing COVID pandemic and the outlook for the sector remains largely dependent on the fallout from the crisis. Given much still unknown about the development of the pandemic globally, there is a high degree of uncertainty for the near and long-term outlook in the CRE space, with risk weighted on the downside. However, several key trends have already emerged which are shaping the nature of the market.

Importantly, although the extent of the impact remains uncertain, it is reasonable to assume some uptick in arrears and drop in valuations. Although the market consensus on the impact of COVID on property valuations is wide, there are clearly justified concerns with respect to valuations across all types of property assets. Given financial metrics are often tied to asset value, a material deterioration in asset values across the board could have considerable impact on the way managers operate their portfolios. The extent of asset value impact will depend largely on the success of government measures to support businesses through the recovery. A high volume of insolvencies could drive vacancies in the office and retail spaces higher, which would likely cause a flow on effect for valuations. This presents a large risk for residual stock exposure, which **relies on the capacity of developers to sell apartment stock at a price that can meet its servicing requirements.**

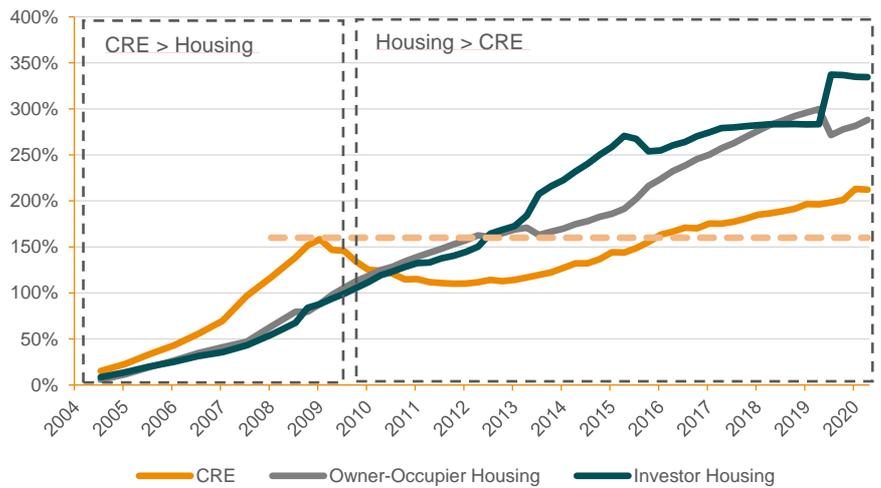
Positively, recently announced government changes to responsible lending requirements may provide a liquidity boost to potential home buyers which may cushion any fall in demand within the residential space. The longer-term impact of muted construction and development over the lockdown period may also provide supply side support for valuations in the longer term. The conclusion of this valuation and arrears pressure is that the selection of manager becomes even more crucial, given the importance of strong structural protection in the loans with respect to default and recovery, and manager competence in managing the portfolio in a distressed environment.

Conversely, the present environment presents great opportunities for prudent managers in the CRE space, especially in relation to a higher private debt premium, which will support an increase in yield on investments. In the period leading up to the pandemic, as a result of higher capital inflows into the private debt market and increased competition, this premium, which is driven largely by illiquidity premium caused by shortfalls in traditional banking capital, had been under pressure. Following the retreat of banks and foreign lenders from the CRE space as a result of the crisis in conjunction increased reluctance to lend (especially by the banks in the CRE sector), this trend is expected to largely if not wholly reverse, **providing significant yield opportunities for the private CRE lenders** which remain willing to deploy capital for prudent investments. In addition, if default conditions worsen substantially, the consolidation of less prudent managers will support rational pricing in the market, leaving the most competent players in a position to operate in a market which is fairly attractive to lenders.

In addition, the Australian market provides structural protections for lenders in comparison to overseas CRE lenders. Following the GFC and the rise of covenant-light loans (“Cov-Lite”) offshore has arguably **widened the divergence between the credit risk of global and domestic corporate loan markets**. Cov-Lite contracts do not contain the usual protective covenants of traditional loans and liken assets to that of bond instruments. While this presents an extreme risk in foreign corporate loan markets, we note Australia does not bear much comparison due to much more restrictive structural mechanisms which have become more stringent in line with APRA’s ongoing development of stricter regulatory controls for banks (lower leveraged and higher capital), especially for property exposures. As the broader Australian corporate loan market is still largely dominated by the domestic banking system, this more attractive pricing of risk has had a beneficial knock-on impact to the non-bank sector which has been able to take advantage of the stronger overarching risk sentiment, especially as some banks have withdrawn from select borrowers entirely. This resultant demand-supply imbalance skews the risk profile in favour of the lenders, allowing for stronger structural protections at relatively higher credit spreads.

There has been continual concern regarding the domestic property market but as Figure 17 shows, the current cycle and the previous cycle paint very different pictures. As illustrated, the run up from the early 2000s to the peak of the GFC was helped by significant activity in the CRE loan market which inflated CRE asset prices domestically and globally but in the post-GFC era, it took 7 years for the system loan portfolio to recover past its peak with lenders (and overseeing regulators) far more reluctant to fund projects. In comparison, residential mortgage lending (both for owner-occupiers and investors) has rarely faltered over the same period and now far exceeds the system CRE debt. Consequently, there has been a **major shift in risk concentration within bank balance sheets**.

**Figure 17. Australian Banking System CRE v Housing Cumulative Growth**

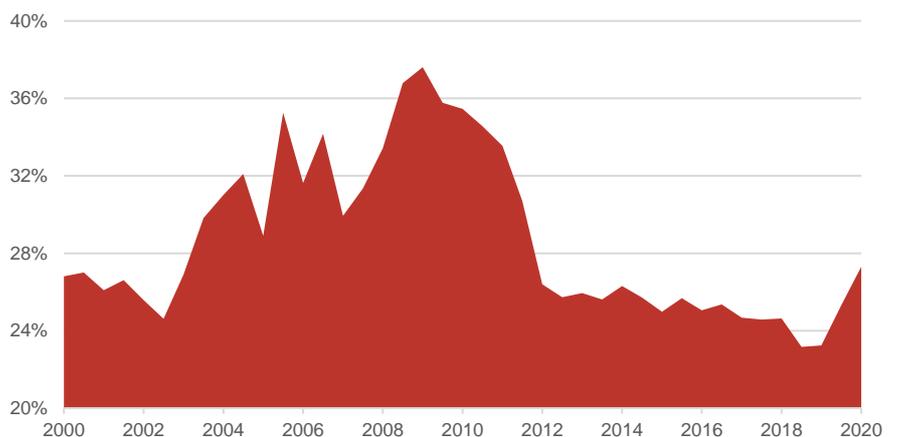


Source: BondAdviser, APRA as at 30 June 2020.

This is further supported by the risk culture of borrowers. Although not truly reflective of the entire demand spectrum for CRE debt, as a general indication, the average gearing ratio of ASX200 Real Estate Investment Trusts (REITs) and property developers demonstrate a clear shift in strategy (Figure 18). Listed property companies are currently far less levered than they were in the GFC period.

For this reason, CRE debt is relatively less risky than a decade ago during the GFC with lower leverage, more robust covenant packages and higher quality assets becoming the new norm for experienced lenders. Although significant risks persist, as highlighted above, it seems there is more capacity for lenders to absorb a (at least modest) deterioration in conditions as a result of the crisis. And given the structural protections embedded in the debt investments, we view CRE (versus equity investment) as the preferred strategy at this point in the cycle.

**Figure 18. Average Gearing Ratio of ASX200 REIT & Property Developers**



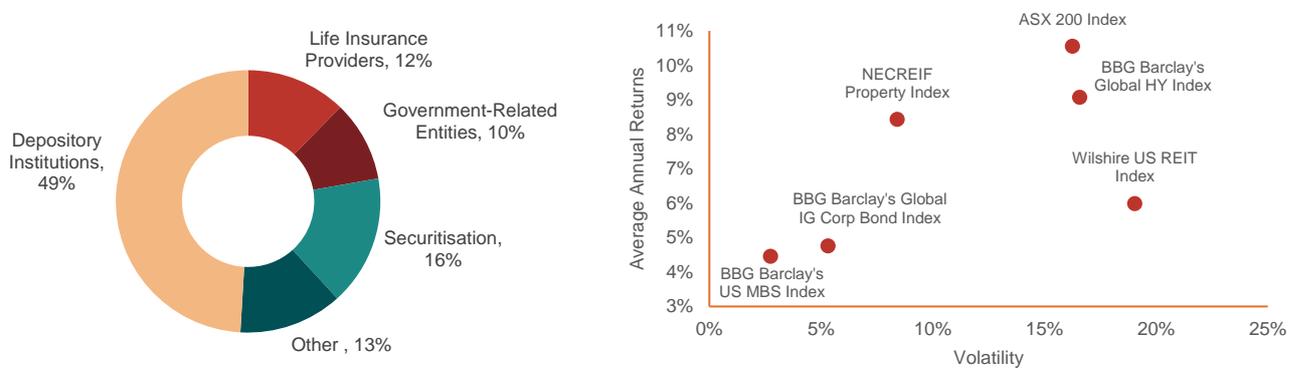
Source: BondAdviser, Bloomberg, Company Reports.

## Commercial Real Estate Debt Risk & Return

As the private debt universe, and more specifically the CRE debt market, is decentralised, mostly confidential and in the relatively early stages of becoming an institutional asset class, there is no historical performance index in Australia. As a result, it is challenging to make assumptions about CRE debt on a risk-return basis.

Figure 19 provides a broad level view of the risk / return environment for CRE debt from a global perspective. Firstly, the, the NCREIF Property Index, which tracks the performance of real estate assets across retail (20%), residential (20%), industrial (20%) and office (40%) held by institutional investors in the US, which has a far greater market participation from life insurance companies and pensions funds (Figure 19), shows long-term returns (20Y) materially above IG corporate bonds but below high-yield investments. We view this as broadly accurate of the return on CRE investments, and the lower volatility illustrated in Figure 19 is indicative of the structurally less volatile nature of real estate assets.

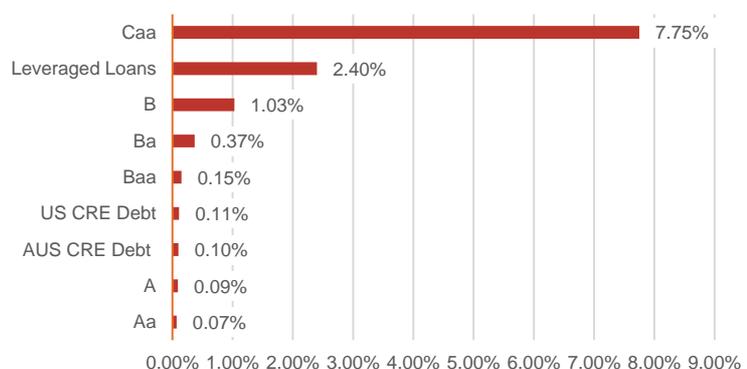
**Figure 19. US Commercial and Multifamily Mortgage Debt by Lender and Long-Term (20Y) Asset Class Risk / Returns**



Source: BondAdviser, Federal Reserve

However, it is reasonable to assume the Australian experience would be different with a legal framework more heavily in favour of lenders. Although this notion is challenging to quantify with objective publicly available evidence, the returns achieved by a limited number of non-bank participants in the domestic CRE market support the relatively more attractive risk-return profile of the Australian asset class.

**Figure 21. Indicative Loss Rates**



Source: BondAdviser, Moody's, Credit Suisse, ACLI.

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