

Executive Summary

Simon Fletcher

Head of Research

(+61) 3 9670 8615

simon.fletcher@bondadviser.com.au

Jack Pobjoy

Credit Analyst

(+61) 3 9670 8615

jack.pobjoy@bondadviser.com.au

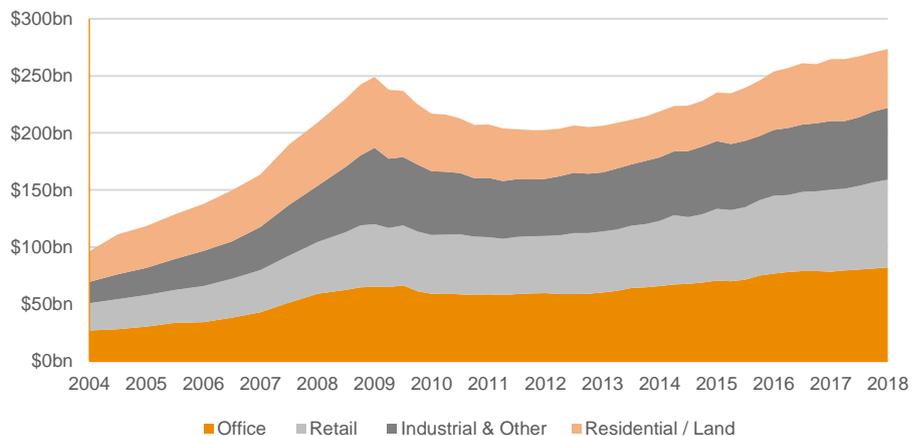
Despite being one of the largest and more diverse asset pools domestically, the Australian private debt market is largely unknown to most investors. Historically restricted to the nation’s banking system, current regulatory pressures mixed with robust demand for credit has resulted in early signs that 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 optimal 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 a third of the aggregate corporate loan book of the domestic banking system. 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).

Nonetheless, if sufficient risk management is applied and upheld, CRE lending can generate lucrative returns with limited capital volatility which 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 the preferred investment strategy at this point in the economic cycle.

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, including key concepts, historical examples and 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.

Figure 1. ADI Commercial Real Estate Exposure by Sector

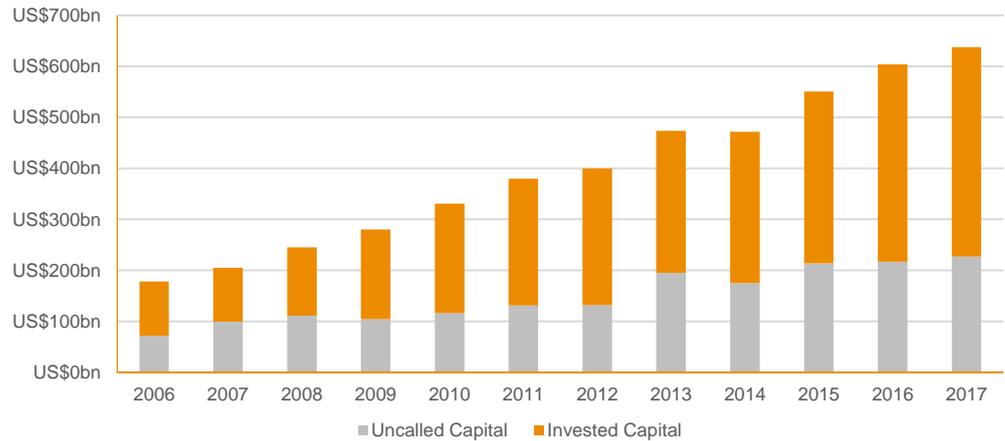


Source: BondAdviser, APRA

Australian Private Debt, a New Asset Class?

Despite its longstanding existence, private debt has 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 naturally confidential nature, worldwide institutional investment has grown substantially to US\$638 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.

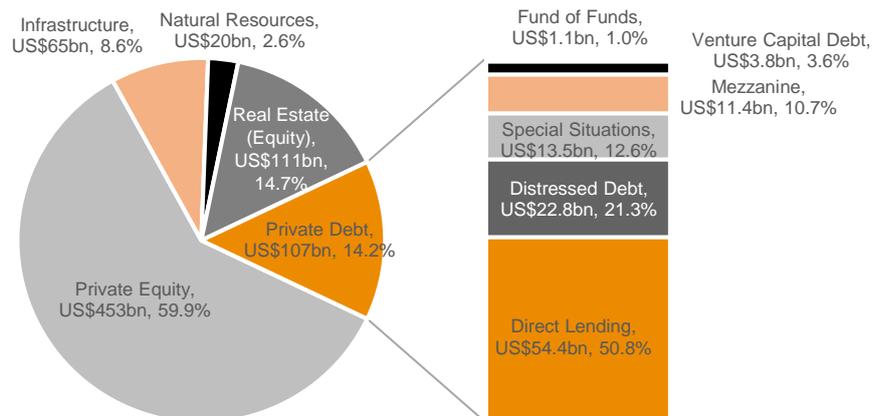
Figure 2. Global Private Debt Assets Under Management



Source: BondAdviser, Preqin

According to Preqin, a leading data provider for the alternative assets industry, private debt comprised 14.2% (US\$107 billion) of all private institutional capital raisings in 2017 and is a material pillar of the global private capital market. Within the private debt asset class there are many strategies, spanning from venture capital financing to distressed debt but direct lending was the most popular category in 2017, collectively raising US\$54.5 billion (or 51% of all private debt raisings) throughout the year (we note this excludes mezzanine lending of US\$11.4 billion which is categorised separately). This contrasts favourably to previous years where direct lending has averaged ~30% of all private debt raisings from 2012 to 2016, highlighting robust demand for the unique risk profile, namely, senior, secured, non-financial, floating rate credit.

Figure 3. 2017 Global Private Capital Fundraising Breakdown



Source: BondAdviser, Preqin

In the private loan 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 to 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

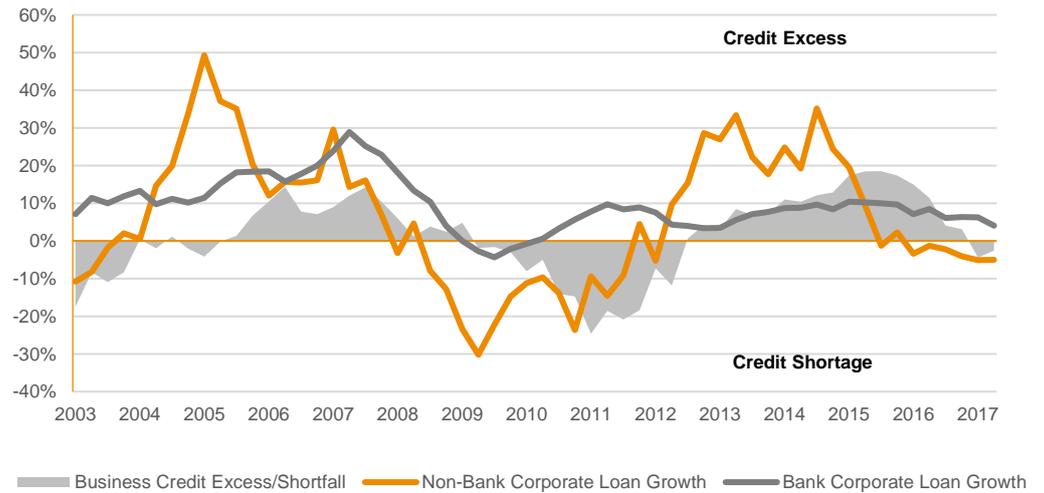
	Bilateral Loans	Syndicated Loans
Loan Size (Commitment)	\$2 – 100 million	>\$100 million
No. of Lenders	Single: Bilateral loans are made on a one-on-one basis with a single borrower and single lender.	Multiple: Multiple banks will form a 'syndicate' and collectively lend funds to a single borrower.
Public Information	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.
Covenants	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 package.
Credit Spread	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.
Liquidity	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.
Non-Bank Participation	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 in private transactions.	Lower: Banks can usually offer loans at competitive rates due to additional ancillary attached to a particular borrower (bank accounts, hedging) making the return profile of large syndicated loans unattractive to non-bank lenders. Greater capital requirements impose another barrier to entry.
Fee Structure	Although the all-in cost of funding may be higher, bilateral agreements are usually subject to a limited number of fees.	In contrast, syndicated loans will typically also involve syndication fees and agent / arranger fees. However, the all-in cost of funding will generally still be lower due to the smaller credit spread.

Source: BondAdviser

In Australia, the private debt market broadly refers to 'middle-market' corporate lending which broadly 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 bank-dominated market (~85%). Figure 4 suggests the next inflection point in this cycle is approaching but, in our opinion, the underlying drivers and composition of lenders is changing. In recent years, tighter banking regulation has seen a healthy influx of non-bank institutional lenders versus the corporate debt binges we have seen in previous cycles. Consequently, this could be 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.

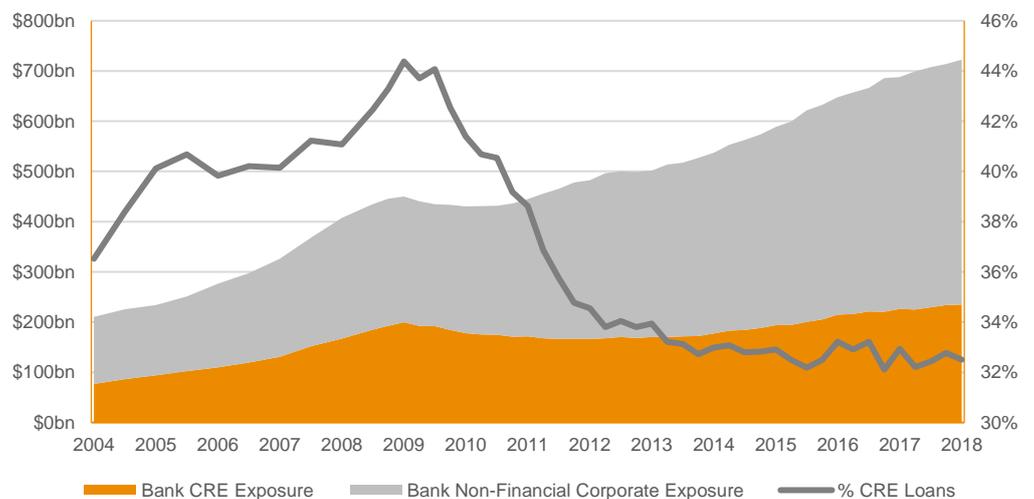
Figure 4. Banks and Non-Banks versus Business Credit Conditions¹



¹Credit Excess/Shortage measured as the difference between business investment and business credit
 Source: BondAdviser, APRA, ABS

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. 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 for all Authorised Deposit-taking Institutions (ADIs) stood at ~A\$235 billion as at 31 March 2018, 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 similar trends 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 these 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 will 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, ensuring all capital is retained and all income is received in a timely manner.

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

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

Source: BondAdviser, JLL Research, ABS

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'. Generally speaking, the capital structure for a given CRE asset is illustrated 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. CRE Capital Structure Example



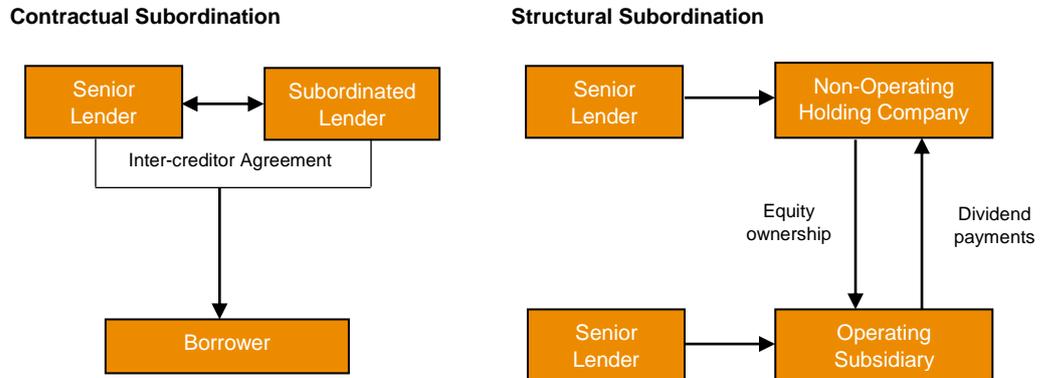
Source: BondAdviser

A first-lien loan is a type of senior debt, whereby 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 inter-creditor 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 quite 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. CRE Loan Subordination



Source: BondAdviser

CRE Loan Valuation: Setting the Credit Spread

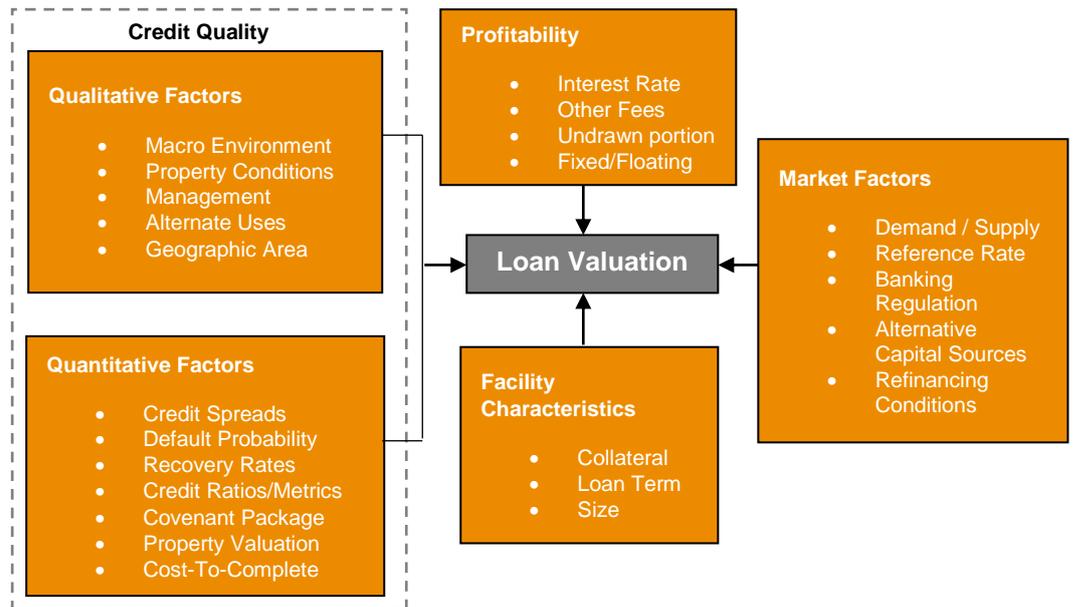
In an active market (i.e. equity and bonds), the value of an asset is its traded price. However, where an asset is less actively traded or a traded price does not exist, the value of an asset for the purposes of calculating Net Asset Value (NAV) is determined in accordance with applicable accounting 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, 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 limited 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 deduce a 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



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 types of covenants for CRE Loans

Limitation	Examples of Covenant / Clause
Indebtedness	Gearing Ratio, Loan-to-Value Ratio
Liquidity	Interest Coverage Ratio, Debt Serviceability Tests, Cost-To-Complete Test
Secured Indebtedness	Secured Gearing Ratio, Negative Pledge
Asset Sales	Minimum Valuation, Debt Repayment Linked to Sale
Transactions 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 give 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 strong 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 stretching back to 1920 where on average senior secured loans have experienced a recovery rate of 81% while senior secured bonds have experienced a recovery rate of 62%. The same trend has occurred also for mezzanine financing (45% and 29% respectively). 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 initial external administrators' reports for Construction industry (2010-2018)



Source: BondAdviser, ASIC

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 serious 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 & Restructuring Techniques

Technique	Description
Recapitalisation	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.
Divestments	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%.
Amendment of Terms	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.
Debt-for-Equity Swap	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.).
Distressed Refinancing	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.

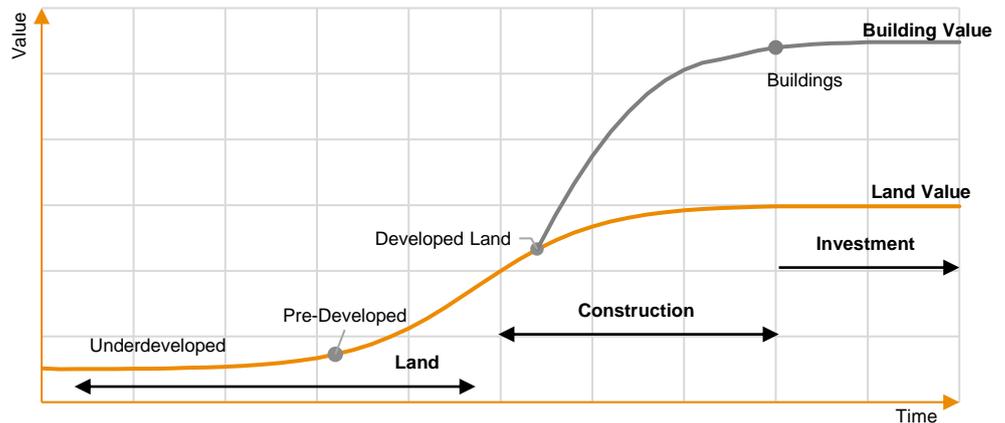
Source: BondAdviser

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.

Table 5. Generalisation of CRE Funding Structures

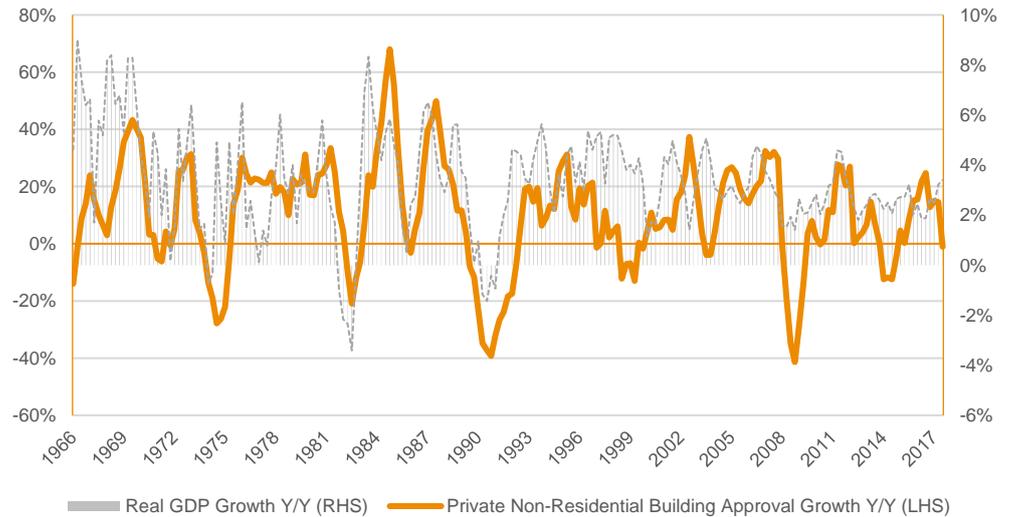
Type	Investment	Development
Asset Base	Established single asset such as commercial office, industrial or retail assets	Unestablished single asset and hence, a ‘project’
Funding Structure	Senior Debt (50-60%), Equity (40%-50%)	Senior (40-50%), Mezzanine (10-20%), Equity (30-40%)
Security	Secured against established asset.	Secured against underlying land, borrower’s assets or project
Funding Use	Senior debt is generally used to fund the acquisition of the asset with the remaining funding utilised to redevelop or refurbish the site.	Funding facilitates initial purchase of site, with progressive debt drawdown (linked to hurdles) as the development progresses
Primary Covenants	LVR and ICR	Cost-to-Complete and Debt Service tests
Debt Repayment	Asset rental stream or refinancing	Pre-sales, settlements, deposits, refinancing or asset sales
Yield / Risk / Control	Lower	Higher

Source: BondAdviser

The Commercial Real Estate 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

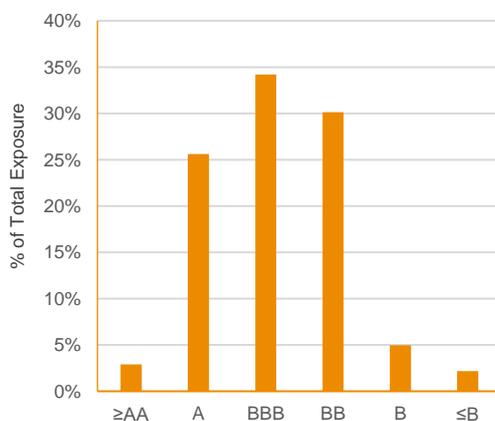


Source: BondAdviser, ABS

What Has History Shown Us?

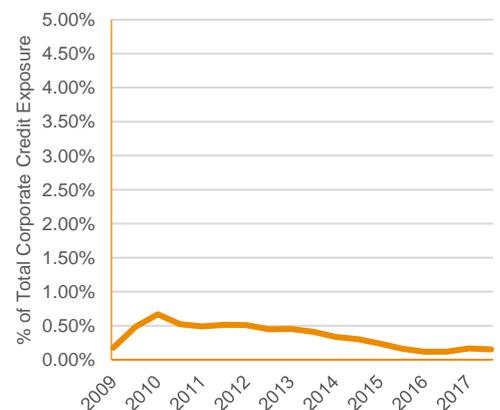
For most economies, the real estate loan market is largely controlled by its banking system making the asset class challenging to analyse on a risk / return basis, especially with limited publicly available data. A useful gauge of domestic market characteristics are the four major Australian banks which dominate the corporate lending landscape and more specifically, the CRE loan universe with a market share of ~78%. 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 ~30-35% non-investment grade (figure 12) on average, loss rates have been muted throughout the last economic cycle (figure 13).

Figure 12. Major Bank Credit Rating Distribution



Source: BondAdviser, Pillar 3 Reports

Figure 13. Major Bank Corporate Loan Write Offs

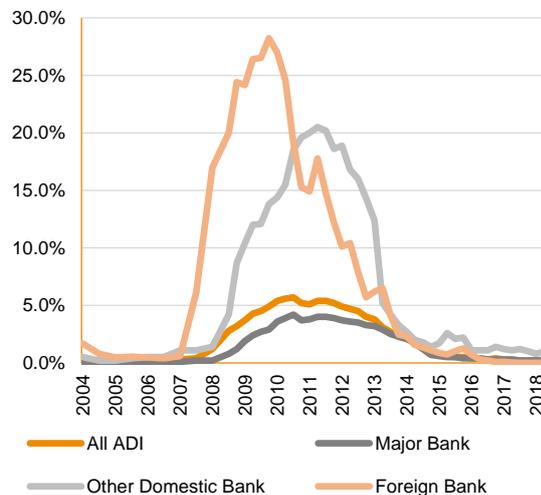


Source: BondAdviser, Pillar 3 Reports

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 has not experienced such conditions since the early 1990s and information regarding CRE from this era is limited, it is more appropriate to analyse the market from 2000 onwards where more data had been made publicly available.

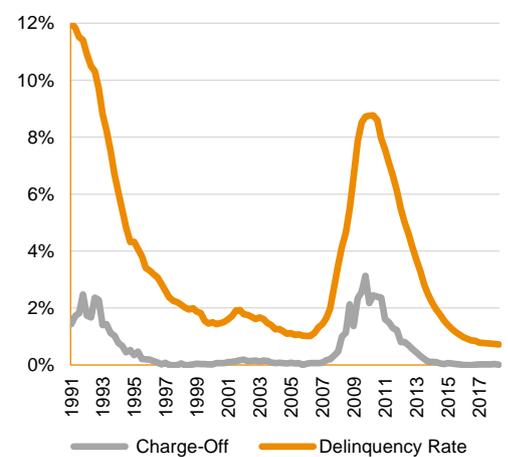
On this basis, the global financial crisis (GFC) is the best example of distressed real estate debt despite Australia not technically experiencing a recession. According to APRA, impaired assets as a percentage of total exposures peaked in 2010-2011 with a strong divergence between the major banks (~4%), 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

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



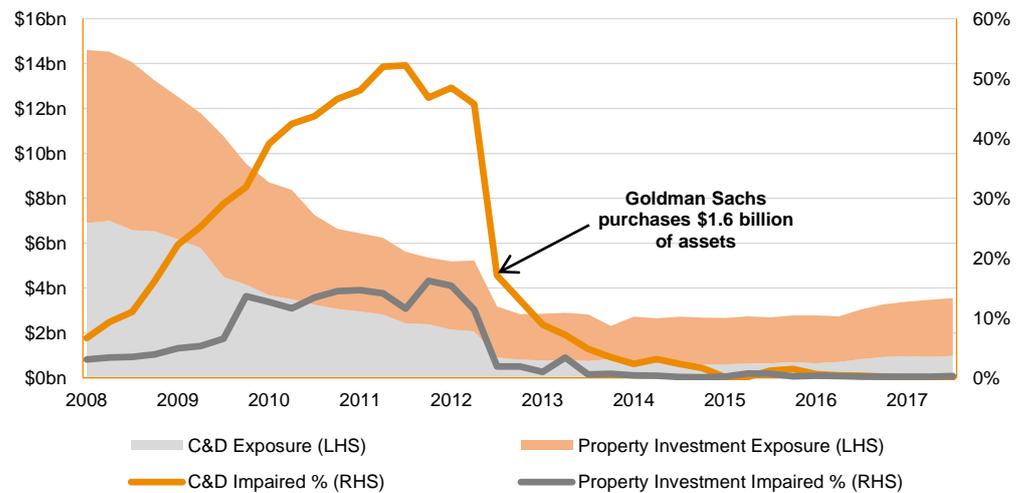
Source: BondAdviser, Federal Reserve

Overall, Australian CRE fared relatively better during the GFC, declining by 24.7% 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 43.7% and 44.2% respectively while Ireland's market lost greater than half its value, falling by 56.3%. While these figures are substantial and demonstrative of 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 and in reality, action is usually taken (or borrower default would likely occur) far before a particular CRE asset reached its trough in value.

In such an event, there are a number of strategies that could be undertaken to protect debt capital such as recapitalisation by 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 equalled 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%.

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



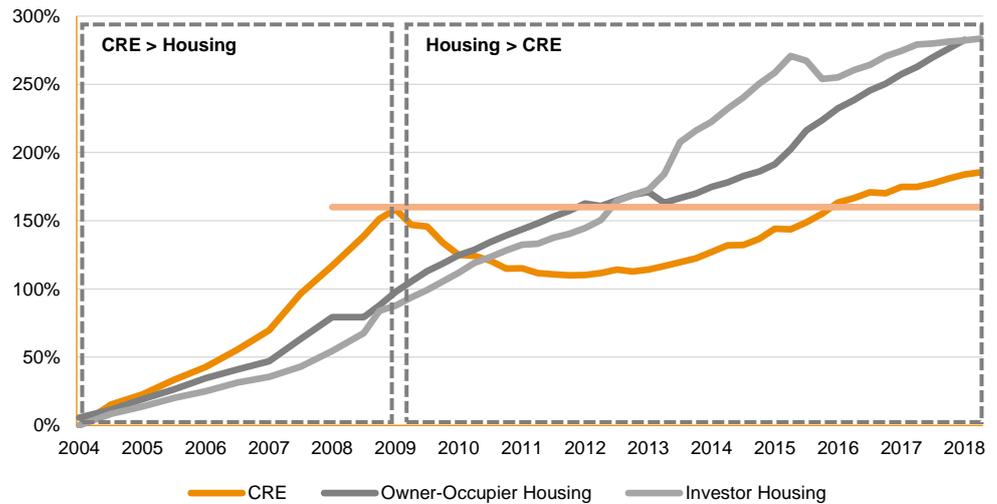
Source: BondAdviser, APS330 Reports

The Current Climate

Ten years on from 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. In the US, this type of lending currently comprises ~76% of all outstanding institutional leveraged loans according to the S&P / LSTA Leveraged Loan Index. 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 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 Growth

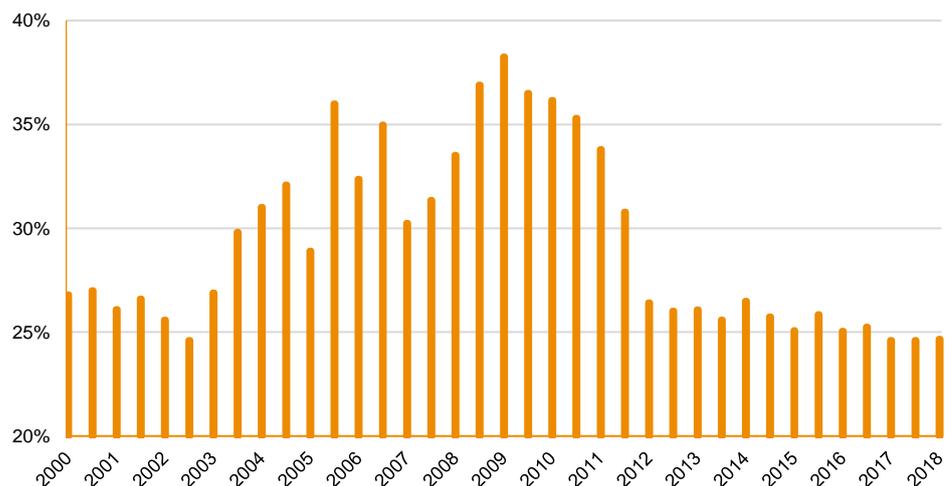


Source: BondAdviser, APRA

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 demonstrates a clear shift in strategy (figure 18). While large CRE asset valuations (or extremely compressed capitalisation ratios) would suggest the CRE cycle is approaching a similar stage to that of 2006-2007, listed property companies are far less levered this time around, which is the general rhetoric for most of corporate Australia.

For this reason, we view CRE debt as far less risky than a decade ago with lower leverage, more robust covenant packages and higher quality assets becoming the new norm for experienced lenders. There will always be clear risks to any economy that has negative externalities on other sectors and markets but, in our opinion, CRE debt is unlikely to be a catalyst in the near future with debt investment (versus equity investment) being the preferred strategy at this point in the cycle.

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



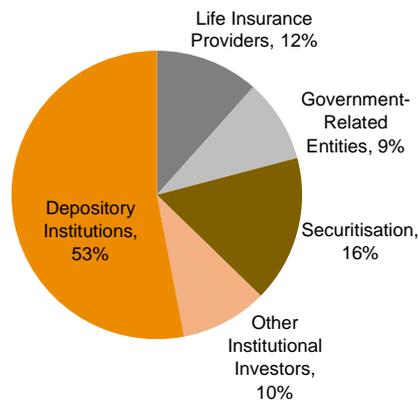
Source: BondAdviser, Bloomberg, Company Reports

Commercial Real Estate Debt Risk & Return

As the private debt universe, and more specifically the CRE loan 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.

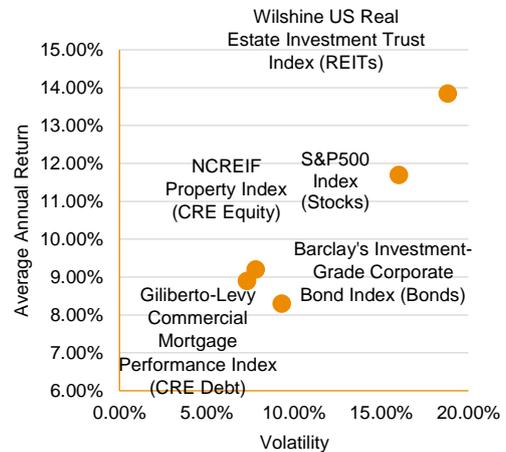
Globally, the most advanced measure of performance that best captures private commercial real estate loan assets has been the Giliberto-Levy Commercial Mortgage Performance Index (GLCMPI). The index tracks the performance of senior CRE loans made by institutional investors in the US, which has far greater market participation from life insurance companies and pension funds (figure 19). Since its creation in 1993, the GLCMPI has tracked over 75,000 CRE loans collectively comprising US\$762 billion of principal. The Giliberto-Levy High-Yield Real Estate Debt Index was subsequently launched in 2010 to include mezzanine debt and preferred equity providing performance measurement on the complete CRE debt spectrum.

Figure 19. US Commercial and Multifamily Mortgage Debt by Lender



Source: BondAdviser, Federal Reserve

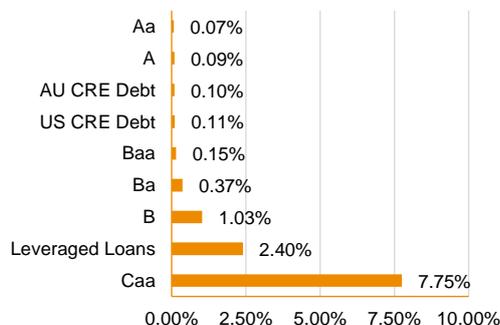
Figure 20. US Asset Class Risk & Return (1978-2015)



Source: BondAdviser, Federal Reserve, Giliberto-Levy, NCREIF

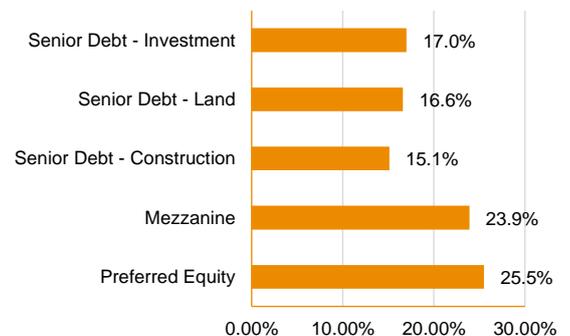
While figure 20 gives some insight into the relative performance of CRE debt over the long-term (8.9% annual return at 7.1% volatility), it is reasonable to assume the Australian experience would be very different with a legal framework more heavily in favour of lenders. Although this notion is challenging to quantify with objective 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 (Figures 21 & 22).

Figure 21. Loss Rates Across Credit Risk Spectrum (2006-2014)



Source: BondAdviser, Moody's, Credit Suisse, Balmain Investment Management, ACLI

Figure 22. Australian CRE Internal Rates of Return (2008 – Present)



Source: BondAdviser, Qualitas

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