BondAdviser

Research Report

Report Created on 8 October 2018

Issuer Name

Qualitas Group

Security Name

Qualitas Real Estate Income Fund

Security Recommendation

Subscribe

Security Risk

Upper Medium

Issuer Outlook

Improving	Stable	Deteriorating

Key Characteristics

Product Type	Listed Investment Trust	**Sub-Asset Class**	Credit
Issue Size*	$150,000,000	**Manager**	QRI Manager Pty Ltd
Net Asset Value	$1.60	**Administrator**	QRI Fund Services Pty Ltd
Target Returns	Variable	**Responsible Entity**	The Trust Company (RE Services) Limited
Payment Frequency	Monthly	**Custodian**	Perpetual Corporate Trust Limited
Target Distribution	8.00% p.a. (net of fees and expenses)	**Unit Registrar**	Automic Pty Ltd
Franking Credits Incl.	No	**Offer Opens**	16 October 2018
ASX Listed	Yes (Prospective ASX Code: QRI)	**Offer Closes**	13 November 2018
Convertible	No	**Allotment Date**	23 November 2018
GICS Sector**	Investment Companies	**Commences Trading on ASX**	27 November 2018
Asset Class	Fixed Income	**First Payment Date**	On or Before 28 February 2019

*Issue size subject to change. **We classify the Trust within the GICS Sector "Investment Companies", but note that the ASX is likely to assign it a "Not Applicable" classification.

Summary

The Qualitas Real Estate Income Fund (the “Trust”) is a listed investment trust (LIT) offered by the Qualitas Group and provides investors with exposure to the commercial real estate (CRE) market. The CRE debt market is currently worth ~ $270 billion and estimated to be growing at ~3% p.a. at a time when the Royal Commission and global Basel III capital reforms are causing banks to increasingly retreat from the sector. This presents a significant growth opportunity for non-bank financiers such as Qualitas to selectively capture additional market share and build upon its A$1.7 billion track record of CRE transactions across the capital structure. The Qualitas Group has a disciplined track record in CRE and loan origination, with zero capital loss losses across 108 transactions since inception in 2008.

The Trust is a closed-ended trust with a target return of 8.00% per annum (net of fees and expenses), which we believe to be commensurate to the risk associated with the provision of debt funding for typically illiquid and bespoke CRE assets. The funds raised within the Trust will be allocated to Qualitas’ wholesale funds (including new funds to be established) thus providing investors with exposure to senior and mezzanine loans across real estate sectors.

The Fund expects to raise a minimum of $150 million and begin trading on 27 November 2018 at an indicative NAV of $1.60 per unit. The fee structure includes a 1.50% p.a. of portfolio NAV management fee as well as a 20.00% performance fee for outperformance above the 8.00% p.a. (net) hurdle rate. Qualitas will cover all the setup and offer costs associated with the launch of the Trust and there is no chargeback mechanism for investors.

Figure 1: 5Y Risk and Return

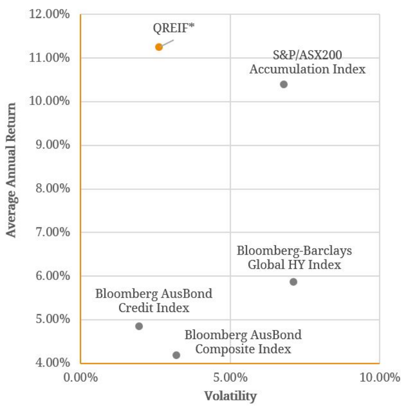
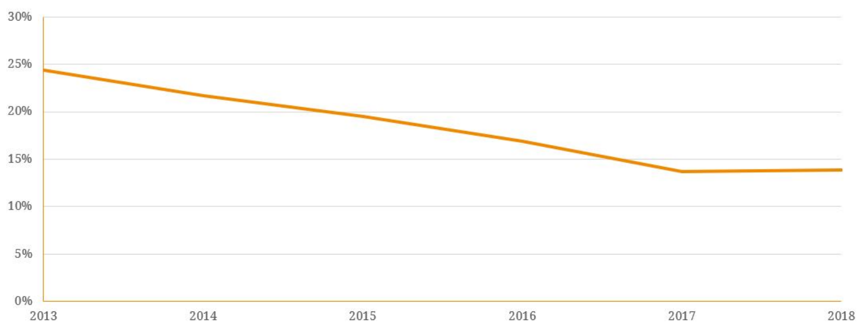


Figure 2: Adjusted 5Y Historical Performance (Net)



Figures 1 and 2 above are based on indicative weights of ~66% senior secured debt and ~33% mezzanine secured debt in the Trust.

Performance is net of ~2% in management and administration fees as well as 20% outperformance fees over the 8% hurdle.

Figure 2 shows that returns have declined over the past five years as Qualitas focuses less on opportunistic deals and more on higher-quality secured debt (with lower IRRs), consistent with evolving market opportunities.

Sources: Qualitas, BondAdviser

Security Recommendation - Subscribe *as at 8 October 2018*

BondAdviser recommends investors **Subscribe** to the Trust.

The Trust is recommended for yield-seeking investors comfortable with exposure to the CRE private debt market. As noted, the progressive withdrawal of authorised deposit-taking institutions (ADIs) from the Australian CRE market in recent years has allowed smaller, non-bank financiers such as Qualitas to selectively capture market share and achieve significant returns on investment. The Trust provides investors with the opportunity to invest alongside institutional investors via allocations to the Group's wholesale funds with a targeted return of 8.0% p.a. (net of fees and expenses). Given the structurally illiquid nature of the CRE debt market, the LIT provides a liquid vehicle by which to invest in these assets whilst offering the opportunity to receive high yields. The firm has very strong risk management protocols in place and an outstanding track record, however, there are unique risks associated with investing in such a highly-specialised area of the private debt markets. As a result, it is our view that the target returns of 8.0% p.a. (net of fees and expenses) is commensurate with exposure to the perceived higher risk of the ~$270 billion CRE debt market. Additionally, current market dynamics have created a capital imbalance for investment in and development of property assets which has presented high-yield opportunities. In our view, the higher expected and targeted returns of the Trust versus other high-yield fixed income LITs is largely explained by these two significant factors.

The firm has significant experience within the 70 employees of the business across all stages of the lending process. Robust loan origination is critical for lenders operating in this sector of the market, where tailored capital structures and covenants are key to capital preservation and the management of default risk. The Qualitas Group has in-house expertise from a variety of stakeholders in the finance and construction sectors to proactively manage default risk and take early and preventative actions including turnaround plans, capital injections or loan recovery where necessary. Fully understanding the capital structure hierarchy is a core justification for Qualitas' success in providing senior and mezzanine loans, and this has significantly contributed to Qualitas' track record of zero capital losses recorded by the firm since inception. Across Qualitas' track record of 108 transactions, only one borrower has entered receivership in this time (with 100% recovery rate) and it is a testament to management's skill, the robustness of underwriting procedures and effective remedial actions that underpin this performance.

A listed investment trust (LIT) structure derives unitholder returns from two sources: distributions (including upfront fees payable to the Trust) and capital returns from the underlying portfolio, in addition to share price movements which drive the prevailing premium/discount to Net Asset Value (NAV). The latter is more a function of market and manager sentiment but also reflects liquidity and structural features of the Trust. The Manager has established multiple mechanisms to bolster NAV stability which should minimise trading price variability. Price movements away from NAV would, in our opinion, be more speculative and not a function of asset fundamentals or financial risk management. The former is, of course, subject to risks, however, the Manager's successful implementation of its investment strategy as well as risk management and governance framework has been enacted and refined since 2008.

We are arguably in the later stages of the current property cycle which poses a risk to both residential and commercial real estate markets. We further note that the Qualitas business model has not yet been tested during a prolonged period of volatility and depressed valuations such as that seen in the early 1990s recession and subsequent property collapse. However, the senior management team and senior directors within the Qualitas Group have extensive experience across cycles, combined with strong origination and risk management expertise, and this should make the Trust well-placed to manage risks arising from a decline in the property market. All assets are secured by the underlying project and/or directors of the borrowing entity acting as personal guarantors, giving Qualitas multiple avenues of recourse to recover supplied capital in an Event of Default. For each loan, the Qualitas team has exit strategies available, including refinancing of the loan via alternative financiers, refinancing into a construction debt facility, repayment by sponsor equity or in extreme cases, the sale of the underlying property asset.

Overall, the Trust is underpinned by a highly specialised investment team with significant experience in the CRE debt markets, and Qualitas exhibits all the key traits of a successful asset manager. The CRE asset class is a niche, but sizeable (~$270 billion) and growing industry with the role of non-bank financiers set to increase in the face of tightening credit, the Royal Commission and Basel III recommendations. However, given the illiquid and specialised nature of CRE debt, sufficient diversification and active management are required to optimise the risk-return profile of the Trust. The product offers both of these key characteristics and for this reason, we recommend investors **Subscribe** to the Qualitas Real Estate Income Fund.

Positive / Negative Risk Factors

What factors would change the Recommendation UP

- The product offers retail investors access to the otherwise largely inaccessible Commercial Real Estate (CRE) debt market investment market in which Qualitas has achieved an audited gross realised IRR since inception of 24.8% across 84 senior and mezzanine debt investments.
- Loans are secured against real property assets and are also most often structured with various protective covenants in place together with other guarantees from stakeholders over committed funds.
- Qualitas' exhibits industry best practices covering its governance and risk procedures. This includes multiple oversight committees, regular portfolio reviews and separate, independent approval from the Risk Management Team and relevant investment committees required for all lending decisions.
- The Group has achieved a disciplined track record in CRE investment – evidenced with the aforementioned IRR outperformance as well as impressively registering zero capital losses since inception.
- The CRE market is a niche one with a large and ongoing opportunity set available for experienced operators (including Qualitas) to significantly expand their assets under management (as well as profits) given the progressive regulatory tightening and pull-back by traditional bank lenders.

- Strong loan origination and structuring is key to overall success, with Qualitas estimating that it rejects around 80% of all applications. Exhaustive scenario analysis is performed on each deal whereby the optimal loan-to-value ratio (LVR) and capital structure position for Qualitas to lend at (e.g. senior or mezzanine) are obtained.

- In-house project expertise and continual project assessment including monthly site visits and quantity surveyor reports before staged fund drawdowns help to mitigate risks of capital loss.

What factors would change the Recommendation DOWN

- Given the unit price of the LIT is determined in a public market (ASX), the value of the product will be more sensitive to topical news flow and other announcements relative to Qualitas' wholesale offerings.

- Credit quality deterioration (or in a worst-case scenario, borrower defaults resulting in credit losses) in the Trust portfolio could result in a material decline in the NAV. However, this is partially mitigated by Qualitas' strong track record and successful active strategies in managing loans and underlying property assets and exposures.

- While we are comfortable with the internal controls and governance procedure within the Qualitas Group, operational risk is always a threat to portfolio performance. This includes the failure of internal processes and includes human error, misjudgement and fraud.

- Significant declines in the property market and/or the CRE debt market specifically could lead to correlated defaults on loans, which may lead to large credit losses. Mitigants to this are origination diversification (by geography, sector and borrower concentration) by Qualitas together with robust performance tracking and the early engagement of dedicated project turnaround staff and managers. Additionally, we take some comfort in the robustness of modelling undertaken by Qualitas during the origination process that sufficient structural mitigants are embedded and contracts are commensurately priced for risk.

- The Trust's fee structure (total expected to be between 1.86% and 2.16% of NAV) is higher than other listed fixed income LITs and LICs. However, we note that the Trust is targeting returns (after fees and expenses) of 8.00% per annum. Broadly, income over this level is subject to 20% performance fees to the Manager and there is an embedded clawback provision for underperformance. Overall, we are comfortable with the fee structure and feel it is fair if targeted returns are achieved. We further note that investors will not be subject to two levels of fees (i.e. both the LIT and the underlying funds).

- Absolute returns afforded to incumbents in the sector are expected to decline somewhat as senior-debt ranked investments become more prevalent than mezzanine debt amongst providers of finance. This evolution means that whilst the secondary market will positively become more liquid for these loans, Qualitas' provision of mezzanine debt should decline (as its senior debt weighting increases) with an associated decline in returns from the more secure, and lower yielding assets.

- An overextension by Qualitas into regions which are over-developed or susceptible to price declines could result in increased risks of credit loss. This is mitigated by maintaining controls over portfolio diversification and by leveraging the Group's substantial market intelligence, "on-the-ground" knowledge and strong industry relationships which help to reduce exposure to such situations.

- Mezzanine debt projects generally represent ~33% of external loans provided and rank behind senior debt (usually provided by a traditional bank). In an Event of Default, this position could lead to capital loss, however strong origination and loan structuring processes mitigate this risk.

- The CRE asset class is illiquid and in a stressed scenario, underperforming or defaulted assets may be difficult to liquidate at perceived fair values, increasing the risk of a capital loss. Notably, the Investment Team conduct analysis on property valuation to stress test worst-case scenarios and determine optimal exit strategies as part of the robust risk management processes in place.

Issuer Outlook - Stable *as at 8 October 2018*

Investment Objectives, Strategy & Performance

The Trust aims to give investors exposure to the ~$270 billion CRE debt market and provide access to high-yielding, illiquid assets via a liquid, exchange-traded vehicle. The Trust will invest in a portfolio of senior and mezzanine loans across the real estate life cycle with a target return of 8.0% p.a. net of fees and expenses. Given its specialised nature, the CRE private lending asset class has traditionally been reserved for institutional and wholesale investors. The Qualitas Group has recorded an internal rate of return (IRR) of over 20% since inception across realised and unrealised equity and debt investments. The Trust will invest in a portfolio of assets to gain direct or indirect exposure to secured real estate loans with a stringent focus on risk management and capital preservation throughout the organisation (see next section).

The secured loans provided by Qualitas have a typical tenor of 12-24 months with a loan-to-value ratio (LVR) of ~50-65% for senior debt and ~65-75% for mezzanine loans provided. The Portfolio will consist of approximately 70-75% senior and 25-30% mezzanine loans subject to review by the Portfolio Allocation Committee (PAC). Capital may be provided to borrowers for land loans, construction loans or investment loans, providing diversification benefits across the real estate sector. The Manager may also achieve indirect exposure to secured real estate loans via the Qualitas Senior Debt Fund (QSDF), notes in the Arch Finance Warehouse Trust (AFWT) and Qualitas funds (to be established) from time to time.

The Qualitas Group aims to manage potential threats to capital and repayment by leveraging its in-house expertise within the project finance, construction and real estate sectors. The Group works with borrowers to escalate potential issues early and provide support for operations, project management and recovery of capital provided where necessary. The success of this strategy is evidenced in the Group's zero capital loss throughout 10 years of operating in a highly-specialised area of the corporate debt market.

All loans provided are secured against the underlying assets, in addition to guarantees provided by Sponsors' equity. In an Event of Default, the Group has a range of exit strategies and access to recourse in order to recover capital and realise gains. Typically, the Group has a 30% equity buffer on the asset to ensure that there is significant headroom within each deal so that adverse circumstances such as property devaluation do not place capital immediately at risk.

The Investment Team's strong experience in loan origination is a key pillar of the Qualitas model. With a team of 20 professionals within these teams, Qualitas places an emphasis on the capital structure and strong loan structuring to ensure relevant covenants and avenues of recourse are in place. The Investment Team is well supported by the Risk and Portfolio Management Teams (see next section) to ensure that all deals are appropriate and within the tolerance threshold for the Group. Additionally, over half of the Qualitas staff are responsible for operations and fiduciary management, underscoring the Group's commitment to internal governance and risk management processes.

The tightening credit environment in Australia, driven by the Royal Commission and Basel III reforms, have seen the traditionally dominant major banks withdraw from the CRE debt market. In an industry experiencing estimated growth of 3% p.a., this restricted lending supply has provided an opportunity for private lenders such as Qualitas to capture market share and achieve a significant return on investment. Given the sound risk management, experience and track record of the Qualitas team, the Trust is able to provide investors with a liquid vehicle in which to invest in an illiquid and high-yielding asset class. Given the specialised nature, there are no applicable credit ratings for the deals within the Portfolio, whilst this is also the first ASX-listed product within the sector, meaning comparable funds are scarce.

Portfolio Construction & Investment Process

The Trust will be constructed in accordance with the Qualitas Group's Investment Strategy and Investment Principles. The Group has built a consistent and successful track record across origination, execution and asset management, having managed 84 secured real estate loans since inception in 2008. The fundamental Investment Principles comprise the quantum (i.e. forecasting) of returns, timing of returns, assessment of known risks and ability to exert influence over known risks.

The Trust will hold fully paid units in the Sub-Trust, being the Qualitas Wholesale Real Estate Income Fund, and as such, the portfolio structure will be identical to the Sub-Trust. The investment strategy of the Sub-Trust is to provide exposure to a diversified portfolio of investment with direct and indirect exposure to predominantly Australian secured real estate loans via direct secured loans and investing in Qualitas Funds.

A key attribute of the Portfolio is its inherent diversification benefits within the real estate sector. The Manager of the Trust will seek to invest in a portfolio of investments with direct and indirect exposure to secured real estate loans in Australia and New Zealand, with a 20% cap imposed on the latter. The Trust will be predominantly invested in senior secured real estate loans diversified across Australian and New Zealand cities with population greater than 100,000, noting that less than 30% of the Trust's assets can be located in non-capital cities. Additionally, no more than 40% of supplied capital can be directly invested into any single Qualitas fund where underlying wholesale funds will have individual mandates and portfolio parameters.

Investments in New Zealand will be primarily focused on the Auckland market (the largest in the country) and comprises the largest opportunity set for secured real estate loans. The Manager may seek to provide investors with exposure via the Qualitas Senior Debt Fund (QSDF) and other Qualitas Funds to be established, or through the Arch Finance Warehouse Trust (AFWT), noting that Arch Finance is a wholly-owned subsidiary of the Qualitas Group.

Extensive investment and risk management processes are run by the Group for each investment opportunity. Starting with origination, the due diligence stage sees a preliminary deal assessment and detailed due diligence completed, and a "Heads Up" Paper provided where the investment team is seeking preliminary review and feedback from the Investment Committee. Before formal approval is provided, the Portfolio Allocation Committee decides how the investment will be allocated to Qualitas funds and Qualitas investors as per the Qualitas Group Allocation Policy. Following this, a detailed Investment Committee Paper is prepared by the Investment Team and presented to the Investment Committee, with unanimous consent required for the transaction to proceed. In an additional layer of control, the Risk Management Team must also sign off on loan documents and condition precedents and continue to perform covenant monitoring and early escalation of potential issues.

Once approved, the Portfolio Asset Management (PAM) Committee meet regularly (every 6-8 weeks) to assess each loan in completing its asset monitoring and compliance duties. This process allows members to apply their unique backgrounds and knowledge to each deal, whilst also receiving a broader perspective on the loan from various stakeholders and non-executive director oversight throughout the process.

If it is determined that a deal should be exited, the Group's strong deal structuring and securitisation procedures present management with several options by which it can do so. These include refinancing of the loan by another financier (i.e. bank), refinancing into a construction debt facility, repayment out of sponsor equity or sale of underlying assets.

Liquidity, Operational & Financial Risk Management

A strong focus on risk is a firmwide effort with robust controls throughout the investment process and further oversight at a firm level (see Governance, Asset Stewardship & Internal Controls).

While the Investment Team originates deals and monitors the performance of these deals alongside the PAM Committee, the Portfolio Management Team is ultimately responsible for the performance of the Trust within the mandate. As a result, the Investment Team is required to undertake due diligence and determine the risk of a project, with the Risk Management Team and Investment Committee providing further oversight. Expertise is required to objectively and consistently manage these risk exposures, which is evident in the significant experience of senior management, as well as the zero-capital loss track record. Broader geographical investment risk is controlled by the Portfolio Allocation Committee which is responsible for investment eligibility and capital deployment within the Qualitas wholesale funds. This addition of oversight incorporates the views of the Head of Institutional Capital & Chief Risk Officer, adding further expertise to the risk management framework. The geographical, sectoral and individual deal selection capabilities of the team are ultimately demonstrated in double-digit returns since inception.

The PAM Committee is a dedicated committee chaired by the Chief Risk Officer which is responsible for evaluating activities, progress and projections of all assets at an investment level. This ensures that the portfolio reflects the intended risk exposures of the Portfolio Management Team as per the portfolio mandate.

The liquidity risk of the Trust is mitigated by its closed-ended nature, being a listed investment trust (LIT). However, given the specialised nature of the underlying assets, the Manager may be subject to risk in the event of a downturn in the broader property market. A correlated default in distressed conditions such as that seen in 1991-92 may leave several borrowers in default and facing bankruptcy. The CRE market is highly leveraged, which provides ample investment opportunity, but this has also led to the downfall of major construction companies when faced with rising funding costs, delays and poor management. Given the Trust is closed-ended, significant aspects of liquidity risk are mitigated through the structure. The major aspect of liquidity risk to the Manager is the ability to enter and exit loans to capitalise on investment opportunities, realise returns and exit from deteriorating deals. The risk management processes in place help to mitigate this risk, with the PAM Committee's regular meetings serving to provide third-party oversight and objective evaluation on an individual loan basis. Additionally, the allocation restrictions by seniority, geography and real estate sector serve to minimise overexposure to individual markets.

Operating risk is defined by the Basel Committee on Banking Supervision (BCBS) as "the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events". As such, operational risk captures business continuity plans, environmental risk, crisis management, process systems and operations risk, people related risks, health and safety, and information technology risks. This includes errors in internal controls, hedging policies and other operational aspects of the Trust and/or underlying portfolio (the Sub-Trust and other wholesale Qualitas funds). The internal controls are overseen by governance mechanisms (see next section), while there is minimal hedging risk associated with the Trust as the only foreign currency exposure is to the New Zealand Dollar (NZD). As a result, we are comfortable with the hedging policies and procedures of the Trust, noting that the Manager intends to ensure these loans are made in AUD where possible.

Governance, Asset Stewardship & Internal Controls

The Qualitas Group is an Australian alternative asset manager specialising in the CRE debt market. As Qualitas are investing in illiquid and specialised assets in a highly cyclical sector, firmwide governance is crucial to ensure internal controls are established and maintained. Qualitas has prioritised governance and risk management since its inception in 2008 and this is evidenced in the structure of the various boards and committees of the Group.

The Qualitas Group Advisory Board fulfils the fiduciary responsibilities of the Group, including group governance, and consists of majority non-executive board members. Another key board is the Trustee Board, where board members are majority independent and monitor Group compliance with AFSL and fiduciary responsibilities. The Qualitas Group Risk Committee is responsible for risk management and reports directly to the Advisory Board and is a crucial control mechanism for Qualitas through each stage of the investment management process.

There are a number of committees established by Qualitas to monitor and control the various functions of the Group, including the Risk, People and Culture, Portfolio Allocation, Portfolio Asset Management and Fund Investment committees. Each of these, alongside others, play a vital role in fund success by managing investments and default risk for the Group's funds. Ultimately, in the origination and assessment phases of individual deals, the Risk Management Team runs a parallel process to the Investment Committee to evaluate all risks independently. The Portfolio and Asset Management (PAM) Committee also act independently and meet on a regular basis to evaluate each loan as part of the active risk management of the Qualitas Group.

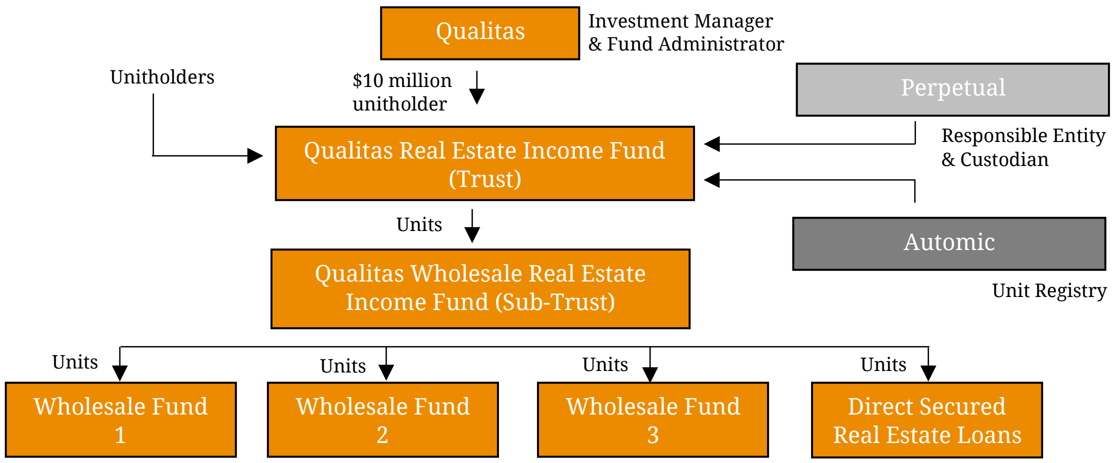
At a product level, the Trust is a closed-ended listed investment trust (LIT) domiciled in Australia (issued by The Trust Company (RE Services) Limited as the Responsible Entity of the Trust) with a single class of units on issue. The LIT is registered with ASIC as a Managed Investment Scheme. QRI Manager Pty Ltd is the Manager of the Trust while the Sub-Trustee of the Sub-Trust has also appointed QRI Manager Pty Ltd as the Manager. The Product Disclosure Statement, Constitution and Investment Management Agreement (IMA) are the key documents governing the Trust.

Asset Allocation and Legal Structure

The legal structure of the Trust is reasonably complex from a high level but protects the unitholder by engaging a separate independent Responsible Entity to act in the best interest of unitholders. The Trust is a passive trust which will invest any funds raised into the Wholesale Qualitas Real Estate Income Fund (Sub-Trust) with the capacity to also invest in direct, secured real estate loans. The allocation process is managed by the Manager with the Responsible Entity required to approve and disclose all material changes to the ASX.

The value of investments made by the Trust is determined in accordance with applicable accounting standards. The Trust is a passive unit trust for taxation purposes (nontrading) and assets are held at fair value through profit and loss. The Net Asset Value (NAV) and NAV per Unit are calculated monthly. In an active market, the value of an asset for the purposes of calculating Net Asset Value is its quoted price (fair value hierarchy Level 1). Where an asset is less actively-traded, or a traded price does not exist, the value of an asset for the purposes of calculating NAV is determined in accordance with the applicable accounting standards and generally takes observable and/or unobservable market data inputs (fair value hierarchy Levels 2 or 3). Loans are typically Level 2 or 3 assets, and the Administrator (QRI Fund Services Pty Ltd) is responsible for asset valuation. To provide additional third-party oversight, the monthly returns of the Trust are audited by KPMG on a 6-month basis, and the existing IRRs across investments made by the Qualitas Group have also been verified by an independent external auditor.

Figure 3. Trust Structure



Source: Company Reports, BondAdviser

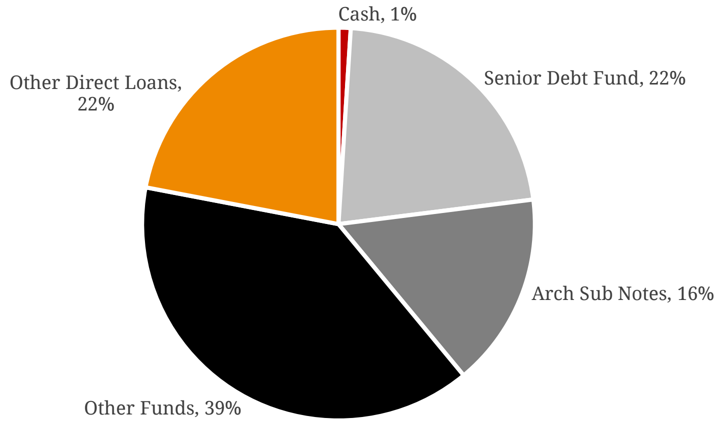
Portfolio Construction & Strategy

The Trust aims to generate a target yield of 8.0% p.a. (net of fees and expenses) by investing in Qualitas' existing and new wholesale funds as well as the Arch Finance Warehouse Trust (AFWT). These investments will be complemented by direct secured real estate loans. This includes the Qualitas Senior Debt Fund (QSDF) and other Qualitas funds to be established from time to time. Key features of the Trust portfolio are noted below:

- Depending on the total capital raised, the Trust will have 12-15 individual positions representing 6-10 direct loan investments via the Sub-Trust. The balance of investments will be through Qualitas wholesale funds and Arch Subordinated Notes.
- The portfolio will be diversified across real estate sectors, investment types and geographies with limited exposure to international assets (New Zealand only, capped at 20% of the Portfolio's NAV) or non-major metropolitan markets.
- Each individual fund exposure is expected to be no greater than 40% of total portfolio NAV.
- On a consolidated basis, the Australian CRE debt market is expected to comprise 80-100% of the portfolio's invested capital (having regard to the cap of 20% in New Zealand).

The QSDF represents Qualitas' core investment fund for the Trust, focusing on first-lien loan mortgage loans across a diverse range of industries. The QSDF, currently in ramp-up, comprises circa 15 investments across the Australian property market, concentrated in Victoria, New South Wales and Queensland. The QSDF was established in September 2017 and is primarily focused on commercial investment and constructions loans, with strong performance (8.36% p.a. (annualised) since inception).

Figure 4. Indicative Portfolio Allocation



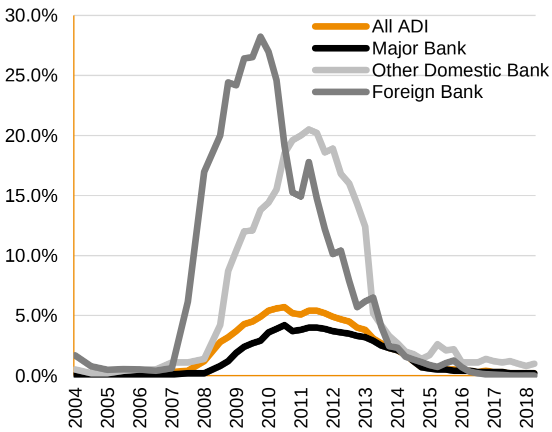
Source: BondAdviser, Qualitas

On this basis and given the indicative weightings, we believe the underlying funds should comfortably meet the Trust target yield of 8.00% p.a. (net of fees and expenses) after the initial portfolio ramp-up period. Given the nature of principal and interest loan repayments, the Manager should be able to achieve this target (after initial portfolio ramp-up) barring the rare event of a significant, correlated default in the CRE debt market. However, as noted elsewhere in our report, we believe that sound risk management, portfolio monitoring and early remedial action by Qualitas leads to low incidence of defaults and in the very rare instances (one to our knowledge) where they do happen, very high recovery rates have been achieved (no losses incurred to date with capital and interest being fully-recovered).

Risk/Return Analysis

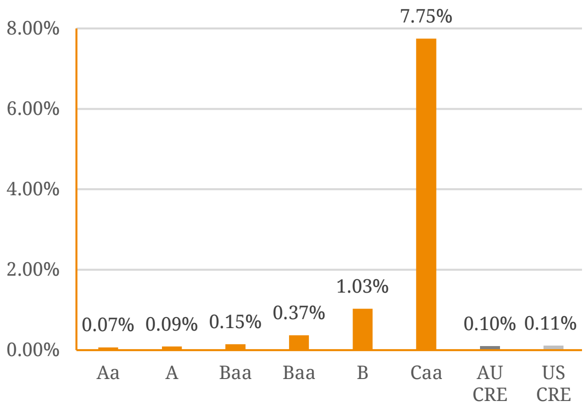
As with most asset classes, real estate is cyclical and will prosper in periods of economic expansion whilst declining in subsequent downturns. Consequently, property values fluctuate through this cycle which will likely impact owners' equity, but depending on underlying leverage of loaned assets, debt can be left unaffected. Undoubtedly, default probabilities increase as economic conditions deteriorate but given the significant equity buffers commonly in place on secured debt (~30%), the recovery rate for secured debt investors ordinarily is close to 100%.

Figure 5. Australian CRE Debt Impairment Ratio by Lender Type



Source: BondAdviser, Company Reports

Figure 6. Loss Rates Across Credit Risk Spectrum (2006-2014)



Source: BondAdviser, Moody's, Credit Suisse, ACLI, Balmain Capital

Given loans are generally held to maturity by the lender, they are not typically marked-to-market for profit purposes as would otherwise occur with traded fixed income instruments. For this reason, credit migration risk (i.e. deterioration in the credit quality of an asset) will typically not impact loan profitability in the absence of an actual default. While loan margins are usually fixed, and the lender may not be adequately compensated for increases in credit risk, this is typically mitigated by the margin being linked to credit quality by way of public credit rating, financial covenants and other structural features. However, for the specialised CRE debt market, credit ratings are often unavailable for individual loan assets and this issue is compounded by a lack of publicly-available data relating to the sector.

As a result, the primary downside risk to a CRE loan or debt portfolio is the risk of default (i.e. non-payment of interest and/or principle at maturity). Although counterparty and sector default risk can be diluted across a portfolio of many assets, systemic risk (market risk) is constant. Mitigation will depend on the effectiveness of origination processes and individual loan structures (i.e. covenant package, tenor, seniority) to ensure recovery rates remain high in the event of default, and this is especially pertinent in the potentially volatile CRE operating environment. Unsurprisingly, there is a strong positive relationship between credit quality, term and the probability of default. For this reason, portfolio performance is closely monitored by lenders to gauge any early signs of financial distress.

There is a lack of publicly-available data to deduce empirical recovery rates for Australian CRE loans but given the domestic legal framework (significant lender protection), historical loss rates of the major banks and zero-capital loss track record of Qualitas, it is reasonable to assume Australian CRE loan recovery to be 90% or above%. As noted, the Australian CRE debt market is relatively underdeveloped (see Industry Background) and this makes finding comparable time series data a difficult task.

Quantitative Analysis

The limited publicly-available data and inherent opacity of CRE private lending makes quantitative analysis of expected credit loss inherently more challenging than for other more developed asset classes. Whilst this is a positive for mitigating credit loss due to the specialised skillset of the Qualitas Investment Team, the difficulty in applying traditional quantitative credit loss models is made more difficult by the bespoke nature of these investments. Whilst imperfect, the analysis presented in this section does provide an indication of the fundamentals underpinning the Trust portfolio in a variety of scenarios.
We are aware of the many deficiencies of our approach, not least that:

- CRE lending is not the same as, and has different default paths and outcomes to large corporates
- There is no incorporation of (high) income in our modelling which would offset a large part, if not all credit losses forecast in most of our simulations.
- We take no account of remedial actions undertaken by the Qualitas Group, which are a large factor in why it has achieved such high returns to date.
- The Arch Subordinated Notes consist of ~180 individual assets across 4 different note structures and the material allocation in the portfolio may result in expected credit losses being overstated in the above analysis. Given the level of diversification and securitisation within the Arch Subordinated Notes, we believe this negates any potential correlated defaults and this has therefore not been reflected in the above.

Whilst external credit ratings are not available for the individual assets invested in by Qualitas, we are able to assign a proxy rating based on rating agency Moody's guidance for commercial mortgage backed security (CMBS) loan-to-value (LTV) ratios outlined in table 1 below. From here, this allows an imperfect rating allocation to each asset based on conventional expected recovery rates for senior bank loans (80.50%) and mezzanine bank loans (45.28%). Based on indicative portfolio allocations of ~66% to senior debt and 25-30% to second-lien loans, we are able to create an approximate expected loss and conduct sensitivity analysis based on varying allocations to each ratings bracket within the Trust portfolio.

Table 1. Moody's Target LTV Ratios by Rating

Moody's Rating	Target LTV
Aaa	45%
Aa2	53%
A2	61%
Baa2	69%
Baa3	72%

Source: BondAdviser, Moody's Approach to Rating European CMBS (2002)

By applying the Moody's ratings to our model, we obtain probability of default (PD) and loss given default (LGD) values which provide an estimate of expected loss for the portfolio in the event of default. Whilst this may not mirror the actual ratings transitions and defaults of the underlying portfolio assets, it provides a measure of risk by conventional means which translates the idiosyncrasies of CRE debt into more traditional credit risk metrics.

It is important to acknowledge the probability of migration is generally lower than the probability of a company's credit rating remaining unchanged. However, the probability of adverse credit migration outweighs positive credit migration (negatively skewed) and this imbalance increases for lower quality credits. This is supported by historical data compiled by Standard & Poor's (table 2).

Table 2. S&P Global Corporate Average 1-Year Credit Transition Rates & Moody's Average Recovery Rates[1]

Current Rating	1-Yr Forward Transition								Instrument	Recovery Rate
	AAA	AA	A	BBB	BB	B	CCC	Default		
AAA	89.82%	9.42%	0.55%	0.05%	0.08%	0.03%	0.05%	0.00%	Bank Loan (Senior)	81%
AA	0.53%	90.54%	8.24%	0.52%	0.05%	0.07%	0.02%	0.02%	Bank Loan (Mezz)	45%
A	0.03%	1.80%	92.18%	5.47%	0.31%	0.13%	0.02%	0.06%	Senior Secured Bonds	62%
BBB	0.01%	0.12%	4.12%	90.36%	4.46%	0.59%	0.13%	0.20%	Senior Unsecured Bonds	48%
BB	0.01%	0.03%	0.13%	5.41%	85.50%	7.52%	0.64%	0.75%	Senior Subordinated Bonds	29%
B	0.00%	0.02%	0.09%	0.21%	5.76%	84.77%	5.06%	4.09%	Subordinated Bonds	27%
CCC	0.00%	0.00%	0.14%	0.25%	0.70%	15.62%	51.51%	31.78%	Junior Subordinated Bonds	15%

1 - Average transition rates from 1982-2017 & average recovery rates from 1920-2017
Source: BondAdviser, S&P, Moody's

The other component of credit risk is default risk. While loan features may mitigate credit migration from a risk-compensation perspective, adverse credit migration will inevitably increase the probability of default (PD) and an increase in the drawn amount of a loan facility will result in a higher exposure at default. Once the expected recovery rate is factored in to this exposure (due to seniority and / or collateral underlying the loan), an expected loss given default (LGD) of the asset is calculated.

As the Trust will have access to a number of the underlying funds, with varying loan terms and LTV ratios, it is difficult to ascertain a complete picture of the expected credit loss of the Trust. However, by applying the above principles to the proposed underlying Qualitas wholesale funds invested in, we are able to analyse the risk to the Trust in isolation and to estimate expected credit losses. Whilst this provides a methodology by which to assess the Trust risk-return profile, there are significant limitations to the scenario which may skew the analysis to the downside, most notably the omission of income from the model and implicit assumption that assets are held to default, in contrast to Qualitas' active management approach.

We conducted three different Monte Carlo simulations over an assumed portfolio structure as outlined in table 3 below. Two of the three scenarios we ran using this portfolio structure vary the credit rating of senior debt investments between BBB and BB (Scenarios 1 and 2) for transition and default probability determination and uses historical Moody's recovery rates. The third scenario varies the recovery rate from Moody's historical levels to a standard 90.0% (Scenario 3) and retains the BBB rating for senior debt. We feel the 90.0% recovery rate is better correlated to Qualitas' experienced loss history of 0.0% but does allow for some actual credit losses to impact the portfolio for analysis purposes.

Table 3. Qualitative Analysis Parameters

Investment	Number of Simulated Assets	Portfolio Exposure (%)	Assumed Rating Equivalent [1, 2]	Recovery Rate [3] (%)
Qualitas Senior Debt Fund	11	18.3	BBB / BB	80.5 / 90.0
Other Senior Debt Exposures	22	31.7	BBB / BB	80.5 / 90.0
Arch Subordinated Notes*	20	15.0	B	45.3 / 90.0
Senior Direct Loans	9	20.0	BBB / BB	80.5 / 90.0
Other Mezzanine Fund Exposures	6	10.0	B	45.3 / 90.0
Mezzanine Direct Loans	3	5.0	B	45.3 / 90.0
Cash	n/a	0.0	n/a	n/a

1 - Scenario 1 uses a BBB rating for senior debt for transition probability purposes and standard recovery rates (left hand side of column)
2 - Scenario 2 uses a BB rating for senior debt for transition probability purposes and standard recovery rates (left hand side of column)
3 - Scenario 3 uses a 90.0% recovery rate for all defaults and Scenario 1 credit ratings for transition

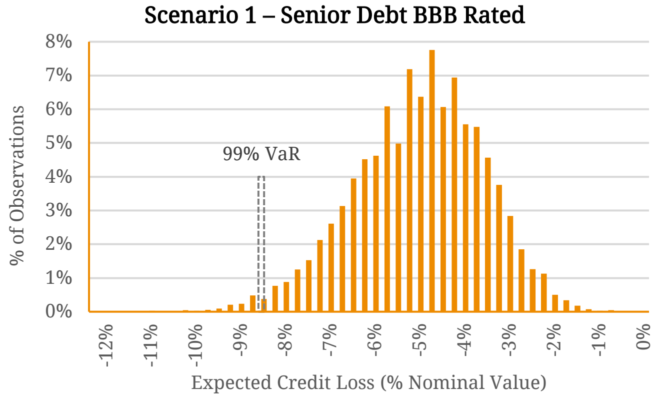
As the results overleaf demonstrate, the Trust is exposed to credit losses caused by individual loans or debts defaulting with a recovery of less than 100%.

In particular, and as a direct result of how we have conducted our analysis, the Arch Subordinated Notes present the most acute risk factor for expected credit loss. The Arch Subordinated Notes holding within the Trust will consist of ~180 individual loans across 4 different note structures and provides significant diversification across the holding within the Trust. However, as they are subordinated note investments and (arguably) the Qualitas Group has less control over them, if they default, recovery is assumed to be low. This is the largest driver of a higher mean expected credit loss in scenarios 1 and 2 (~4-5%) occurring in instances where the subordinated notes default. As shown in table 3 above, our model portfolio includes 20 assets for the Arch Subordinated Notes, however, even with this lower-than-actual number, we see a more normalised (and lower credit loss) distribution in these scenarios even with default.

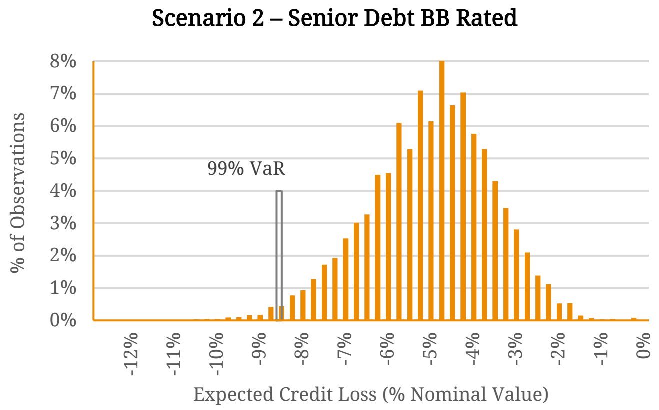
Scenario 3 probably presents a fair 'real-world' forecast of credit losses in a stressed environment for Qualitas over a one-year time horizon because it sets the recovery values at 90%, much closer to the actual 100% achieved by the Group since its inception.

Overall, and given the paucity of publicly-available exposure, default and loss data to test, we feel our approach is a fair one but are wary of a significant, sector-wide downturn which causes large credit losses. Ultimately, the Qualitas Group has a zero-capital loss record since inception, and the strong risk and portfolio management processes in place serve to maximise recovery rates even in times of distress.

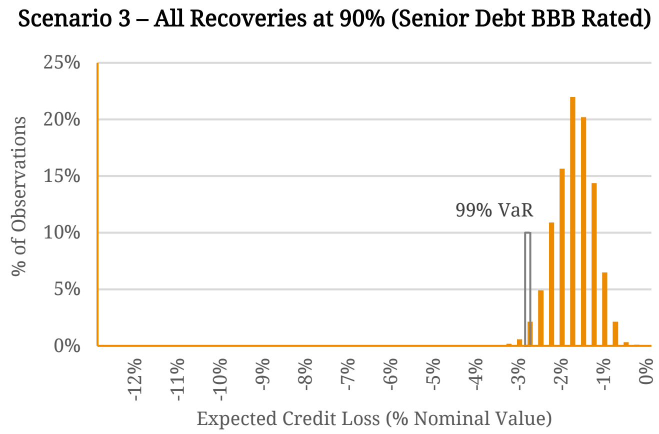
Figure 7. Quantitative Analysis Results



- **Scenario 1** models senior debt exposures with an assumed rating of BBB and mezzanine exposures of B.
- Scenario 1 assumes Moody's recovery rates of ~81% for senior debt and ~45% for mezzanine debt
- For the majority of Monte Carlo simulations, the portfolio is not materially impacted by credit losses with a mean loss of ~5% and standard deviation of ~1.50%.



- **Scenario 2** varies Scenario 1 by *lowering* the rating of senior debt to BB (from BBB).
- As well as increasing the likelihood of adverse credit rating transitions within the one-year horizon, this change also (at a minimum) more than triples the chance of a default in our modelling.
- As can be seen though, this has very minimal effects on the portfolio overall, reinforcing the point that Loss Given Default (LGD) really drives outcomes.

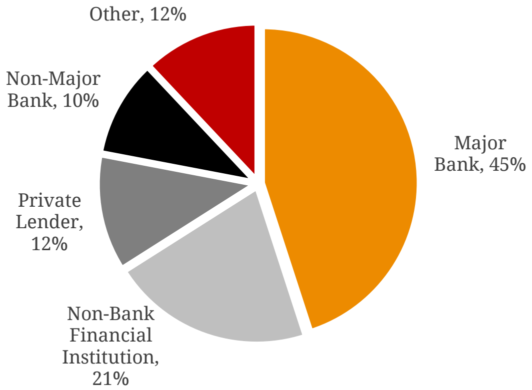


- **Scenario 3** attempts to reflect Qualitas' real-world experiences of zero-loss defaults.
- To model this, whilst still attempting to generate *some* credit losses, we set the recovery values of *all* exposures to 90%.
- This has the most noticeable effect of significantly lowering losses.
- We feel that Scenario 3 is most reflective of Trust exposures with any credit losses (if actually incurred) more than offset by income generated by the portfolio (> 8% p.a. net of fees).

Appendix 1: Industry Background – Commercial Real Estate Lending

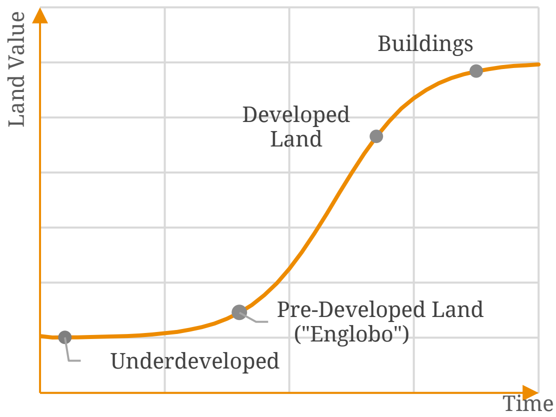
Commercial real estate (CRE) lending is a specialised, yet major component of the middle-market corporate loan universe where lenders participate in the finance and/or development of new or established assets across real estate sectors including office, industrial, retail or residential developments. The ~A$270 billion sector has traditionally been dominated by the major Australian banks, however recent headwinds and a tightening credit environment have seen banks withdraw funding in CRE debt and create an estimated $30 billion funding gap. This has allowed non-bank financiers such as Qualitas to provide senior or mezzanine debt funding across the entire spectrum of the CRE market, fulfilling the needs of borrowers to continue growth in the sector who cannot gain additional financing from the banks. Whilst the Australian CRE debt market remains underdeveloped relative to peers in the US and Europe, these more mature markets provide insights into the likely future evolution of Australian CRE.

Figure 8. Real Estate Debt Lending by Lender Type



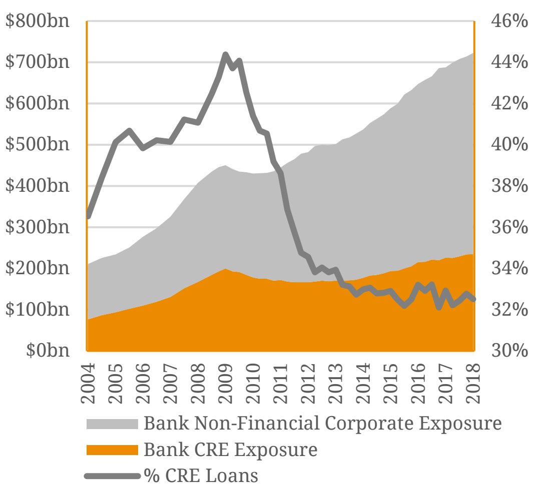
Source: BondAdviser, Stamford Capital

Figure 9. CRE Development Stages



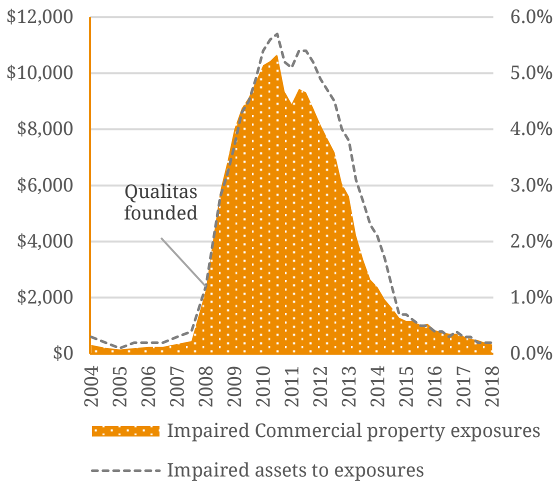
Source: BondAdviser

Figure 10. Australian Banking System CRE Exposure



Source: BondAdviser, APRA

Figure 11. Bank Non-Performing Loans



Source: BondAdviser, APRA

Borrowers in the CRE debt market can source funds for their developments generally from either debt or equity. Within CRE credit, loans provided are typically first-lien or second-lien depending on access to financing, funding requirements and idiosyncratic risk characteristics of the project.

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 largely structured as secured arrangements, CRE loans almost always rank ahead of other investors in the capital structure. These loans are utilised for projects throughout the CRE life cycles, from land loans through to investment loans, and provide the flexibility necessary for project development and delivery.

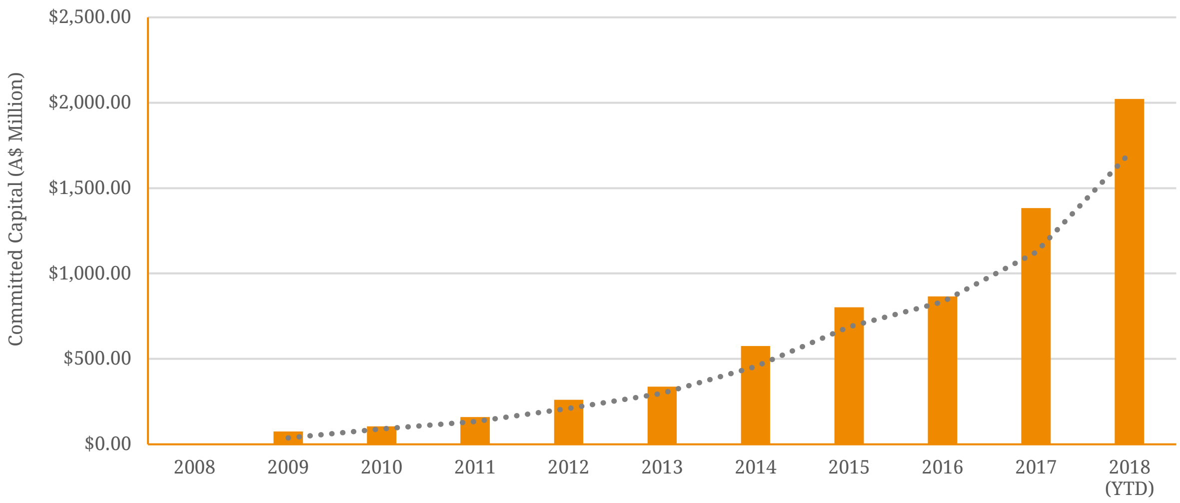
Appendix 2: About Qualitas Group

The Qualitas Group (Qualitas) is a real estate investment management firm founded in 2008. Qualitas has invested in or financed assets valued over ~A$7 billion since inception, allocating over A$1.5 billion of capital in equity and debt deals within the sector. The Group offers alternative financing across the entire spectrum of commercial real estate (CRE) including land loans, construction loans and investment loans in both Australia and New Zealand.

The Qualitas Investment Team boasts a wealth of experience which has seen the Group record an internal rate of return (IRR) on firmwide assets in excess of 20% and record zero capital losses since inception. Success in the highly-specialised CRE debt market is a function of strong origination and loan structuring experience within the various teams, with the investment teams ably supported by strong risk management and governance mechanisms in place.

With over 70 employees working across the Group, and 20 within the Investment Team, Qualitas continues to grow its reputation and size despite signs of headwinds in the Australian property market. However, with the major banks withdrawing from the sector in face of heightened Royal Commission scrutiny and tighter lending standards, there exists an estimated A$30 billion funding gap within the ~A$270 billion CRE debt market. Qualitas remains well placed to fill this void and continue to provide mezzanine and debt funding in major metropolitan areas across Australia and New Zealand.

Figure 12. Qualitas Group Committed Capital Growth since Inception



Source: Company Reports

Senior Executives

Andrew Schwartz, Group Managing Director – Andrew is the Group Managing Director and a co-founder of the Qualitas Group. Andrew has over 32 years' experience in financial services with an extensive track record across real estate investment. He is responsible for overseeing the Qualitas Group's activities, setting the strategic direction of the business, transaction origination as well as building and enhancing relationships with the firm's clients and investors. Andrew has previously held senior roles within a number of global organisations specifically focused on real estate and corporate finance.

Gerd Mayer, Chief Risk Officer – Gerd joined the Qualitas Group in 2010 as Chief Risk Officer and is responsible for the management of the firm's financial and compliance risks. Gerd is responsible for the management of the firm's investment transaction financial and compliance risks. Gerd's experience spans over 30 years in banking, specialising in credit risk management, project financing, structured lending and financial advisory roles. Prior to joining the Qualitas Group, Gerd held senior risk and credit positions at large financial institutions and investment banks.

Kathleen Yeung, CFO & Head of Strategy - Kathleen joined the Qualitas Group in 2014 and is responsible for corporate strategy, finance and operations, including investment operations. Kathleen has over 18 years' experience in financial services spanning debt and equity advisory for major infrastructure projects as well as the development and financing of renewable energy and power generation assets for both listed and unlisted funds. Prior to joining the Qualitas Group, Kathleen has held roles, both locally and internationally, with major financial institutions and global advisory firms.

Tim Johansen, Managing Director (Real Estate Finance) – Tim joined the Qualitas Group in 2012 where he established the firm's presence in Sydney and is responsible for the firm's real estate finance activities. Tim has extensive experience across real estate financing markets over 30 years including senior debt, mezzanine debt, equity co-investments and financing advice. Prior to joining the Qualitas Group, Tim was the Head of Structured Real Estate Finance at an international investment bank and also worked for some of Australia's largest lenders.

Yossi Kraemer, Head of Institutional Capital & Portfolio Management – Yossi joined the Qualitas Group in 2012 and is responsible for the institutional capital relationships, general investor relations strategy and portfolio management across the firm. Yossi has over 20 years' experience in global real estate finance, capital markets, real estate structured products and capital raising. Prior to joining the Qualitas Team, Yossi held roles in London at an international investment bank and a British banking and insurance company.

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- **Sell** - Over the next 12 months, the analyst expects the security to underperform the current yield due to credit spread widening or adverse movements in the underlying yield curve.
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