

Why now is a good time to invest in commercial real estate

1. Commercial Real Estate Industry Overview

The Trust participates in this market with an Investment Strategy to invest in a portfolio of investments that provides Unitholders with direct and indirect exposure to predominantly Australian secured real estate loans. The Trust may also invest in New Zealand secured real estate loans from time to time subject to a 20% cap¹.

1.1 The Commercial Real Estate Finance Market

Commercial real estate finance relates to the provision of loans to commercial borrowers, for the development, investment, acquisition or improvement of real estate². This type of finance also includes the refinancing of existing debts owed against commercial real estate, as well as the refinancing of debt which is secured against existing real estate but is for another business purpose.

The main real estate sectors in which commercial borrowers seek financing are residential (namely multiple dwellings), office, retail, industrial, hotels and other specialised real estate assets.

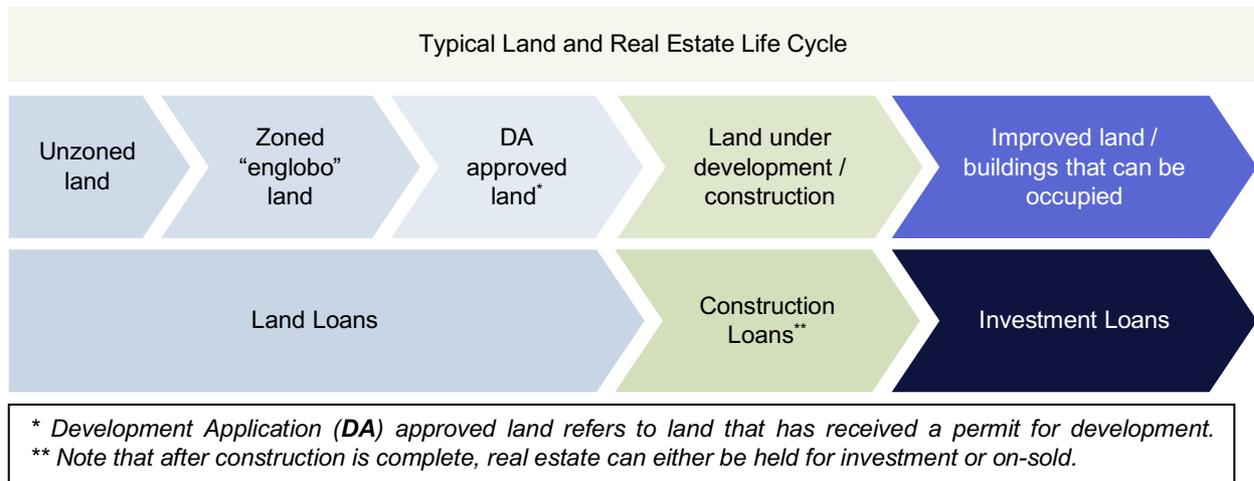
Typical secured real estate loans across the commercial real estate finance market include:

- **Land Loans:** secured against vacant land with the potential for development. This includes land (i.e. undeveloped land that is capable of subdivision into smaller lots), land that has not been approved for development and land that has been approved for development.
- **Construction Loans:** provided to fund development and construction costs of real estate development projects. They are secured against land with the potential for development, or real estate assets that are soon to be or are under construction. Construction loans also include financing for land subdivision projects. Construction loans are typically progressively drawn down over time to finance the project to completion.
- **Investment Loans:** secured against real estate assets that are income generating or have the potential to generate income on a going-concern basis.
- **Other Loans:** secured against real estate and/or land for which the purpose does not fit within the above categories. This could include owner occupier loans, short term loans (i.e. bridging loans), pre-development early works loans and working capital loans.

The following diagram illustrates when the different types of loans are required across the real estate life cycle:

¹ It is expected that the Manager will primarily focus on the Auckland market as this is the largest real estate market in New Zealand and accounts for the majority of secured real estate loan opportunities in New Zealand.

² Quarterly Authorised Deposit-taking Institution Property Exposures, APRA, March 2018 (issued on 21 June 2018).



1.2 Participants in the Commercial Real Estate Finance Market

Borrowers in the Australian commercial real estate finance market are typically third-party corporate entities or individuals, with an equity or economic interest in real estate domiciled in Australia that can be provided as security (via a real property mortgage) in favour of the lender as mortgagee.

Finance in the commercial real estate market is provided by:

1. Authorised Deposit-Taking Institutions (**ADIs**), including banks, credit unions and building societies;
2. Financial Institutions that are not ADIs (e.g. foreign banks that do not take deposits in Australia);
3. Private and public debt capital markets; and
4. Non-ADI lenders, including companies such as the Qualitas Group and other private specialist lenders, superannuation funds and international funds.

A key difference between ADIs and non-ADI lenders is that ADIs accept and make loans with deposits from the general public. Accordingly, this attracts a level of regulatory oversight by Australian Prudential Regulation Authority (**APRA**) in Australia. By contrast, non-ADI lenders privately raise funds that they can provide to borrowers under their own lending criteria, and this is currently largely unregulated by APRA. For example, non-ADI lenders, whilst maintaining discipline, are reported to accept lower levels of pre-sales and allow greater leverage. In recognition of these risks, investors typically demand higher premiums³. Furthermore, loans secured by second ranking mortgages (i.e. mezzanine loans as discussed in Section 3.3) are typically only provided by non-ADI lenders⁴.

1.3 Trends in Commercial Real Estate Finance

As of March 2018, the total size of Australian ADIs' exposure to total (secured and unsecured) commercial real estate finance is estimated to be \$273.6 billion⁵. Following the Global Financial

³ <https://www.rba.gov.au/publications/fsr/2018/apr/pdf/03-australian-financial-system.pdf>

⁴ Reserve Bank of Australia, Financial Stability Review – April 2018, 3. The Australian Financial System, <http://www.rba.gov.au/publications/fsr/2018/apr/australian-financial-system.html>

⁵ Australian Prudential Regulation Authority, Quarterly ADI Property Exposures Statistics, 21 June 2018

Crisis (**GFC**), ADIs and their subsidiaries have continued to carry the bulk of domestic debt provision in Australia's financial system, with an estimated market share of 94%⁶.

Recent regulatory changes and elevated levels of commercial real estate finance have altered the nature of this category of debt in Australia, forcing ADIs to reassess their exposures to the real estate market. For example, ADIs tightened finance for residential developers over the course of 2016 with measures such as stricter pre-sales requirements, lower maximum loan to value ratios and stricter geographic concentration limits⁷. As ADIs move towards these increasingly selective and conservative credit terms, more flexible forms of finance from alternative lenders are being provided to fill the gap.

It is estimated that non-ADI lenders in Australia account for approximately 6.0%⁸ of total financial system assets, which is below the 40.0%⁹ to 50.0%¹⁰ share held by their counterparts in Europe and the United States respectively. The United States Federal Reserve's guidance to reduce banks' leveraged lending to businesses in 2016 saw the non-ADI sector increase their market share¹¹. Similarly, in the Netherlands in 2017, stricter capital requirements for banks have contributed to a significant rise over the past six years in the share of outstanding mortgage credit originated by pension funds and insurers¹². This international experience is informative given APRA's recent tightening of constraints on ADIs' real estate lending.

The trend of ADIs retreating in Australia has already been observed. For example, senior construction financing has reduced significantly compared to five years ago. This has created an opportunity for non-ADI lenders to capture the market share that was previously held by the major ADIs, generally at a higher price¹³.

Given that the majority of New Zealand banks are owned by the Australian banks, New Zealand banks are experiencing the flow-through impact of increasing regulatory control on their Australian owners. Accordingly, real estate developers and investors in the New Zealand market are experiencing similar capital constraints to those in Australia. This is further exacerbated by a lack of well-funded capital providers in New Zealand's alternative finance market.

The Qualitas Group believes that:

- the demand among borrowers for alternative real estate capital sources is growing; and
- as a result, high-quality investment opportunities will be accessible to experienced lenders with strong relationships and sound governance practices.

1.4 Commercial Real Estate Finance Capital Structure

The capital structure of any asset refers to a systematic approach to financing the asset. For any asset, including real estate, this will typically comprise both debt and equity.

⁶ Reserve Bank of Australia, Financial Stability Review, The Australian Financial System, April 2018

⁷ Reserve Bank of Australia, Financial Stability Review – April 2017, 2. Household and Business Finances, <https://www.rba.gov.au/publications/fsr/2017/apr/household-business-finances.html>

⁸ Reserve Bank of Australia, Financial Stability Review – April 2018, 3. The Australian Financial System, <http://www.rba.gov.au/publications/fsr/2018/apr/australian-financial-system.html>

⁹ http://www.esrb.europa.eu/pub/pdf/reports/20170529_shadow_banking_report.en.pdf

¹⁰ <http://www.fsb.org/wp-content/uploads/P050318-1.pdf>

¹¹ Kim S, M Plosser and J Santos (2016), 'Did the Supervisory Guidance on Leveraged Lending Work?', Liberty Street Economics site, 16 May. Available at <http://libertystreeteconomics.newyorkfed.org/2016/05/did-the-supervisory-guidance-on-leveraged-lending-work.html>.

¹² http://www.esrb.europa.eu/pub/pdf/reports/20170529_shadow_banking_report.en.pdf

¹³ Reserve Bank of Australia, Financial Stability Review – April 2017, 2. Household and Business Finances, <https://www.rba.gov.au/publications/fsr/2017/apr/household-business-finances.html>

The debt component is a fixed amount and is often provided by external parties as a secured real estate loan. The debt component is normally secured by either a first ranking (i.e. senior loan) or second ranking (i.e. mezzanine loan) mortgage. The ranking represents the lender’s priority position for repayment of a loan. Senior lenders have the right to be repaid first, ahead of mezzanine lenders. The equity component includes not only the contribution by the borrower but also any assumed profit component that the owner of the property is anticipating upon sale or development of the real estate asset.

Loans, which can provide stable and regular income to the lender in the form of interest payments, have lower risk of capital losses than other asset classes, such as equities. Typically, debt holders have a preferential treatment over equity holders for income distributions and return of capital in an event of default. Secured loans are generally considered of lower risk than equity investments and tend to provide a less volatile return. The figure below illustrates the position of typical loans on a relative risk basis.

		Typical Qualitas Protections	Loan to Value Ratio (LVR) Covenants
Level of Protection	Limited security structure		
	Ordinary Equity	<ul style="list-style-type: none"> • Full project and counterparty due diligence 	N/A
	Preferred Equity	<ul style="list-style-type: none"> • Full project and counterparty due diligence • Preferred return before ordinary / common equity 	N/A
	✓ Mezzanine Debt	<ul style="list-style-type: none"> • Full project and counterparty due diligence • Same protections as Senior Debt but ranks second ¹ 	Typical LVR: 65 – 75%
Strong security structure	✓ Senior Debt	<ul style="list-style-type: none"> • Full project and counterparty due diligence • Contracted cash flows • First ranking security over property • Bank guarantees • Personal guarantees • Asset pre-sales 	Typical LVR: 50 – 65%

¹ Qualitas does not invest in senior and mezzanine debt for the same transaction

✓ = included in QREIF portfolio

1.5 Typical Secured Real Estate Loan Pricing

Commercial real estate finance provided by ADIs is set at a margin above a published benchmark interest rate. The most common referenced interest rates are the short-term bank bill rate and the 90-day Bank Bill Swap (**BBSW or BBSY**) rate. The margin above these published benchmark interest rates is the compensation required by the lender for default risk, often referred to as the ‘risk premium’. This can vary considerably across loans and depends on the credit worthiness of the borrower, capital market conditions, leverage, mortgage covenants and type of security provided.

Secured real estate loans provided by non-ADI lenders like the Qualitas Group are often priced at a fixed interest rate, however from time to time may also be floating rate (i.e. set at a margin above the BBSW or BBSY) depending on the lender’s return requirements.

In the current market, the Manager believes that borrowers will pay a premium to source capital from

outside of the narrow bank lending parameters¹⁴. This presents an attractive opportunity for non-ADI lenders like the Qualitas Group to provide debt financing that generates strong, risk-adjusted returns from commercial real estate.

1.6 Typical fixed income returns

A yield is the expected income return on an investment. In the case of fixed income, it is usually the interest received from a security expressed as an annual percentage. Commercial real estate finance has high returns relative to cash and term deposits which offer moderate returns. “Other Listed” relates to the average return of two recently ASX-listed fixed income style listed investment trusts¹⁵. Due to their equity-like features, hybrid securities (i.e. bank hybrids) are compensated with a higher return in comparison to pure fixed income investments.

The Trust’s return profile is higher relative to traditional fixed income securities, as shown below¹⁶:



1.7 Market Dynamics of Commercial Real Estate Finance

The Qualitas Group considers Australia’s supportive macro-economic environment and robust real estate fundamentals to be attractive to lenders in this market. Australia remains at the upper end of developed economies for projected economic growth, supported by population growth and low interest rates, demonstrating a suitable environment for the continued demand for commercial real estate

¹⁴ Reserve Bank of Australia, Shadow Bank Lending to the Residential Property Market, September Quarter 2017, <https://www.rba.gov.au/publications/bulletin/2017/sep/pdf/bu-0917-6-shadow-bank-lending-to-the-residential-property-market.pdf>

¹⁵ One of the listed investment trusts provides investors with exposure to the Australian Securitisation market, primarily of Residential Mortgage Backed Securities and the other listed investment trust provides investors with direct exposure to the Australian corporate loan market, specializing in direct lending and private debt market investments.

¹⁶ Source: Bloomberg RBA Cash Rate, Bloomberg Australia Bond 5 Year Yield, Bloomberg S&P Fixed Interest 1-5 Year Index and publicly available sources. All information as of 31 July 2018. All rates quoted are indicative and approximate only.

finance.

The New Zealand economic story is similar to Australia, experiencing stable and consistent economic growth for the last eight years. Behind Australia, New Zealand has experienced one of the highest rates of Gross Domestic Product (**GDP**) growth of the Organisation for Economic Co-operation and Development (**OECD**) countries since the GFC and maintains its status as one of the strongest performing and most stable Western economies¹⁷.

3.7.1 Population Growth

The Australian population continues to grow, with population growth recorded at 1.6% in the year to 31 December 2017¹⁸ and is expected to continue increasing. Based on Government projections, Australia's population is expected to reach at least 38 million by 2050, an increase of circa 13 million people from today's population size, concentrated across Australia's east coast, being in New South Wales, Victoria, Queensland and the Australian Capital Territory¹⁹.

Population growth from both natural increase and net overseas migration provide ongoing demand for housing in Australia, particularly across the east coast, which accounts for approximately 80.0% of the national population growth over the last 10 years²⁰. The demand for other real estate asset classes is also fundamentally based on population growth and typically follows the demand for housing.

In the last two years, New Zealand's population has been boosted by record net migration numbers, attributable to a combination of higher migration inflows and the reversal of the emigration of New Zealanders, creating increased demand for residential dwellings outside of natural population growth.

3.7.2 Interest Rates

Interest rates are a key factor that make Australian real estate attractive to both local and offshore investors. Australia continues to experience a low interest rate environment, leading many investors to move excess funds into investment assets in search for higher returns.

On 2 August 2016, the Board of the Reserve Bank of Australia (**RBA**) reduced the cash rate by 25 basis points to 1.5% per annum, following inflationary pressures being lower than expected²¹. Since then, the Board of the RBA has left the official cash rate unchanged at 1.5% per annum²². At the same time, moderate economic growth has meant that Australian interest rates have been kept stable relative to global counterparts, averaging approximately 3.1% per annum²³ since the beginning of 2008 (compared with a pre-2008 decade average of approximately 5.5% per annum)²⁴.

Similarly, the official cash rate in New Zealand is 1.75% per annum²⁵. This low interest rate environment combined with the strong currency has supported capital flows into the Australian and New Zealand markets.

¹⁷ <https://www.oecd.org/eco/surveys/New%20Zealand-2017-OECD-economic%20survey-overview.pdf>

¹⁸ Australian Bureau of Statistics, 3101.0 Australian Demographic Statistics December 2017, 21 June 2018.

¹⁹ Australian Bureau of Statistics, 3101.0 Australian Demographic Statistics December 2017, 21 June 2018.

²⁰ Australian Bureau of Statistics, 3218.0 Regional Population Growth, Australia, 2016, July 2017.

²¹ Reserve Bank of Australia, Board Meeting Minutes, 6 August 2016.

²² Reserve Bank of Australia, Board Meeting Minutes, 3 July 2018.

²³ Reserve Bank of Australia, <https://www.rba.gov.au/statistics/cash-rate/>

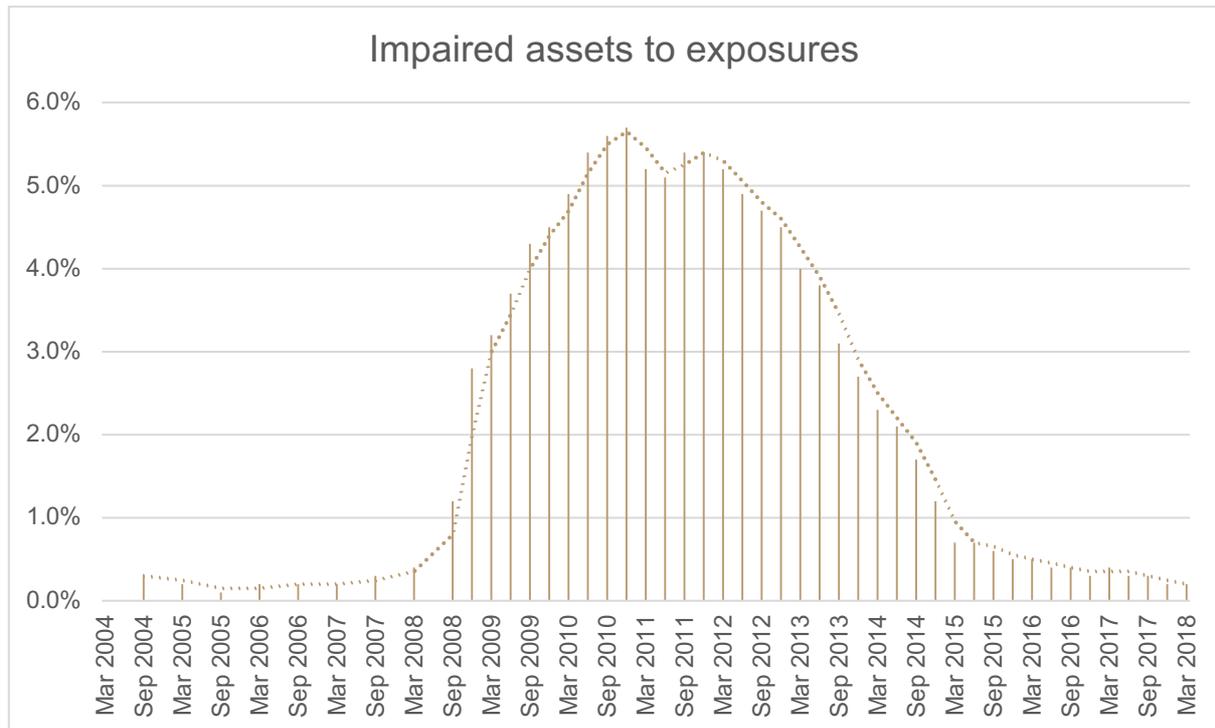
²⁴ Reserve Bank of Australia, <https://www.rba.gov.au/statistics/cash-rate/>

²⁵ Reserve Bank of New Zealand, <https://www.rbnz.govt.nz/monetary-policy/official-cash-rate-decisions>

1.8 Impairment in Australia's Commercial Real Estate Market

The Australian commercial first mortgage lending market has historically sustained low impairment rates and losses, including during the GFC. For the major Australian ADIs, commercial real estate impairments as a percentage of overall commercial real estate exposures peaked at 4.2% during the GFC and have remained at less than 0.5% for the two years ended 31 March 2018²⁶. The impairment rate on the major Australian ADIs' commercial real estate loans has also declined in recent years and is now close to pre-GFC lows.

The chart below illustrates the steady incline in impairment rates in the commercial real estate industry immediately after the GFC as well as the decline to 0.2% of total commercial real estate exposures, across both secured and unsecured real estate lending in March 2018²⁷. Due to its stability and resilience, the Qualitas Group believes that the commercial real estate finance market is an attractive investment class.



Source: APRA Quarterly ADI Property Exposure March 2018.

This trend has also been witnessed in the New Zealand market where New Zealand banks' lending to the real estate development sector has declined slightly since the beginning of 2018²⁸. Non-performing loans (NPL) in New Zealand's banking system continue to remain low, aided by favourable conditions in the New Zealand economy. NPL ratios for the commercial real estate sector declined from 0.9% in December 2016 to 0.8% in September 2017²⁹.

²⁶ APRA, Quarterly ADI Property Exposures March 2018, 21 June 2018.

²⁷ APRA, Quarterly ADI Property Exposures March 2018, 21 June 2018.

²⁸ RBNZ, Financial Stability Report May 2018, 24 May 2018.

²⁹ RBNZ, Financial Stability Report May 2018, 24 May 2018.