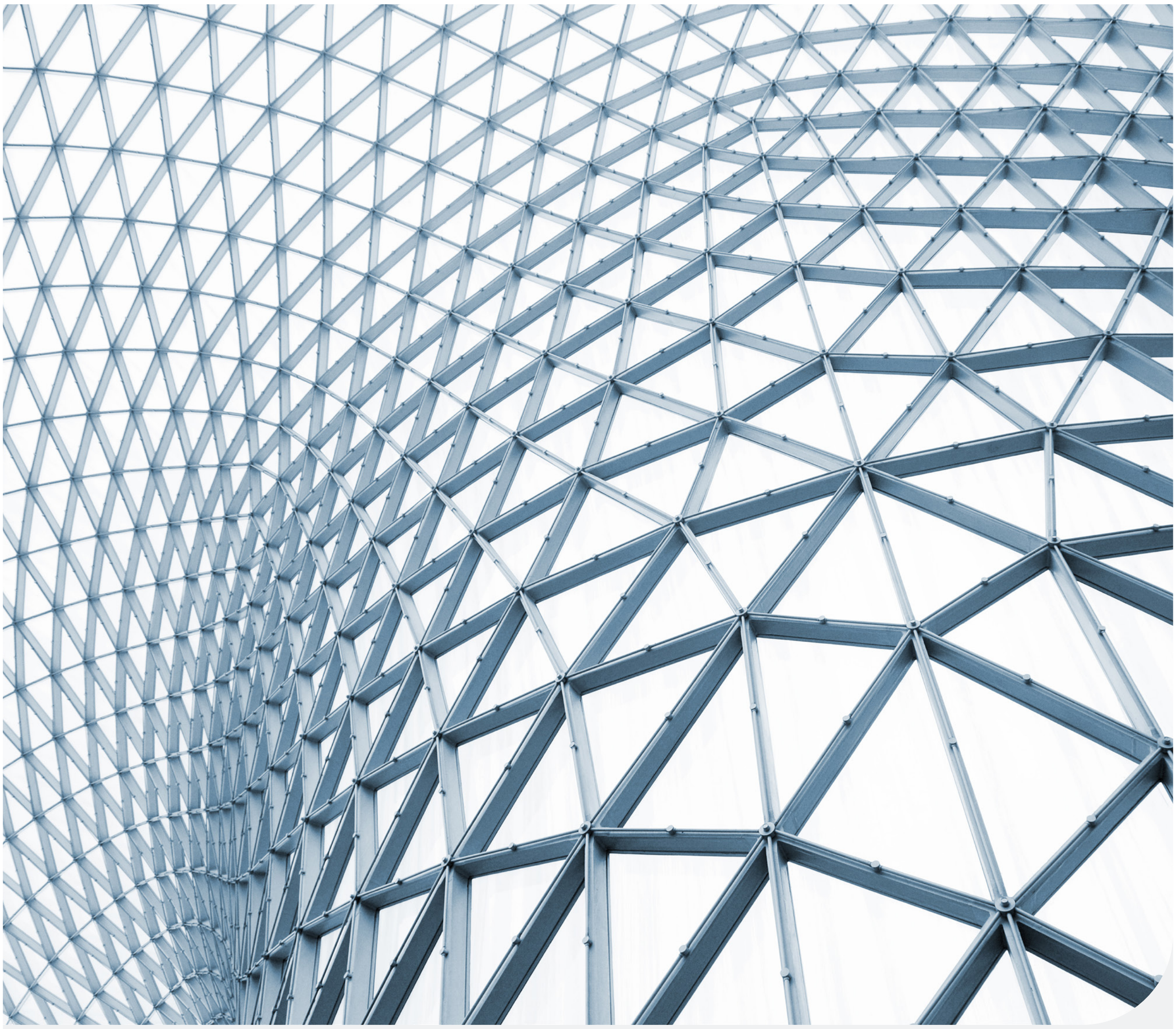

# A FRESH TAKE ON AUSTRALIAN COMMERCIAL REAL ESTATE DEBT

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## EXECUTIVE SUMMARY

Market dislocations create opportunities. In the Australian Commercial Real Estate (CRE) debt market, GFC-induced dislocation has resulted in significantly higher than average returns for substantially lower than average risk.

Globally, commercial real estate finance has become harder for borrowers to obtain and the number of active lenders has fallen dramatically. In Australia, there were more than 150 lenders pre-GFC; today this number is down to around 40. Those remaining have been able to improve risk-reward trade-offs through lower Loan to Value Ratios (LVR), improved debt service requirements (DSCR) and stronger loan covenant conditions. At the same time, loan margins on offer are two-to-three times higher than long-term averages.

Yet there is minimal institutional investment in Australian CRE Debt. One reason for this has been the lack of quality data on performance relative to other floating-rate investments. This paper contains the first such analysis, based on CRE debt data compiled by Australia's largest independent servicer of commercial loan receivables[1].

Based on that data, we provide a framework for assessing the relative risk and return of a portfolio of mid-cap Australian CRE loans[2]. We compare yields, margins, volatility, correlations and levels of default and recovery of CRE debt to other floating-rate investments including global investment grade corporate debt and leveraged loans.

The key findings are that Australian CRE Debt offers:

- **High returns relative to other floating-rate investments** – current Australian CRE Debt margins provide a substantial premium over corporate bonds of similar risk notwithstanding the illiquidity of CRE debt. The margins (or spreads)[3] between CRE debt and more risky assets like leveraged loans have narrowed to their lowest level in over six years.
- **Low volatility** – Australian CRE Debt margins have been less volatile than all but the highest rated tiers of global corporate debt.
- **Low levels of default** – Australian CRE Debt default rates are lower than all but the highest rated tiers of global corporate debt.
- **Low levels of loss given default** – Australian CRE Debt recovery rates are significantly better than recovery rates for most categories of global corporate debt[4].
- **Low correlations** – Australian CRE Debt has low correlations with traditional fixed income and other floating-rate investments. It thus lowers the risk of a fixed income portfolio dominated by government and corporate credit.
- **Resilience to margin pressure** – Mid-cap Australian CRE loans in particular, have demonstrated considerable resilience to margin pressure post-GFC.

In our financially repressed world, traditional fixed interest instruments such as investment grade bonds have negative real yields. The damage to real return objectives calls for larger strategic exposures to both liquid and illiquid floating-rate investments. Australian CRE Debt warrants special consideration as a component of this defensive, income-producing segment on the basis that it will:

- **Boost income …** through yield that is competitive with or greater than many other floating-rate investments.
- **Reduce portfolio risk …** through a combination of near-zero duration (due to the regular re-set of interest rates on CRE loans), low default rates, high recovery rates and low correlations with other portfolio investments.
- **Continue delivering …** due to market dynamics, in particular low competition and new prudential requirements such as BASEL II and III.

CRE debt is often dismissed by even astute institutional investors, sometimes due to a lack of data. Based on new data this paper demonstrates that CRE debt has an enduring role to play in institutional portfolios and currently offers compelling risk/return dynamics when compared to more liquid floating-rate investments. A well-structured mid-market CRE loan portfolio will have a better risk-adjusted return than many floating-rate alternatives.

Australian CRE Debt should appeal to all superannuation funds but especially to those with members near and post retirement who have strong appetites for income-producing assets. There is strong precedent for this in offshore markets where investors such as US pension funds and life insurers have been significant and successful investors in CRE debt for decades.

# CONTENTS

## CRE DEBT MARGINS VERSUS OTHER FLOATING-RATE INVESTMENTS

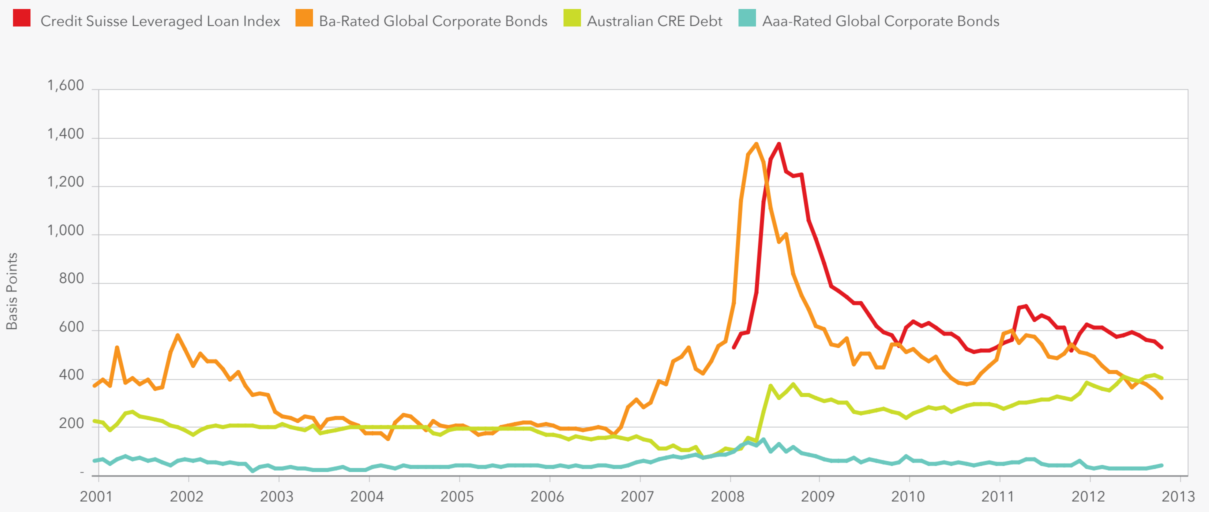
2008 heralded the end of a decade long credit cycle that saw ever-increasing capital become available to borrower markets. These conditions resulted in intense competition, which in turn caused an erosion of loan margins. This led to a deterioration of credit quality through reduced underwriting standards (pricing and loan conditioning) and generally higher leverage. These factors were present in private and public capital markets and in both corporate and CRE debt.

As debt markets corrected in 2008/09, spreads on corporate and CRE debt behaved very differently. Spreads on corporate paper exploded and margins on some non-investment grade bonds (including leveraged loans) breached 13%. Yet within three years, margins returned to levels close to those before the GFC. By comparison, CRE debt margins corrected in 2008 and have since remained at levels 2-3 times higher than pre-GFC margins.

Exhibit 1 shows that margins on Australian CRE Debt currently exceed Moody's Ba-rated debt, the highest rated level of non-investment grade global corporate bonds. CRE debt margins are now also closer to those of leveraged loans than they have been at any time since the onset of the GFC. The difference in margins between Australian CRE Debt and leveraged loans narrowed from a maximum of 10.5% in December 2008 to just 1.3% as of March 2013.

While global Ba-rated corporate bonds and leveraged loans offered extraordinary post-GFC returns, the margins from these securities have largely returned to pre-GFC levels. As a consequence, the opportunity for outsized returns in these sectors has largely disappeared.

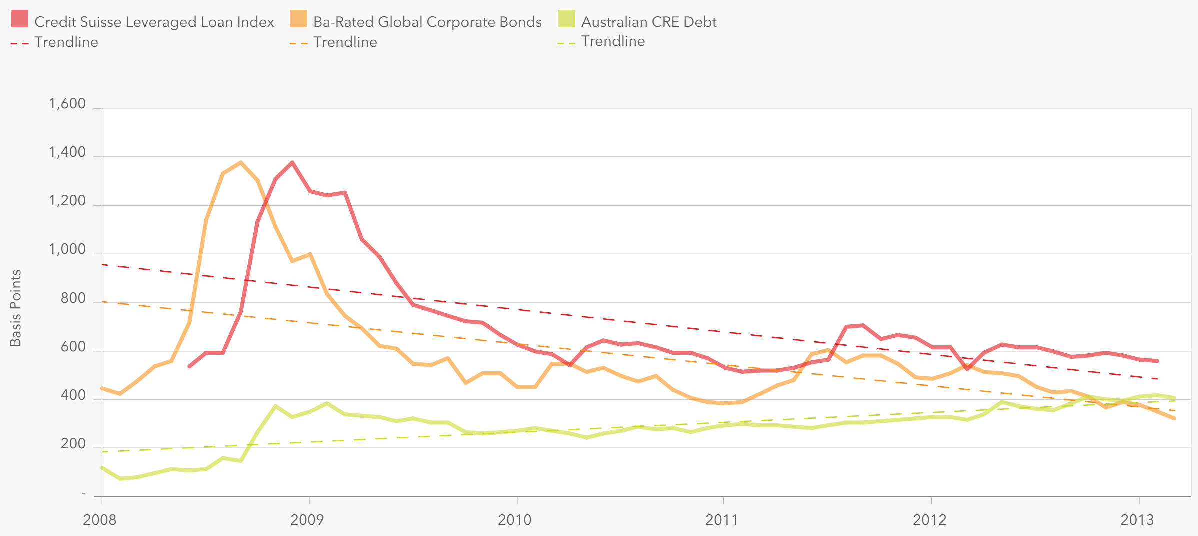
**Exhibit 1: Convergence of CRE Debt and Non-Investment Grade Debt Margins**




Source: Credit Suisse, Moody's, AMAL Asset Management

Exhibit 2 shows the moderately positive (upward) trend in CRE debt margins against the downward trend in margins of leveraged loans and non-investment grade corporate bonds. This reflects changes in the market over the past five years and showcases CRE debt's resistance to margin pressure in this environment. There is little stress on this trend and both market and regulatory conditions suggest it is likely to continue until new and substantial lending balance sheets emerge.

**Exhibit 2: Convergence of CRE Debt, Leveraged Loans, and Corporate Debt Margins (Trends Post-GFC)**




Source: Credit Suisse, Moody's, AMAL Asset Management

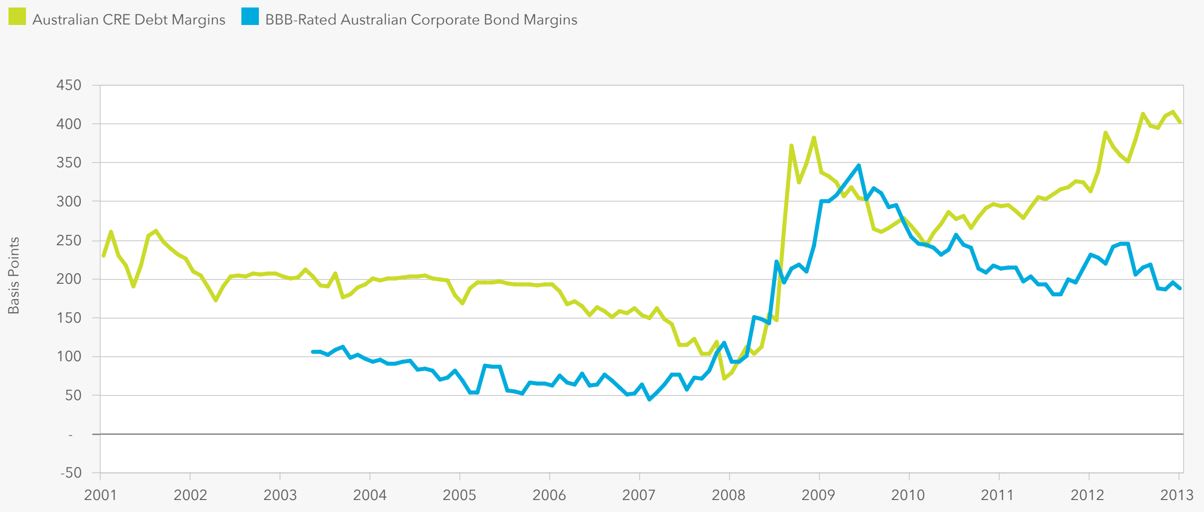
While most other floating-rate strategies have experienced significant institutional and retail fund flows over the last twenty years, the CRE debt sector has seen very little institutional support in Australia. This contrasts with the US CRE Debt market where life companies and pension funds account for over 13% of all US CRE Debt (Appendix).

## A CLOSER LOOK AT THE AUSTRALIAN CRE DEBT MARKET

A similar return pattern exists in the much smaller Australian corporate bond market. Although Australian corporate bond margins were not as volatile as those in offshore markets, yields have fallen towards pre-GFC levels, suggesting that out-sized opportunities available just a few years ago have largely dissipated.

Exhibit 3 shows that yields on Australian CRE Debt have also been consistently higher than those on Australian BBB-rated corporate bonds[5] and confirms that Australian CRE Debt has been much more resilient to spread compression than comparable corporate debt.

**Exhibit 3: Margins: Australian Corporate Bonds vs. CRE Debt**



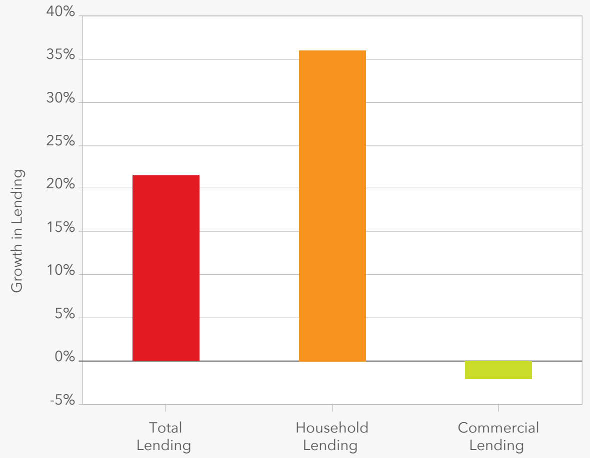

Source: Commonwealth Bank of Australia, AMAL Asset Management

Banks have been the biggest providers of Australian CRE Debt, accounting for an estimated 90%+ of CRE lending in the last decade. Market dislocation since 2008 has given the major banks (ANZ, Commonwealth, NAB, and Westpac) even greater market dominance[6]. Second-tier banks (St George, Bankwest, Suncorp) have either been taken over or have effectively withdrawn from the market. Third-tier banks are now focussed principally on residential lending.

Many foreign lenders have closed down as their parents scale back global operations. Others are in the midst of repatriating capital to their home markets and are not actively lending on commercial real estate. Further, the non-bank mortgage trust sector, once a $30b competitor to the banks, has closed and is not likely to re-open.

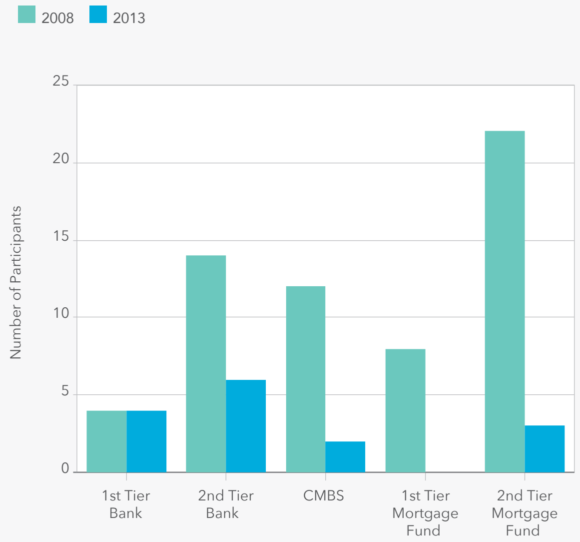
As a result and for the first time since the RBA has maintained records, the extent of commercial lending in Australia has fallen over a five-year period (Exhibit 4). Exhibit 5 shows there has been a considerable decrease in the number of participants lending money in the Australian market over the past five years. Yet compared to years prior to the GFC, LVRs are lower and DSCRs are substantially higher.

**Exhibit 4:**
**Residential and Commercial Lending (2008 - 2013)**




Source: RBA

**Exhibit 5:**
**Far Fewer Lending Participants (2008 - 2013)**




Source: Balmain Corporation

Credit conditions are also significantly more lender-friendly than for much of the last credit cycle and there is an opportunity for new providers of capital to develop significant market share at healthy yields and sustainable margins. A funding gap now exists for alternative providers of credit to become an important source of financing for CRE debt in Australia. Similar conditions prevail in other markets, particularly in Europe. However, spreads in many of those markets are more likely to be eroded as there are more sources of new capital. There is also added political and regulatory risk.

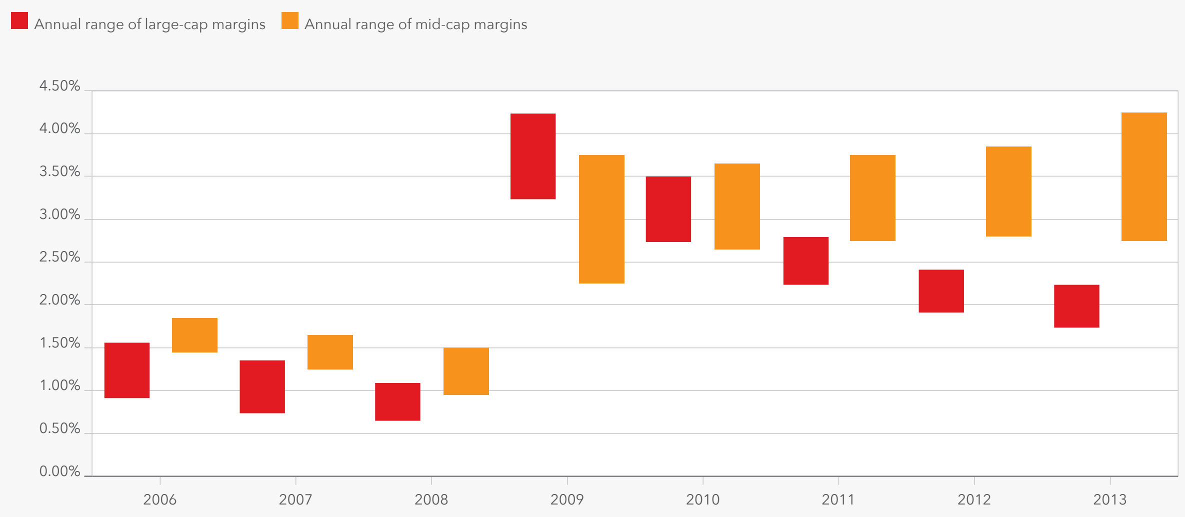
## RESILIENCE TO MARGIN PRESSURE: LARGE-CAP VERSUS MID-CAP CRE LOANS

The Australian CRE debt sector is significantly under-supported. Pre-GFC, capital was widely available for large capitalisation loans, the middle market sector, transitional properties requiring capital improvements and also for property development. Currently the limited CRE capital available from the banks and other institutional lenders is overwhelmingly directed towards listed or A-REIT borrowers and income producing larger-capitalisation loans. As a consequence of competition, margins on large-cap loans have tightened considerably and lenders seeking yield in this space have had to resort to higher leverage to achieve the returns that were available only 18 months ago.

As shown in Exhibit 6 the margins on large-cap loans peaked in 2009 during the aftermath of the GFC. Loan funds were exceedingly difficult to raise amidst uncertainty around bank funding capacity and heightened concern over the balance sheets of the A-REIT sector. As the Australian banking sector proved resilient and A-REITs successfully recapitalised, margins on large-cap loans fell away dramatically.

Balmain loan bid data[7] indicates that margins on large-cap loans are currently 50% lower than in 2009. By contrast margins on mid-cap loans are 15% higher. The strength in mid-cap loan margins is due partly to the lack of competition but also because lower overall cash rates have allowed mid-cap lenders to increase margins while still offering historically attractive whole rates to borrowers.

**Exhibit 6: Year on Year Changes in Margins on Australian Large- and Mid-Cap CRE Loans**



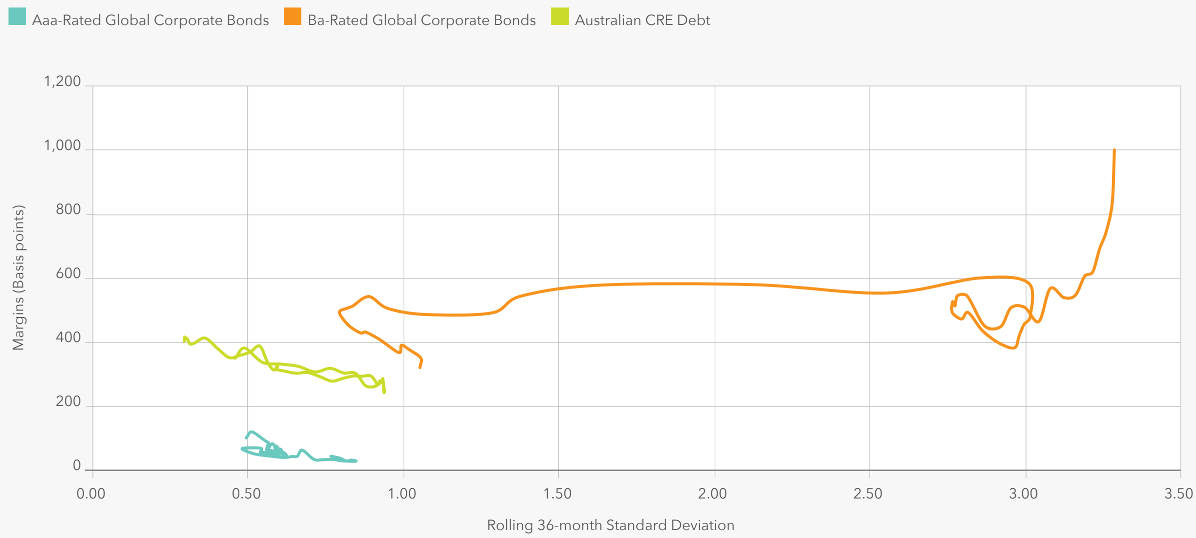

Source: Balmain Corporation bid data (2006 - 2013)

## RISK AND REWARD CHARACTERISTICS

Risk and reward characteristics of assets change over time. Exhibit 7 maps the rolling three-year risk[8] and margin characteristics from 2009 to 2013 of Australian CRE Debt, Aaa-rated global corporate bonds[9] and Ba-rated corporate bonds[10].

Clearly, Aaa-rated corporate bonds are the safest credit investment. However, the variation in margins of Australian CRE Debt and Aaa-rated bonds are similar. The margins of both investments have consistently displayed less than 1% volatility on a trailing 36-month basis. At the same time margins on Australian CRE Debt are more in line with those of the riskier Ba-rated bonds[11].

**Exhibit 7: Risk and Reward Characteristics (2009 - 2013)**




Source: Moody's, AMAL Asset Management

## CORRELATIONS WITH OTHER FLOATING-RATE INVESTMENTS

Low correlation of returns among different asset classes is desirable because it lowers overall portfolio volatility. Correlations between margins on Australian CRE Debt and traditional fixed and floating-rate investments are very low. Since 2008 they have been negative, supporting the diversification benefit of investment in CRE debt. This is evidenced in Exhibit 8A. The correlation between Australian CRE Debt and Ba-rated global corporate bonds (2008-2013) is -0.22 and it falls to -0.63 for Aaa-rated bonds. The correlation with the margin on the Credit Suisse Leveraged Loan Index was -0.12.

Correlations of CRE debt to other asset classes widely included in Australian institutional portfolios are also favourable. Exhibit 8B shows correlations between the total return of Australian CRE Debt and the Credit Suisse Leveraged Loan Index, the Barclays Global Aggregate Index, international shares and Australian shares[12]. Since 2008 the correlation to the Barclays Global Aggregate Index was low-moderate and the correlation to equities was negative. In sum, there is a diversification benefit to portfolios dominated by interest rate-sensitive fixed income, corporate credit and equities.

Correlation stability over time is another important concern for investors. Exhibit 9 breaks down the various correlations by financial year to give a clearer picture of the stability of correlations over the period since 2008. In particular the correlations of CRE debt to the margins and total returns of other asset classes have almost consistently been low to negative.

**Exhibit 8A:**
**Australian CRE Debt Margin Correlations (2008 - 2013)**

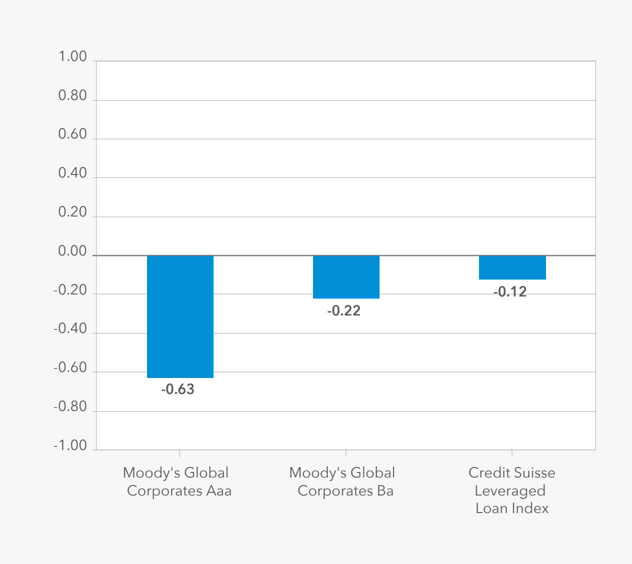
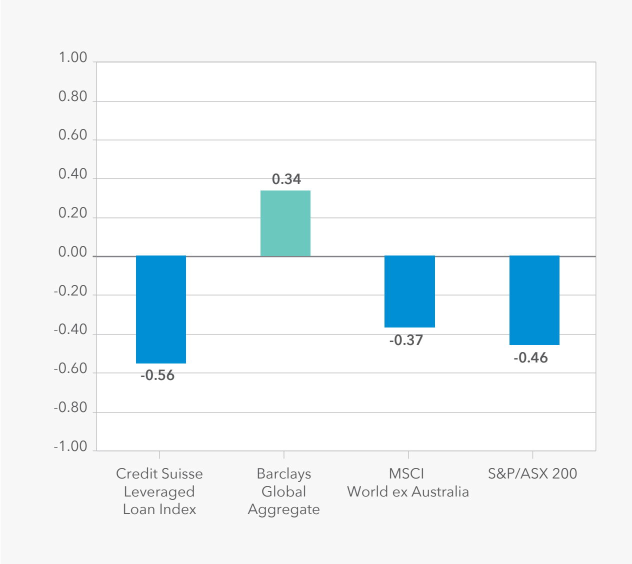



**Exhibit 8B:**
**Australian CRE Debt Total Return Correlations (2008 - 2013)**



### Exhibit 9: Correlation Heat Map

| 0.75-1.00 | 0.5-0.75 | 0.25-0.5 | <0.25 |
|---|---|---|---|
| HIGH | MODERATE TO HIGH | LOW TO MODERATE | LOW TO NEGATIVE |

| | MARGINS | | | TOTAL RETURN (AUD) | | | |
|---|---|---|---|---|---|---|---|
| | CREDIT SUISSE LEVERAGED LOAN INDEX | MOODY'S GLOBAL CORPORATES - Aaa | MOODY'S GLOBAL CORPORATES - Ba | CREDIT SUISSE LEVERAGED LOAN INDEX | BARCLAYS GLOBAL AGGREGATE | MSCI WORLD EX AUSTRALIA | S&P/ASX 200 |
| FY 2008/2009 | 0.49 | -0.39 | 0.11 | -0.69 | 0.74 | -0.53 | -0.58 |
| FY 2009/2010 | 0.59 | -0.17 | 0.31 | -0.59 | 0.40 | -0.61 | -0.63 |
| FY 2010/2011 | -0.40 | -0.49 | -0.38 | -0.29 | 0.25 | -0.34 | -0.55 |
| FY 2011/2012 | -0.05 | -0.60 | -0.28 | -0.25 | 0.23 | -0.33 | -0.23 |
| FY 2012/2013 | -0.55 | 0.20 | -0.61 | 0.16 | -0.19 | 0.05 | -0.40 |

Exhibit 10 is a correlation matrix for the margins of Australian CRE Debt, global corporate bonds and leveraged loans. Exhibit 11 is the correlation matrix for the total return of Australia CRE Debt, leveraged loans, Australian equities and international equities.

### Exhibit 10: Correlation Matrix – Margins

| | AUSTRALIAN CRE DEBT | CREDIT SUISSE LEVERAGED LOAN INDEX | MOODY'S GLOBAL CORPORATES - Aaa | MOODY'S GLOBAL CORPORATES - Ba |
|---|---|---|---|---|
| Australian CRE Debt | 1.00 | | | |
| Credit Suisse Leveraged Loan Index | -0.12 | 1.00 | | |
| Moody's Global Corporates - Aaa | -0.63 | 0.70 | 1.00 | |
| Moody's Global Corporates - Ba | -0.22 | 0.83 | 0.79 | 1.00 |

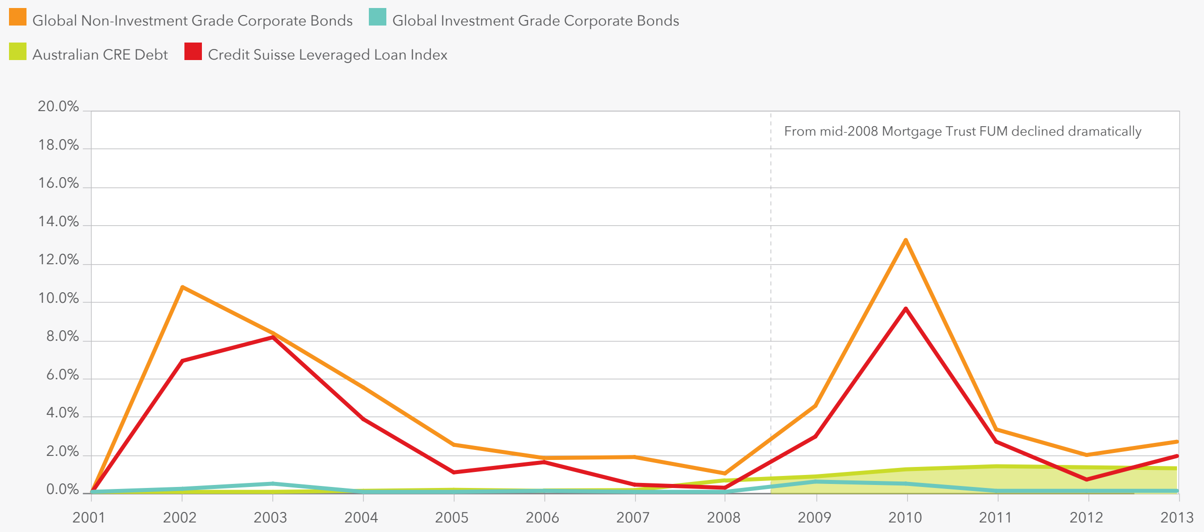
### Exhibit 11: Correlation Matrix – Total Return

| | AUSTRALIAN CRE DEBT | CREDIT SUISSE LEVERAGED LOAN INDEX | BARCLAYS GLOBAL AGGREGATE | MSCI WORLD EX-AUSTRALIA | S&P/ASX 200 |
|---|---|---|---|---|---|
| Australian CRE Debt | 1.00 | | | | |
| Credit Suisse Leveraged Loan Index | -0.56 | 1.00 | | | |
| Barclays Global Aggregate | 0.34 | -0.60 | 1.00 | | |
| MSCI World ex-Australia | -0.37 | 0.63 | -0.79 | 1.00 | |
| S&P/ASX 200 | -0.46 | 0.58 | -0.67 | 0.86 | 1.00 |

## DEFAULT RATES VERSUS OTHER FLOATING-RATE INVESTMENTS

The default rate on Australian CRE Debt has been significantly and consistently lower than those of global non-investment grade corporate bonds and leveraged loans. Exhibit 12 shows the average annual default rates from 2001 through 2012. There are two episodes where global non-investment grade bonds and leveraged loans default rates both rose significantly, and at the peak of the GFC, non-investment grade debt nearly reached a 14.0% default rate.

**Exhibit 12: Annual Default Rates**



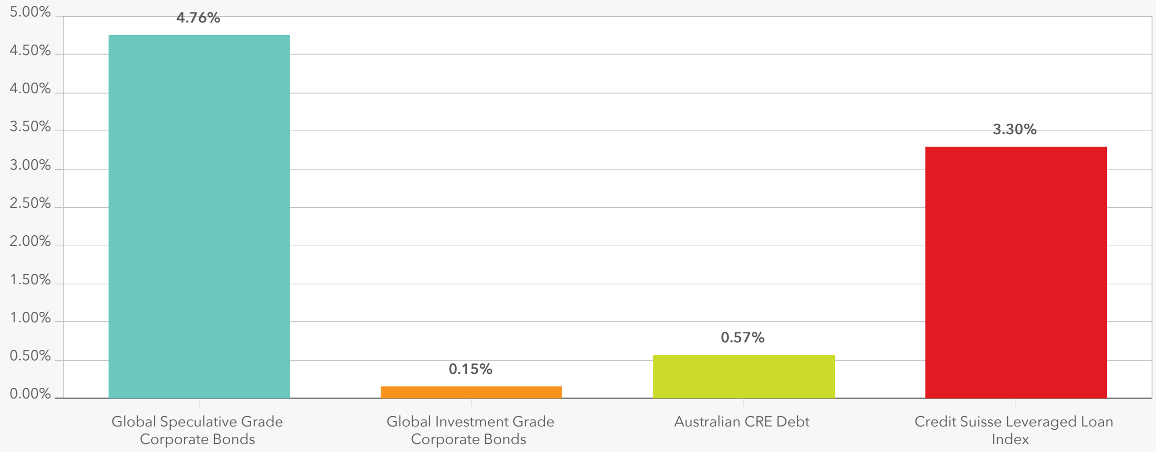

Source: Moody's Credit Suisse, AMAL Asset Management

Investment grade corporate bonds have essentially a 0.0% default rate. As the chart illustrates, Australian CRE Debt defaults (as illustrated by the subject portfolio in Exhibit 12) were also very low for the period leading up to mid-2008 but rose slightly from that time due to several factors:

1. General credit and property stress in the post-GFC environment.
2. The $30b Australian mortgage trust sector was effectively frozen when it was excluded from the Federal Government guarantee of Australian Deposit-taking Institutions (ADIs) in October 2008. This led the trusts to seek to rapidly amortise their portfolios to create investor liquidity which resulted in aggressive technical default action on assets that would otherwise have been resolved over time and in a more orderly fashion. The effect of this can be seen in the green shaded area in Exhibit 12. These actions did not lead to a material increase in losses.
3. The difficulty in refinancing assets in 2008/2009 with an almost total lack of credit availability leading to a rise in non-monetary defaults due to loan term breaches.
4. As the mortgage trust sector stopped lending and actively pursued CRE loan repayment, outstanding loan balances fell rapidly and the percentage of non-performing loans to performing loans grew as the performing loans were repaid.

Despite the above factors, the average annual default rate of these mid-cap CRE debt portfolios is still only 0.57%, as shown in Exhibit 13. Balmain estimates that in the absence of the events described above, the underlying default rate of Australian CRE Debt would have been in line with investment grade bonds and US life company CRE debt. These data are averages and so ignore the role experienced CRE debt managers can play in further reducing defaults and improving recoveries. By comparison the average default rate on commercial loan exposures of the major Australian banks between 2008-2013 was approximately 1.0%[13].

**Exhibit 13: Average Annual Default Rates (2001 - 2012)**




Source: Moody's, AMAL Asset Management, Credit Suisse

## LOSS RATES VERSUS OTHER FLOATING-RATE INVESTMENTS

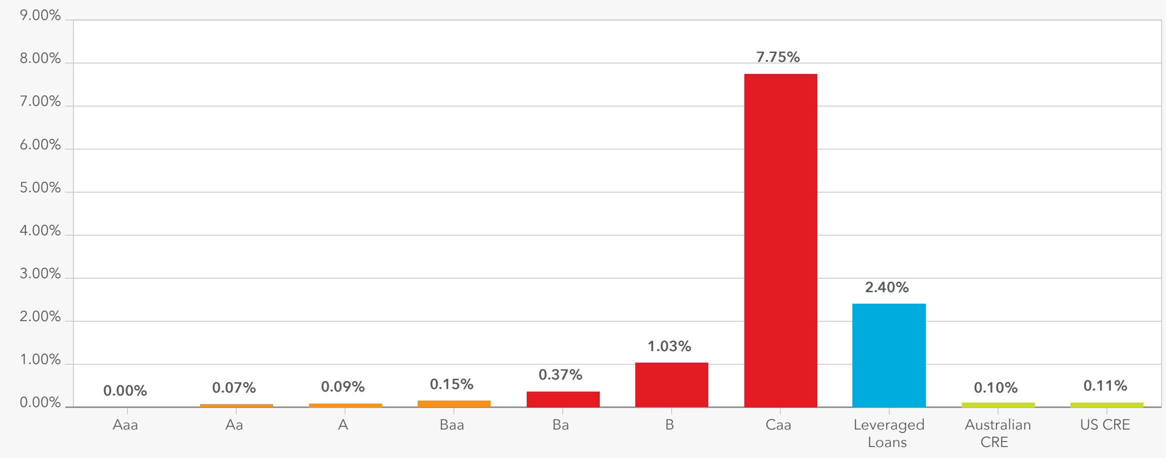
Loss and recovery metrics on global corporate bonds and leveraged loans are based on submissions by institutional investors. Reliable data on performance of CRE debt is harder to obtain. AMAL has significant experience in managing CRE loan portfolios for over two decades and records data on defaults as part of its core servicing role. Data on loss given default is more problematic as many clients' programs were mortgage trusts that utilised accounting practices aimed at preserving $1.00 unit values[14]. These practices are not adopted by banks, commercial mortgage-backed securitisation (CMBS) or institutional programs.

A relevant example of Australian CRE Debt performance with respect to loss given default is provided by the Balmain-managed AllFinance loan portfolio of mid-cap commercial real estate loans which was serviced by AMAL from the inception of the program in 2008 to its conclusion in 2013. Experience with the AllFinance portfolio, where losses given default were managed in accordance with strict CMBS waterfall guidelines[15], shows the loss rate[16] was 0.10%. The 2006-2013 period is instructive as it reflects loans underwritten pre-GFC when lending conditions were exuberant, but recovered post-GFC when credit and commercial real estate conditions were much more constrained.

The AllFinance experience is in line with that of US life company insurers that reported average loss rates from 2006- 2012 of a negligible 0.11% on their commercial mortgage portfolios. Loss rates for Australian CRE Debt (0.10%) over that same period are significantly lower than those of both Ba-rated global corporate bonds (0.70%) and leveraged loans (2.40%).

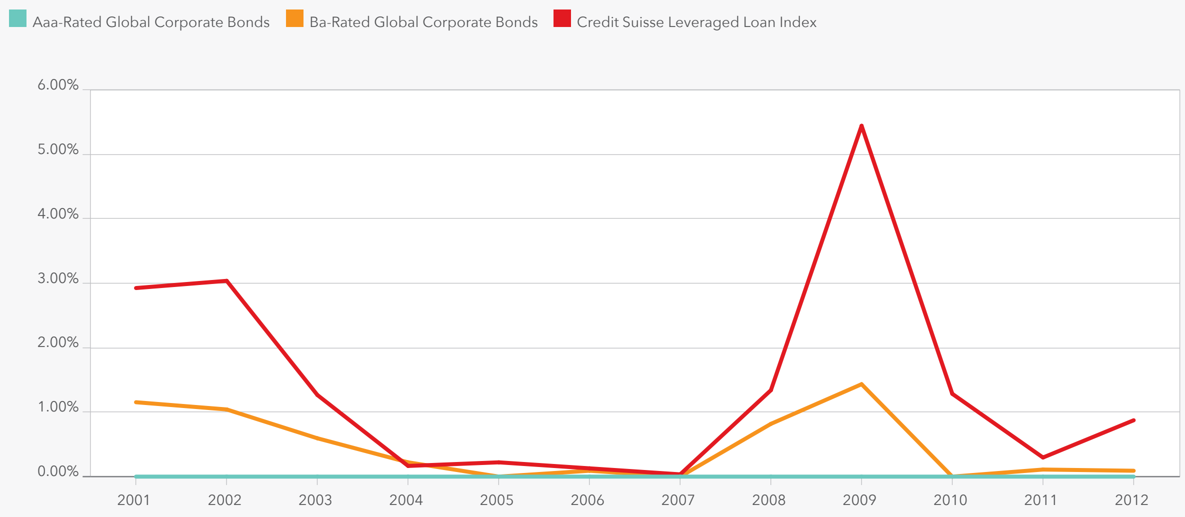
Exhibits 14 and 15 compare loss rates for various grades of investment grade debt, high-yield debt, leveraged loans, Australian CRE Debt and US life company CRE debt. Exhibit 14 depicts the average annual loss rates and Exhibit 15 illustrates how these rates have varied over time. There is a very distinct cyclical pattern in default rates of high-yield debt and leveraged loans over time. There is also a much more pronounced negative relationship between default rates and recovery rates on these assets.

**Exhibit 14: Average Annual Loss Rates (2006 - 2012)**




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

**Exhibit 15: Annual Loss Rates**




Source: Moody's, Credit Suisse

## MITIGATING RISK OF LOSS IN CRE DEBT

A number of factors contribute to the high recovery rates and low loss rates in Australian CRE Debt:

- Average portfolio LVRs (typically 55-65%) are conservative while average debt service coverage ratios are prudent, normally greater than 1.5x.
- Higher default interest rates on fully recovered loans will often offset the effect of any capital loss from loans in serious default[17].
- CRE debt is secured by 1st mortgage security over real property assets.
- Mid-cap CRE loans in particular, are almost invariably supplemented by borrower and/or associate guarantees.
- Finally, the relevant statutory enforcement procedures are both more secure (direct to asset) and more efficient (by comparison with company liquidation, which is the typical recovery process for defaulted corporate debt.)

Managing defaults in mid-cap CRE debt poses fewer problems than in more complex investments, including large-cap CRE loans. Guarantees are typically provided with mid-cap loans but are generally unavailable for large-cap loans. In the event of default or loan stress, personal and corporate guarantees act to improve borrower behaviour and hence the level of recovery. Ongoing monitoring of property fundamentals and borrower credit capacity (active credit management) allows many issues to be detected and remedied before the loan principal is put at risk. First mortgage security also provides a high degree of recovery, which when necessary is supplemented by sponsor guarantees.

Exhibit 16 sets out a number of measures CRE debt managers take to mitigate the risk of loss.

**Exhibit 16: Mitigating Risk of Loss in CRE Debt**

| RISK | IMPACT | MITIGANT |
|---|---|---|
| Borrowers fail to pay interest (tenants remain) | **Returns reduce** | Unpaid interest is accrued and remains recoverable provided the sale of the asset (and action against guarantors) releases sufficient proceeds. Appointment of receivers or acceleration of security (mortgagee in possession) used to retain rental income. |
| Borrowers fail to pay interest (tenants vacated or no property income) | **Returns reduce** | Unpaid interest is accrued and remains recoverable provided the sale of the asset (and action against guarantors) releases sufficient proceeds. |
| Property values fall significantly | **Capital threatened** | Loans reviewed regularly and resulting LVR breaches promptly addressed to assist expeditious loan recovery. |
| Loans not repaid on their maturity dates | **Investment term may be extended** | Late repayments attract higher interest rates to the Investors benefit and provide a strong incentive to borrowers to repay on maturity. |
| Documentation flawed | **Capital threatened** | All loan documentation certified by independent lawyers who are obliged to maintain appropriate insurance. |
| Property destruction | **Capital threatened** | Borrowers required to fully insure to agreed levels and provide certifications of currency evidencing insurance. |
| Loans repay early | **Projected returns not achieved** | A portfolio comprising multiple loans combined with active management ensures limited impact of early loan repayment on portfolio returns. |

# APPENDIX:
# US LIFE COMPANY PRECEDENT FOR INSTITUTIONAL INVESTMENT IN CRE DEBT

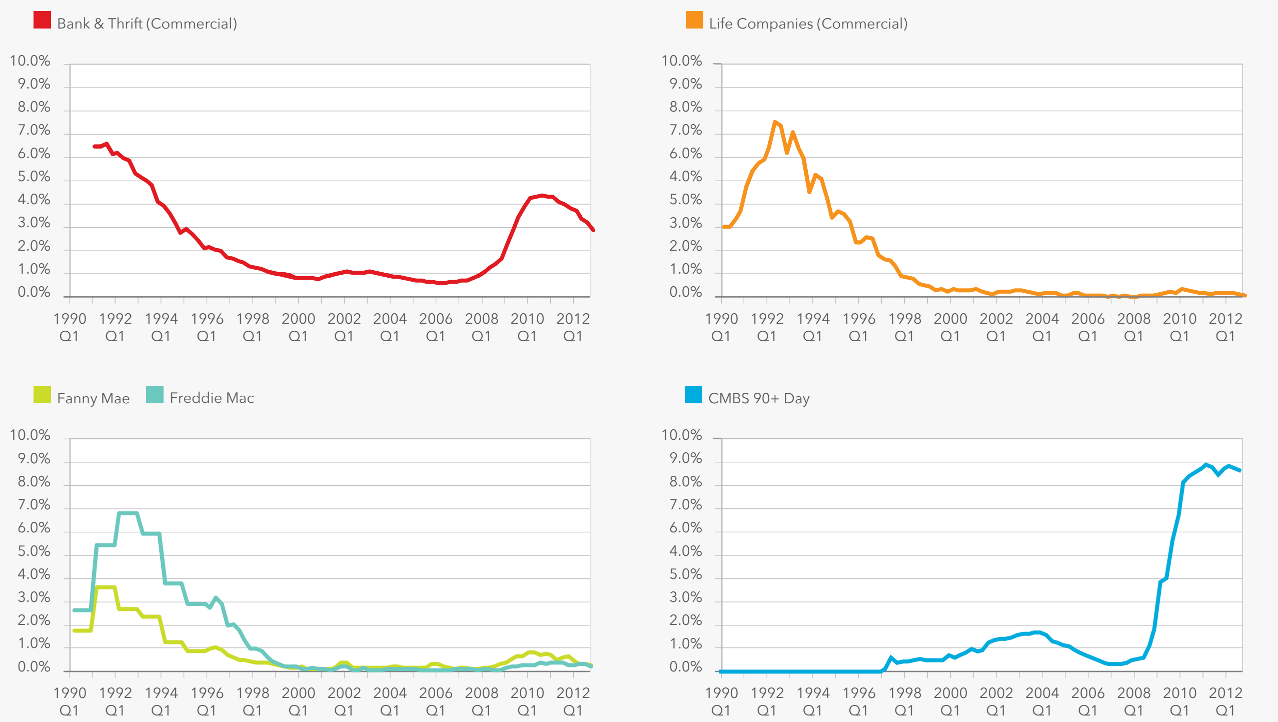
US life companies have been significant investors in commercial real estate for decades. In 2012 US life companies held $312 billion or 13% of all outstanding US commercial mortgage loans[18]. On average, life companies that invest in CRE debt allocate 11% of their total investments to the commercial mortgage asset class[19]. Their exposure includes a broad base of exposures across all capitalisation tiers.

Commercial mortgages are a natural fit for US life insurers with long-term liabilities. The asset class provides steady income streams and has delivered a high degree of capital stability. US life insurers typically invest in only A- or higher-rated corporate bonds and typically avoid other high-yield, floating-rate investments.

The sub-prime mortgage crisis started in the US in 2008 where the fallout from the global financial crisis had damaging effects on both the residential and commercial property markets. The period from 2008 to 2012 (peaking in 2011) saw CRE loan delinquencies dramatically increase across all investor groups except life companies and government agencies. This is evident in Exhibit 17.

The main reason for the rise in delinquencies within the CMBS sector relates to excess capital and exuberant lending practices in that sector in the later part of the last credit cycle which was matched somewhat by banks and thrifts seeking to protect market share. Lessons learned in earlier distressed market periods were well remembered by US life companies during the exuberance of the last credit cycle. Not only were lending disciplines maintained but importantly they withdrew from the market where transaction pricing did not justify the risk.

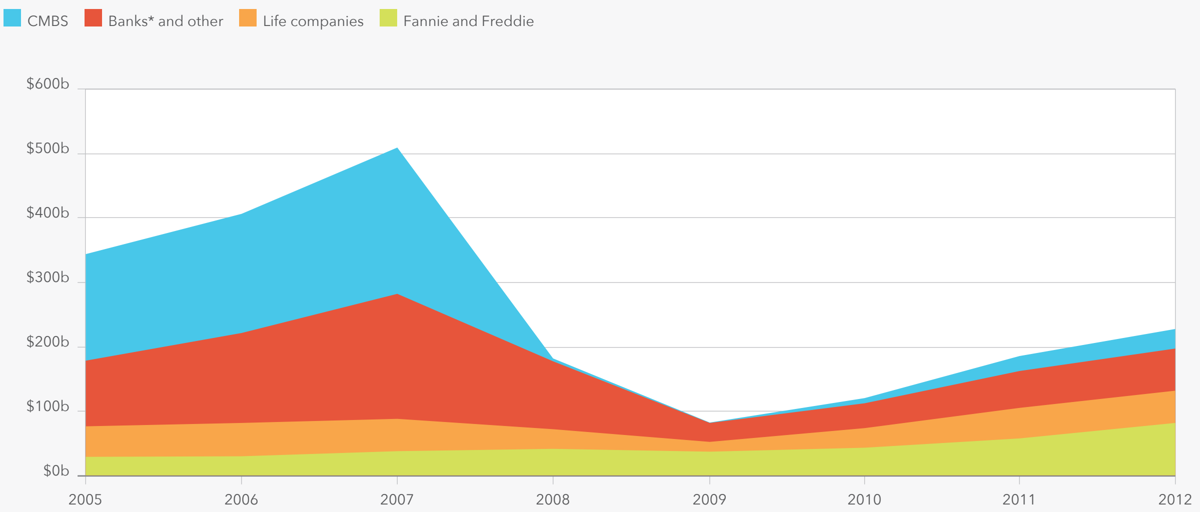
**Exhibit 17: Commercial Mortgage Default Rates Among Major Investor Groups**




Source: FDIC, Wells Fargo Securities and Intex, ACLI, Fannie Mae and Freddie Mac

Exhibit 18 illustrates the flexibility of US life companies during the highly competitive 2005 to 2007 period when excessive competition from both the capital markets and banks/thrifts pushed risk upwards and margins down. Yet the life companies were able to capitalise on opportunities post-GFC when returns and risk justified the investment by increasing origination to levels much higher than pre-GFC. The ability to move in and out of the CRE debt markets comes with market experience and access to infrastructure through being a market participant over the long-term.

**Exhibit 18: US CRE Debt Originations Among Major Investor Groups ($billions)**

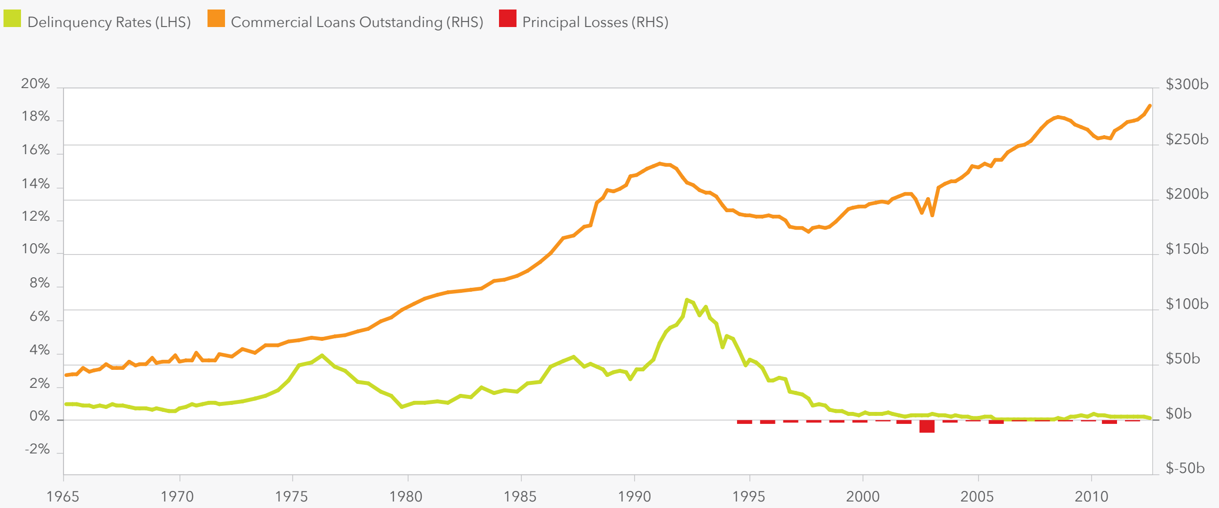



Source: Mortgage Bankers Association
* excludes many banks, especially smaller local and regional institutions

Exhibit 19 plots default rates versus the total balance of CRE holdings since 1965. It also includes principal losses since 1995 (when that data is first available). Delinquency rates spiked during 1974 – 1975, 1986 – 1989 and 1991 – 1993, periods where market conditions deteriorated.

The experience of US life companies since 2001 is consistent with Balmain's experience of the loss and recovery rates of Australian CRE Debt. Despite the clear spike in delinquency rates in earlier periods principal losses were negligible. A clear and differentiated feature of broad-based CRE lending is the high recovery rate.

**Exhibit 19: US Life Insurers' Experience with CRE Debt**




Source: American Council of Life Insurers

The US life company experience reinforces how prudent underwriting drives portfolio quality and investment performance. Fitch Ratings reported in 2012 that 99.6% of insurer-held mortgages were in good standing at year-end 2011[20].

In the 2012 Trepp/CRE Finance Council Survey[21] of life insurers, respondents reported average total realised losses from their commercial mortgage holdings of only 0.05%. No respondents reported realised losses greater than 1%. Such loss rates are typically associated with portfolios of very high-quality corporate bonds.

Since the mid 1990's, US life companies have excelled at CRE debt lending. As a group they have been disciplined lenders and thus avoided the post-2008 scale of losses experienced by other CRE lenders. They have developed strong origination networks, prudent credit underwriting and emphasised repeat relationships with quality borrowers. They have also known when to 'ramp-up' or 'wind back' CRE lending.

Current market conditions in the Australian CRE Debt sector present an ideal time for entry into this sector. For Australian institutional investors, the US life company track record in CRE debt provides a compelling example of how knowledge and experience in CRE debt markets can provide outsized returns over time.

# ENDNOTES, SOURCES AND DEFINITIONS

## ENDNOTES

1 AMAL Asset Management Ltd was established in 1994 and manages over $8b in commercial loan receivables. The data is based on returns from seven separate institutional grade mid-cap commercial real estate loan portfolios (average portfolio balance >$2.5b) managed by AMAL since 2001. Balmain is a foundation shareholder in AMAL.

2 This paper focuses on mid-cap CRE loans, those that range between $2m and $30m. For the purposes of this paper, a large-cap CRE loan is one greater than $30m. Banks lend across the full spectrum of loan sizes which has been a commercially effective diversification and risk minimisation strategy. In corporate debt few programs concentrate on just a handful of the largest issuers and similarly in CRE debt few lenders concentrate solely on the largest borrowers. Rather most lenders recognise the merit in a broader base of exposures and the opportunity to actively enhance returns in the mid-cap tiers. For a more detailed appraisal of the merits of mid-cap CRE loans see "Enhancing Returns and Mitigating Risks in Australian Commercial Real Estate Debt," Balmain Investment Management, February 2013. The paper can be found at www.balmaininvestment.com.au.

3 Throughout this paper 'margin on a security' means the difference between the yield on that security and the base currency official cash rate. 'Margins' are often also called 'spreads'. Margins (or otherwise 'spreads') are a common metric used by bond analysts and portfolio managers to differentiate between securities in different sectors and reflect concern of investors about the possibility of both default and illiquidity.

4 Highly rated (>A+) corporate debt rarely defaults.

5 The Australian corporate debt market is modest by comparison to the US or global corporate bond markets. Nevertheless, Australian CRE Debt does get compared to BBB-rated Australian corporate debt and the yield differential is instructive.

6 Balmain estimates that due to the withdrawal of foreign banks, the acquisition of 2nd tier banks and removal of the mortgage trust sector, the major banks currently advance over 95% of all secured CRE loans.

7 Balmain bid data comprises quotations on pricing on both mid- and large-cap loans, it comprises both issued and accepted mandates. The bid data provides a fair and appropriate measure of market conditions and spreads on mid- and large-cap loans during these periods.

8 As measured by the standard deviation of margins over rolling 36-month periods.

9 As rated by Moody's. Aaa bonds are the highest rated tier of investment grade debt.

10 As rated by Moody's. Ba bonds are the highest rated tier of non-investment grade debt.

11 From a whole rate (yield) perspective loans are valued at par (in the absence of impairments) which provides low asset class volatility from a pure accounting perspective.

12 The correlations between CRE debt and other floating rate investments are based on margins rather than returns or yields. This has been done to remove the distorting effect of different base currency cash rates and changes in asset values, and to reflect that most Australian investors look at these asset classes from a $A (fully hedged) perspective. Total return in $A are used in the case of Credit Suisse Leveraged Loans, Barclays Global Aggregate, MSCI World-ex-Australia, and S&P/ASX 200. Correlations are calculated on monthly data. CRE debt is not publicly traded. The total return of Australian CRE Debt is based on yield net of loss given default.

13 Sourced from Australian bank annual reports.

14 To protect $1.00 unit prices, mortgage funds often provisioned from income distributions at the portfolio level which created a lower return for investors rather than provisioning against principal on individual loans which would have affected portfolio unit prices.

15 Between 2006 and 2008, the AllFinance program originated a mid-cap CRE debt portfolio of $500m to be issued as Commercial Mortgage Backed Securities. The program was funded by CBA and NAB, with Allco/Balmain as equity providers and Balmain as credit and fund manager. Following Allco's demise in March 2008, the program ceased lending and Balmain managed out the amortisation of the portfolio. This was largely completed by 2012 and resulted in a loss rate of 0.10%.

16 Loss rate for CRE debt is defined as the loss given default net of additional default interest charges levied on defaulting borrowers. In the case of corporate debt that has an active secondary market it is measured by reference to the post-default security price (generally measured 30 days after the default).

17 Mid-cap CRE debt investments generally carry higher interest charges where loan covenants are breached. This often means that defaulting loans (whilst not desirable) can earn higher rates of overall return once full recovery is achieved. Balmain's experience is that default interest earned from a portfolio of commercial mortgages substantially mitigates losses from default.

18 As at 31 March, 2012, Mortgage Bankers Association

19 CRE Finance Council and Trepp, LLC Insurance Company Investment Performance Survey Results, January 2013

20 Fitch Ratings US Life Insurers Special Report, 14 August 2012

21 Trepp/CREFC Portfolio Lender Survey of commercial mortgage investment performance within the insurance company sector, January 2013

## SOURCES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Moody's Investors, Annual Default Study: Corporate Default and Recovery Rates, 1920-2012 - Excel data
2013 Mortgage Bankers Association, Data Serries, as at 31 March 2012
Trepp/CREFC Portfolio Lender Survey of Commercial Mortgage Investment Performance within The Insurance Company Sector, January 2013


## DEFINITIONS

| | |
|---|---|
| ASX/S&P 200 Accumulation Index | This index tracks the largest 200 stocks in the Australian sharemarket. |
| Australian Mid-cap CRE Debt | Mid-cap loans range from $2m – $30m. |
| Barclays Global Aggregate Index | The index provides a broad-based measure of the global investment grade fixed-rate debt markets. |
| Commercial Mortgage Back Securities (CMBS) | CMBS are securities backed by underlying pools of mortgages secured by commercial rather than residential real estate. |
| Credit Suisse Leveraged Loan Index | The index tracks the investable market of the U.S. dollar denominated leveraged loan market. |
| Default Rate | Percentage of total portfolio outstanding more than 90 days in arrears. |
| Debt Service Coverage Ratios (DSCR) | Cash flow from both security property and/ or obligated guarantors divided by loan payments. |
| Investment Grade Bonds | Bonds are considered investment grade if they have a credit rating of Baa or higher by Moody's (or BBB- or higher by Standard & Poor's). |
| Large-cap Loan | Large-cap loans are greater than $30m. |
| Loan Covenants | Specific conditions written into loan contracts that are regularly tested and Borrowers must meet or risk loan review or default. |
| Loan-to-Value Ratio (LVR) | The percentage of the amount lent against the valuation of a property security. |
| Loss Rate | The loss given default net of additional default interest charges levied on defaulting borrowers. |
| Margins | The difference between the yield on a security and the base currency official cash rate. 'Margins' are often also called 'spreads.' |
| MSCI World ex-Australia Index | The index captures large and mid-cap stock representation across 22 developed markets (excluding Australia). |
| Non-Investment Grade Bonds | Bonds are considered non-investment grade if they have a credit rating of Ba or lower by Moody's (or BB+ or lower by Standard & Poor's). |
| Principal Losses | Actual dollar amount lost on the original amount borrowed. |

## ABOUT BALMAIN INVESTMENT MANAGEMENT

Balmain Investment Management Pty Limited (Balmain) is the institutional funds management arm of the Balmain Group, Australia's leading non-bank secured private debt group. Balmain has been operating for over 30 years and its sole focus is commercial real estate debt. Balmain is one of Australia's largest and most experienced secured private debt fund managers, the group controls Australia's largest specialist commercial loan origination network, is the regions largest special loan servicer and commercial loan asset manager and through it's investment in AMAL Asset Management is the regions largest non-bank primary servicer of commercial receivables.

In 2011 Balmain established a joint venture with Brookvine Pty Ltd to facilitate institutional investment in Australian secured private debt. Brookvine is an independent Australian investment advisory and marketing business.

By partnering with Balmain, institutional investors gain access to:

- A portfolio of mid-sized commercial real estate loans.
- The most significant source of secured commercial real estate loans outside of the major banks.
- An established, vertically integrated full service provider, with single point responsibility and accountability for all fund and loan services.
- An independent and cycle-experienced funds management team, with dedicated in-house credit, portfolio management and asset recovery functions.
- A fully aligned and transparent funds management model with a strong focus on governance and independent oversight.
- A range of investment options, including the Secured Private Debt Fund and Separately Managed Accounts.

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