RESEARCH NOTE

APRIL 2014

EMBRACING COMMERCIAL REAL ESTATE DEBT AS A DEFENSIVE INCOME ALTERNATIVE

INTRODUCTION

Australian superannuation funds face a conundrum. Their burgeoning appetite for regular income, driven by the growing cohort of near-retirees, is unlikely to be met by conventional investment options.

Superannuation funds are rightly concerned about their allocations to traditional bonds as many bonds are priced to offer negative real yields. Yet many funds are unwilling to allocate more to high yield credit and leveraged loans amidst concerns about increased leverage, weaker deal structures and a growing imbalance between investor demand and new issuance. These concerns are particularly relevant at a time when margins on these securities have compressed significantly over the past twelve months.

Nonetheless, the risk tolerance for income investing has increased since 2008 and superannuation funds are relying more on active management to achieve income targets. Despite this, few funds have embraced non-traditional floating-rate investments, such as commercial real estate (CRE) debt[1].

Some superannuation funds have taken a progressive stance on CRE debt as a defensive income investment but most have struggled to pigeon-hole it. A few have funded an allocation from a fixed income bucket while others have decided that an investment should only be made opportunistically.

A small number of superannuation funds made an allocation to large-cap CRE loans[2] in the aftermath of 2008. However as the Australian banking sector proved resilient and A-REITS successfully recapitalised, margins on large-cap loans declined dramatically. Many of these investors are now tending to allow these mandates to expire rather than pursue CRE debt opportunities that exhibit higher margins and more resilience to margin compression.

Compared to large-cap loans, there has been very limited margin compression in the mid-cap CRE debt sector since 2008. These are loans that range in size from $3m-$30m and are secured over commercial real estate assets that typically range in size from $4m-$60m, and comprise the majority of commercial real estate assets in Australia.

Mid-cap CRE loan margins are at levels two or more times higher than pre-GFC[3] levels. Deal structures have improved and leverage has reduced. Importantly, the default metrics of mid-cap CRE debt remains unaffected and with a re-rating of CRE values underway, loan-to-valuation ratios (LVRs) at a portfolio level will likely improve.

There is a substantial risk-adjusted premium embedded in mid-cap CRE debt investments. Investors receive default risk akin to that of A-rated investment-grade bonds but margins more in line with riskier high yield bonds and leveraged loans. Current margins are well above those justified by an illiquidity premium alone.

The purpose of this paper is to renew the case for CRE debt, and specifically mid-cap CRE debt, as a defensive income allocation that should be funded from the fixed income bucket.

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1 While most other floating-rate strategies have experienced significant institutional and retail fund flows over the last five years, the CRE debt sector has seen very little institutional support in Australia. This contrasts with the US (and increasingly European) CRE debt markets where life insurance companies and pension funds are substantial investors.

2 Large-cap loans are defined as those loans of $30m or more. Mid-cap loans range in size from $3m to $30m.

3 The 2008-2009 Global Financial Crisis.

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RESILIENCE OF MID-CAP CRE LENDING MARGINS

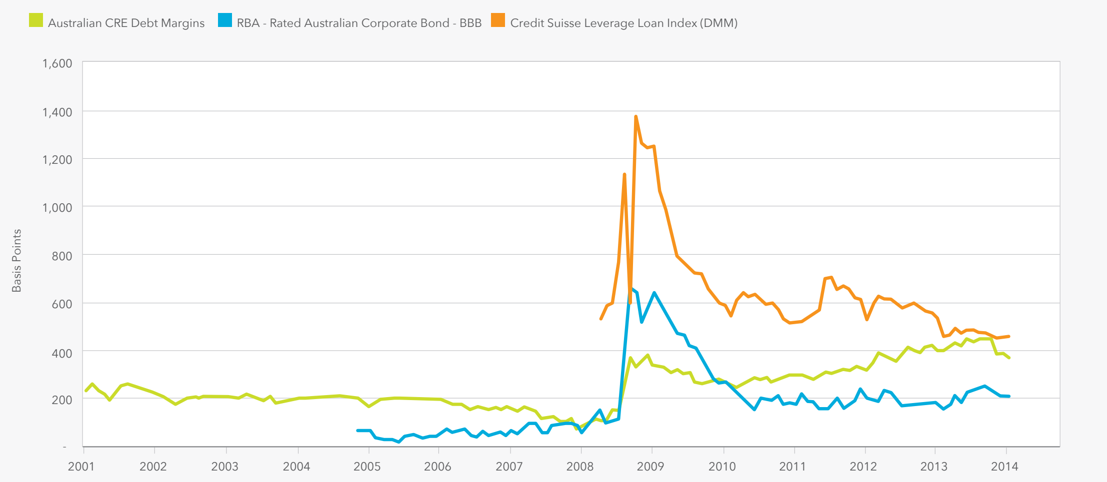
The decade-long credit cycle that ended in 2008 saw ever-increasing amounts of capital directed to credit markets. The result was not only intense competition and an erosion of loan margins, but also reduced underwriting standards and generally higher leverage. These factors were present in both corporate and CRE debt markets.

In 2006 as lending markets loosened, mid-cap CRE debt margins did drop significantly for a period. At this stage, prudent lenders maintained their lending disciplines, changed the pace of their commitments and held to underwriting standards. The results of this discipline are evident in the post-2008 performance of their loan books[4].

Chart 1 below compares mid-cap CRE debt margins[5] to margins on leveraged loans and BBB-rated Australian corporate bonds. Mid-cap CRE debt margins are now at levels two or more times higher than the margins on offer pre-GFC. There has been very limited compression in mid-cap CRE loan margins since 2008, reflecting diminished lending competition.

By comparison, margins on corporate debt and leveraged loans dropped significantly from 2009 and the opportunity for outsized returns in those sectors has largely dissipated.

Chart 1 - Margin Comparison - Australian Corporate Bonds vs. Mid-Cap CRE Debt



Source: RBA (UBS, Bloomberg), Credit Suisse, AMAL Asset Management

MID-CAP VERSUS LARGE-CAP CRE SENIOR INVESTMENT LOAN MARGINS

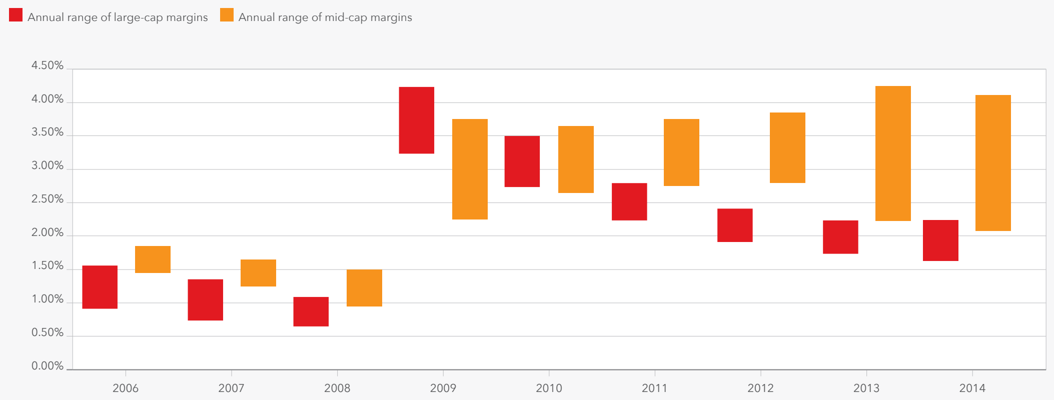
Interestingly, CRE debt margins have moved differently from 2009 onwards, depending on loan size. Chart 2 plots margins for large-cap and mid-cap senior investment loans (with LVRs of less than 65%) using Balmain bid data[6].

4 From 1990 to 2008 the major retail mortgage fund managers (Colonial First State, ING, Perpetual, AXA and Challenger) accumulated portfolios totalling over $20bn and consistently achieved returns well in excess of 90-day bank bill rates. During 2008, when retail investors called their investments and the bank guarantee was enacted that excluded mortgage funds, these managers were unable to liquidate loan holdings and the sector subsequently closed for redemptions. Nonetheless, these managers largely maintained a $1 unit price and the majority of capital has been repaid in full to investors.

5 Sourced from AMAL Asset Management Limited (AMAL). AMAL was established in 1994 and manages over $8 billion in commercial loan receivables. The data on mid-cap loan margins is based on returns from seven separate institutional-grade mid-cap commercial real estate loan programs managed by AMAL since 2001. Balmain is a founding shareholder in AMAL.

6 Balmain bid data comprises quotations on pricing on both mid- and large-cap loans, and on 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.

Chart 2 - Margins on Australian Large - and Mid-Cap Senior Investment Loans (LVR<65%)



Source: Balmain Corporation bid data (2006 - 2014) on senior investment loans

While margins on large-cap loans have declined dramatically since 2009 there has been very little compression of margins in the mid-cap loan sector. Where lower margins exist, it has largely happened at higher loan values in the mid-cap space (>$20m) where there has been some encroachment from large-cap lenders seeking transactional volume. This is unlikely to affect the mid-cap sector significantly where the bulk of senior investment loans with LVRs of less than 65% are currently settling at margins in a range of 2.5% to 4.0% above 90-day bank bills.

CURRENT MARGINS ON OTHER TYPES OF MID-CAP CRE LOANS

Stretch senior investment loans[7] offer both a higher yield on the senior debt component, and for the stretch senior component, returns commensurate with lower LVR mezzanine lending. Modest exposure to construction lending[8] can also add appreciably to portfolio returns. Investments in these sectors are likely to earn gross margins above 90-day bank bills of 4.0%-7.0% p.a.

Chart 3 following shows the range of gross margins above 90-day bank bills on loans settled by Balmain over the past six months. The average gross margin on senior investment loans with LVRs of less than 65% was 3.3%, the average gross margin on stretch senior investment loans (with LVRs of up to 75% but with a weighted average LVR of less than 68%) was 3.9% and the average gross margin on senior construction loans was 5.9%.

Chart 3 - Margins on Loans Settled Since 30 September 2013

LOAN CATEGORY	LOW	AVERAGE	HIGH
Senior Investment Loans (LVR<65%)	2.0	3.3	4.8
Stretch Senior Investment Loans (LVR>65%)	2.2	3.9	9.2
Senior Construction Loans	3.6	5.9	8.4

Source: Balmain settled loans 1 October 2013 to 31 March 2014

7 A stretch senior loan is a senior investment loan that exceeds a certain LVR. This is typically an LVR of between 65% and 75%. Balmain classifies any loan with an LVR of more than 65% as a stretch senior loan.

8 Construction lending comprises loans on real estate assets that are intended to be held as investment assets and/or sold on project completion. LVRs referred to in this paper in the context of construction loans are assessed based on 'on completion' value and have an LVR of less than 65%. These loans typically have a loan-to-cost ratio of less than 80% and pre-commitments via pre-sales equal to 50% of debt or pre-committed leases of at least 50% of net lettable area.

THE RISK TRADE-OFF INCREASINGLY FAVOURS MID-CAP CRE LENDING

There are signs of increased leverage, weaker deal structures and a growing imbalance between investor demand and new issuance in other credit markets including leveraged loans and high yield credit.
For example:

- Increased leverage: The amount of indebtedness in leveraged buyouts (LBOs) is increasing fast. The average amount of debt used to finance LBOs jumped from a low of 3.7 times earnings in 2009 to an average of 5.4 times in 2013. At the height of the LBO boom, average indebtedness was 6.1 times earnings[9]. Not surprisingly, more than USD200bn of 'covenant-lite' bank loans were issued in 2013, eclipsing the USD 100bn issued in 2007[10]. Global covenant-lite loan activity in 2014 YTD stands at the highest YTD level on record[11]. As well, second-lien leverage loan issuance is soaring. By mid-March 2014, USD8.5bn of second-lien leveraged loans had been issued in 2014. This is a 132% increase from the same period in 2013[12].
- Weaker deal structures: It is now eight years since the 'Payment in Kind (PIK) toggle'[13] first appeared and companies are again following this practice, along with a host of riskier borrower-friendly conditions associated with the buyout boom that helped inflate the 2006-2007 credit bubble.
- Imbalance between investor demand and new issuance: As of 21 March 2014 leveraged loan funds in the US have experienced 92 straight weeks of positive retail-driven cash flows, totalling USD66bn[14]. Total US leveraged loan volume is down 7% so far in 2014[15].

In contrast, mid-cap CRE lending structures and leverage have remained unchanged and show little sign of shifting. There is considerable loan volume across all CRE loan tiers and diminished competition amongst lenders as commercial lending markets in Australia have changed dramatically in the past few years. There are far fewer lenders and with new capital constraints on the remaining participants (including the Big 4 banks) CRE financing capacity remains underserviced. As well, many major borrowers are seeking to diversify their sources of CRE debt via non-bank lenders.

A funding gap exists and provides an opportunity for superannuation funds to become an important source of financing for CRE debt in Australia.

9 Financial Times, October 22, as reported in "The Race is On", Memo from H. Marks to Oaktree Clients, November 2013

10 Ibid.

11 As reported on www.dealogic.com, 2 April 2014.

12 As reported on www.leveragedloan.com, 21 March, 2014.

13 With a Payment in Kind (PIK) toggle note the borrower in each interest period has the option to pay interest in cash or to PIK some or all of the interest payment. PIK is to be interpreted as interest accruing until maturity or refinancing.

14 As reported on www.leveragedloan.com, 21 March, 2014.

15 As reported on www.dealogic.com, 7 April 2014, though current YTD leveraged loan lending has fallen 7% from the same period in 2013, 2014 volume is the third highest YTD leveraged loan lending amount on record.

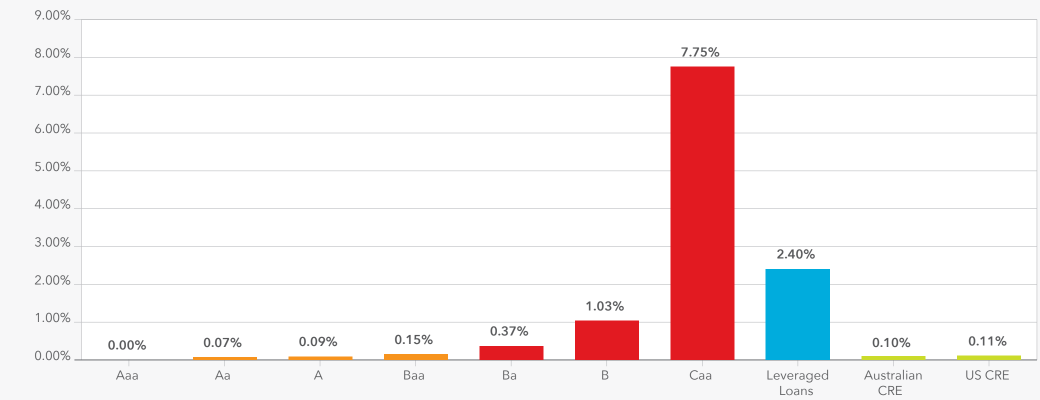
HOW TO EQUATE RISK ACROSS DIFFERENT LENDING STRATEGIES

The default rate on mid-cap Australian CRE debt portfolios has been significantly and consistently lower than that of global non-investment-grade corporate bonds and leveraged loans[16].

In fact, the annual loss rate of CRE lending programs operated by Balmain (2006-2012)[17] aligns more closely with the loss rate of A-rated (Moody's Investors) corporate debt. This is in line with the CRE lending of US life company insurers, who reported similar annual loss rates over the same period on their commercial mortgage portfolios[18].

This argument is supported by a comparison of the loss rates of various grades of investment grade debt, high yield debt, leveraged loans, and CRE debt, as shown in Chart 4.

Chart 4 - Average Annual Loss Rates (2006-2012)



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

The low loss rates of mid-cap CRE debt programs can be explained by various factors, including:

- prudent LVRs;
- mid-cap real estate securities are less complex and easier to manage in the event of default;
- a comparatively simple legal enforcement process;
- additional security in the form of sponsor and corporate guarantees;
- the effect of default fees and higher interest rates charged during periods of default;
- experienced managers with proven systems for active loan management.

It is important to note that there is a substantial risk-adjusted premium embedded in mid-cap CRE debt investments. Investors receive default risk akin to that of A-rated investment-grade bonds but margins more in line with riskier non-investment grade, high yield bonds and leveraged loans.

16 For an analysis of default rates and loss given default rates of mid-cap secured commercial real estate loans see 'A Fresh Take on Australian Commercial Real Estate Debt', Balmain Investment Management Limited, August 2013.

17 Between 2006 and 2008 Balmain managed a number of mid-cap CRE debt portfolios destined for capital market issuance as Commercial Mortgage Backed Securities (CMBS). As capital markets closed in 2008, these programs ceased lending and Balmain managed the amortisation of these portfolios. This process was largely completed by 2012 and resulted in an annual loss rate of less than 0.1%. These programs originated pre-GFC and collected out post GFC included senior investment loans, stretch senior investment loans and construction loans.

18 American Council of Life Insurers, US Life Co CRE Debt, 2012.

MID-CAP CRE LOANS AS AN ENDURING PORTFOLIO ALLOCATION

Most fixed income programs are diversified across multiple securities and issuers. A portfolio of CRE loans needs to be similarly diversified for risk across geographies, industry sectors (i.e. industrial, commercial and retail), lessees and individual borrowers. Mid-cap loans have an immense advantage over large-cap loans in this respect.

It can be argued that large-cap loans do not make a sound lending base. There are a number of reasons for this but the two principal ones are poor diversification and vulnerable lending margins. Mid-cap loans, on the other hand, are an essential foundation on which to build a sustainable lending program. Australian banks, for example, lend across the full spectrum of loan sizes but their risk-weighted capital allocations strongly favour mid-cap loans[19].

As well, prudent lenders either withdraw from the CRE lending market or lower their commitment pace when competition causes loan margins to be less attractive. This key control is an essential element that must be available in any CRE debt program. A portfolio should also retain the flexibility to target out-sized and significantly mispriced loan opportunities when circumstances arise (as superannuation funds did in large-cap loans immediately post 2008). This strategy has been the hallmark of all successful CRE lending programs in Australia and offshore.

LIQUIDITY AND THE REFINANCING ADVANTAGE OF MID-CAP CRE LOANS

CRE loans have less liquidity than leveraged loans and high yield credit. However there is secondary interest in large, diverse portfolios of CRE loans, particularly those with a mid-cap focus. Potential exit strategies such as securitisation and the sale of whole portfolios are far more tractable for mid-cap CRE loan portfolios than for large-cap loan portfolios[20].

As well, early repayments in a mid-cap loan portfolio have little impact on portfolio returns, unlike the impact of early repayment of large-cap loans. Finally, mid-cap loans are unquestionably easier to refinance at term, reducing repayment risk.

UNDERLYING SECURITY OF MID-CAP CRE LOANS

Mid-cap CRE loans are secured by real estate assets that superannuation funds have had no previous exposure to. These are loans that range in size from $3m-$30m and are secured over commercial real estate assets that typically range in size from $4m to $60m. The real estate assets over which mid-cap CRE loans are secured comprise the majority of commercial real estate assets in Australia. To date, funds have preferred loans secured by larger commercial office, retail and industrial assets; security assets they are familiar with.

Yet there are precedents for mid-cap forms of security in other lending strategies favoured by superannuation funds. The underlying exposures of many leveraged loan, high yield bond and direct corporate lending strategies, for example, are to smaller, unlisted companies that do not form part of a mainstream equities portfolio.

Indeed, mid-cap loans of almost any type are easier to acquire and manage than direct investment in the underlying equity or real estate security. This makes mid-cap loans more amenable to institutional investment.

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19 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.

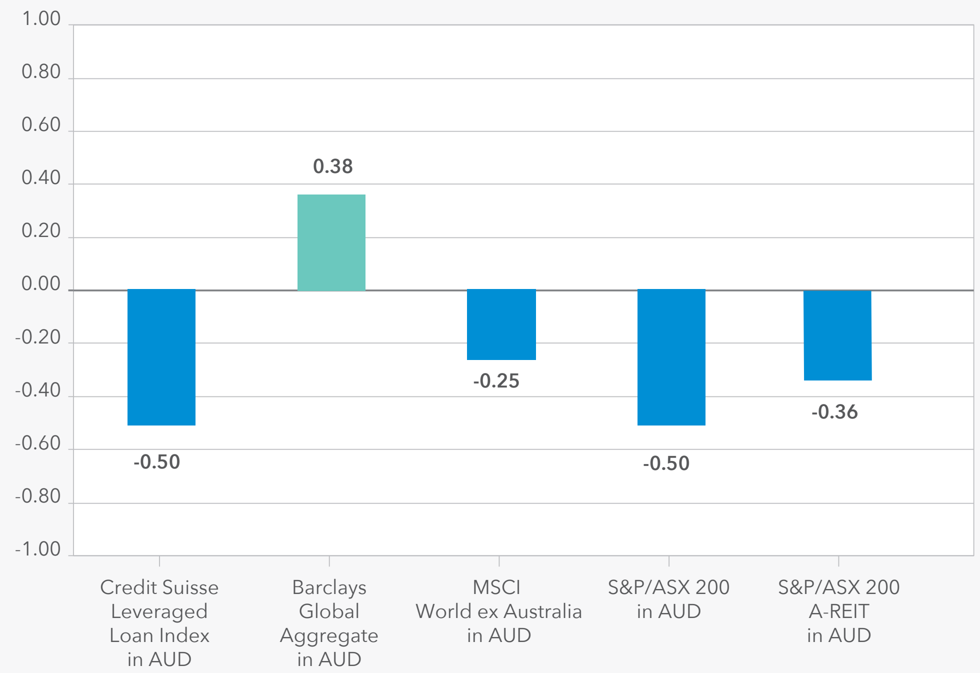
20 Notwithstanding the potential liquidity advantage of portfolios of mid-cap loans over portfolios of large-cap loans, investors accessing the asset class via a closed end comingled fund may only be afforded liquidity prior to the return of capital to the extent that there is secondary interest in their particular unit holding.

COMBINING MID-CAP CRE DEBT WITH OTHER DEFENSIVE INCOME INVESTMENTS

Low correlation of returns among different asset classes is desirable because it lowers overall portfolio volatility. Correlations of mid-cap CRE debt to other asset classes included in the defensive income allocation of superannuation funds are low.

Chart 5 shows the correlation of mid-cap CRE debt with leveraged loans, global fixed income, Australian shares, global shares and A-REITS. It suggests there is a strong diversification benefit to portfolios dominated by interest rate-sensitive fixed income, floating-rate corporate credit strategies, equities and real estate.

Chart 5 - Correlations (in Australian dollars, 2008-2014)



Source: eVestment

CRE DEBT COMPLEMENTS DIRECT REAL ESTATE INVESTMENTS

Superannuation funds are earning attractive rental yields on direct commercial real estate holdings. A-grade office buildings in Sydney and Melbourne, for example, are currently yielding between 5.75%-7.00% (gross) depending on location and tenancy.

Nonetheless, direct real estate holdings are far from a substitute for debt. They are an illiquid component of a growth allocation within a well balanced portfolio. As an equity investment they are far more susceptible to market vagaries. Senior loans, for example, with an LVR of 50%-65%, provide investors with a 35%-50% fall in value cushion before capital might be impaired. Sponsor and corporate guarantees provide another layer of capital protection. Further, in a rising interest rate environment property returns generally become depressed while floating-rate debt returns are enhanced.

Attractive rental yields also enhance the quality of a CRE lending program given the level of debt cover they provide. As well, with a re-rating of CRE values underway, security values are improving and this provides added support for a CRE lending allocation.

RELIANCE ON ACTIVE LOAN MANAGEMENT

A feature of the renewed pursuit of yield is greater reliance on active management and less on readily accessible market exposures.

Active management is required in direct lending strategies to originate loans, underwrite and mitigate risk, seek mis-pricings of credit, allocate between sub-sectors, work out troubled loans and service the loan portfolio. It typically relies on a systematic process and a large operating infrastructure.

As a consequence of a systematic process, past performance of many lending strategies (albeit through a full economic cycle) is a fair indicator of future success. This is particularly the case if a high proportion of loans is made to proven, repeat borrowers.

PRICING OF ACTIVE LOAN MANAGEMENT

It is difficult to compare pricing across different lending platforms given the idiosyncratic nature of lending and trading activities. As a general rule however, smaller loans and primary (as opposed to secondary) transactions are more expensive to originate and manage. Even so a few common principles hold to the pricing of active management of CRE loan portfolios:

- The management fee should reflect the cost of the operating infrastructure and any scale economies that accrue to the manager.
- A proportion of the management fee should be 'at risk' and placed in a loss reserve and only made payable on the return of capital to the investors.
- A proportion of the management fee should only be payable subject to the achievement of target returns without recourse to excessive leverage.
- All fees in the lending chain should be fully disclosed to investors.
- There should be no banking-style, broader commercial relationship with the borrower, for example, in other loan categories, transactions or deposits, as these can lead to price distortions.

A MID-CAP CRE LOAN PORTFOLIO ALIGNED TO INVESTOR PREFERENCES

For a defensive income allocation to private debt superannuation funds seek margins that are at least 3% (net of all fees) above 90-day bank bills to compensate for the relative illiquidity. They want stable margins and minimal risk of loss given default. They do not want to rely on excessive leverage to achieve their returns.

In response, Balmain's Secured Commercial Real Estate Loan Strategy (the Loan Strategy) is a broadly diversified portfolio of mid-cap CRE loans, all secured by first mortgage.

The Loan Strategy is designed to deliver stable net returns of 2.75%-3.25% p.a. over 90-day bank bills with modest LVRs, strong debt servicing coverage, embedded rental growth and, unlike large-cap loans, with the benefit of additional security in the form of sponsor and corporate guarantees.

The Loan Strategy blends senior secured investment loans (loans with LVRs of less than 65%) with lesser allocations to stretch senior investment loans and senior construction loans[21]. Only 15% of the loan portfolio can have an LVR of more than 65% and there is always a clear strategy to reduce LVRs to less than 65% prior to maturity. At no stage is mezzanine lending permitted.

The weighted average gross margin above 90-day bank bills of the allocation to senior investment loans will likely average between 3.0% and 3.5% p.a. The allocation to stretch senior investment loans boosts margins on the senior debt component of each of these loans, and for the stretch senior component, proffers returns commensurate with lower LVR mezzanine lending but with first mortgage security. The Loan Strategy is likely to earn gross margins above 90-day bank bills of 4%-7% p.a. on stretch senior loans.

Balmain also firmly favours a modest allocation to senior construction loans, a percentage of which will convert to attractive senior investment loans and improve the quality of the overall loan portfolio. These are loans secured against properties with new tenants, longer WALEs[22], higher NABERS[23] ratings and lower maintenance costs. They tend to improve the underlying portfolio quality and security as the Loan Strategy approaches maturity.

Investors are likely to earn gross margins above 90-day bank bills of 4%-7% p.a. on senior construction loans. These loans earn a margin that more than compensates for added risk taken. Furthermore, Balmain uses long established, conservative loan guidelines and lending structures designed to mitigate any added risk of default. Active management from loan settlement to loan repayment further mitigates risk.

The inclusion of modest allocations to both stretch senior investment loans and senior construction loans enhances the return of the Loan Strategy. It does this sufficiently well to produce a target net portfolio return 2.75%-3.25% p.a. over 90-day bills[24]. The return is expected to be stable over time. Interest can be reinvested or is able to be paid regularly to investors.

The target LVR across this lending program is a modest 62.5% or less, with a loss given default rate that will likely be consistent with investment grade bonds. A high proportion of loans is made to proven, repeat borrowers and a significant proportion of Balmain's management fee is placed in a loss reserve and is only payable on the return of capital to investors within these LVR and default rate targets[25]. A commitment to transparency ensures that all fees in the lending chain are fully disclosed to investors.

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21 Balmain classifies any loan with an LVR of more than 65% as a stretch senior loan. Construction lending comprises loans on real estate assets that are intended to be held as investment assets and/ or sold on project completion. LVRs referred to in this paper in the context of construction loans are assessed based on 'on completion' value and are restricted to a maximum LVR of 65%. Construction loans typically have a loan-to-cost ratio of no greater than 80% and pre-commitments via pre-sales equal to 50% of debt or pre-committed leases of at least 50% of net lettable area.

22 WALE is the weighted average lease expiry.

23 NABERS is a national rating system that measures environmental factors such as energy efficiency, water usage and waste management.

24 See 'A Fresh Take on Australian Commercial Real Estate Debt' for an explanation of how Balmain mitigates the risk of stretch senior and construction lending.

25 For details of the terms and features of Balmain's Secured Commercial Real estate Debt Strategy refer to the fund's Information Memorandum.

CONCLUSION

Few funds have embraced non-traditional floating-rate investments, such as mid-cap CRE debt. This reflects uncertainty regarding the risk/ reward of an allocation, lack of familiarity with the asset class and the underlying mid-cap real estate security, a preference for CRE debt as an opportunistic investment and concerns about illiquidity.

This paper petitions for mid-cap CRE debt as a defensive income allocation. It should be funded from the fixed income bucket, notwithstanding its illiquidity. There is considerable opportunity for the first movers amongst Australian superannuation funds to build an enduring loan program that would better meet the income needs of an aging membership base.

Balmain's Secured Commercial Real Estate Loan Strategy is a broadly diversified portfolio of mid-cap loans for commercial real estate all secured by first mortgage. It seeks to deliver stable net returns of 2.75%-3.25% p.a. over 90-day bank bills with regular cash flows to investors, modest LVRs, strong debt coverage, embedded rental growth and additional security in the form of sponsor and corporate guarantees.

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. The Balmain Group 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 is also the largest distressed debt portfolio manager in Australia currently overseeing more than $6 billion in loan assets on behalf of a variety of investors including Goldman Sachs, Morgan Stanley, Blackstone and Deutsche Bank.

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 granular portfolio of mid-cap commercial real estate loans with an average size of $3m - $30m.
- 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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