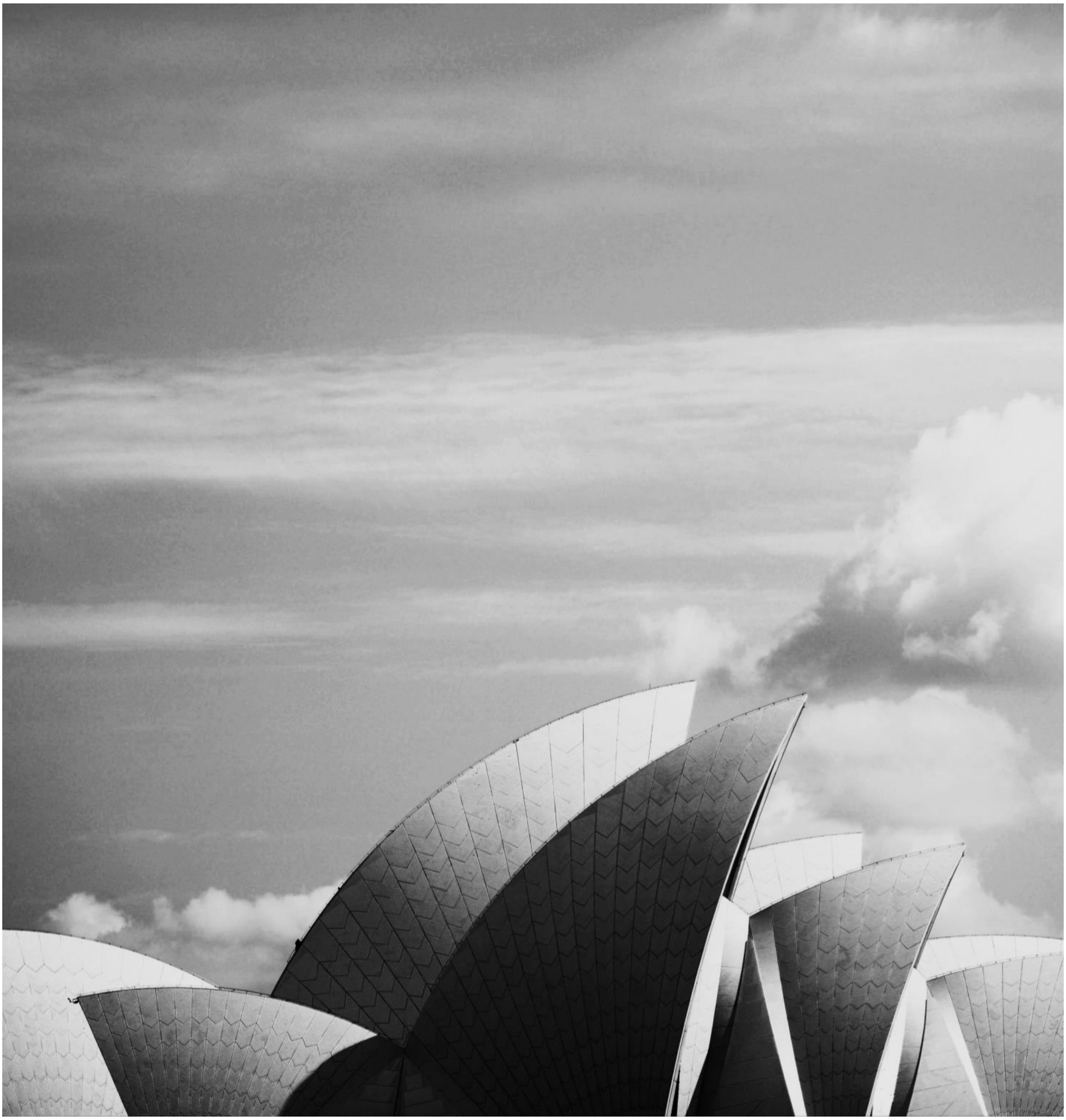
Special Report

Commercial Real Estate Lending

September 2021



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Executive Summary

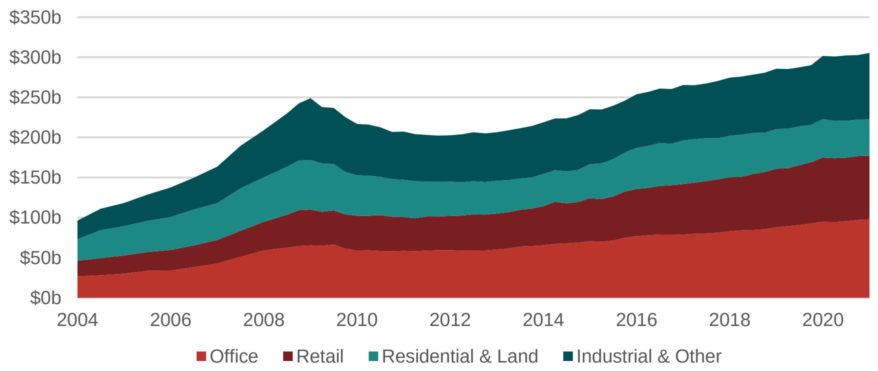
Although the Australian private debt market is one of the largest and more diverse asset pools domestically, it is largely unknown to most investors.

Historically, the sector's funding needs were almost entirely met by the traditional banking system. However, recent regulatory reform, customer specialisation requirements and the non-vanilla nature of cashflows have seen the market turn to institutional financing. Complementing these supply-side drivers is the asset class's unique risk profile: typically, CRE debt is secured over real assets and floating rate in nature. These features mean private debt provides ideal positioning within the interest rate and credit cycles.

The commercial real estate (CRE) loan market is a major but specialised subset of the Australian private debt universe. This sector comprises approximately a third of the aggregate corporate loan book for domestic ADIs *(APRA)*. As opposed to typical corporate lending, CRE debt funding will revolve around a particular commercial property asset (rather than a company) which can vary in terms of stages of development, seniority, geography, use of the underlying asset and timing of cashflows.

Consequently, expertise is necessary to navigate this complex market. Critically, the lender must ensure processes at both the origination and monitoring stages are robust enough to prevent capital losses. This became apparent during the global financial crisis (GFC) when the loose lending practices of the Australian banks, elevated leverage of borrowers and deteriorating economic conditions resulted in significant impairments to some CRE loan books.

Figure 1. ADI CRE Exposure by Sector



Source: BondAdviser, APRA. As at 31 March 2021.

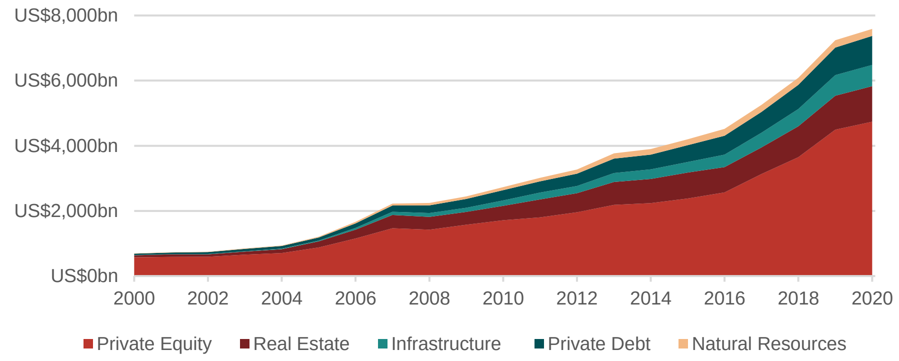
As a result of the inherent complexity, with appropriate risk management, CRE lending can generate excess returns with limited capital volatility; **this is currently being achieved by a number of non-bank CRE lenders**. While the broader property asset class will always remain cyclical, the risk profile of CRE has materially improved in the past decade with debt (rather than equity) being our preferred investment strategy.

Although the direct and indirect (via property funds) purchase of CRE has been a popular investment strategy domestically for decades, we believe investor knowledge of the CRE debt market is limited. As a result, **this primer is designed to be a useful reference for debt investors in the CRE space**, detailing key concepts, examining historical examples, analysing its risk / return profile and **providing an overview of the major domestic players**. Overall, this market represents an attractive investment opportunity and will continue to be an important pillar of the emerging and ever-increasing Australian private debt institutional asset class.

Australian Private Debt, a New Asset Class?

Despite its longstanding existence, private debt has only in the past decade become globally recognised as a separate asset class. Although it has always been difficult to quantify the size of this market due to its inherently confidential nature, worldwide institutional investment in private debt is estimated to have grown substantially to US$887 billion (Figure 2), as investors have sought out income alternatives in a historically low interest-rate environment. As the underlying investments in private debt are typically illiquid, funds will generally be closed end in nature, meaning capital will be drawn down with investor liquidity provided periodically or within an extended time frame.

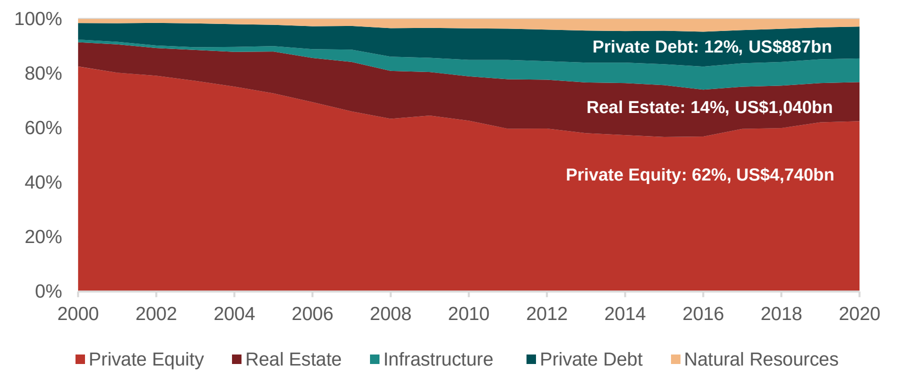
Figure 2. Global Alternative Assets Under Management[1]



Source: BondAdviser, Preqin Pro.
[1]To avoid double counting of available and unreaslised value, funds of funds and secondaries are excluded.

According to Preqin, a leading data provider for the alternative assets industry, private debt comprised 12% (US$118 billion) of all private institutional capital raisings in 2020, making it a material pillar of global private capital markets. Preqin estimate that private debt and the equity portion of real estate now comprise 12% and 14%, respectively, of the global total of US$7,587 billion alternative assets under management. Within the private debt asset class there are many strategies, spanning from venture capital financing to distressed debt, but direct lending has consistently been one of the most popular. This has largely been catalysed by a changing regulatory environment, which has made traditional commercial banking activities less profitable on a return on equity basis. This capital vacuum is now increasingly being serviced by non-bank lenders.

Figure 3. 2018 Global Alternative AUM Breakdown



Source: BondAdviser, Preqin Pro.
[1]To avoid double counting of available and unreaslised value, funds of funds and secondaries are excluded

In the private debt market, lending is typically undertaken on a direct basis between a single lender and single borrower. These arrangements are known as bilateral loans and can be tailored to suit the underlying borrower's situation and / or business model. This contrasts with syndicated loans, where multiple banks will lend to a single borrower to divide risk exposure either directly with the borrower or via an agent / arranger.

Due to the bespoke structure of bilateral loans, they are relatively more illiquid when compared to syndicated loans and will generally involve a buy-and-hold strategy. As there is only a single lender, these loans will generally be made to smaller borrowers (the middle-market) with loan commitments typically less than A$100 million. As the market is private, usually overlayed with multiple confidentiality agreements and does not have an active secondary market, data is non-standardised and fragmented. While some of Australia's largest buildings will involve loan syndication, most domestic CRE financing arrangements are conducted on a bilateral basis, especially given the unique circumstances and attributes of CRE assets.

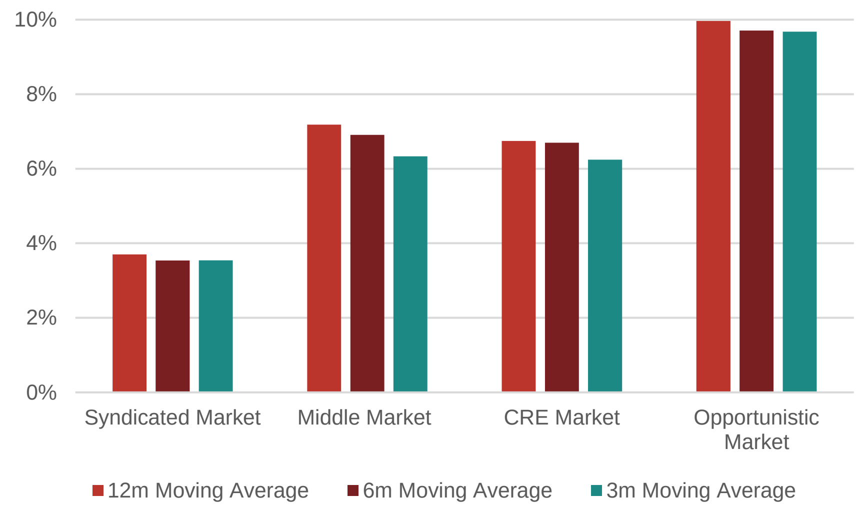
Table 1. Bilateral v Syndicated Loans

	Bilateral Loans	Syndicated Loans
Loan Size	$2-100 million	>$100 million
No. of Lenders	Single: loans are made between a single borrower and a single lender.	Multiple: Multiple banks will form a 'syndicate' and collectively lend to a single borrower.
Public Information	Lower: Bilateral contracts are highly confidential with the terms generally giving the lender significant non-public information about the borrower.	Higher: As syndicated loans typically involve large public companies, there is some public disclosure with collection from a number of self-reported data vendors.
Covenants	Due to risk concentration for the lender and usually bespoke requirements of the borrower, bilateral agreements tend to have more robust covenant packages.	As syndicated loans are generally made to the largest borrowers and for common purposes, contracts typically have a greater degree of standardisation and less restrictive covenant packages.
Credit Spread	Higher: Bilateral loans are typically made to smaller and relatively riskier borrowers. As a result, lenders will usually require a greater risk premium.	Lower: Syndicated loans are typically made to larger and relatively less risky borrowers. As a result, lenders will usually require a lower risk premium.
Liquidity	Lower: As there is less standardisation and only a single borrower, bilateral loans have a very limited secondary market.	Higher: Syndicated loans have some degree of liquidity either between syndicate participants or other large banks.
Non-Bank Participation	Higher: Due to the attractive risk profile which can be tailored to the lender, confidentiality of agreements and lower capital requirements, there is a greater participation from non-bank lenders.	Lower: Banks usually offer loans at competitive rates due to additional ancillary attached to a particular borrower (bank accounts, hedging) making the return profile of syndicated loans unattractive to non-bank lenders. Greater capital requirements also impose a barrier to entry.
Fee Structure	Although the all-in cost of funding may be higher, bilateral agreements are usually subject to a limited number of fees.	Syndicated loans typically involve syndication fees and agent / arranger fees. However, the all-in cost of funding will generally still be lower due to a smaller capital spread.

Source: BondAdviser.

In Australia, the private debt market broadly refers to 'middle-market' corporate lending which mostly comprises all borrowers too small to access large, syndicated bank loans, yet too large for small business loans. As this segment does not have the high capital requirements needed to participate in large loan syndications while also allowing lenders to tailor loan contracts, there has always been a material non-bank presence due to attractive, customised investment opportunities.

Figure 4. AUD Private Debt Market Net Yields

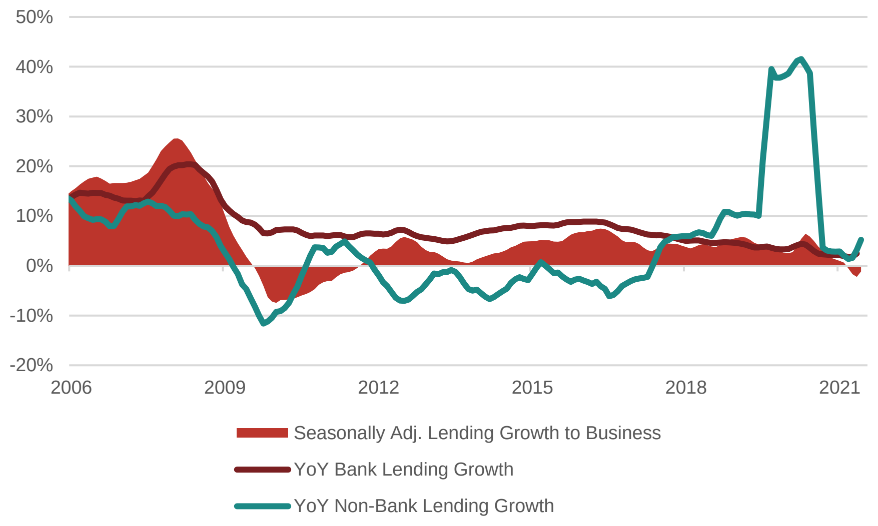


Source: BondAdviser. As at 31 July 2021. Net is after all fees. Yields based off NAV.

Historically, this participation has been cyclical with the domestic corporate loan landscape remaining a major bank-dominated market with APRA figures indicating that the majors represent 70-80% of all domestic corporate lending. As illustrated in Figure 5, from 2017 until early 2020 non-bank lending experienced strong growth and substantially outperformed bank lending from a growth perspective. In our opinion, this is supported by underlying drivers which are changing the composition of lenders in favour of the non-banks. In recent years, **tighter banking regulation** has seen a healthy influx of non-bank institutional lenders versus the surges in corporate debt we have seen in previous cycles. We view this period (2017-2021) as having marked the beginning of a permanent shift in market structure supported by a greater focus on risk management.

In response, there has been a **growing appetite for various loan funds**, but given the relative opacity of underlying assets, education and data is a direct function of investor confidence – which is gradually improving. Ultimately, all of these factors are contributing to the case of the emerging private debt asset class in Australia. We did see growth significantly taper off in early 2020, as a consequence of the COVID pandemic. Although the COVID health and economic crises present risks to these supportive conditions, the **muted lending growth may benefit corporate lenders** regardless, as they can charge higher premiums on a scarcity basis.

Figure 5. Australian Corporate Lending Growth

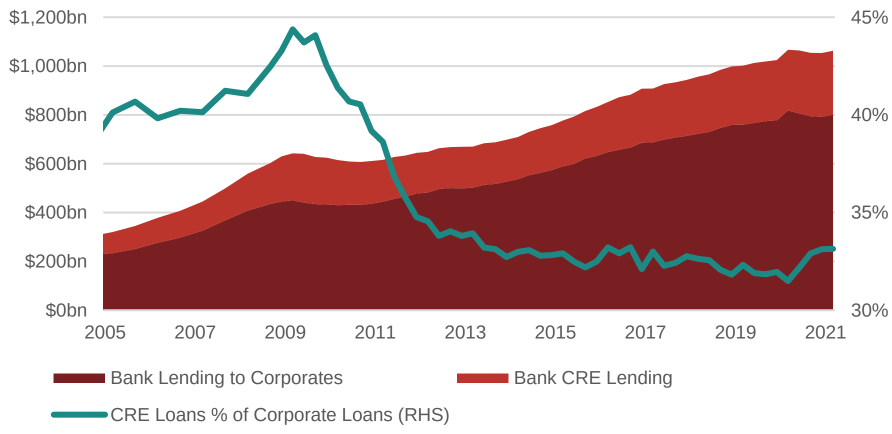


Source: BondAdviser, RBA. As at 30 June 2021.

CRE lending, is a specialised, yet major component of the middle-market corporate loan universe where lenders participate in the development of new or established real estate developments across office, industrial, retail or residential. In addition to this development-based lending, residual stock lending, where a developer borrows to fund left-over apartment stock, is an increasingly important aspect of the CRE market at this point in the cycle.

As loans that are made by non-bank lenders are private and hence data is decentralised, it is difficult to quantify the total size of the universe. However, according to APRA, total domestic CRE exposure is estimated to be ~A$300 billion, demonstrating the size and breath of the market. As Figure 6 illustrates, Australian bank exposure to CRE loans has proportionately declined within their corporate loan books. This trend is the inverse of what we have seen across the domestic private debt market.

Figure 6. Australian Banking System Domestic CRE Exposure

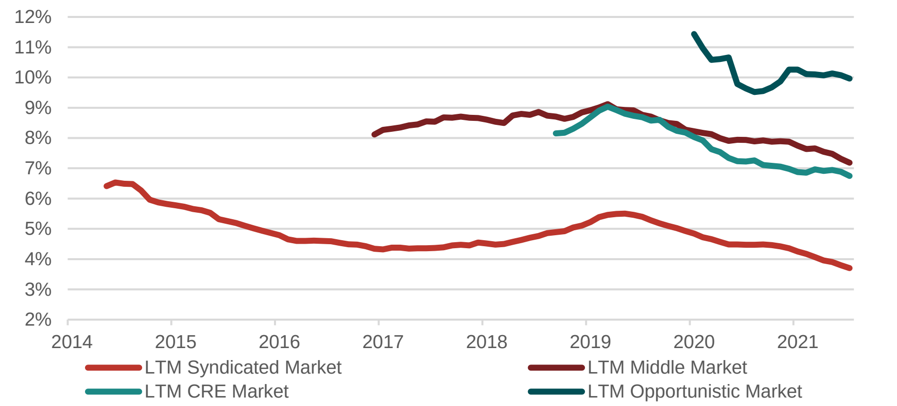


Source: BondAdviser, APRA. As at 31 March 2021.

Commercial Real Estate Debt Risk & Return

As the private debt universe, and more specifically the CRE debt market, is decentralised, mostly confidential and in the relatively early stages of becoming an institutional asset class, there is no historical performance index in Australia. As a result, it is challenging to make assumptions about CRE debt on a risk-return basis. We have built a proxy for net performance, using returns of some domestic funds. As illustrated in Figure 7, CRE debt has returns that are largely commensurate with the broader middle market of private credit.

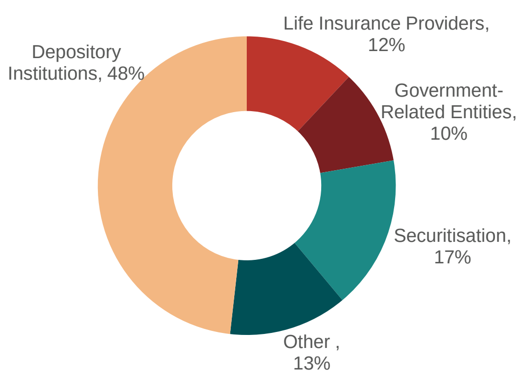
Figure 7. Time Series - AUD Private Debt Market Net Yields LTM Rolling Average

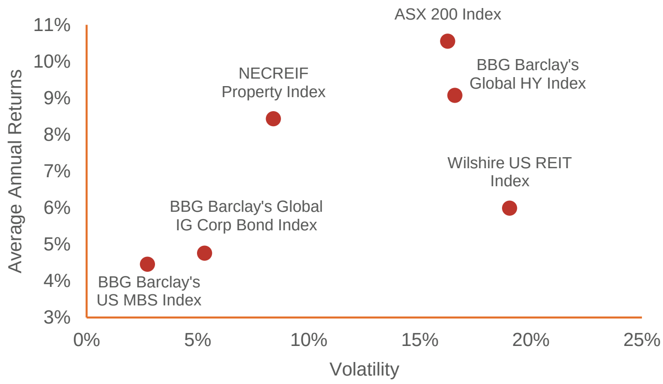


Source: BondAdviser. As at 31 July 2021. Syndicated Market proxied as Metrics DASLF. Middle Market proxied as average of Metrics SPDF I, SPDF II. CRE Market proxied as average of Qualitas QRI and Metrics REDF. Opportunistic Market proxied as Metrics. Credit Trust. Net is after all fees. Yields based off NAV.

Figure 8 provides a global perspective of the broad risk / return environment for CRE debt. Firstly, the, the NCREIF Property Index, which tracks the performance of real estate assets across retail (20%), residential (20%), industrial (20%) and office (40%), which has a far greater market participation from life insurance companies and pensions funds, shows long-term returns (20Y) materially above IG corporate bonds but below high-yield investments. We view this as broadly accurate of the return on CRE investments, and the lower volatility illustrated in Figure 8 is indicative of the structurally less volatile nature of real estate assets.

Figure 8. US Commercial and Multifamily Mortgage Debt by Lender and Long-Term (20 Year) Asset Class Risk / Returns

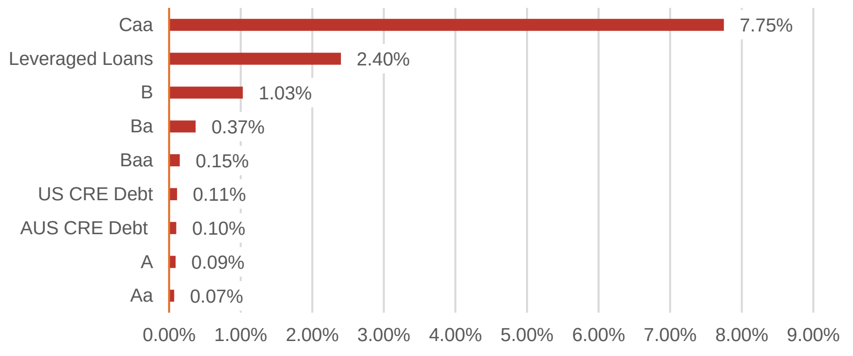




Source: BondAdviser, Federal Reserve, Bloomberg.

However, it is reasonable to assume the Australian experience would be different with a legal framework more heavily in favour of lenders. Although this notion is challenging to quantify with objective publicly available evidence, the returns achieved by a limited number of non-bank participants in the domestic CRE market support the relatively more attractive risk-return profile of the asset class.

Figure 9. Indicative Loss Rates



Source: BondAdviser, Moody's, Credit Suisse, ACLI.

Australian CRE Debt Provider Overview

The COVID-19 pandemic and its economic impacts have introduced considerable uncertainty into the fundamentals of the CRE market. As noted above, this makes the choice of CRE debt manager even more important.

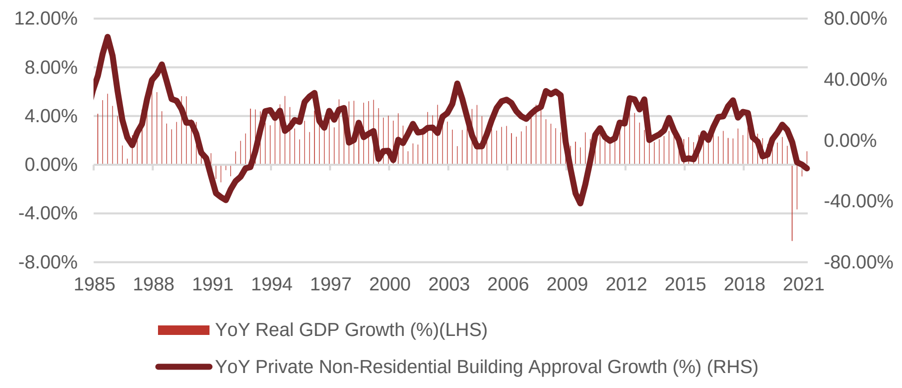
Whilst the Australian landscape is relatively young, it has undergone rapid development in recent years. To an extent, its infancy makes it more dynamic with the entrance of a several new managers attempting to gain exposure to the maturing market.

The result is an Australian market comprised of several managers, including some specialist CRE firms (Pure CRE Debt Managers) whilst others (Multi Strategy Providers) are more general private lenders or fund managers which have developed specialised CRE products or alternatively, diversified their portfolios with CRE exposure.

The CRE Debt Cycle

As with most asset classes, real estate is cyclical (Figure 10) and will prosper in periods of economic expansion and decline in subsequent downturns. Consequently, property values will fluctuate throughout a complete cycle, which will in turn impact the owner's equity. **Default probabilities will rise as economic conditions deteriorate** but assuming a sufficient equity buffer is in place, and swift active management is undertaken, the recovery rate for secured debt investors can be 100%. However, as the following sections show, this is not always the case.

Figure 10. GDP Growth v Private Non-Residential Building Approvals

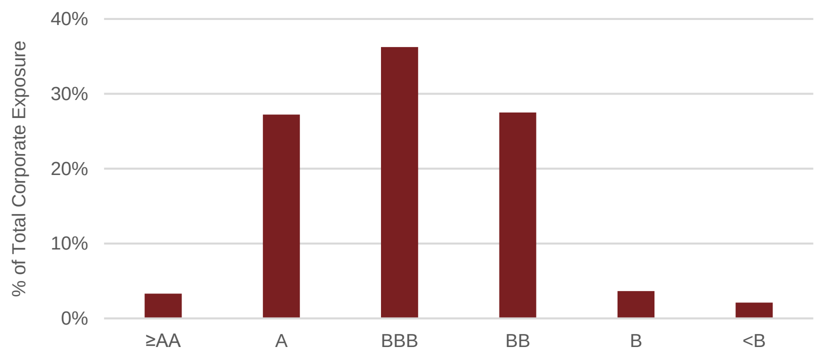


Source: BondAdviser, RBA as at 31 March 2021.

What Has History Shown Us?

For most economies, the real estate loan market is largely controlled by banks, making the asset class challenging to analyse on a risk / return basis, especially with limited publicly available data. A useful gauge of domestic market characteristics are the four major Australian banks, which dominate both the corporate lending landscape and more specifically, the CRE loan universe; with the major banks holding ~75% of all domestic ADI exposure to CRE lending according to APRA data. Loan-level data from the banks is limited but historical risk metrics regarding their broader corporate loan books can be derived from regulatory disclosures. While credit quality across the major banks' aggregate corporate portfolio is diverse and ~30-40% non-investment grade on average (Figure 11), loss rates have been muted throughout the last economic cycle (Figure 12).

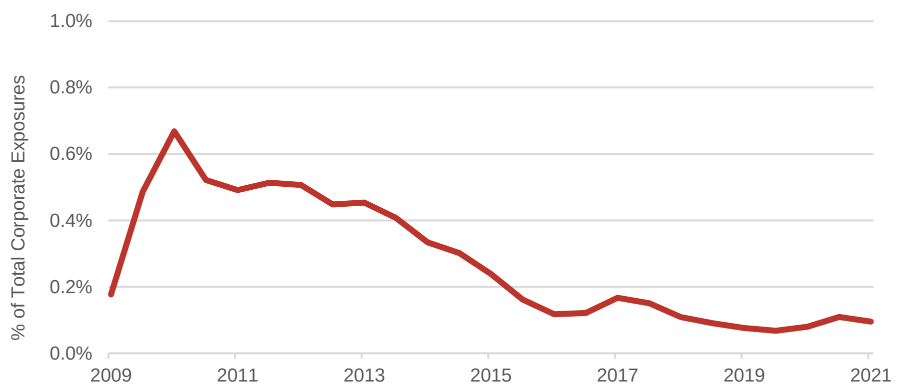
Figure 11. Major Bank Rating Distribution



Source: BondAdviser, Pillar 3 Disclosures as at 31 March 2021.

In terms of domestic CRE debt, the best objective data of distressed assets would most likely have occurred during the nation's recessionary periods. Australia's last experience with such conditions (excluding the COVID period) was in the early 1990s when CRE bad debts almost resulted in the collapse of Westpac (ASX: WBC) and ANZ Bank (ASX: ANZ). However, because detailed information regarding CRE loans from this period is limited, it is more appropriate to analyse the market from 2000 onwards, since more data is publicly available for this period.

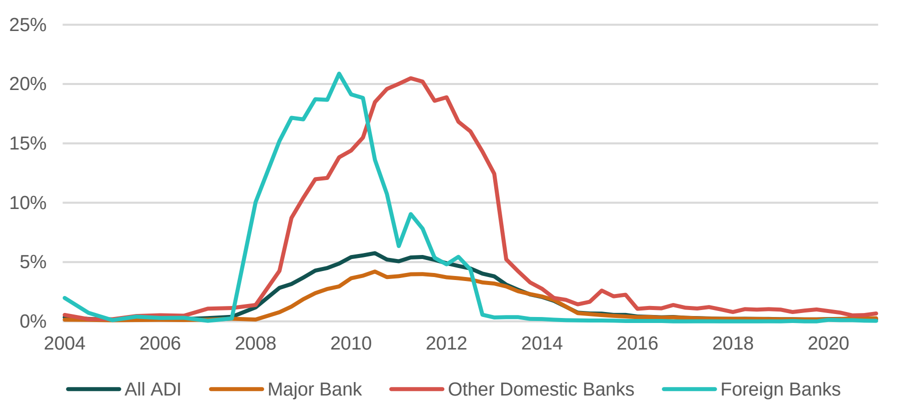
Figure 12. Major Bank Historical Loss Rates – Net Write Offs



Source: BondAdviser, Pillar 3 Disclosures as at 31 March 2021.

As discussed in detail below, despite entering a recession for the first time in decades (Figure 13), the impact of COVID on CRE markets has been relatively muted so far. Thus, the global financial crisis (GFC) is the best example of distressed real estate debt despite Australia not technically experiencing a recession in that period. According to APRA, impaired assets as a percentage of total exposures peaked in 2010-2011 with a strong divergence between the major banks (~4%), other domestic banks (~20%) and foreign banks (~28%, though peaked earlier in 2009). Interestingly, the latter resulted in the vast exodus of UK and European banks from the Australian corporate loan market while a number of small banks consolidated and/or restructured to arguably remain viable. While actual losses (write-offs) are hard to estimate with conviction, US data (Figure 14) suggests there is usually a notable difference in arrear rates that widens in challenging economic conditions (albeit using a slight change in terminology with charge-off and delinquency rates).

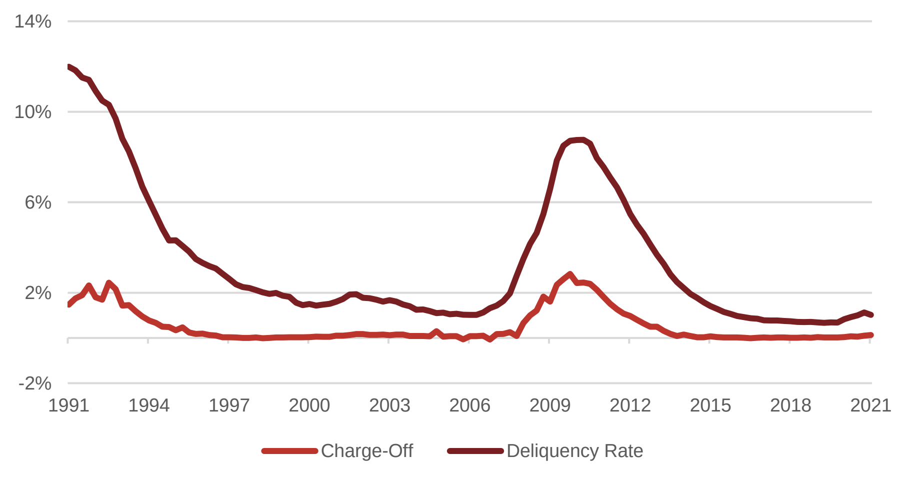
Figure 13. Australian CRE Debt Impairment Ratio by Type of Lender



Source: BondAdviser, APRA. As at 31 March 2021.

Overall, Australian CRE debt impairments fared relatively better during the GFC, declining by 25% from peak to trough according to information compiled by the RBA. In comparison, some countries amidst the depths of the global recession recorded declines of more than double those seen in Australia. For example, the US and the United Kingdom experienced contractions of 43% and 44%, respectively while Ireland's market lost greater than half its value, falling by 56%. While these figures are substantial and demonstrate the cyclical nature of CRE assets, it is important to note that these are passive capital losses. In other words, typical CRE loan contracts give lenders significant control and ability to intervene in such scenarios. Therefore, in reality, action is usually taken (or borrower default would likely occur) far before a particular CRE asset reached its trough in value.

Figure 14. US Charge Off v Delinquency Rates for CRE Debt at Commercial Banks

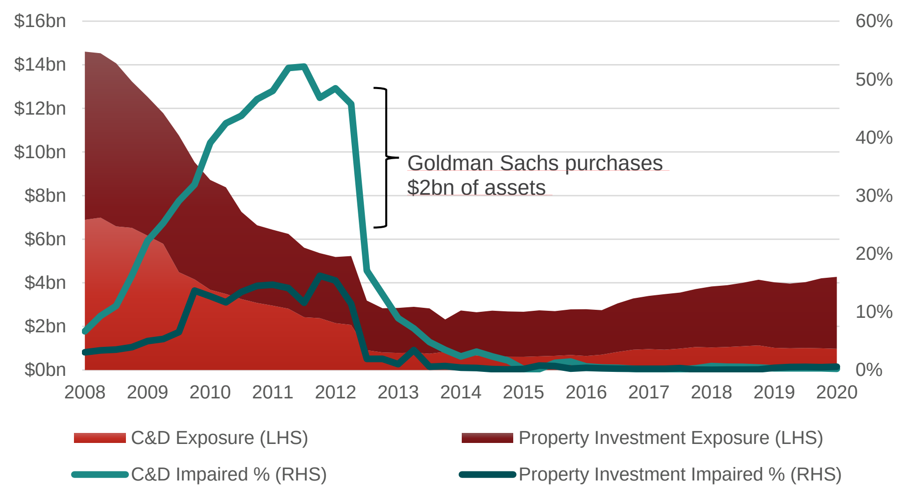


Source: BondAdviser, Federal Reserve. As at 31 March 2021.

In such an event, there are a number of strategies that could be undertaken to protect debt capital, such as recapitalisation of the borrower, ownership of the asset (i.e. swapping debt for equity) and/or the forced fire sale of the asset (albeit this is less ideal). However, we note that due to construction lag and the default risk associated with pre-sales, **development projects generally perform worse in distressed environments versus established assets**. Underlying land value, alternate uses and cost-to-completion, combined with significant lender experience, are important variables for development projects to avoid sub-par recovery rates. Ultimately it is challenging to quantify with accuracy actual cumulative losses that were experienced by all the domestic CRE lenders in the aftermath of the GFC but it is well known some fared far better than others. In 2012, the Royal Bank of Scotland received just 48% of par value for most of its Australian commercial property exposure, while in 2013, Suncorp sold A$1.6 billion of damaged commercial property loans at a 60% recovery rate.

In 2009 when the financial crisis hit, Suncorp opted to set up a non-core or 'bad bank' to run-off ~$17.5 billion of loans consisting of commercial property loans (65%) and corporate loans (35%), that soured after the GFC due to "inappropriate risk settings". When these loans were 'carved out' of the Group's more stable regional banking franchise, the non-core loan book equaled about 20% of group assets, which was dangerously high. Suncorp's regulatory disclosures in the years that followed depict the deterioration in credit quality for the CRE portion of the 'non-core portfolio' with Construction & Development (C&D) book reaching an gross impairment ratio of 50% and the Property Investment book (i.e. established assets) experiencing a gross impairment of 15% (Figure 15). This reaffirms that development projects are subject to greater credit risk in a downturn. It is also important to note that while these figures are concerning, banks are naturally levered vehicles (Suncorp had a leverage ratio of ~9x in 2009) which compounds a sharp deterioration in assets. On an unlevered basis (a key attribute of non-bank institutional lenders), impairments would have been below ~6%. In 2013, in a move designed to 'de-risk' the Group, Suncorp sold a portion of this non-core or 'bad debt' book to Goldman Sachs for ~60 cents on the dollar.

Figure 15. Suncorp's C&D and CRE Property Investment Loan Book Run-Off



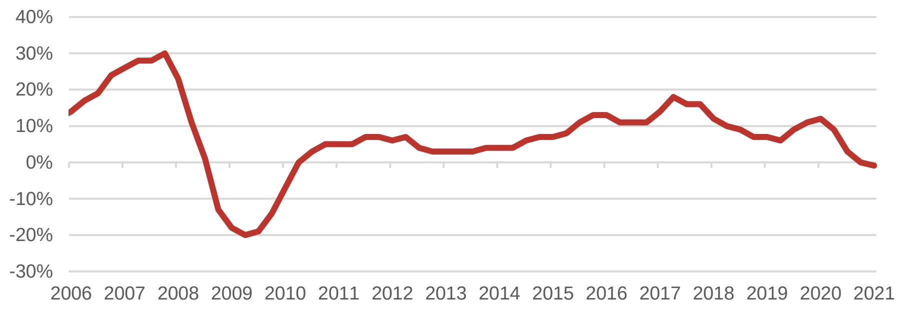
Source: BondAdviser, Suncorp APS300 Reports as at 31 December 2020.

The Current Climate

The CRE climate remains dominated by the COVID pandemic and the outlook for the sector remains hostage to developments in the crisis. As Figures 12 and 13 illustrate, despite Australia dipping into a recession – an event which did not occur during the GFC – the deterioration in CRE default and impairment metrics has been considerably more muted than the movements during 2009-2012. Whilst there was a slight uptick in major bank loss rates and CRE debt impairments in the latter half of 2020, monetary and fiscal support measures and Australia's substantial elimination of the virus for much of 2020 and the first quarter of 2021 meant most of this deterioration was retraced. These domestic movements broadly reflect those in the United States. Unfortunately, lockdowns continue to plague the Australian economy with conditions deteriorating since March 2021. Yet, because of the delay in the release of data, we are unable to see clearly what the impact of the latest development has been on the CRE market. However, on the basis of the past year and, importantly, taking account of a number of policy measures which seem to have materially improved conditions, we can get a sense of how current conditions may or may not be analogous to trends seen over the last 18 months.

The consequences of COVID on the CRE market is a complex narrative to tell given the impact has varied extensively across geographies and sectors. Nevertheless, it is clear that the impact in general has been far less severe than some anticipated early on. This has been a function of a several factors.

Figure 16. Australian CRE Price Change Year on Year



Source: BondAdviser, St Louis Fed.

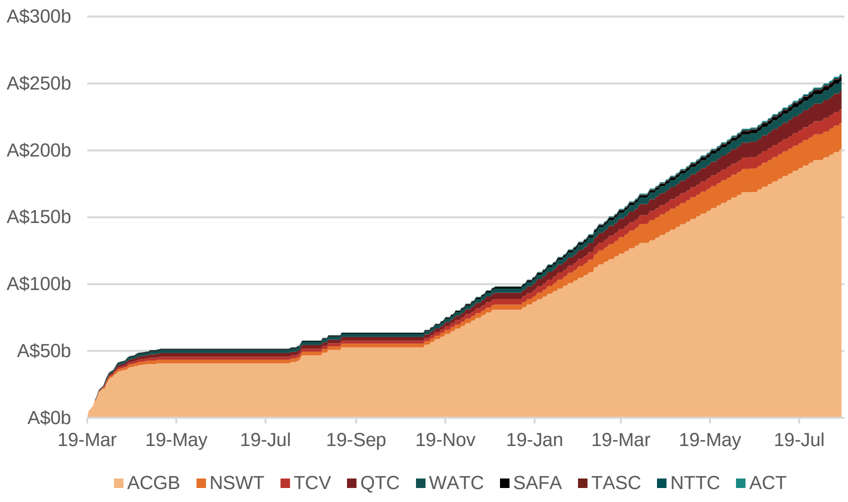
The first is the extensive and comprehensive support from the Federal and State Governments. 2020 saw the implementation of a staggering amount of fiscal support and similarly extensive, though less apparent, regulatory changes which cushioned the economic impact on businesses and mitigated a full-scale CRE crisis. In addition to the headline income support programs like JobKeeper, these measures included **a National Code of Conduct** (National Code) for commercial landlords dealing with business tenants which made eviction and recovery more difficult and similar moratoriums on evicting residential tenants. The National Code set eligibility criteria for rent relief and implemented a process for such negotiations as well as mandating landlords do not increase rent for a period of time, among other things. The most notable feature of the Code was requiring landlords to relieve rent for a commercial or retail tenant with turnover up to $50 million in proportion to the tenant's decline in turnover; with at least 50% of the relief in the form of waiver and the remainder a deferral.

The consequences of the support measures have been mixed. On the one hand, as a result of the fiscal support and all-time low interest rates, the Australian residential housing market has rebounded extraordinarily well following a brief period of cooling early in the pandemic and national dwelling prices are now expected to rise 18% over 2021. Given financial metrics are often tied to asset values, a material deterioration in asset values across the market considerably impacts on the way managers operate their portfolios. As such, this governmental support has hugely benefited CRE managers by cushioning what could otherwise have been a period of severe disturbance to portfolios.

This is especially beneficial for residual stock exposure, which relies on the capacity of developers to sell apartment stock at a price that can meet its servicing requirements – notwithstanding the price movements have not been as stark in the apartment subsector.

In addition, apart from the almost two-week construction shutdown in NSW during July 2021, for most of the lockdown periods commercial construction has been allowed to continue, albeit with some capacity constraints. This exception has avoided a worst-case scenario for construction loans, with managers largely having been able to overcome delays and disruptions. Although construction sites have not shutdown, the subdued development activity may provide supply side support for valuations in the longer term. Given this, continued accommodative government policy remains critical for CRE managers in staving off the full impact of the COVID disruption. The extent of support has been less than was seen through 2020, with the Federal Government adamant that programs such as JobKeeper, JobSeeker and HomeBuilder will not return. However, alternative income support measures have been put in place to help mitigate the impact of lockdowns on household income.

Figure 17. RBA Bond Purchases – Time Series



Source: BondAdviser, RBA. As at 18 August 2021.

Conversely, the National Code materially muted cash collections on CRE managers as they were mandated to negotiate rent relief and reductions with SME tenants. The impact of these requirements were clearly seen through financial reporting over FY20 on CRE managers. Whilst this must be balanced with the reality of lockdowns – in other words, how realistic would it have been that landlords could have located a better deal in the market? It is clear that the $15 billion in support provided to tenants in 2020 has impacted CRE managers. Thus, whilst this Code was set to be a historic anomaly (was set to expire on August 20), NSW has recently reinstated the Code given the deterioration in the COVID situation following Victoria, which reinstated the Code weeks prior. Any similar deterioration elsewhere and we would expect a similar reinstatement. This outcome merely reinforces the adverse impacts of COVID on the CRE market as it has shifted the balance of favour towards SMEs. Whether this shift remains post-COVID remains unclear.

The impact has been especially severe for office and retail assets, the former having especially suffered from the profound changes to work behaviour triggered by the pandemic. Whilst there has not yet been a radical increase in office vacancies despite the economic crisis and widespread lockdowns, it does now seem clear that there has been a fundamental shift in the way businesses are using offices. Although the full impact will not be clear for some time, it seems likely that flexible work arrangements with regular days of working from home will be a permanent side effect of the pandemic. It will not be until office leases (entered prior to the pandemic) run-off that we will see the true impact of these changes, and thus the COVID impact on office vacancies may still pass through in the coming 1-3 years. If this occurs, we expect such vacancies to cause a flow on effect for valuations.

Figure 18. Australian CBD Office Vacancies

Source: BondAdviser, Statista. As at 30 June 2021.

Retail CRE faces similar challenges. Prior to the pandemic, retail purchases had been trending towards online platforms instead of traditional 'bricks and mortar' shops. However, COVID has rapidly accelerated this trend, with online shopping growth of 45% for the 12 months to December 2020. Online shopping accounted for 16.3% of total retail spending in Australia (excluding cafes, restaurants and takeaway food) in the month of June 2021 (*ABS*). Whilst the impact on regional shopping centres and in-person sales of non-discretionary items has been relatively inelastic, for managers of metropolitan discretionary-focused shopping centres, this is cause for considerable concern as these behavioural trends reduce the demand for such retail real estate. Conversely, these changes introduce considerable areas of CRE growth. In particular, logistics has boomed since the pandemic. Given online shopping relies on logistics and warehousing centres to service and deliver the goods, these trends have created opportunities for logistics CRE managers. The conclusion of this valuation and arrears pressure is that the selection of manager becomes even more crucial, given the importance of strong structural protection in the loans with respect to default and recovery, and manager competence in managing the portfolio in a distressed environment.

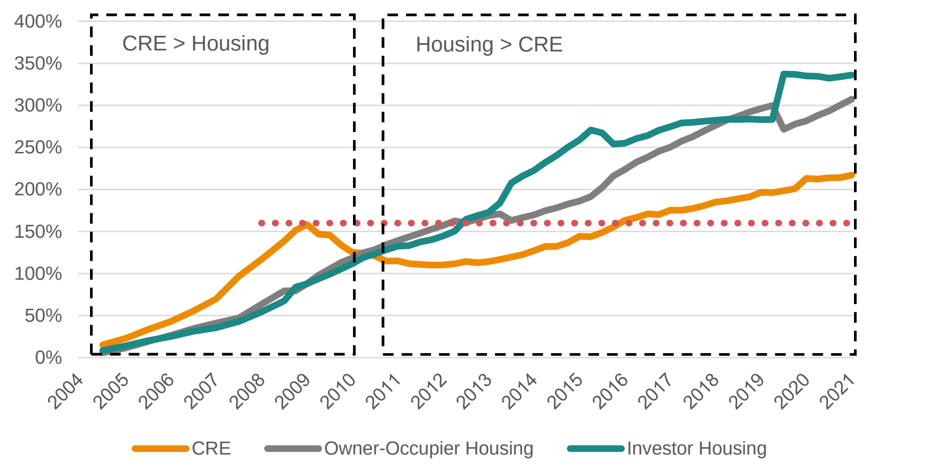
At a structural level, the **current environment presents great opportunities for astute managers** in the CRE space, especially in relation to a higher private debt premium, which will support an increase in relative yields on investments. In the period leading up to the pandemic, as a result of higher capital inflows into the private debt market and increased competition, this premium, which is driven largely driven by illiquidity premium caused by shortfalls in traditional banking capital, had been under incremental pressure. Following the retreat of banks and foreign lenders from the CRE space as a result of the crisis in conjunction increased reluctance to lend (especially by the banks in the CRE sector), this trend is expected to largely if not wholly reverse, **providing significant yield opportunities for the private CRE lenders** which remain willing to deploy capital for prudent investments. In addition, if default conditions worsen substantially, the **consolidation of less prudent managers will support rational pricing** in the market, leaving the most competent players in a position to operate in a market which is fairly attractive to lenders.

In addition, the Australian market provides structural protections for lenders in comparison to overseas CRE lenders. Following the GFC and the offshore rise of covenant-light loans ("Cov-Lite") has arguably **widened the divergence between the**

credit risk of global and domestic corporate loan markets. Cov-Lite contracts do not contain the usual protective covenants of traditional loans and liken assets to that of bond instruments. While this presents an extreme risk in foreign corporate loan markets, we note Australia does not bear much comparison due to much more restrictive structural mechanisms which have become more stringent in line with APRA's ongoing development of stricter regulatory controls for banks (lower leveraged and higher capital), especially for property exposures. As the broader Australian corporate loan market is still largely dominated by the domestic banking system, this more attractive pricing of risk has had a beneficial knock-on impact to the non-bank sector which has been able to take advantage of the stronger overarching risk sentiment, especially as some banks have withdrawn from select borrowers entirely. This resultant demand-supply imbalance skews the risk profile in favour of the lenders, allowing for stronger structural protections at relatively higher credit spreads.

There has been continual concern regarding the domestic property market, but as Figure 19 shows, the current cycle and the previous cycle paint very different pictures. As illustrated, the run up from the early 2000s to the peak of the GFC was helped by significant activity in the CRE loan market which inflated CRE asset prices domestically and globally but in the post-GFC era, it took 7 years for the system loan portfolio to recover past its peak with lenders (and overseeing regulators) far more reluctant to fund projects. In comparison, residential mortgage lending (both for owner-occupiers and investors) has rarely faltered over the same period and now far exceeds the system CRE debt. Consequently, there has been a **major shift in risk concentration within bank balance sheets**.

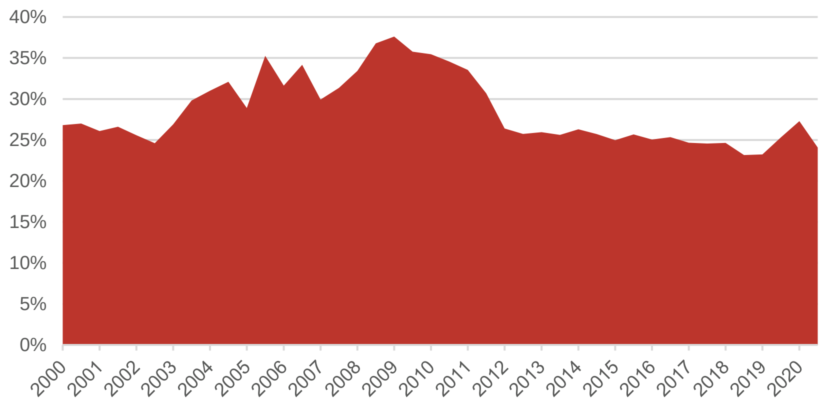
Figure 19. Australian Banking System CRE vs Housing Cumulative Growth



Source: BondAdviser, APRA as at 31 March 2021.

This is further supported by the risk culture of borrowers. Although not truly reflective of the entire demand spectrum for CRE debt, as a general indication, the average gearing ratio of ASX200 Real Estate Investment Trusts (REITs) and property developers demonstrate a clear shift in strategy (Figure 20). Listed property companies are currently far less levered than they were in the GFC period. And while gearing slightly increased over 2020 as REITs took on more leverage in order to sure up their operational viability in response to the risks of the pandemic; positively, as conditions have normalised we have already begun to see a winding down of leverage.

Figure 20. Average Gearing Ratio of ASX200 REIT & Property Developers



Source: BondAdviser, Bloomberg, Company Reports. As at 31 December 2021.

For this reason, CRE debt is relatively less risky than a decade ago during the GFC with lower leverage, more robust covenant packages and higher quality assets becoming the new norm for experienced lenders. Although significant risks persist, as highlighted above, it seems there is more capacity for lenders to absorb at least a modest deterioration in asset quality as a result of the pandemic. And given the structural protections embedded in the debt investments, we view CRE debt (versus equity investment) as the preferred exposure at this point in the cycle.

Commercial Real Estate Credit Concepts

Unlike traditional bottom-up credit analysis across a wide range of assets and sectors, the CRE loan market has a greater degree of correlation due to a strong influence from top-down macroeconomic variables. As a result, investment managers can utilise diversification across sub-markets and geographies, but the **extent of diversification will always be limited**. In other words, it is difficult to achieve negative correlations to protect capital within the CRE asset class (Table 2). Consequently, asset-level strategies such as covenants, clauses and other conditions together with substantial expertise, are of utmost importance when investing in the space, which will vary significantly across transactions with each loan asset typically having its own unique risk profile. As capital price appreciation for loan assets is rare, emphasising the natural skew in credit investing (i.e. limited upside), credit risk management is two-fold, requiring all capital is retained and all income is received in a timely manner.

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

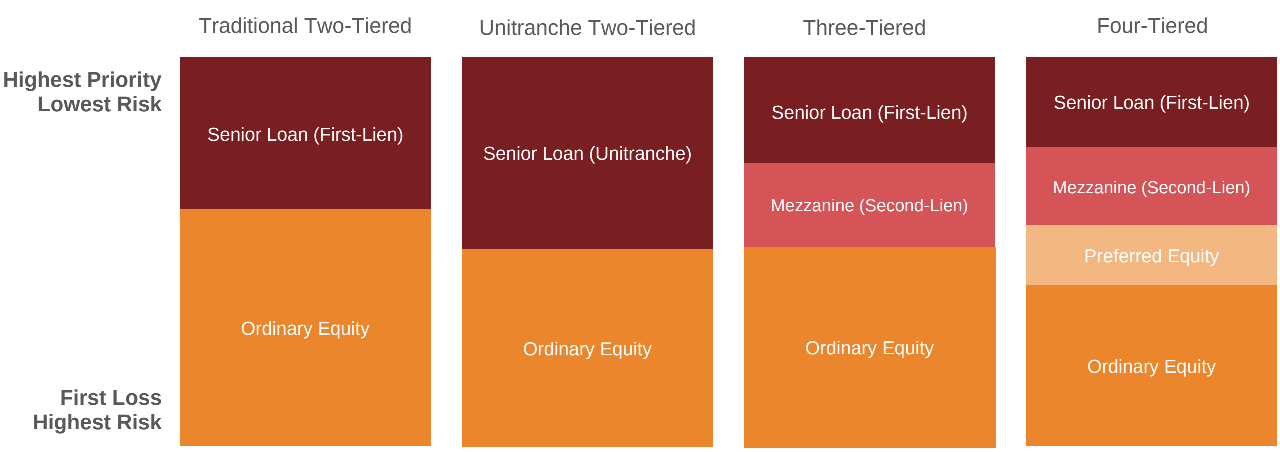
	Residential	Retail	Industrial	Office
Residential	1.00			
Retail	0.22	1.00		
Industrial	0.26	0.91	1.00	
Office	0.29	0.78	0.88	1.00

Source: JLL Research, ABS as at December 2017.

Seniority and the Capital Structure

When deciding on CRE funding requirements, assets are generally financed from a mix of debt and equity capital. However, within each class, investors can be subordinated depending on the specific funding composition of the underlying asset which forms the 'capital structure'. The types of capital structures for a given CRE asset are illustrated in general terms in Figure 21. While CRE lending can be conducted on an unsecured basis, this is rare with most loans secured to the underlying real estate/project. Equity forms the residual value of the asset once the debt is subtracted from its value and can be raised externally or contributed internally by the borrower.

Figure 21. Examples of CRE Capital Structures



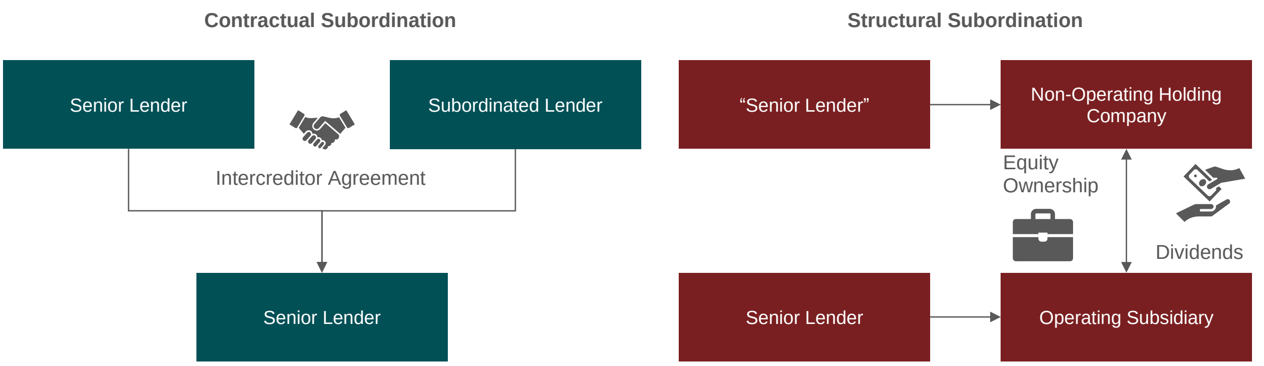
Source: BondAdviser.

A first-lien loan is a type of senior debt where debt holders have the **highest priority claims to the collateral of the loan in the event of default**. Claims on the collateral of second-lien loans (also known as mezzanine financing) rank behind claims of first-lien loans. Due to the implied risk in a wind-up scenario, second-lien loans usually price at a premium to first-lien loans. As both obligation types are typically structured as secured arrangements, CRE loans almost always rank ahead of other investors in the capital structure.

Senior secured (first-lien) and subordinated (second-lien / mezzanine) lenders can share the same security package with an intercreditor agreement stating that senior lenders are subject to priority application of assets and cash flows toward their repayment. This is known as contractual subordination. The deployment of mezzanine debt (higher risk stage of development / project) will precede the deployment of senior debt (lower risk stage of development / project), but the inter-creditor agreement will typically restrict repayment unless certain credit conditions have been met by the borrower.

Although a lender can also be structurally subordinated, this is rare in CRE lending. In this scenario, the lender will usually be counterparty to a non-operating holding company (NOHC) which will hold equity in the downstream operating subsidiaries. While the loan will be structured as senior secured, it will structurally rank behind senior secured lenders of the operating subsidiaries. This will result in a risk premium for the NOHC lender but can be mitigated if the operating subsidiaries guarantee the obligations of the NOHC.

Figure 22. Forms of CRE Loan Subordination



Source: BondAdviser.

Loan Valuation: Setting the Credit Spread

In an active market (i.e. equity and bonds), the value of an asset is its traded price. However, where an asset is less actively traded or a traded price does not exist, the value of an asset for the purposes of calculating its Net Asset Value (NAV) is determined in accordance with applicable accounting standards (fair value hierarchy Levels 2 or 3). The largest risk for any loan asset is its embedded credit risk, meaning the probability of credit migration and / or loss of capital. Credit risk is always the largest variable when pricing and subsequently valuing any loan, and the credit quality of an asset will usually be represented by its credit rating or in the case of CRE debt, by a loan-to-value ratio (LVR) which describes the proportion of debt used to fund an asset or other project-specific measures.

The **credit spread paid should reflect the borrower's credit risk** and will be contingent on many factors such as facility size, term, equity buffer, associated covenant package, purpose, the demand / supply dynamics of the market (business credit availability, alternative funding sources), liquidity, and can also be linked to certain conditions (credit deterioration or prepayment triggers). Material shifts in the perceived credit risk of the borrower from the loan's credit spread will impact capital value and can be driven by many factors (Figure 23).

Due to the partial liquidity of the secondary market, large corporate loans can be categorised as Level 2 assets and include a subjective element in the valuation process. As there is limited transactional data, market participants utilise multiple channels to compile valuation sources to determine capital value. However, the private debt market comprises mostly Level 3 assets from an accounting perspective, meaning **observable inputs for fair valuation are very limited**. As a result, assets are recorded at the amount drawn on the valuation date and will be tested for impairment on a periodic basis driven by the expected loss (the product of the probability of default and loss given default). If impairment occurs, this will directly impact the NAV of the portfolio.

Given the nature of the assets, the decision to impair is relatively binary and will usually involve a number of external parties and opinions. It involves tracking the performance of key ratios versus their initial base-case scenario and stressed thresholds (this will likely be accompanied by a downgraded credit assessment). In fact, loan structures are manufactured in this way to ensure experienced lenders can participate and act before an Event of Default materialises. While assets will typically be valued around par value, potential valuation write-downs are dependent on underlying probability of default as well as recovery rates at the point of default.

Figure 23. CRE Loan Valuation Elements

Qualitative Factors	• Macro environment • Property conditions • Management • Alternate uses • Geographic area
Quantitative Factors	• Credit spreads • Default probability • Recovery rates • Credit metrics • Covenant package • Property valuation • Cost-to-Complete
Profitability	• Interest rate • Other fees • Undrawn portion • Fixed / floating
Facility Characteristics	• Collateral • Loan term • Size
Market Factors	• Demand / supply • Reference rates • Banking • Regulation • Alternative capital sources • Refinancing • Economic conditions

Source: BondAdviser.

Risk Mitigation: Structuring and Covenants

While an issuer's fundamentals, underlying industry and valuation can make a potential transaction attractive, a covenant package can alter this significantly, and can even make a loan uneconomical (i.e. too much can go wrong). **Covenants are a balancing act between operational flexibility for the company and mitigating downside risk for the investor**. They are crucial to the investment process and allow loan managers to benchmark the credit quality of an asset against the covenant requirement or scenario analysis to assess if credit is improving or deteriorating. Importantly, documentation is not standardised and arguably an advantage for lenders (increased flexibility).

Asset covenants play a crucial role in lender protection and serve as a major contributor to the credit analysis process. While financial institutions such as banks and insurance companies are subject to regulatory requirements, the covenant package is instrumental to downside protection when investing in corporate loans. Covenants are legally enforceable conditions that borrowers and lenders agree upon in the origination process. These conditions are legally binding, require the issuer to operate within certain limits and are defined in the loan documentation such as the facility document or inter-creditor agreement.

Covenants can be either affirmative (positive) or negative. Affirmative covenants are clauses that require a borrower to perform specific actions. Examples are complying with certain laws, maintaining assets and / or submitting certain reports beyond typical disclosure requirements. On the other hand, negative covenants are established to restrict the issuer from certain actions that would reduce its ability to service its obligations regarding the loan. These limits can be specified in the form of financial ratios which are tested on a periodic basis. The objective of these ratios generally involves capping leverage while creating floors for earnings, cash flow and overall liquidity. These are known as financial covenants.

Negative covenants can be subject to maintenance or incurrence tests. Maintenance tests require the issuer to maintain compliance with a metric to avoid a technical default. For example, a maintenance test could be a maximum loan-to-value (LVR) ratio of 70%, which if the borrower (or underlying asset) exceeded, would result in default. However, using the same example, an incurrence test would only be breached if the company actively incurred additional debt to the point where the LVR exceeded 70%, but not if total capital declined and caused gearing to increase.

Table 3. Common CRE Loan Covenants

Limitation	Example of Covenant
Indebtedness	Gearing ratio, LVR
Liquidity	ICR, Debt Serviceability, Cost-to-Complete Test
Secured Indebtedness	Secured Gearing Ratio, Negative Pledge
Asset Sales	Minimum Valuation, Debt repayment linked to sale
Transaction with Affiliates	Minimum cash balance of borrower

Source: BondAdviser.

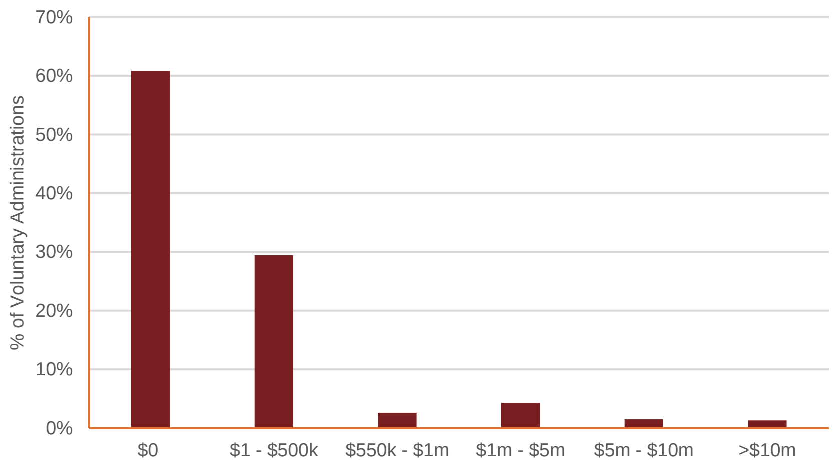
If a specified limit or condition is breached by the lender, the legal documentation may also specify cure periods and remedies to the lender. Covenants can also be subject to a Review Event provision that allows lenders to alter covenants should a material event occur such as large asset sales, changes in management and / or loss of major customers. In general, financial covenants are set at a level where there is sufficient headroom for lenders to act before there is a risk of capital loss. This ability to be hands-on is what differentiates the corporate loan market from other asset classes where individual investors have minimal influence on a company's actions.

Worst Case: Restructuring and Workout Process

The domestic insolvency landscape for corporate lending gives lenders significant flexibility in terms of recovery, with sufficient protection embedded in the domestic legal framework to ensure recovery rates remain high (Figure 9, 24). As a result, default does not automatically mean loss but rather, restructuring, and subsequently, potential recovery. This is of significance to CRE lenders given the underlying asset will generally be the first line of defence in an Event of Default for a secured loan. However, knowing what the optimal restructuring strategy is in such an event is critical and requires substantial expertise.

Importantly, as there is usually only a single lender (bilateral loans) who will be counterparty to a large proportion of the company's liabilities, lenders can have significant power and influence in the workout and restructuring process. This is evidenced by global recovery rate data from Moody's where on average (from 1970-2019) loans experienced a recovery rate of 76.9% while senior secured bonds had a recovery rate of 59.1%. Subordinated bonds experienced a recovery rate of 31.8% over the same period. However, most of the time, lenders will try and avoid insolvency proceedings as it is a lengthy and resource-consuming process with complex legalities.

Figure 24. Amount Owed to Secured Creditors in Construction Industry



Source: BondAdviser, ASIC, calculated for 2018-2019.

A technical default relates to the scenario where a borrower breaches a covenant as specified in the documentation. In this situation, the borrower may still be able to meet interest payments and / or repay principal but due to the breach, the borrower will usually be subject to some form of remedy. Usually, the borrower can agree on a solution and / or amendment to waive the violation in exchange for compensation to the lender (i.e. one-off penalty fee, increased spread and / or amended loan terms).

Payment default is the traditional and more severe concept of default where a borrower fails to make a scheduled payment of interest or principal. If this event occurs, the borrower will be usually subject to a 'cure' period where it has 30 days to rectify the default. Following this period, if the borrower has 'not made' good on the missed payment, the lender can take appropriate action (contingent on the circumstances). Usually, this either involves calling the loan (and potentially forcing the lender into bankruptcy and / or liquidation) or giving the borrower further time under strict controls and oversight. Under each option, there are a number of restructuring techniques that can utilised by the lender to ensure loan value is recovered (Table 4).

Table 4. Workout and Restructuring Techniques

Recapitalisation	A recapitalisation is a common form of restructuring and will usually result in the borrower raising fresh equity capital to repay debt. This would ultimately lower the LVR of the asset.
Divestments	Another common option is to force the borrower to divest the asset or project (i.e. liquidate) to repay debt immediately. Assuming a sufficient equity buffer, the lender should recover 100%.
Amendment of Terms	In a technical default, a lender and borrower can simply agree to amend the terms of the contract. This can take many forms but will typically involve waiving the breach. Further amendments may include increasing the term of the loan in exchange for a higher credit spread, charging penalty fees, rescheduling interest payments and / or imposing harsher covenants. Lenders will usually favour this outcome to avoid resource-consuming bankruptcy proceedings
Debt-for-Equity Swap	A debt-for-equity swap refers to the situation where lenders cancel their debt claims in exchange for equity in the restructured company on favourable terms. This will usually involve significant dilution of current equity investors and the new shares issued to the lenders may be defined by a superior class (dividend preference, voting rights etc.).
Distressed Refinancing	There are a number of global firms that specialise in distressed debt. As a result, these firms may refinance existing lenders or simply buy the outstanding loans, usually at a discount to par. This strategy is commonly utilised by banks due to regulatory constraints. This was common for CRE bank loans during the GFC.

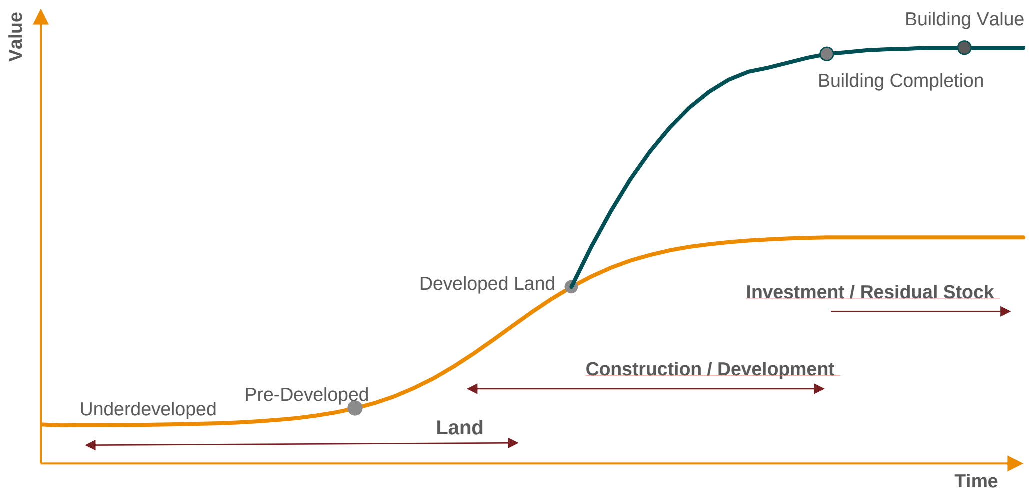
Source: BondAdviser.

While the goal of any workout period is to recover 100% of loan capital, a debt-for-equity swap can potentially allow for a recovery rate exceeding par value, i.e the amount of loan principal and accrued interest outstanding. Specifically, lenders can implement “loan-to-own” structures where debt claims are converted to equity in the underlying borrower on significantly favourable terms and control. This allows the lender to partially-or-wholly own the recapitalised and / or restructured asset / project with significant upside potential. This strategy is typically employed by non-bank lenders who are not subject to the same regulatory constraints as banks (high cost of capital for equity holdings) and is a popular strategy for distressed and deeply undervalued CRE assets.

CRE Debt in Practice

CRE lending involves a bespoke approach as each situation is generally unique to the underlying asset or asset. Each transaction can vary by sector (office, residential development, industrial or retail) and can be funded by senior debt, mezzanine debt or preferred equity. However, all CRE broadly undergoes the same asset cycle (Figure 25) and as a result, loans will generally fit into one of three categories: land, construction or investment.

Figure 25. The CRE Asset Cycle



Source: BondAdviser.

For development projects, Cost-to-Completion tests and other metrics will be tested each time new funds are advanced. For example, for a residential development project, the lender may require drawn debt be covered by pre-sales before each stage of funding will be released to the borrower. Loan terms are kept relatively short to match the development timeline and are highly controlled by the lender over the development period.

Table 5. Generalisation of CRE Funding Structures

	Investment / Residual Stock	Development
Asset Base	Established single assets such as commercial office, industrial or retail.	Unestablished single assets.
Funding Structure	Senior (30-60%), Equity (40-70%).	Senior (30-50%), Mezzanine (0-20%), Equity (30-50%).
Security	Secured against established assets.	Secured against underlying land, borrower's assets or project.
Funding Use	Senior debt is used to fund the acquisition of the asset, with the remainder utilised for redevelopment.	Funding facilitates initial purchase of site, with progressive drawdown as the development progresses.
Primary Covenants	LVR and ICR.	Cost-to-Complete and Debt Service tests.
Debt Repayment	Asset rental stream, settlements or refinancing.	Pre-sales, settlements, deposits, refinancing or asset sales.
Yield / Risk / Control	Lower.	Higher.

Source: BondAdviser.

In contrast, if the loan is secured by an established CRE property (i.e. brownfield projects), an Interest Coverage Ratio (ICR) and Loan-to-Value Ratio (LVR) will be determined in the origination process and monitored throughout the loan's tenor, capturing the debt servicing ability and asset value of the underlying asset.

Residual stock loans, broadly considered to be a class of investment lending, involves the borrower accessing the equity embedded within unsold stock and the lender securing the loan against the asset. Especially in periods of high supply and longer selling periods for left-over stock, the loans can provide a cushion for developers and assist in steadying cash flow. The lender will generally structure the loans on an LVR basis during funding and will seek to reduce LVR exposure over the selling period. However, loan servicing, and thus reduction of LVR exposure relies on the developer being able to sell the stock, which attaches material risk to the loans.

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