Introduction to Australian Real Estate Debt Securities

Introduction

Superannuation fund investors and managers have for a long time invested in real estate as part of their asset allocation in the belief that it provides the following attributes:

- Relatively high and stable income returns from long dated contractual cash flows
- Attractive total returns
- Diversification to stocks and bonds
- Hedge against inflation
- Long term sustainable demand

The ever expanding range of investment products offers new opportunities and challenges to real estate investors and managers. The menu of real estate investment choices in Australia (core, core plus, value add, opportunistic) is lengthening rapidly, however, to date many property investors in Australia have focussed largely on only the equity component of the real estate investment capital stack.

Debt is a significant (if not the most significant) part of the capital stack in most real estate acquisitions and plays an important role in most well structured property portfolios. In the United State, Europe, the United Kingdom and Asia, structured real estate credit products have been the largest component of the real estate capital markets for many years. In stark contrast there have historically been few opportunities for institutional investors in invest in Australian domicile real estate backed debt. This lack of participation is despite long dated (5 year plus) debt providing Australian Superannuation funds an excellent match to the long term investment horizon and return targets in addition to debt being inherently less risky than equity. One can only assume that much of the lack of participation has been borne out of great uncertainty by many potential real estate investors while fixed income/bond buyers prefer to access the market via the Collateralized Loan Obligation (CLO) market and buy bank issued or REIT corporate bonds.

Australia has the most securitised real estate equity market in the world and clearly understands and is comfortable with the concepts involved in complex financial structures. However, for a variety of reasons we have yet to see the investor market accept and invest in debt–based securitised structures in a property context.

A better informed market and more institutional participation in real estate backed debt would enable investors to better determine the optimal risk adjusted return from their real estate investment and allocate capital accordingly.

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Size of the Market

In order to establish a coherent platform to construct and manage real estate portfolios using a relative value approach across all real estate-related financial markets: public and private, debt and equity we have adopted the four quadrant investment model.

The four quadrant model involves the traditional real estate fundamental considerations of location, geography, asset type and tenant covenants. However, in addition the model considers an investment based upon the structural options available to the investor be they in the equity or debt quadrants.

Australia: The Four Investment Quadrants

2006

	Equity		Debt		Total
Private	Unlisted wholesale	41	Bank lending	24	
	Unlisted retail	10	Mortgage trusts	19	
	Property securities	39	Mezzanine funds	2	
	Total	**90**	**Total**	**44**	**134**
Public	LPTs	33	CMBS	11	
			Corporate Bonds	7	
	Total	**33**	**Total**	**18**	**51**
Total		**123**		**62**	**185**

2008

	Equity		Debt		Total
Private	Unlisted wholesale	82	Bank lending	57	
	Unlisted retail	16	Mortgage trusts	21	
	Property securities	45	Mezzanine funds	2	
	Total	**143**	**Total**	**81**	**224**
Public	LPTs	48	CMBS	8	
			Corporate Bonds	7	
	Total	**48**	**Total**	**15**	**63**
Total		**192**		**95**	**287**

2007

	Equity		Debt		Total
Private	Unlisted wholesale	59	Bank lending	40	
	Unlisted retail	13	Mortgage trusts	20	
	Property securities	52	Mezzanine funds	2	
	Total	**124**	**Total**	**62**	**186**
Public	LPTs	52	CMBS	12	
			Corporate Bonds	6	
	Total	**52**	**Total**	**18**	**70**
Total		**176**		**80**	**256**

2009

	Equity		Debt		Total
Private	Unlisted wholesale	67	Bank lending	55	
	Unlisted retail	12	Mortgage trusts	21	
	Property securities	38	Mezzanine funds	2	
	Total	**117**	**Total**	**78**	**195**
Public	LPTs	39	CMBS	7	
			Corporate Bonds	3	
	Total	**39**	**Total**	**10**	**49**
Total		**155**		**88**	**244**

Source: Mercer, APRA, PIR, Westpac, APRA, Fitch, Standard and Poors, Deutsche, Mirvac

The four quadrant model illustrated above provides a framework which can be used to evaluate the current market in terms of relative value in order to better position investments based upon where we are in the economic cycle by orientating capital offensively or defensively as the market dictates.

In other words, assuming a property is fundamentally sound, the key question is which segment of the property's capital stack offers the best risk-adjusted returns (i.e. senior debt, subordinated debt or equity). The answer will be highly dependent upon the current market and the capital market cycle stage.

By way of example it is currently generally understood by sophisticated Australian investors that real estate backed debt provides a higher income yield than core equity real estate with better downside protection – i.e. at this stage of the market cycle debt offers a better risk adjusted return than equity.

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The four quadrant concept provides a natural platform to focus on the performance attributes of the underlying assets and the markets in which they operate. Returns, risk and cash flow as well as the characteristics of the underlying real estate markets form the foundation of this threshold analysis. Once these basic factors are understood, attention then shifts to the type of claims – equity and debt based – that match these assets and which investment provides the optimum risk adjusted return.

Defining Debt Investment Types

In an Australian context the structure and investment characteristics of a real estate equity investment are well understood by institutional investors, however, the nuances of the various types of debt investment available are less well understood and rarely considered. The broad real estate debt investment types and parameters are outlined below.

Real Estate Debt Market Investment Attributes

Investment	Yields	Risk	Liquidity	Call Protection	Diversif-ication	Ongoing Control	Average Loan Term
Senior Loans	Med	Med.	Low / Med.	Med. / High	Low	High	5 years
CMBS (AAA)	Med	Low	Med/High	Med. / High	High	Low	3-5 years
CMBS BBB	Med. / High	Med.	Med.	High	High	Low	3-5 years
High Yield Bonds (BB-NR)	High	High	Low / Med.	High	High	Med.	3-5 years
Low Leverage Sub-ordinate debt	Med. / High	Med. / High	Low	Med. / High	Low	Med.	5 years
Mezzanine Debt	High	High	Low	Med.	Low	Med.	1-3 years
Preferred Equity	High	High	Low	Med.	Low	Med.	1-3 years

Senior Loans are debt securities that are first ranking commercial mortgage loans. The loans are secured by one or more properties and represent a non recourse obligation of the borrower. Senior loans may be fixed or floating rate, with generally three to five year maturities. (In Australia there is presently great demand for longer duration, i.e. 5 – 8 year term loans being a market not satisfied by the major commercial banks). For Loans not guaranteed, the only remedy of the lender in the event of a default is to foreclose upon the property.

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Commercial Mortgage Backed Securities (CMBS) are securities in a multi class pay through debt vehicle backed by a mortgage loan or pool of mortgage loans on commercial real estate, including office, retail and industrial properties. Assets underlying CMBS may relate to many properties, only a few properties, or to a single property. Similarly, they may be multi borrower or single borrower issuances. Each commercial mortgage loan that underlies a CMBS has certain distinct characteristics. Defaults under a CMBS structure are dealt with under the loan documents by the security trustee on behalf of the CMBS investors.

Sub-ordinate or Mezzanine Loans are debt securities that are second ranking commercial mortgage loans (in contrast to Mezzanine Loans as described in the US which are not secured by a mortgage over the property but rather by the ownership interest in the borrower). The loans are secured by one or more properties and represent a non recourse obligation of the borrower. Mezzanine loans may be fixed or floating rate, with generally one to three year maturities. For Loans not guaranteed, the only remedy of the lender in the event of a default is to foreclose upon the property subject to the rights and obligations of the sub-ordinate lender under the sub-ordination and priority deed with the Senior Lender.

Preferred Equity and Convertible Notes are essentially equity investments that are structured as debt. The lender receives a priority return from cash flow over the other equity holders to achieve the agreed coupon plus a small share of any back end growth in the value of the property. The non-preferred equity holders typically retain day to day control of the entity perhaps with preferred equity participating in major decisions. In the case of convertible notes, the investment is structured as unsecured entity level debt until the agreed trigger point is reached (such as a fixed date or a future IPO) and the investment converts into common equity of the ownership entity.

Preferred equity would not typically have any direct cure or purchase rights for mortgage loan defaults. In the event of a default under the Preferred Equity Agreement the preferred equity members rights and remedies may include some or all of the following: (1) immediate replacement of the other equity holders with new equity holders of its choosing; (2) adjustment of the ownership percentages within the ownership entity to give the preferred equity member a higher ownership share and/or a higher preferred rate; (3) the unpaid preferred distribution becomes a high-rate partnership loan from the preferred equity member to the ownership entity which may have a due date or not.

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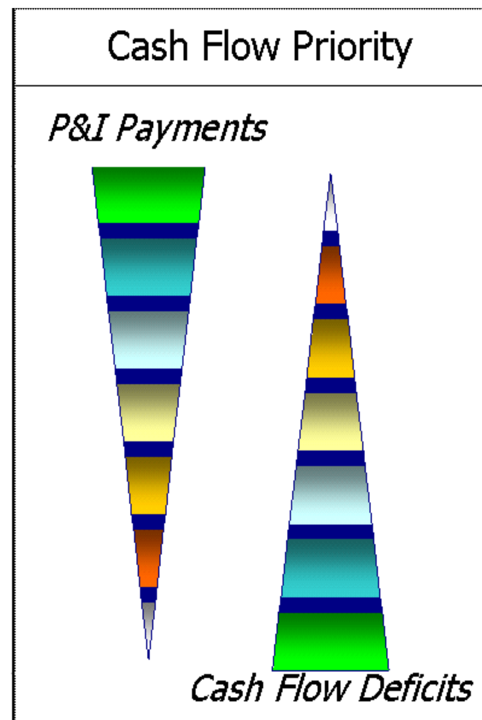
Capital Stack

The above investment types and their respective priority over cash flows derived from the real estate can be illustrated as follows.

Property Capital Stack

	CMBS	LTV
Senior Debt	AAA	45%
	AA	50%
	A	55%
	BBB	60%
Subordinated Debt	BB	62%
	B	64%
	NR	66%
Mezzanine Loans		80%
Preferred Equity		90%
Borrower Equity		100%



A property transaction or portfolio may be structured to include one, some or all of the above components, however, at any point in time a property or portfolio may be divided into its component parts depending upon where a potential investor can achieve the optimal risk adjusted return at any given point in the real estate cycle.

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Conclusion

Given their superior position in the capital structure of a property, debt investments are inherently less risky than equity investments (if underwritten prudently and properly structured). Today, given persistent market inefficiencies, it is quite feasible to find debt investments with equal or better current cash yields than the underlying equity real estate.

Whereas 10 years ago US institutional investment in such products was limited to a fairly narrow group of investors, today such investor participation is quite common place. Given the sheer size, diversity, and segmentation of the US debt markets, it is straightforward to assemble portfolios that are finely tailored to an investor's objectives – even in the current economic climate. Whilst this is not yet the case in Australia we are already seeing signs of increasing segmentation and diversification of the real estate capital markets and going forward we expect this trend to accelerate.

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