U.S. Real Estate Debt – A Proven Asset Class

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Privately placed first lien debt collateralized by U.S. income-producing properties, or private "whole loans," has been a staple of U.S. institutional investor portfolios since the late 19th century. Insurance companies, and particularly life insurers, dominated the fixed rate whole loan market until the late 1980's, when sloppy underwriting, bank deregulation, and excessive property valuations shook the market and resulted in insurers managing losses rather than growing whole loan portfolios. This released insurers' stranglehold on new whole loan origination and, beginning in 1993, paved the way for investment bankers to seize market share and securitize private real estate debt in a new product – commercial mortgage backed securities ("CMBS"). This new entrant forced life insurance companies to learn from the self-inflicted challenges of the late 1980's and recalibrate their whole loan investment model to a more prudent, long-term oriented approach.

The updated insurance whole loan lending model has focused on more transparently originating conservatively underwritten loans secured by high quality assets located in attractive markets. As such, delinquencies on loans originated by life insurance companies fell from a peak of 7.53% in 1992 to only 0.15% in the second quarter of 2012 (see Figure 1). This compared to second quarter 2012 CMBS delinquencies of 8.95%, a direct result of CMBS lenders falling into the same 'loose underwriting on unrealistic valuations' trap in the mid-2000's that insurers experienced over 20 years prior.

Over the past two decades, the reconfigured life insurance whole loan model has proven to be a low-risk, profitable, and easily replicated framework applicable for many institutional investors for three reasons: 1) the spread focus and asset/liability duration matching mitigates interest rate risk; 2) whole loans offer enhanced risk-adjusted returns versus public market alternatives, including corporate bonds; and 3) privately originated whole loans provide structural benefits versus CMBS.

Institutional investors, particularly insurance companies and pension schemes, can benefit from duration matching assets to liabilities

Kurt Wright (top) and Richard Sauerman

with fixed spreads. This locks in a dependable, accretive income return for pension fund investors and guarantees a profit margin for insurers for the entire life of such liabilities, thereby limiting the effect of fluctuating interest rates. This feature of conservative whole loans is especially valuable in today's record low interest rate environment.

Falling rates have created an increasingly difficult conundrum for fixed income investors. Although this environment has produced strong total returns, investors are faced with the challenge of reinvesting capital at historically low rates. Certainly, portfolio level cash flow generation will remain low in the intermediate term, so over-weighting asset classes offering superior current cash flow and attractive risk-adjusted yields is crucial.

As Figure 2 shows, U.S. private whole loans offer enhanced yields relative to public market alternatives. However, whole loans also offer the following attributes:

- Superior call protection relative to corporate bonds;
- Materially lower historical incidence, delinquency, and severity rates than both corporate bonds and CMBS; and
- Significantly lower volatility as measured by the standard deviation of quarterly total returns over the past 10 years.

Long-term risk-adjusted income returns for diversified whole loan portfolios, therefore, compare very favorably to typical public market alternatives.

Structurally, whole loans offer particular advantages over CMBS for buy-and-hold investors. Private whole loans afford the lender much more control both in loan structuring and in realizing a recovery in the unlikely event of default, since CMBS investors are subject to third party special servicers, which vary widely in competency and effectiveness as fiduciaries. This is due to conflicts of interest created by both the typical fee structures and the special servicers' right to buy the assets they service at 'fair market value.' Also, CMBS pools must pay additional third-party costs such as master servicing and trustee fees that total approximately 10-to-25 basis points more than comparable whole loan expenses.

Relative Value to Distressed Debt

Further complicating fixed income investing today, many institutional investment managers have spent the past two to three years sounding off on perceived opportunities for outsized returns in the distressed debt market, particularly that which is secured by commercial real estate. Certainly, a short and highly lucrative window of opportunity to acquire such investments at deep and unwarranted discounts did exist early in the current commercial real estate cycle (i.e. 2008-to-2010, or between 3 and 9 in Figure 3), but distressed investors have since realized most of the upside. Remaining distressed opportunities have been largely picked over and are subject to adverse selection risk.

Given lingering sovereign debt concerns in the European Union and measurable slowing of U.S. economic growth in 2012, the volatility and generally low current income offered by the distressed debt sector does not appear attractive relative to whole loan strategies on a risk-adjusted basis.

Property Valuation Factor

Debt secured by income-producing properties, while highly defensive when conservatively underwritten at origination, is not 100% invulnerable to the commercial real estate cycle. The soaring incidence and severity of default rates in the late 1980's to early 1990's (insurance lenders) and, more recently, in the late 2000's (CMBS lenders) were largely driven by lending based on unwarranted property valuations resulting in overleveraged assets once values eventually normalized. In both cases, valuations were artificially inflated by poor underwriting, unrealistic income growth projections, and excessive cash chasing 'trophy' assets. For

Figure 1

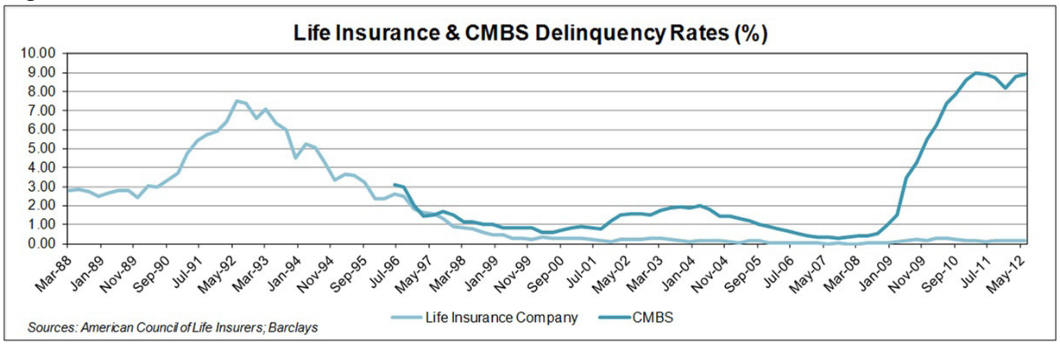


Figure 2

U.S. Fixed Income Yields – 2nd Quarter 2012 (Approximately 7-7.5 year Mod. Duration)			
Asset	Yield	10Yr TR (Annualized)	10Yr STD (Annualized)
U.S. Treasury Notes (Barclays UST, 7-10 Yrs Index)	1.1-1.3%	6.94%	3.95%
Corporate Bonds (Barclays Corporate Bond Index)	3.0-3.5%	6.60%	3.08%
CMBS – AAA-rated (Barclays AAA CMBS Index)	3.5-4.0%	5.61%	4.10%
Private Whole Loans (Giliberto-Levy Index)	3.5-5.0%	6.21%	2.39%

this reason, realistic equity valuations should be a major focus of whole loan investors.

Unlike the aforementioned periods of overvaluation, income-producing property values currently provide an appropriate basis for near-term lending opportunities, because 1) elevated vacancies and low rents provide cash flow upside for well-positioned properties as economic and property fundamentals improve, 2) the 2008-to-2009 credit crisis resulted in valuation normalization, and 3) the low interest rate environment is allowing private equity investors to inexpensively leverage investments despite tighter underwriting standards. Quadrant further views current valuations as durable due to high institutional capital flows into private equity, which have resulted in investor queues such that newly committed capital will not be called for roughly two years.

Given the high demand for equity and corresponding demand for low rate financing, non-bank institutional lenders are in a position to very carefully underwrite loans and pick only the most attractive opportunities. Similarly, many of the most sophisticated borrowers have exhibited a clear preference for institutional, rather than CMBS, lenders due to the greater flexibility institutional investors can offer in terms of rate, loan structure, prepayment options, and earn-outs. Therefore, insurance company and pension fund lenders have a distinct advantage in winning superior loan opportunities.

Considerations for Whole Loan Investing

Property fundamentals such as market, tenancy, and particular individual property characteristics support an asset's valuation and differentiate the best whole loan investments. Institutional quality U.S. assets are most often found in in-fill locations within top 25 markets (e.g. New York City, Washington D.C., Houston, and San Francisco) or in secondary markets (e.g. Portland, OR) with particularly attractive demographics and employment statistics. Among the most important considerations are population size, age, income, and educational attainment as well as dominant industries and drivers of job growth. Furthermore, an asset should present favorable supply constraints such as zoning issues for new construction, easements, or limited buildable land. Lastly, vacancy and rent growth trends should reflect market strengths via stable or improving metrics.

A property's tenancy is the second major consideration in underwriting a whole loan opportunity. Investment grade tenants are always preferable, but a diverse and staggered rent roll is equally important. In the case of a single tenant or owner-occupier, the lease term should ideally extend well beyond the loan maturity. Furthermore, either multi-tenant or single-tenant properties should exhibit advantages over the competitive set to support re-leasing in the event of unplanned vacancy.

Such individual property characteristics include: location within a market, construction quality, vacancy and rent relative to market, borrower and property manager experience, and the property's overall capital structure.

- A building in an attractive submarket within an average secondary market might underwrite more favorably than a building located in a somewhat overbuilt or otherwise soft neighborhood within an attractive primary market. Strengths such as access to transportation nodes, submarket demographics, and area economic development initiatives can affect such a scenario.
- Construction quality includes building materials, layout, and accessibility. Brick and mortar buildings are historically more reliable collateral than prefabricated metal buildings, and aged buildings generally require substantial annual capital expenditures. Likewise, the best buildings exhibit flexibility in terms of configuration and access.
- Rents may be near or below market rates, and vacancy should be around the market level (or slightly below with demonstrable upside).
- Highly experienced borrowers and property managers will be more apt to fill vacant space in a timely and cost effective manner than less-seasoned operators. Furthermore, well capitalized borrowers are often more likely to come out of pocket to cover unexpected leasing and tenant improvement expenses or interest shortfalls if reserve balances prove insufficient.
- Since whole loans sit atop the capital structure, the lender's primary concern is subordinate stakeholders' ability to service the first mortgage under a default scenario. Given the conservative underwriting associated with whole loan origination, however, the probability of a senior noteholder losing principal is remote.

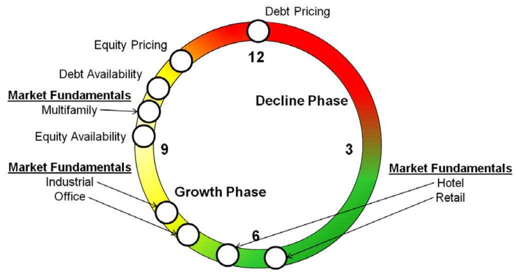
The Best Opportunities Now

In the context of current global economic conditions, core fixed rate U.S. whole loans originated with conservative underwriting parameters, located in favorable markets, exhibiting credit-worthy tenancy, and offering advantages over the competitive leasing set provide a compelling risk and return profile. Both insurance companies and pension funds can benefit from the predictability of whole loan investments by duration matching the assets to liabilities and locking in fixed spreads. Furthermore, non-U.S. based institutions can employ U.S. dollar denominated whole loan strategies as a conservative hedge against local currency volatility and downside risk.

Typical terms of newly originated whole loans are currently:

- Term: Between 3 and 15 years
- Amortization: 20-to-30 year schedule; selectively Interest Only

Figure 3



Source: Quadrant Real Estate Advisors; presented in a format adapted from Rosen Consulting Group.

- Loan-to-Value: Maximum 75%
- Debt Service Coverage: Minimum 1.20x on Net Cash Flow
- Spread to UST: 200+ basis points
- Coupon: 3.5-to-5.0%.

For institutional investors requiring 6.0% or higher current yields, prudently leveraged whole loan portfolios may be beneficial. Likewise, stepping down the capital structure to well secured mezzanine debt can provide higher yields in exchange for incrementally greater risk without portfolio level leverage.

How to Invest in Core U.S. Commercial Real Estate Debt

Investing in core U.S. commercial real estate debt can be accomplished via three mechanisms.

- First, an investor can pursue a single-client account with an individual investor mandate.
  - This vehicle is most appropriate for significant allocations so appropriate portfolio diversification can be achieved.
  - A single-client account provides an investor with the most control over structuring the mandate, hiring or removing the investment manager, and controlling assets in foreclosure scenarios.
- Institutions can also invest as partners in participations with other institutional investors.
  - Note that participations may limit control, since voting rights are often proportional based on each noteholder's ownership interest or may even be held solely by the noteholder with the largest ownership stake.
- The third option is especially appropriate for smaller allocations. Commingled funds allow multiple investors to co-invest in a fund with a fully pre-negotiated structure.

Quadrant Real Estate Advisors LLC ("Quadrant") is an SEC Registered Investment Advisor with $6.2 billion of commercial and multifamily real estate assets under management (whole loans, mezzanine debt, CMBS, and REIT securities) for institutional clients. Since 1998, Quadrant has originated over $7.1 billion of private debt investments.

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