Australian Commercial Real Estate Backed Debt – Investor Opportunity or Mirage?

By Michael Wood and Stephen O'Keeffe

Executive Summary

The most recent dislocation in the global capital markets has energised the debate over the depth and diversity of debt capital available within the Australian economy. Of note is that unlike most other developed economies, Australia does not have a diverse "home grown" debt capital market beyond the bank market.

While there is little argument over the desire for Australia to maintain a robust banking market, the ongoing financial stresses in the global economy has highlighted a structural weakness in the local economy where borrowers seek a long term and durable source of debt capital to supplement the banking system.

This weakness is a consequence of a dominant banking sector that had in the years leading up to the GFC become increasingly able to rely upon offshore term funding markets to support the high credit growth in our economy. When the availability of capital in the offshore term funding markets was restricted at the height of the post Lehman crisis, the Australian banks issued significant volumes of debt with the support of a guarantee of the Australian Government. The cost of refinancing these bonds as they reach maturity, preparation for regulatory changes (Basel III) and the rates being offered to attract retail deposit holders is having a marked impact on banks cost of capital.

The increased cost of capital is making it difficult for bank lending margins to reduce much below the typical current range of 225bp – 275bp for the highest quality investment grade assets on 60% LTV loans. We see these lending margins being the norm for the foreseeable future.

In addition to the cost of debt capital, the duration of loans offered by the Australian Banks is significantly constrained as a direct consequence of their own funding models where the average duration for the big four Australian banks is circa 3.4 years[1].

Commercial real estate is a significant consumer of debt capital and, prudently managed, should be funded by long term debt capital to match the long term nature of the underlying asset. That said, the Weighted Average Debt Expiry for the ASX AREIT Index composite is just 3.6 years largely due to the dearth of longer term funding options.

Do the above circumstances create an environment for the emergence of non bank participants, notably Superannuation Funds, as meaningful participants in the provision of debt capital to Australian institutional grade real estate investment market?

Introduction

During the Global Financial Crisis ("GFC"), the Australian real estate sector got a taste of what life is like as a nation that relies on global capital markets for its long term capital needs. Arguably the credit crunch that started in 2008/09 is the first time we have witnessed the effects of our over reliance on foreign capital coincident with a sustained recession across Europe and the United States.

---

[1] CLSA May 2012

The crisis in Europe continues with the latest Eurozone Summit (the 20th since the European crisis began in earnest in early 2010) failing to develop a comprehensive plan for recovery and accordingly “hope” appears to be their adopted strategy. We believe this is specifically the result of sovereigns and corporate borrowers having “kicked the can down the road” thereby delaying the inevitable consequences of having over leveraged balance sheets. Weaker European countries including Greece, Spain and Italy have been the main focus of capital markets during early 2012 but no one is losing sight of the potential contagion effect on other seemingly stronger European nations such as Germany and notably, France. In contrast to Europe, there are positive economic signals emerging from the US, albeit consensus is that the recovery there is likely to be protracted.

Closer to home, and despite the continued positive story being told about the relative strength of the Chinese economy, there is also growing awareness of China’s debt fuelled growth and the desire for the central government to manage a soft landing for their economy. This mixed message, together with the large pockets of weakness in the Australian domestic economy (particularly retail, manufacturing and financial services) means there are major hurdles for capital markets to overcome. In recognition of the global and domestic uncertainty and lower economic growth expectations the Reserve Bank of Australia (“RBA”) has seen fit to reduce interest rates in 2012 with the resulting cash rate now at 3.5%. It should of course be noted that the RBA cash rate is still significantly higher than most other developed economies.

From a property market fundamentals perspective, Australian real estate prices and capitalisation rates have largely stabilised for premium quality core assets, however, we believe that slowing economic conditions will lead to a low rental growth environment, placing further pricing pressure on secondary assets, development projects and impaired bank assets. Combining expectations of low income growth with the large volume of properties for sale (either officially or unofficially) may lead to slower capital growth being achieved from institutional real estate assets.

On the debt side, the “Big Four” Australian banks (ANZ, Westpac, Commonwealth and NAB) have consolidated their position as the major source of commercial real estate debt. Their position has been strengthened by the foreign banks largely withdrawing from the market and the smaller banks having either been acquired by the “Big Four”, or dramatically scaling back their property lending activities (due to a substantial rise in their commercial property loan impairments).

Over the last 12 months there has only been one new CMBS transaction, that being the ALE Property Group (ALE.ASX) AU$160 million CMBS issuance. Therefore, CMBS is unlikely to be a significant source of real estate capital for the next few years. As such, there is enhanced scope for new non-bank lenders to enter the market and provide an alternate and diversified source of capital for real estate borrowers. Non-bank lenders (including superannuation fund investors) are starting to emerge as an alternate source of debt capital, albeit they are only minor participants at this stage.

In our view, any shift toward the development of a locally robust mature and diversified alternate debt capital market will be evolutionary not revolutionary.

The Australian Banks

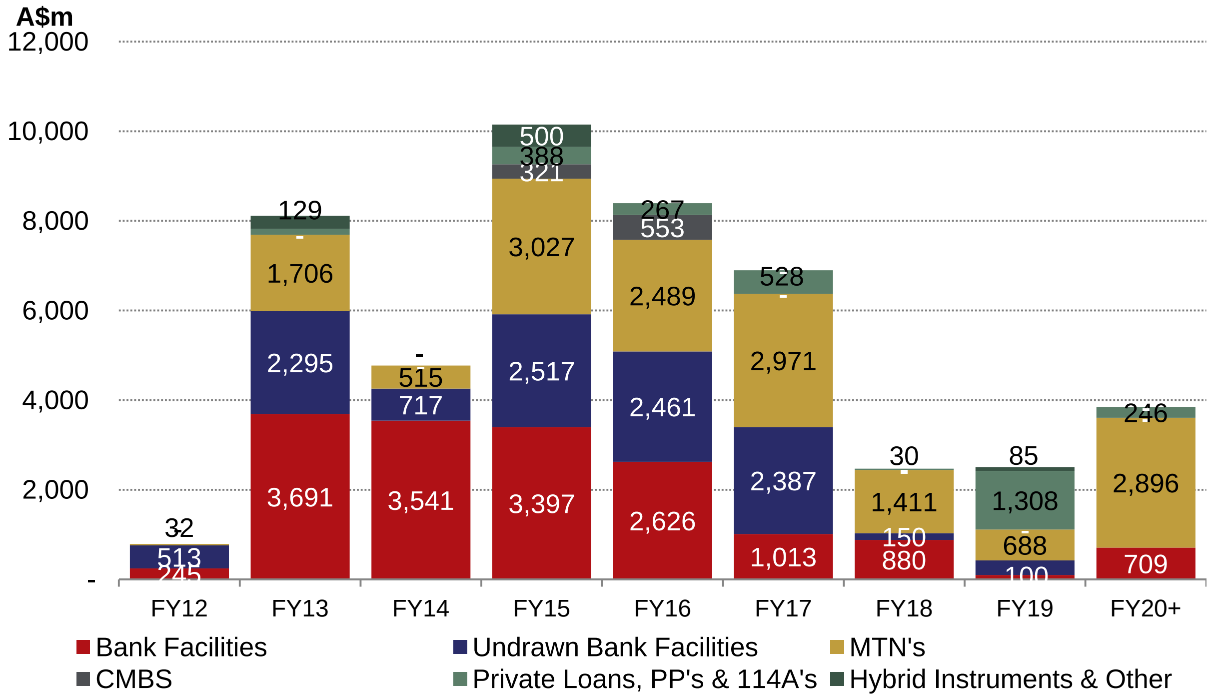
The banking sector has been largely focussed on the European crisis over the last year and whilst the “Big Four” are not directly in the firing line, they remain concerned as to the potential impact on wholesale funding markets. Though the “Big Four” have to date assured the market that they currently have sufficient funding in place, the possibility remains that the cost of wholesale funding will be significantly higher when they enter the market and look to raise debt capital later this year. This is likely to restrict Australian bank credit growth and limit margin compression for at least the next 18 to 24 months as maturing historically cheap pre-GFC issued term debt is refinanced with more expensive longer-term debt.

While we focus on the real estate sector, the challenges confronting real estate debt finance are a microcosm of the entire Australian economy - where the availability and pricing of debt capital is inextricably linked to global sentiment and capital flows. Accordingly, the Australian economy is still highly susceptible to future shocks. The severity of any future shocks could be dampened by the development of alternative sources of home grown debt capital. Alternate sources include;

- Shoring up bank balance sheets via increased bank savings and deposits,
- Emergence of new lender participants including the AU$1.3 trillion[2] Superannuation fund sector,
- Opening up of securitisation markets, (REIT Bonds, CMBS, CLOs and other asset backed securities).

One of the key concerns regarding the availability of real estate debt is the overall potential for credit rationing from the "Big Four" together with the increasing costs for the banks in funding their own capital requirements. Credit growth (demand for bank debt) is currently moderate, however, while growth may be moderate there are significant refinancing requirements for their existing loan books over the next 1-2 years as illustrated by their exposure to just the A-REIT market as shown in (Fig1).

(Fig 1) Australian REIT Debt Maturity Profiles (AU$ billion)



Source: Company Reports, NAB AREIT Research.

This high level of demand is occurring at the same time there are severe restrictions on the availability of capital from both the domestic and more markedly from the foreign banks. Overlay this with the global debt concern and the general aversion to risk and the likely outcome may be further credit tightening in addition to that seen subsequent to the credit crunch of late 2008 and early 2009.

---

[2] Australian Prudential Regulation Authority (APRA), Annual Report, 2011, 1 March 2012.

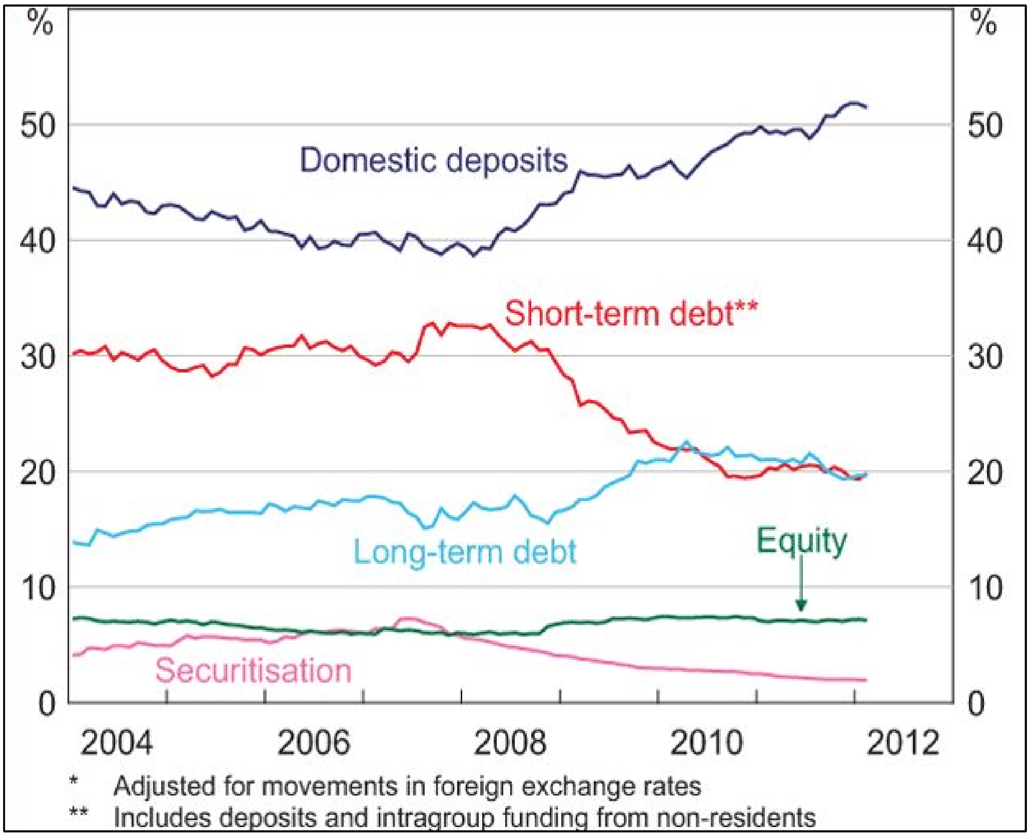
RE Debt Funding – Where the Banks Get Their Money to Lend?

Unlike most other large sophisticated economies, real estate lending in Australia is substantially a (approximately 80%[3]) bank intermediated market. Accordingly, the ability of borrowers to access debt funding relies to a large extent on the credit availability from the "Big Four", i.e. any impact on the banks ability to lend has a corresponding and direct impact on overall real estate financing. This is in contrast to the major markets of North America, Europe and Japan where the non-bank debt markets are larger and have historically been more liquid.

While there is no doubt that the relative strength of Australia's "Big Four" has proven fortuitous during the GFC, this is no reason to believe it will always be thus. In order to support future growth (not only of the Australian real estate sector but the wider economy) stabilisation of the global banking market and the development of alternate sources of debt capital in the Australian market will be required. In order to understand local debt availability it is necessary to appreciate the current bank funding model.

Prior to the early 1990's Australian banks funded their lending operations predominantly from retail deposits, that is to say they would take a dollar on deposit and lend a dollar out thus matching their asset to their liabilities. Since that time Australian banks have migrated away from this traditional funding model and have become far more reliant upon wholesale borrowing (Term Debt Financing) to arrive at the present scenario where only approximately 50%[4] of their funding is derived from retail depositors (Fig 2).

(Fig 2) Australian Bank Funding*



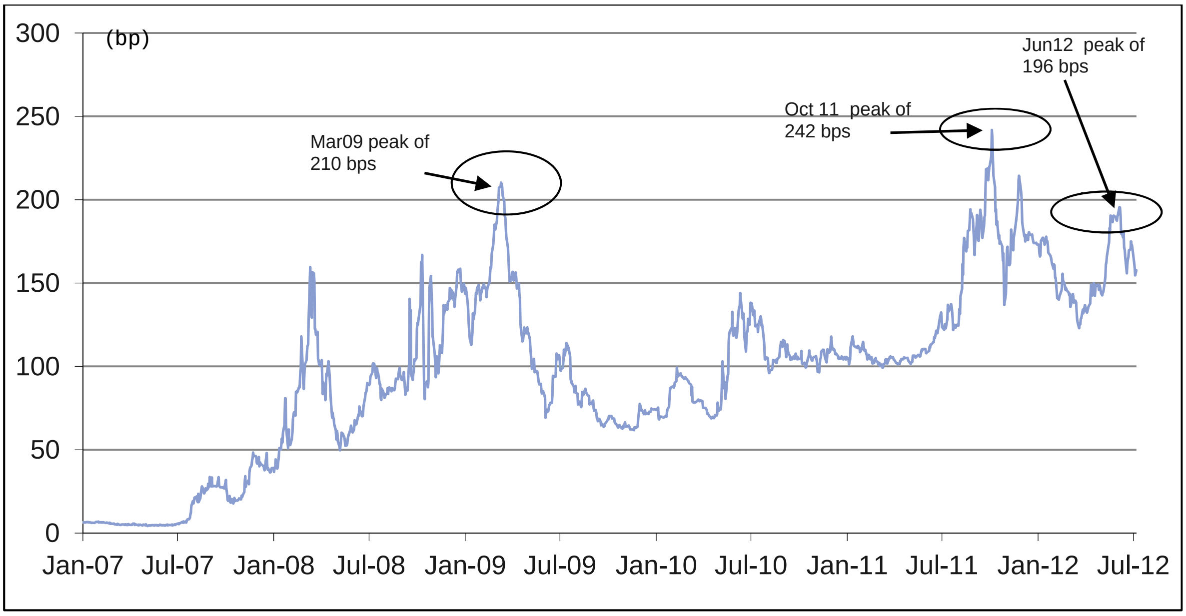
[3] Property Investment Research, Deutsche Bank, AFMA, Standard & Poors, APRA
[4] APRA, Monthly Banking Statistics, 1 March 2012

Source: APRA, RBA, Standard & Poors

Recent efforts by the banks to increase their retail deposit base (you will have noted the attractive rates currently on offer) have resulted in an increase in deposits from below 40%[5] in September 2008 to just over 50%[5] today, however, there is insufficient capital available from depositors to see any structural reversion to the pre early 1990's position where there was limited reliance on foreign funding sources.

As a consequence of this systemic shift Australia's bank funding rates remain elevated. As shown in (Fig 3) the bank term funding spreads (as illustrated by the credit default swap spread) have rapidly increased during the latter part of 2011 and early part of 2012 and while easing during April and May, rose again in June.

(Fig 3) Average major bank five-year Credit Default Swap spread

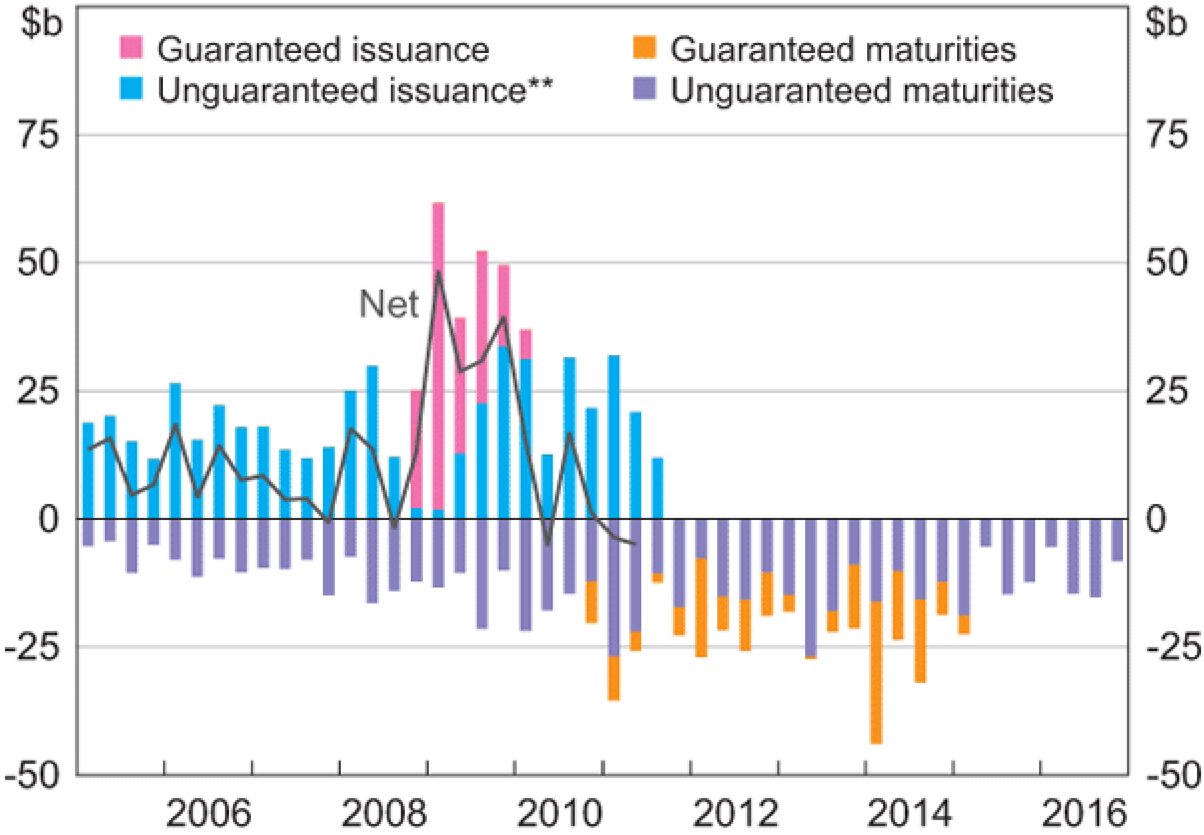


Source: CLSA.

Following the Lehman collapse in October 2008 Australian banks went "back to the well" to issue term debt only to find that this source of capital had gone to the sidelines (there was less than AU$1 billion of Australian bank issuance in the last quarter of calendar 2008[6]). When the debt markets reopened, the price at which term debt financing was accessible (with and without the support of the Australian Government in the form of the taxpayer guarantee) was far in excess of that anticipated. Not knowing what the future held, the banks issued Government guaranteed bonds at an unprecedented rate to provide a cushion in case the term debt markets locked up again (Fig 4).

[5] APRA, Monthly Banking Statistics, 1 March 2012.
[6] J.P. Morgan, Australian Banking Sector Research, 8 July 2010.

(Fig 4) Australian Bank Bonds – Issuance and Maturity (AU$ billion)*



* Excludes 12-15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme

** September 2011 is quarter-to-date

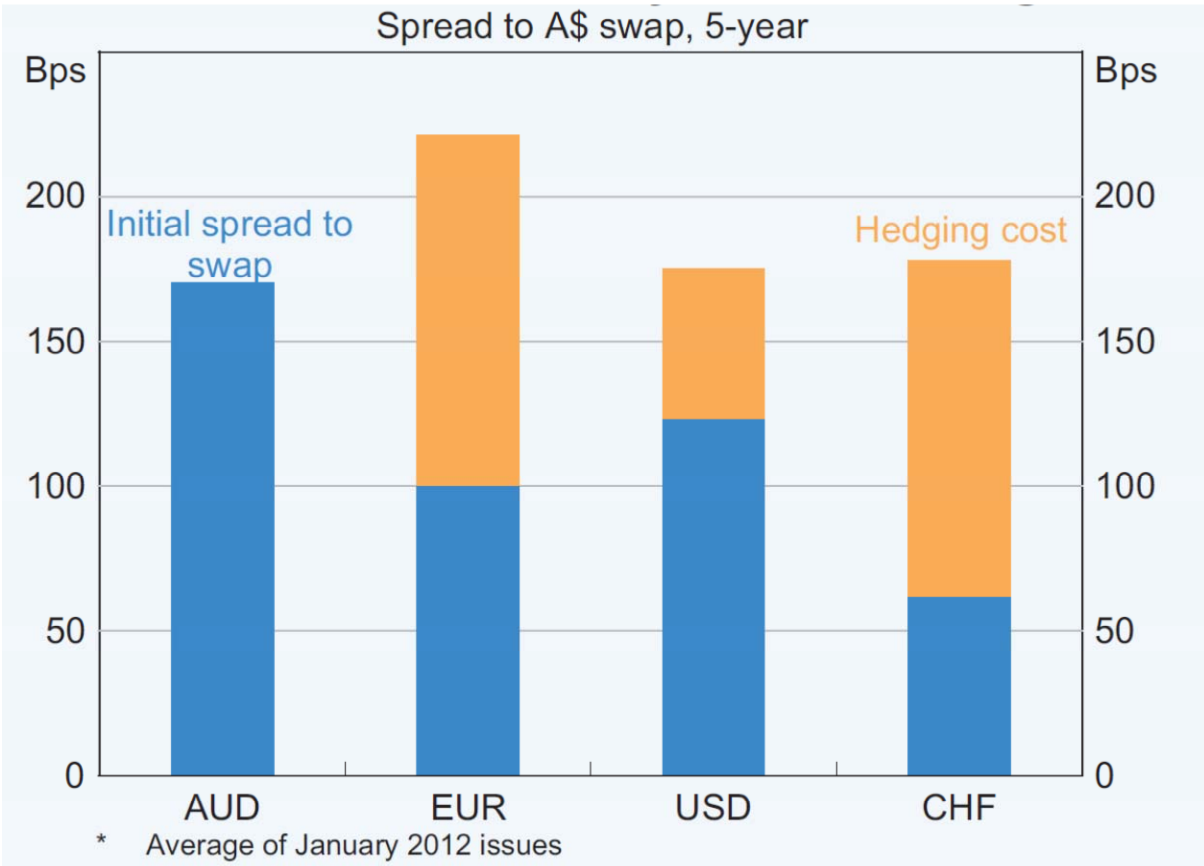
Source: RBA Statistics, Bank Liabilities, 31 January 2012.

Since the withdrawal of the government guarantee the "Big Four" have looked for alternate sources of funding and the introduction of covered bonds in late 2011 was seen as a possible panacea for bank funding. Covered bonds are on-balance sheet asset-backed securities issued by financial institutions.

Investors in covered bonds have a preferential claim on a pool of assets (called the cover pool) in the event that the issuing institution fails to make the scheduled payments on the covered bond. If the cover pool is insufficient to meet the issuer's obligations to investors, they have an unsecured claim on the issuer for any residual amount. Covered bonds typically have a higher credit rating than that of the issuer because the cover pools are usually comprised of high-quality assets such as prime residential mortgages, covered bond holders rank above unsecured creditors, and extra collateral is held in the cover pool.

Despite the higher credit rating and attraction of covered bonds to investors, the prevailing global uncertainty has meant that pricing of these bonds issued by Australian banks has been a disappointing result to say the least.

(Fig 5) Australian Bank Covered Bonds Pricing



Source: RBA, RBA Statement of Monetary Policy February 2012.

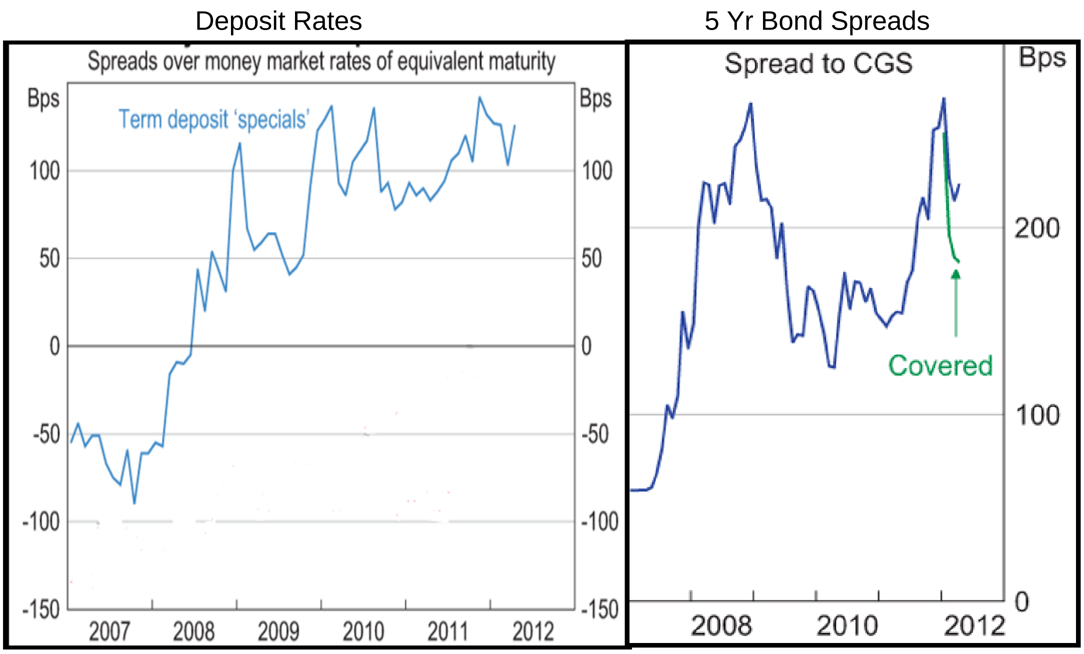
Issuance by geography and currency (Fig 5) shows over AU$6 billion of covered bonds being sold in the domestic Australian market followed by Europe and the U.S.. The cost of hedging foreign currency issuance back into AUD is also shown in (Fig 5). The cost of hedging currency issuance back into AU$ increases the lower initial margins to a higher all in cost than the domestic issues. There is no doubt that the cost of funds for the Australian major banks has risen significantly. However their desire to meet refinancing requirements has left them little choice but to access those markets that are open to them; regardless of cost.

Having established the source of bank funding we can now turn to the cost of bank debt as both a borrower and as a lender. As expected the demand supply equation had and continues to have a significant impact on the price banks pay for the capital they access.

The “Big Four” are currently paying depositors a premium of 125 bps above 3yr Commonwealth Government Securities (“CGS”) (Fig 6 on left). This is part of a concerted effort by the banks to secure their long term funding via retail deposit holders in marked contrast to their strategy of recent years. While depositors are being paid a premium compared to previous years, the price for retail deposits is still significantly lower than the spreads on bank bonds.

Bank funding costs for term funding (Fig 6, on right) continue to trend higher having dipped during 2009 by virtue of the price advantage afforded by the government guarantee, unfortunately for the banks this is no longer available.

(Fig 6) Australian Major Banks Average Funding Costs



Source: RBA Statement of Monetary Policy May 2012.

It is costing the banks a margin of approximately 225bp (above 5yr CGS) for their capital (Fig 6). Obviously if they are to on-lend this capital at a profit they need to charge borrowers a premium to cover their lending costs and profit margin. Accordingly, we see lending margins of 225bp+ (for those transactions the banks want to do) being the norm for the foreseeable future.

Overall, given the relative global strength of the Australian banks it can be expected that they will be able to meet their existing term debt refinancing obligations in the global capital markets, however, the price they pay to access capital will continue to increase in the near term. Further, the availability of additional capital to fund credit growth is likely to be severely constrained.

It's Not Just Price - Duration is Also the Challenge

The Big Four banks fund their business with an average duration of 3.4 years[7] albeit there is a very strong desire for the banks, like all borrowers, to extend this maturity profile. This means that when a bank makes a loan part of their internal risk management process aims to match their income (your loan interest and capital repayment) with their own liabilities (principally obligations to retail depositors and bond owners). In short, the current bank funding model and risk management practices discourages them from lending long term (i.e. longer than five years) without increasing overall balance sheet risk and cost of capital.

As an aside the provision of short term funding allows banks to regularly reset terms and conditions with their borrowers and charge fees more frequently.

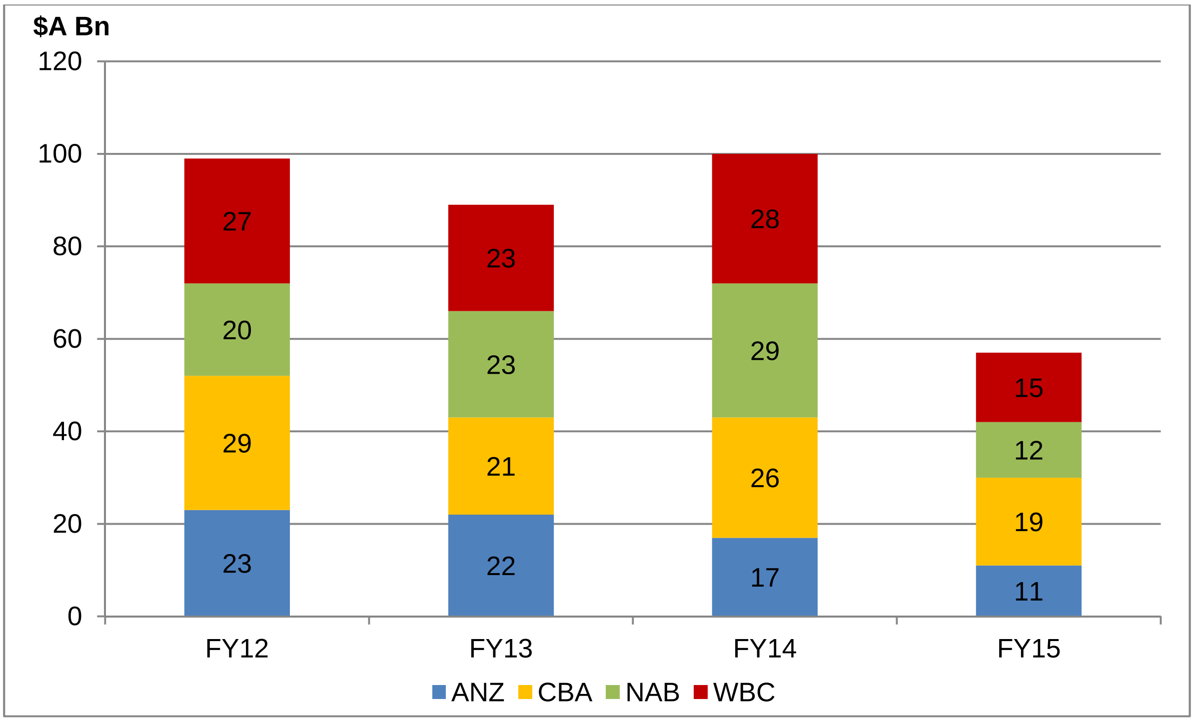
[7] CLSA May 2012

QUADRANT
REAL ESTATE ADVISORS

The Risks to the Banks' Refinancing Plans

In the five years leading up to the GFC the "Big Four" had approximately AU$36 billion[8] of bonds to refinance each year. As shown in (Fig 9), in 2012 and 2013 the banks need to refinance AU$99 billion[9] and AU$89 billion[7] respectively in term debt - a difficult challenge in a constrained global capital environment.

(Fig 9) Australian Major Banks Term Debt Maturities



Source: ANZ, Debt Markets Newsletter, 2 February 2012

Accordingly we are entering a period where the majority of the banks' annual term debt issuance will simply be absorbed by refinancing their existing maturities, leaving limited capacity to fund any credit growth.

There is also the question of who will be the buyers of those bonds originally sold with a Commonwealth Government Guarantee (shown pink in the previous Fig 4) noting that many of those buyers are unable to acquire anything other than Government guaranteed securities.

The reality is, there is only so much capital out there to acquire debt globally and foreign government backed institutions and governments themselves are presently major participants in these markets acting as borrowers. Due to the high demand for bond investor's capital, bond buyers will be more selective about which bonds they buy and will be demanding higher margins on the bonds they purchase.

In effect we are about to witness peak bank refinancing requirements at a time when the cost (margin) to do so is close to an all time high. What is also evident is that larger credit-rated corporates in

8 RBA Statistics, Bank Liabilities, 31 January 2012.
9 Morgan Stanley Research

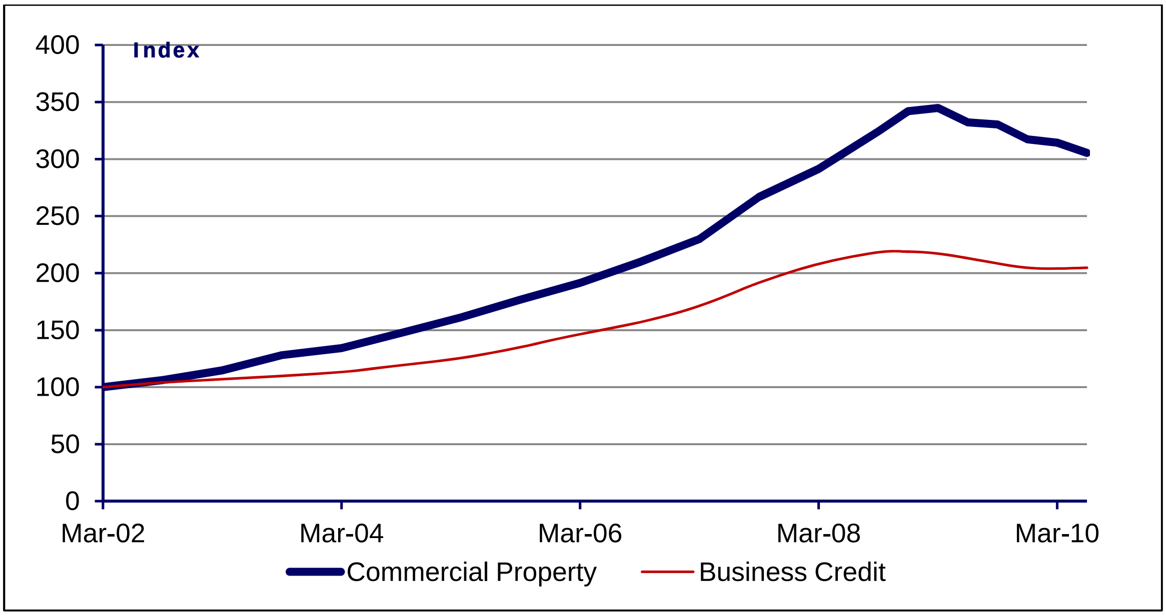
Australia can tap global bond markets at pricing cheaper than the Australian banks and in some cases European sovereign borrowers.

These capital constraints and price increases will be passed on to borrowers, including those participating in the Australian real estate market. Until such time that global capital is available to fund the credit growth of the banks and pricing of the banks term debt starts to reduce, borrowers will be forced to pay the price.

Australian Major Banks Commercial Property Exposure v Overall Business

Over the past decade Australia's commercial property credit growth has outpaced overall business lending by 100% as shown on (Fig 7). This over-exposure to the commercial property asset class has resulted in the need for banks to reduce their exposures in order to reweight their loan book.

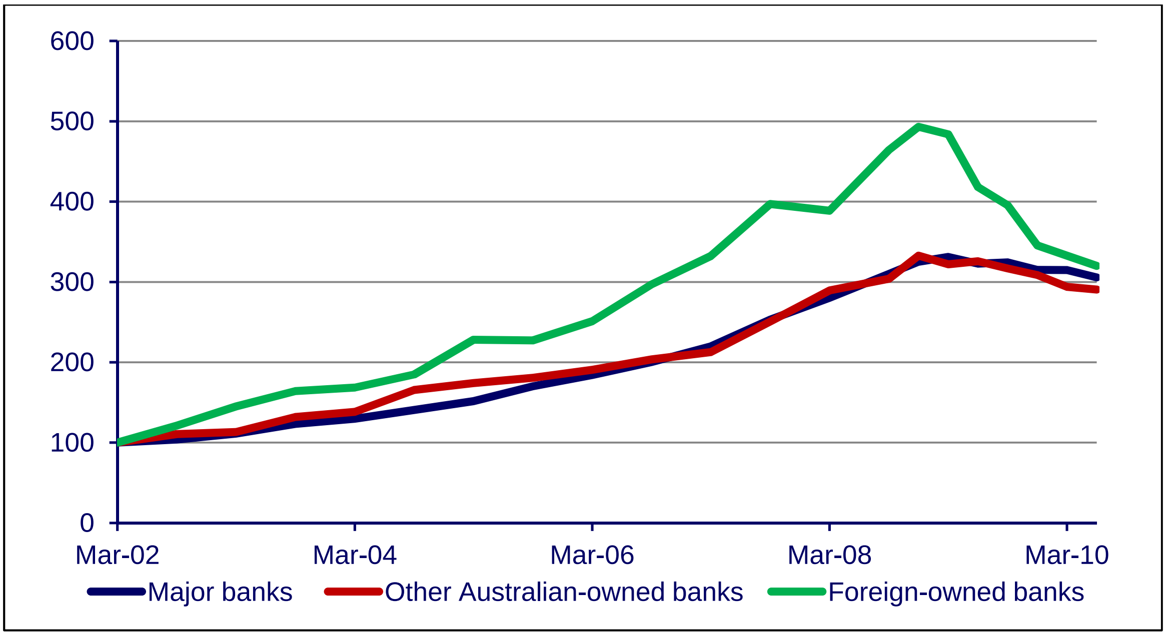
(Fig 7) Banks Credit Growth for Commercial Property vs. Business Credit



Source: CLSA.

As shown in (Fig 8) the banks have significantly reduced their exposures to commercial property, however, they still remain elevated in an historical context. The reduction in commercial property exposures has been a result of non-renewal at maturity, loan workouts, property sales and loan sales, most notably from the foreign-owned banks. As the banks continue to unwind their over-exposure to commercial property we expect the door to open to new sources of debt capital to meet the financing needs of the commercial property sector.

<u>**(Fig 8) Banks Commercial Property Exposures in Australia**</u>



Source: CLSA.

<u>The Non Bank CRE Lending Market in Australia</u>

In considering the development of a non bank Commercial Real Estate (CRE) lending market in Australia it is useful to examine the relativities as between Australia and the United States. The United States has been chosen as the depth and liquidity of the U.S. are often cited as a benchmark in the global capital markets.

As shown in (Fig 10), the U.S. is a significantly larger economy than Australia which provides a depth and liquidity to markets that has previously been unavailable in Australia, however, given the current stronger economic fundamentals at play in Australia many investors are now investigating potential investments here.

<u>**(Fig 10) Macro Comparison Australia and the United States**</u>

Macro Economy	Australia	USA
GDP	$1.3 trillion	$15.1 trillion
GDP per Capita	$57,800	$48,200
GDP Growth p.a.	3.6%	1.9%
Public Debt/GDP	30%	100%
Unemployment Rate	5.2%	8.2%

Source: Australian Bureau of Statistics, Bloomberg, US Treasury

A comparison of the respective commercial real estate lending markets as shown in (Fig 11) tells a similar story with the depth of the U.S. market highlighted across the private debt market, CMBS and the real estate corporate bond market. It is important to note also the diversification of capital sources in the U.S. with banks, securitisation, life insurance companies, mortgage REITs and pension funds all significant contributors of capital to the CRE debt space[10]. In contrast, Quadrant estimates that approximately 80% of the Australia CRE debt market (for institutional grade income producing property) is controlled by the banks. As the banks are currently capital constrained, this may present an ideal opportunity for new participants to enter the market in Australia.

(Fig 11) Core Commercial Real Estate Lending Australian and United States

CRE Debt Market	Australia	USA
Private CRE Debt Market	$66 billion	$1,800 billion
Commercial Real Estate Backed Securities (CMBS)	$2.0bn	$724bn
Corporate Bonds (RE)	$3.8bn	$184bn
Rate Setting	Predominately Floating Rate	Predominately Fixed Rate
Typical Loan Duration	3 Years	10 Years
Private Market Participants	80% Bank Intermediated	Banks – becoming active Securitisation – re-emerging Life Insurance - very active

Source: IPD Australia, PIR Research, Emerging Trends in Real Estate, Standard and Poors

In addition to the current bank capital deficiency, we have also seen a re-set in lending standards with lenders reverting to more prudent lending standards than those prevalent immediately prior to the GFC. Furthermore the lack of competition between debt capital providers in Australia has allowed lenders to be even more stringent than their U.S. counterparts, despite arguably better real estate fundamentals as shown in (Fig 12) below.

(Fig 12) Current Loan Credit Metrics Australia and United States

Real Estate	Melbourne	New York
Loan to Value *(Typical Limit)*	60%	75%
Debt Service Cover Ratio *(Typical Limit)*	1.50x	1.25x
Capitalisation Rate *(A Grade Office)*	7.0%	5.0%
Vacancy Rate *(A Grade Office)*	5.0%	10%
Collateral Quality	Prime RE, (little appetite for secondary)	Higher quality collateral than US CMBS
"Reference" Rate	3.4% (BBSY)	UST 1.7%

[10] Emerging Trends in Real Estate 2012

Private Debt RE Margins	Stable	Compressing
Private Debt Resale Market	Illiquid	Active
Coupon (incl. establishment fees)	6.5 – 7.5%	4.0 – 5.0 %

Source: Bloomberg, APRA, JLL, IPD Australia, NACREF, CBRE

Superannuation Funds as Lenders

In Australia investors have been focused on the equity component of real estate notwithstanding the fact that the privately placed real estate debt component comprises approximately 31% or AU$66 billion[11] of the institutional grade commercial real estate universe domestically.

While much of the privately placed debt market in Australia is intermediated by the domestic banks, this has not always been the case with life companies being major participants in the market prior to the late 1980s.

The opportunity is therefore for institutional investors, including superannuation funds, to seek returns from the same domestic underlying assets and cash flows with capital being deployed more conservatively within the capital stack.

For superannuation funds, the key point to be aware of is that real estate debt investing involves investing in the same property types and markets that they are currently investing in (i.e. Sydney CBD office buildings, regional shopping centres, etc) merely using a structure that places the investor in a more conservative position in the capital stack.

Prudently deployed privately placed real estate loans are underwritten in much the same way as a direct equity investment with a significant amount of due diligence undertaken reviewing leases, outgoings, capital expenditure, leasing markets, valuations, building condition, etc.

Such an approach allows investors to construct a portfolio of assets that they would otherwise be comfortable owning. The downside is that privately placed loans are “lumpy” assets that are resource intensive to originate, underwrite and close and do not provide the same diversification benefits that publicly traded securities can. However, due to the long dated nature of real estate leases and the significant equity capital buffer provided by the borrower, an investor should enjoy a relatively high income return with a strong capital preservation position.

Whilst privately placed loans are not as liquid as listed REIT securities or publicly traded debt, each of the loans has a stated maturity which allows for constant repayment and redeployment of capital.

The Asset Allocation Conundrum

Superannuation fund investors and managers have for a long time invested in CRE 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 (8 – 10% through the cycle)

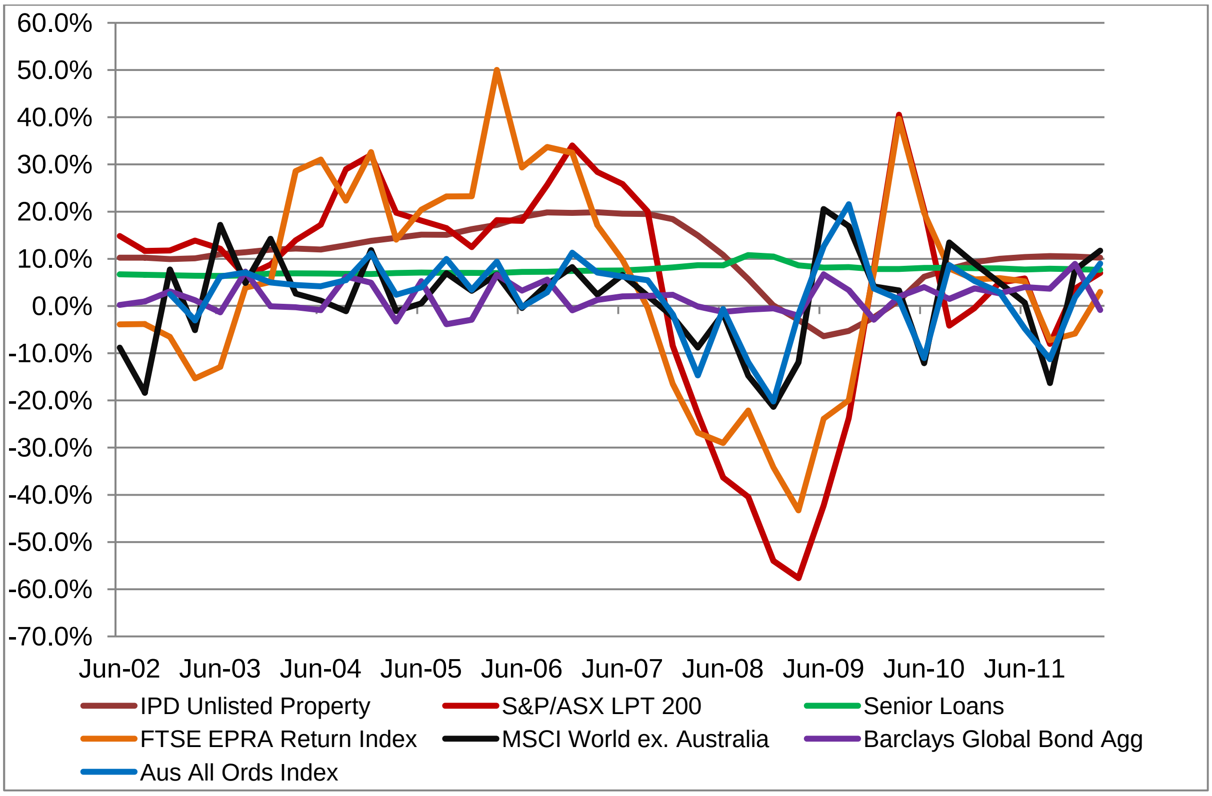
[11] Quadrant Real Estate Advisors, IPD, PIR Research, APRA.

- Diversification to stocks and bonds
- Hedge against inflation
- Inefficient markets allow superior relative value opportunities

The recent financial crisis brought into question the ability of real estate equity to deliver on these objectives and investor's patience has been sorely tested as fund level CRE equity investments, both public and private exhibited significant volatility. As investors look to broaden their search for investments that meet the requirements of a CRE allocation the question arises as how CRE debt fits within an investor's portfolio.

In order to evaluate the return and volatility characteristics of various real estate investment categories we have compared the annualised returns for Unlisted Property, Listed REITs and CRE debt in (Fig 13).

(Fig 13) Historical Total Returns



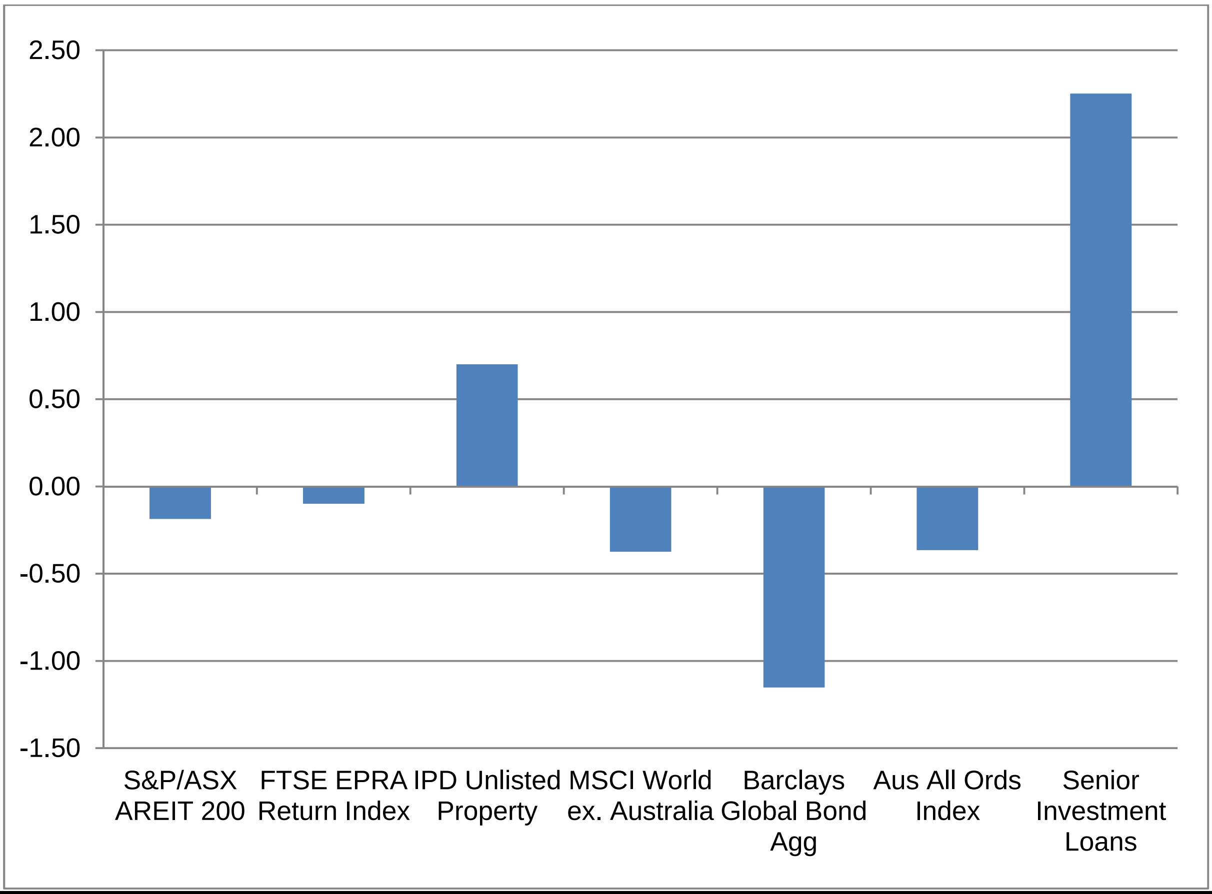
Source: IPD, Bloomberg, Quadrant Real Estate Advisors LLC.
Note – Senior Loans are hold to maturity investments and are not marked to market.

As the credit crunch took hold, the performance of the listed sector (as represented by the S&P/ASX LPT 200 and the FTSE EPRA Index) was the first and most severely impacted due to panic selling as investors struggled to ascertain the depth and severity of the downturn. In comparison the direct sector (due in part to better capital management and the longer asset valuation cycle) was slower to react and suffered less distress as investors and owners had more time to assess the rapidly changing financial landscape.

Furthermore, the CRE debt sector showed the least volatility during the downturn due to its secured nature and priority access to any income or capital flows from the property. Accordingly, when property values fell during the GFC the equity component of the capital stack bore the brunt of the capital losses whereas prudent leverage secured senior loans were better protected by the equity buffer.

In order to compare the relative value of the various investment categories we have calculated the Sharpe Ratio. The Sharpe Ratio is used to characterise how well the return of an asset compensates the investor for the risk taken, the higher the Sharpe ratio, the greater the return achieved per unit of risk. To calculate the Sharpe Ratio we have taken the above returns data and standard deviation and we have used the 10 year Australian Government bond rate as a risk free proxy. The relative value on a risk return basis for the various asset classes is illustrated in (Fig 14).

(Fig 14) 10 Year Sharpe Ratio

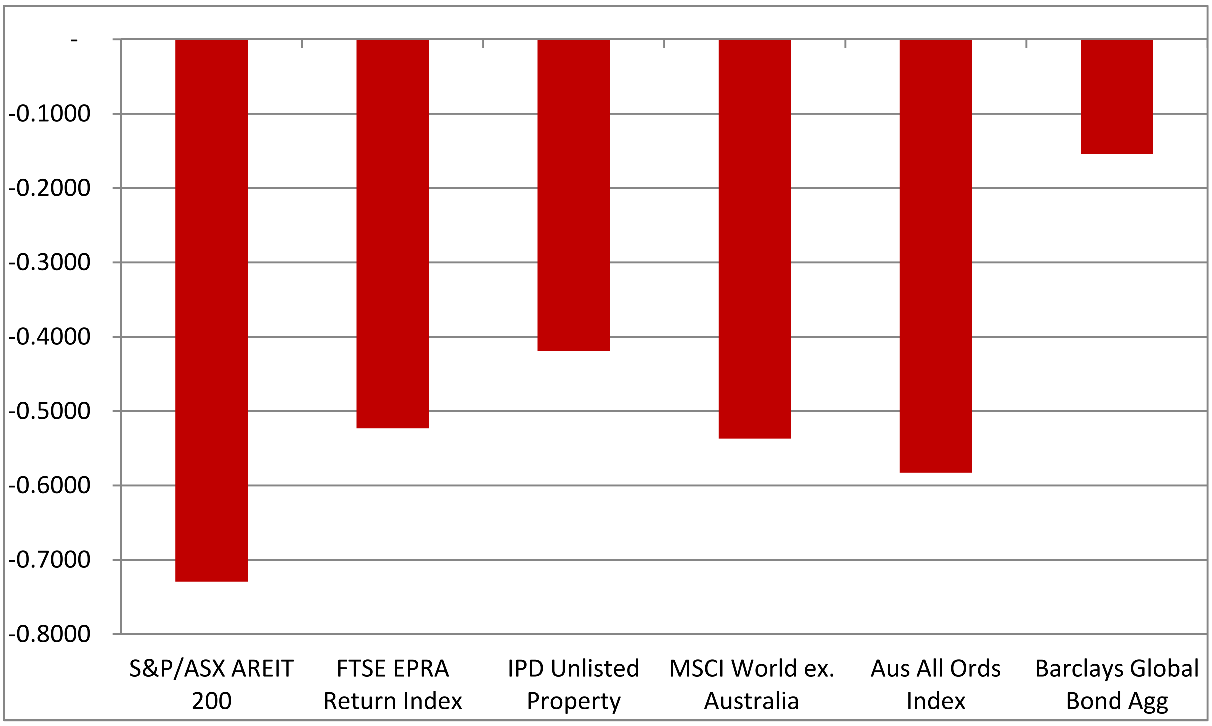


Source: IPD, Bloomberg, Quadrant Real Estate Advisors LLC.
Note – Senior Loans are hold to maturity investments and are not marked to market.

It should be noted that valuation (appraisal) smoothing has long been highlighted as a significant factor to consider when comparing the inherent risk and the level of statistical variance between listed and direct real estate investment performance (including privately placed senior loans). While it is acknowledged that liquidity (or illiquidity) is a critical element in portfolio management, this analysis does not consider this element.

In order to measure the diversification from stocks and bonds we have compared the correlation over a 10 year period between the various performance indices and a sample portfolio of privately placed senior investment loans. The results of this correlation analysis are shown in (Fig 15).

(Fig 15) 10 Year Correlation to CRE Senior Loans



Source: IPD, Bloomberg, Quadrant Real Estate Advisors LLC.
Note – Senior Loans are hold to maturity investments and are not marked to market.

As illustrated above privately placed CRE debt has a strong negative correlation with the majority of the equities indices (as does the Barclays Global Bond Agg) meaning that CRE debt investments may provide a buffer to equity real estate portfolio performance during periods of equity market volatility as occurred during the GFC.

To date, a large proportion of institutional real estate investing in Australia has focused on the equity component only, however, going forward we believe that the significant forecast undersupply of Australian real estate equity investments means that super funds in Australia will need to look beyond the traditional listed and unlisted real estate equity investments and source a broader range of investment products in order to meet their core real estate allocation objectives.

For those followers of our commentaries on the US and Australian markets, you will be familiar with our strong desire to promote institutional investment in CRE debt. We have long held the view that the inclusion of a component of CRE debt within an institutional real estate portfolio can enhance portfolio performance and dampen volatility.

CRE debt carries many of the attributes of fixed interest, real estate and alternatives and offers good risk adjusted returns. Accordingly, Quadrant believes it is worthy of discussion as to where an allocation belongs within a diversified Institutional Investment real estate portfolio.

Risks and Opportunities

As with any investment strategy there a number of risks and opportunities facing potential investors such as:

- Manager risk – there are only a small number of Managers presently focussed on sector in Australia

- Concentration risk – while a large portfolio of smaller loans may provide numeric diversification benefits, it is often the case that the higher quality CRE assets are larger properties which generally require bigger loan tickets AUD $30m+
- Loan duration – where you can offer longer loan tenor it is a key differentiator
- Volume - 2013 and 2014 have large CRE debt maturities[12] at a time when traditional lenders are credit constrained accordingly there is likely to be greater scope for investors to establish a foothold in the market during this time
- Rate structure – the banking market is predominately floating rate loans that require borrowers to then hedge by swapping the floating rate to fixed rate therefore lenders who can provide fixed rate loans will have an advantage
- Liquidity – the market is evolutionary NOT revolutionary and so it will take time and participation by an increased number of investors before liquidity is achieved

Accordingly, in our view there is an immediate opportunity to exploit the inability of Australian banks to provide longer duration loans and higher LTV's (loan to value ratios) that will provide CRE debt investors with outsized returns and an opportunity to establish super funds as a credible alternative source of CRE debt capital for the long term.

We believe the current opportunity is to target CRE loans secured against well leased institutional grade assets in major markets (primarily Sydney and Melbourne) in the retail, office and industrial sectors. Whilst "Distressed" or "Vulture" opportunities are available, in our view these are generally "hit or miss" and carry substantial volatility risks.

Conclusion

The opportunity to deepen and broaden the sources of debt capital in Australia is something that will benefit not only borrowers but banks, non-bank lenders and investor alike. In recognition of this there has been an increasing role of banks in facilitating alternate funding sources either via assisting borrowers to access the bond or US Private Placement markets or in the case of the National Australia Bank (NAB), participating in the establishment of non-bank providers of credit. This allows the banks to offer their existing clients a range of financing alternatives whilst retaining control of the client relationship.

As sophisticated capital markets like those of the United States have shown, just as there are different demands for debt capital (short term vs. long term, highly structured vs. flexible terms, high leverage vs. low leverage, fixed rate vs. floating rate, diversified sources of capital vs. single relationships, revolving facilities vs. fully drawn) there are different investment objectives for debt providers.

Whilst there may be some cross over and competition between potential debt providers, the Australian real estate capital markets needs cannot be satisfied by the domestic banks alone nor should the banks be expected to be the cheapest and/or most appropriate source of capital for all real estate capital needs. A robust debt capital market should have the capacity to match borrower requirements for duration, flexibility, capacity, leverage and loan structure from a range of sources including banks, unsecured bonds, CMBS, non-bank lenders and superannuation funds.

In a period of uncertainty and volatility we believe a high relative income yield is a good risk mitigant as the investor is not as reliant upon achieving future capital growth in order to generate the required investment returns. Accordingly, whilst debt and hybrid investments may not have the same degree of "upside" growth potential as equity investments, the high probability of achieving an investor's stated

[12] NAB Research

return hurdle on a regular income cash flow basis provides a high degree of comfort in an uncertain market and a "defensive alternative" to equity real estate. Quadrant believes that a high income orientation should always be an objective for core real estate allocations.

For further details;

Michael Wood – mwood@quadrantrea.com
Stephen O'Keeffe – sokeeffe@quadrantrea.com

Quadrant Real Estate Advisors LLC
www.quadrantrea.com