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Senior Commercial Real Estate Debt

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The market opportunity

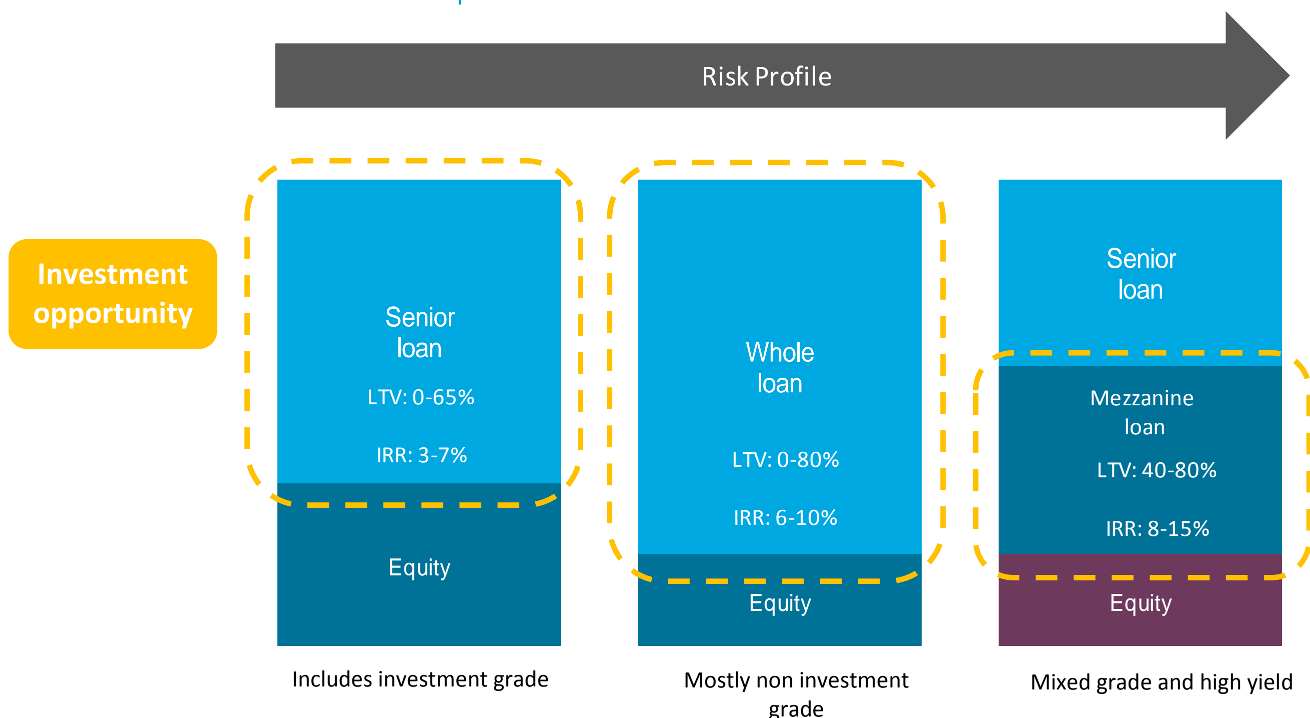
A supply-demand imbalance exists in the commercial real estate ("CRE") debt market which has created a scalable opportunity for investors to capture attractive returns. The introduction of Basel III has led to a large financing gap with banks deleveraging, selling discounted assets and lending more cautiously. These developments have provided an attractive opportunity for alternative lenders to enter the primary market and provide debt thereby filling the gap created by banks.

CRE debt offers diversification benefits within the credit universe given its low correlation with investment grade credit. It has an attractive risk/return profile with spreads for senior loans at a premium of c.100bps in comparison to similar corporate bonds. Given the limited default rate, senior secured loans provide capital preservation and also offer the investor an illiquidity premium, which, in our view, is compensated in the margin. It is also the market norm for the borrower to pay a 1-2% origination fee to the lender thereby enhancing returns.

The commercial property market is in good shape with little oversupply in most major markets. Pre global financial crisis lending criteria was very stretched with high LTVs, low margins and high asset valuations. Market dynamics are now characterised by more sensible valuations, lower LTVs and attractive compensation for limited relative risk at the senior end.

Going forward, central bank policy is expected to keep interest rates relatively low and given current spreads there is little room for much more yield reduction. There is a risk that over the short term margins will come down due to increased competition, but we feel this is only a possibility and in the hands of the right manager should not present a problem in terms of deployment (as a result of superior deal flow and strong underwriting).

Where it falls in the capital stack



1. Venn Commercial Real Estate, January 2016

Commercial Real Estate Debt as an Asset Class

CRE debt is essentially a loan secured by commercial real estate property. The underlying income stream is supported by the tenant and derived from rental income, refinancing and sale proceeds. The main types of financing for commercial real estate debt include[2]:

1) Investment financing: funding for the purchase of a property, relying on the asset's ability to generate long term, stable income in order to service debt. The underlying factors are the quality of the tenant, lease length, rent received and operating costs.

2) Refinancing existing debt: it is estimated that £150bn[3] of commercial real estate loans are due to expire in 2016 and banks do not have the capacity to renew terms. This has created an opportunity for specialist lenders to provide funding solutions.

3) Development/construction: the funding for new development projects or for the repositioning of an existing building's current use in order to make it more attractive and to capitalise on market opportunities. The key factors are the borrower's ability to execute the business plan for the project and to lease up the space in order to achieve a stable income profile. This type of debt is typically shorter term and once the development phase is complete it is usually refinanced.

4) Operating real estate: financing less traditional assets such as hotels, nursing homes and pubs. For these types of properties the rental income is significantly dependent on the performance of the operating business and it can often have a riskier cash flow profile.

Key considerations

CRE loans depend on the quality of the underlying asset, cash flow and financing structure in terms of covenants. The main considerations before investing[2] include:

- Cash flow generation: the ability of the property to generate sustainable cash flows. Often dependent on the location of the property, the quality of the space, how modern it is and how attractive it is for its desired use.
- Type of debt: the reasons behind the financing – investment, refinancing, development/construction or for operating real estate (described in more detail above).
- Financial covenants: the key cash flow based covenants are debt service coverage ratio (DSCR), interest coverage ratio, loan-to-value (LTV), prepayment clauses and cash traps.
- Position of capital structure and LTV: a common industry standard for senior loans is a LTV cap at c.65% and investment grade loans are usually below the 70% threshold. As the LTV increases, the credit quality decreases. Leverage is a key driver of default rates and typically loans with a LTV of below 60% have a default rate of c.2%[4].

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2. EY Commercial real estate debt, 2015
3. Venn Commercial real estate, October 2014
4. BofA Merril Lynch Global Research, September 2015

Moody's target LTV levels by rating:

Rating	Target LTV
Aaa	45%
Aa2	53%
A2	61%
Baa2	69%
Baa3	72%

5. EY Commercial real estate debt, 2015 – Benedicte Pfister, Moody's approach to rating European CMBS 2002

> The sponsor: the entity which will buy and then operate the property; what is their experience developing real estate and how well are they capitalised in case the project requires more capital. Deals can be executed by private equity shops and developers.

> Profile of loan: this can be amortising or a bullet structure and typically depends on the lease profile. The profile of the loan is based on the risk of the cash flow which ultimately comes down to the quality of the tenant. As loans amortise, the LTV will reduce.

> Maturity of debt: currently the market has relatively low levels of long term fixed rate CRE debt due to limited borrower demand (though this has started to change with growing demand from insurers and pension funds)

> Pricing: the global financial crisis triggered an increase in spreads. Recently, the larger spread at longer durations has been narrowing due to the increased supply of funds operating in the area and a wider contraction of margins in credit.

Fixed vs. Floating

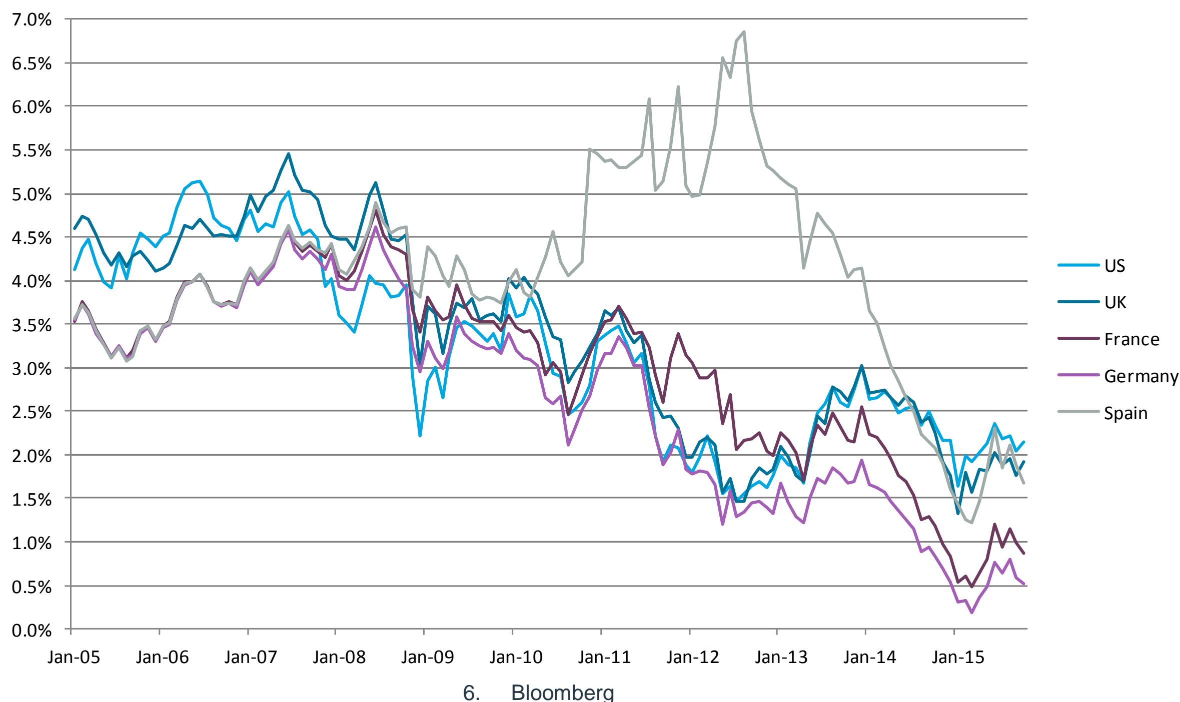
Fixed rates: a competitive market that is dominated by a few large lenders. Amongst the benefits include that financing costs are set and that loans are not usually pre-payable (with penalties equating to the loss in yield) providing certainty around cash flows. Typically fixed rates are offered by select large insurers, e.g. M&G, Aviva and Rothesay Life who focus on predominately larger deal sizes, lower LTVs and correspondingly accept lower yields. Currently, c.10% of the market issues longer term debt (7+ years) in fixed rate loans.

Floating rates: dominate the CRE debt market in Europe and tend to have a tenor of 3-5 years. Borrowers prefer floating rate because there is less call protection and it is more suitable for buildings that do not necessarily require long term financing. Generally the borrower will swap floating rate exposure for fixed to match the underlying streams of income from the property and hedge interest rate risk. Hedging can also be done through purchasing a cap.

Overall: The market norm for UK and Europe is floating rate loans with a typical tenor of 3-5 years. It is possible to create a fixed rate portfolio but it depends on the size of the allocation and may impact the rate of deployment and ultimately the attractiveness of the risk/reward profile.

Geographical Landscape

10 year government yields for US, UK, France, Germany and Spain from 2005-2015



6. Bloomberg

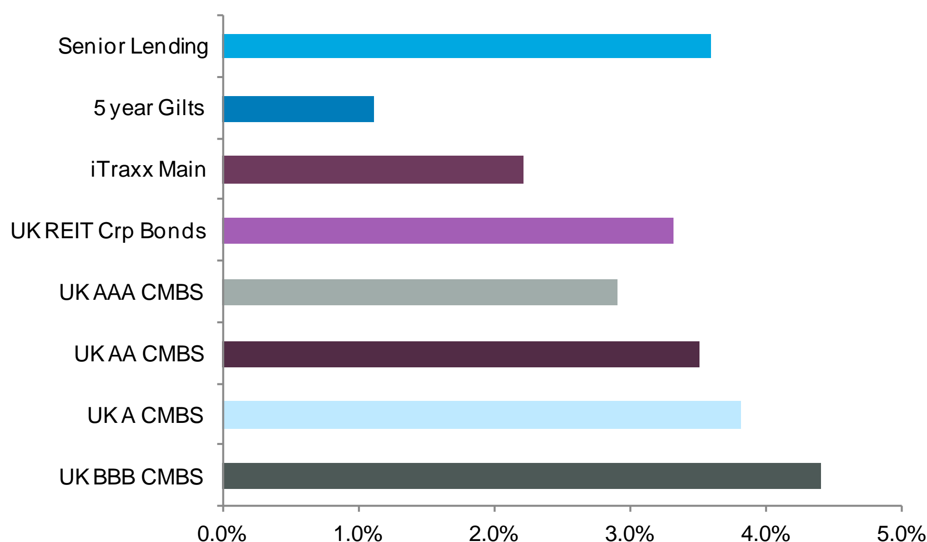
UK

The UK offers attractive value with strong fundamentals – GDP has grown 0.5% and employment levels have risen 0.6% to 31m over Q3 2015 alone[7]. It represents one of the core lending markets and accounts for a significant volume of loans, with a 45% share of recorded origination in Europe. LTVs are typically between 60-70% and spreads range from 1-3%. High quality offices can offer yields of LIBOR + 150bps, whilst non-London assets (hotels or less core assets) can offer up to 250bps. Currently, there are relatively low levels of CRE development in comparison to pre GFC and a strong demand for debt, which is gaining investor interest now that more banks have exited the space. Banks typically offer tighter yields vs. private debt funds and insurance companies who look to access more attractive deals.

Generally, the UK is a very lender friendly market with attractive risk positioning that offers downside protection from first ranking legal mortgages. There is landlord friendly tenant legislation in place which is underpinned by the Landlord and Tenant Act 1954 and lender-friendly legal framework for real estate debt investments underpinned by Law of Property Act 1925[8].

Over the page is a chart that shows the lending returns for Senior CRE debt in the context of the wider market:

7. UK GDP and labour market update, ONS Q3 2015
8. ICG, UK CRE Senior Debt



9. CBRE, UK debt prospects, Autumn 2015 – Bank of England, BofAML, CBRE, Macrobond

Europe

The European market has been more active with banks who have contracted from pan-European lending focussing more on their core local market and relationship lending. Typical LTVs are c.50-55% and can be pushed up to 60% depending on the deal. Germany, France (and the UK) tend to be the core markets with Italy, Spain and Portugal acting as satellites, offering higher returns. Prime assets in Germany continue to be difficult to finance as local banks offer a lower cost of capital. Generally, local banks operate on a low LTV basis, with a max spread of c.150bps. Opportunities tend to be in the logistics and industrial space. Chinese and Japanese lenders are starting to enter the European market, alongside US banks which are now also lending. This has led to a compression in margins over Q2 and Q3 2015. It should be noted that there tends to be less transparency in the European market due to the lack of CMBS.

US

Very segregated market in terms of credit quality with 3 main types of lenders who operate in different quality and sized loans:

1) Pension fund advisors – $50m+, good quality deals (core, up to 60% LTV)
2) Insurance companies, split between small insurance companies who look at deals less than $25m, max LTV: 60-65% no ratings attached and large insurance companies who look at $50m+ good quality loans
3) Wall Street banks who look at both high quality, converting the loan to a security or investment grade bond, as well as lower quality at LTVs of 75-90% and package together 100s of loans

The US offers strong fundamentals, healthy GDP growth and presents a large market with potentially more deals in the prime space in comparison to the UK and Europe. It is also relatively easy to originate products being a market dominated by a brokerage community. The average loan size is $50-100m. The US market tends to be more transparent in terms of pricing due to more constructed whole loans in the CMBS market and generally more available data, but it is fairly crowded.

Currently the higher IRR opportunities lie in transition lending where 50-70% of the property is going through change in core areas such as New York, California, South Florida and Chicago, offering higher yields of c.7-11%.

Overview of debt market

The main players in Europe for the prime space are UK banks, German banks and insurance companies. The senior space is dominated by local banks, insurers and debt funds. In the US the prime, senior space is filled by CMBS, domestic insurance companies, Asian pension and German banks.

Below we show a table of typical returns that can be expected for a £200-300m investment in senior CRE debt across different geographies. A 5 year swap rate is used for Europe as it is mostly a floating rate market and the 10 year treasury rate is used for the US as the senior space typically longer rate fixed loans.

Type of lending	Description	Returns Europe	Returns US
Prime	First mortgage secured, very best properties / top cities in country	**Spread:** 80-110bps **IRR**: 1.0-1.5%	**Spread:** 100-150bps **IRR**: 3-4%
Senior	First mortgage lending secured by stablisied properties	**Spread:** 150-350bps **IRR**: 2-4%	**Spread:** 150-300bps **IRR**: 3-5%
Transitional	First mortgage lending on less or non-stablised properties	**All in, IRR: 7-11%**	**Spread:** 300-550bps **IRR**: 4-7%
Mezzanine	Junior debt: LTV up to 85-90%, often secured by shares	**All in, IRR: 6-10%**	**All in, IRR: 4-12%**

10. Green Oak view and bfinance estimates

Overall

We feel that the UK and US are strong markets, and to a certain extent Germany, to deploy capital at the senior end. France is borrower friendly and we would recommend taking a more considered view on the jurisdiction. We see the dynamics of the geographies changing over time and from a portfolio perspective would recommend an allocation split between UK/Europe and the US and perhaps adjusting the split depending on market conditions (possibly at manager discretion).

Lenders

The CRE debt market has traditionally been dominated by banks and a few direct lenders in the mid-market space. Many of the large insurers also issue loans, for instance their total transactions in commercial mortgage loans in 2015 was in the range of $6-8bn (each). Recently, more alternative lenders have been entering the space with different strategies ranging from private debt, mezzanine, opportunistic and distressed debt. They are normally either small boutique funds set up by ex-investment bankers or large asset managers diversifying into the space. These fund managers have been able to compete with banks by offering advantages in the speed of execution, flexibility in structuring and scale of deployment.

Key differences to bank lenders:

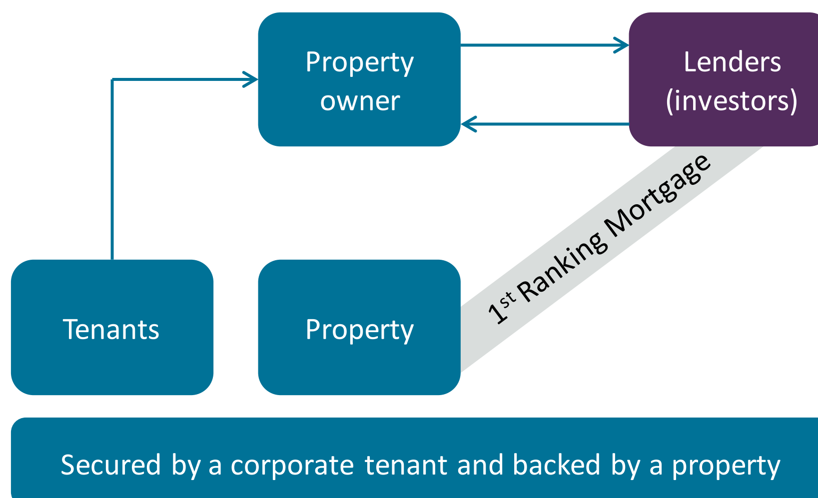
Alternative lenders offer a more flexible approach than perhaps a bank. They are able to provide more flexibility in loan documentation and customisation of key covenants. Generally they offer a more streamlined process and direct access to decision makers which can lead to a faster, more efficient process. Lenders often have the ability to hold

larger loans at higher leverages and can access the entire capital structure. In return for such flexibility they will target a higher yield[11].

Universe

We expect 40+ managers to be able to offer a quality product in the senior CRE debt space. Most funds typically have a 3-5 year investment period and 10 year life.

The chart below emphasises that the better real estate debt managers underwrite the sponsor (property owner) as much as the asset (property). Real estate debt is an asset backed investment in comparison to direct lending, so all things being equal it offers less downside and lower margins for equivalent levels of risk.



12. AXA Investment Managers: European CRE Loans October 2015

Final Recommendation

We see CRE debt as a strong opportunity to access favourable margins in an evolving asset class. The UK and US offer a balance in terms of their property markets, while at the same time offer an imbalance in the demand and supply of CRE debt. There is competition from banks on prime, senior loans but overall we see that there is good deal flow (with the right managers) to the extent that a balanced portfolio of senior real estate loans can be built out. A key aspect to underwrite with each manager is governance over deal flow and the overall business plan they have on senior lending.

11. Deloitte Alternative Lender Deal Tracker Q2 2015

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