TH Real Estate

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Q&A

Based in Sydney, **Martin Priestley** is the Head of Debt, Asia Pacific, overseeing the origination, portfolio management and business development activities for TH Real Estate across Australia and the broader Asia Pacific region. Here, Martin gives his view on why now is the right time for investors to engage in commercial real estate (CRE) debt in Australia.

What is CRE debt?
CRE debt is typically structured as a loan secured on commercial real estate. It offers income-focused returns through periodic interest (and principal) payments, culminating with the repayment of the remaining principal either amortising or at maturity.

Why could investing in CRE debt be a good investment strategy?
Well-managed CRE debt can provide performance protection through diversified, stable income streams. CRE debt benefits from a substantial degree of downside protection provided by the 'buffer' of the sponsor's equity. While there is typically no additional upside to debt returns in a rising market, the sponsor's equity will absorb the first loss in a falling market. In addition, contractually-agreed interest payments insulate the lender from the volatility of a changing rental income profile. As real estate market cycles become shorter and harder to predict, this insulation and degree of certainty is increasingly regarded as highly attractive by investors.

Australian CRE loans usually include covenants which are put in place to protect the lender in the event of capital value or income declines. These typically include loan-to-value (LTV) and debt service cover ratios (DSCR), along with asset-specific covenants such as a 'cash trap', where any surplus income not required for debt service can be retained by the lender and used to reduce the loan, and a default clause, which allows the lender to step-in or sell the property if the default covenants are breached. These covenants are typically triggered at thresholds long before the deterioration of income or capital value would leave the lender at risk of first loss.

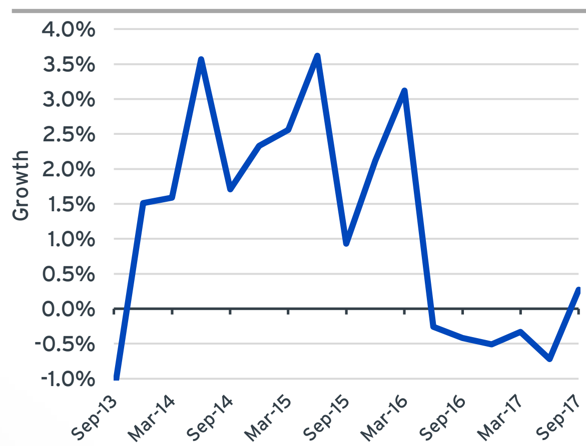
Why is now a good time to invest in CRE debt?
Real estate equity markets are currently experiencing significant volatility, elevated valuations, and heightened uncertainty. An investor focus on income, given the low interest rate environment, is a welcome addition to the portfolio.

As such, the downside protection investment attributes of CRE debt are becoming increasingly sought after; alongside stability, diversification and contracted income. CRE debt presents very competitive relative value, compared to fixed income and direct real estate.

Who are the main players in the CRE debt space?
Although CRE non-bank debt has been a part of the Australian real estate market, the dominance of the major banks, until recently, has restricted investment opportunities for the non-bank sector. Post the Global Financial Crisis (GFC), tightening of regulatory, capital and liquidity requirements has increased the levels of capital to be assigned to CRE. This has led to a tightening of underwriting standards, significant reductions in the leverage of loans, increases in loan pricing and reduced availability.

The slow withdrawal of traditional lenders, as well as the reduction and repricing of available capital, have created a permanent, attractive and executable investment opportunity for non-bank lenders and debt funds to provide a meaningful share of future CRE debt finance in Australia.

Fig.1: The Big 4 banks' exposures to commercial property in Australia



Source: APRA, Quarterly Authorised Deposit-taking Property Exposures, December 2017

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Q&A (continued)

What are the current opportunities in the sector?
In the context of retreating traditional lenders, and the persistent narrow focus, reduced LTVs and wider margins, we see increasing opportunities for well-capitalised, specialist, alternative finance providers with local debt professionals who understand the local markets. Investment opportunities can be found in those assets currently 'off the radar' in established markets across Australia. With robust underwriting, ideally informed by direct real estate expertise, these underserved markets present the most appealing prospect for the selective 'cherry-picking' of transactions, backed by strong fundamentals and robust return characteristics.

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Stability	Income	Relative value	Diversification	Market opportunity
CRE debt occupies a more secure part of the capital stack than equity, offering a measure of downside and performance protection through the buffer of the borrower's equity and excess rent.	Well-structured CRE debt offers the potential for stable, income-focused returns.	Historically attractive risk-adjusted returns, relative to fixed income investments and direct real estate, particularly late cycle, can be achieved through investing in CRE debt.	The historical profile of CRE debt supports its use as a diversifier to fixed income and direct real estate allocations in a well-constructed portfolio.	Structural changes in the CRE lending market have created a long-term opportunity for alternative lenders to originate CRE debt investments with attractive risk-adjusted target returns.

Contact us

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