Funding debt down under

With Australia's superannuation pool growing rapidly, some local fund managers are looking to move into a commercial real estate financing space that they see as inadequately serviced by the major banks. By Florence Chong

Gold Coast skyline: pending, approved and under construction properties in Queensland

After what seems like a false dawn, Australia's nascent real estate debt market may be reawakening, with several fund managers hoping to raise at least A$2 billion ($1.76 billion) between them from institutional investors in the coming weeks. It will be a test of whether Australia's institutions are ready to invest in debt as an asset class in its own right.

The first of these debt funds, Qualitas Real Estate Debt Fund, is due for its first close by the end of 2014. A boutique fund manager, Qualitas is targeting a minimum of A$500 million in the first instance, from both domestic superannuation funds and offshore investors.

Another Sydney-based firm, Balmain Investment Management, a broad-based financial services firm with long experience in commercial mortgages and loan servicing, also is marketing a debt fund, Balmain Investment, and expects its first closing in February, initially aiming to raise A$500 million.

Perhaps the most ambitious of all is the Melbourne-based MaxCap Group, which is in advanced negotiations with two leading Australian superannuation funds and a large US pension plan, each for mandates of A$300 million to A$500 million.

Falling between the cracks

Industry sources told *PERE* that, until now, real estate debt in Australia has not been seen as an investment option, but perhaps that mindset is starting to change.

According to Michael Wood, senior partner of Quadrant, a specialist real estate lender, a real estate debt market has not yet developed in Australia because of the many challenges that exist in the market. One of the major challenges, he says, is the imprecise classification of debt within an investment portfolio.

Wood shares the views of others that real estate debt as an asset class falls between the cracks – neither fixed income nor special opportunities nor real estate. Yet, debt per se – such as government and corporate bonds – does have a role in the investment strategy of Australian institutions. For example, at the end of September, Australia's A$104 million sovereign wealth fund, Future Fund, had 11.3 percent of its assets (A$11.8 billion) in debt securities, compared with property at 5.8 percent.

With the nation's superannuation pool growing rapidly – it stood at A$1.8 trillion on December 31, 2013 and is forecast by the Australian Treasury to pass the A$7 trillion mark by 2030 – the ambition of some fund managers is to redirect

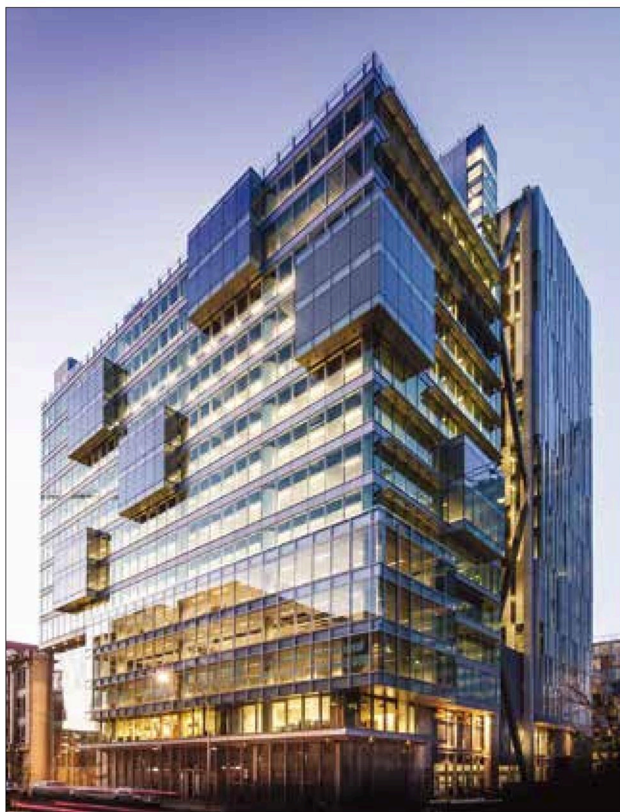
some of this money into commercial real estate financing.

The need to have an alternate real estate financing market was clearly amplified by the global credit crunch, when many large global and US money market funds closed down. For a brief moment, it seemed Australia was primed to develop an alternate real estate debt market as a circuit breaker to the liquidity crisis that had engulfed the corporate sector and, most of all, the vulnerable and highly-geared property sector.

Australian banks, which had – and still have – a stranglehold on real estate funding, pulled back from lending – in development finance, commercial real estate mortgages and the refinancing of existing loans. Fearful of borrowers breaching their loan-to-value (LTV) ratios, the banks started to call in some highly-leveraged loans, nearly sending some of the largest listed and unlisted property groups to the wall. For six months, they reportedly stopped lending altogether.

A light in the dark

These were the darkest days in the history of Australia's listed property sector, but they provided a golden moment for new players to step into the market to provide a much-needed alternative source of funding. And indeed, a tiny number of firms rose to the challenge.



ATO Building in Adelaide: Funded with A$250 million from Telstra Super

Sydney-based Challenger Group, Australia's largest non-bank commercial real estate lender with more than A$1.5 billion in real estate loans over the past five years, took the lead. Within months, it had received three mandates totaling some A$700 million to lend on income-producing prime commercial assets.

Challenger raised A$400 million from Australia's largest superannuation fund, the A$180 billion AustralianSuper, and from Hesta, an A$29 billion health and community services sector industry fund. It also raised A$300 million from Singapore's GIC Private Limited, which previously had formed a joint venture with a listed Australian company to provide mezzanine debt. Today, according to industry sources, GIC is focusing on other markets, such as China and India, believing that Australia had not lived up to its expectations.

Still, others like the A$15 billion Telstra Super chose to deal directly with borrowers. That superannuation provided a two-tranche loan totaling A$250 million to the listed Aspen Property Group for its development project in Adelaide.

After this spurt of activity, however, Australia's embryonic commercial real estate debt market again became dormant. The reason, sources say, is that the banks have regrouped to once again step up lending to the market and have become increasingly competitive in squeezing margins to "push money out of their doors."

Not doing enough

Still, critics say the banks are not doing enough. Australia's four large banks are said to control more than 85 percent of the senior loan market, with collective exposure of almost A$230 billion at the end of June – up 7.9 percent from the previous year. However, much more is needed to adequately cater for the needs of property developers and investors.

Former Prime Minister Paul Keating, who introduced Australia's universal superannuation scheme in 1992, recently told a forum on debt in Melbourne: "Superannuation funds will have to do things in the spaces traditionally left to banks – such as property development – and we will see a shift in the balance of financing in this industry."

Borrowers for investment properties still have their LTVs capped by the banks at between 60 percent and 65 percent – or lower, depending on the borrower – although they may have a slightly higher LTV for development projects, according to sources. The standard term of the loan is three to five years, although some banks are extending that to seven years. Still, this is more an exception than the rule.

As they face growing competition for choice assets, superannuation funds and their consultants are taking a fresh look at real estate debt. "In this low (growth) market environment,

investors are looking for interest rate margins," says Ken Atchison, managing director of Atchison Consultants, which advises superannuation funds on asset allocations. "They will selectively look at participating in debt funds if they can get returns of 5.5 percent to 6.5 percent."

Tim Johansen, managing director of real estate finance at Qualitas, tells *PERE* that the Qualitas Real Estate Debt Fund plans to deliver "compelling " returns net of fees to investors. "We are very confident that we can achieve our stated returns across a product mix that will include senior debt, unitranche and mezzanine lending against both stabilized assets and development projects," he says.

Still, Atchison notes that, in order to attract superannuation capital, fund managers must demonstrate that they have experience in dealing with these issues – like Challenger, which has been in the wider mortgage markets for a long time. "They will be wary until they are convinced that there is a process in place to deal with credit risks and the management of arrears and defaults," he adds.

A highly attractive proxy

Felicity Ambler, head of distribution at MaxCap, says her firm is partnering with superannuations and pension plans to provide them with a highly specialized investment management platform that delivers strong risk-adjusted investment returns via Australian commercial real estate debt. She adds the real estate debt market in Australia is a highly attractive proxy for real estate, fixed income or alternative debt, and there are significant first-mover advantage available.

Brae Sokolski, chief investment officer of MaxCap, says it has become clear from discussions with US pension plans that they are focused on opportunities in Australia's real estate debt space. And Ambler adds that more superannuations are becoming interested in real estate debt as consultants begin to understand the value of the asset class.

Michael Holm, executive chairman of Balmain Investment Management, agrees that superannuations are emerging in the market again. "We are in the midst of an A$500 million capital raising and getting a good response," he adds, noting that the fund is due to close in February.

Asked to describe the real estate debt market today, Holm replies: "It is all over the place. Everyone is trying to work out how to compete with the banks." Nevertheless, he and others that spoke to *PERE* are convinced that there is a share of the market that can be tapped, such as structured senior debt, second mortgages and mezzanine debt.

"Australia needs long-term asset stability and long-term, fixed-rate debt capital to match the long-term nature of the underlying asset," says Quadrant's Wood. The firm, which has offices in Sydney, Atlanta and London, manages some

Keating: sees superannuations filling finance roles left by banks

$6 billion of debt secured by about $9 billion of commercial real estate in overseas markets, notably in the US.

Opportunity in loans

There is a big opportunity for new lenders prepared to write longer-dated loans, says Wood, who believes there is demand for 10-year, interest-only debt and LTVs up to 70 percent.

Indeed, Wood points out that some Australian real estate groups have taken to issuing bonds in the US debt market, where they are able to obtain terms of 10 to 15 years in duration. However, in doing so, they must wrestle with the conundrum of borrowing in a foreign currency secured by an Australian dollar income stream.

Brae Sokolski says some borrowers look for alternatives, such as institutional funding, because they may have aggregation issues with their banks. Others find it difficult to work within the strict covenant requirements of their banks.

Indeed, MaxCap has a long track record of funding transactions with specialized requirements that banks are unable or unwilling to fund. It lends up to a 75 percent LTV on institutional-grade investment and development facilities.

"Our debt fund will offer a broad range of products," says Qualitas' Johansen. "We could offer to finance up to 80 percent of the value of a commercial office building as a structured, unitranche senior loan."

Johansen notes that investors and developers have become more sophisticated in terms of capital requirement. "When a developer is looking at an A$100 million project, the major banks will lend $75 million and the developer is expected to fund the balance using equity," he explains. "Instead of locking up so much cash, the developer will take mezzanine debt of around $15 million to free money for a second project, or provide working capital liquidity. Structures such as this will be considered by our fund, undertaking both the first

mortgage and mezzanine component."

Like banks, which want borrowers to have 'hurt money' in their projects, Qualitas will require borrowers to put up equity. "We will only get a true alignment of interest when the borrower has equity in a project," says Johansen.

Gerard Hargraves, who leads Challenger's real estate lending division, says: "We focus on deals slightly outside the major banks' appetite. If there is concentration risk or an asset-specific risk that falls outside bank policy, we will look to combine some structural supports and increased pricing to compensate for that risk."

Although banks have increased their exposure in commercial real estate, Hargraves notes that "they remain focused on the investment-grade end of the institutional and corporate real estate markets. Pricing in these markets has firmed substantially from the low 200 basis points to margins in the low- to mid-100 basis point range." Outside these markets, there is a dearth of capital, hence the wider spreads are holding, he adds.

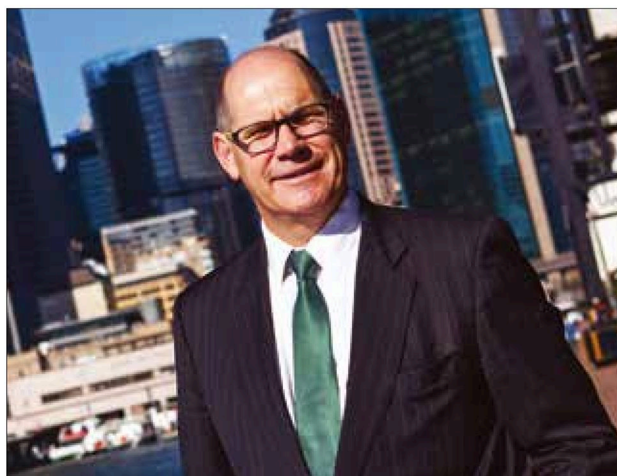
Competition on all sides

Those contemplating entering the real estate debt market are fully cognizant of the stiff competition from major banks. However, while margins for senior loans are being compressed, competition is growing in the mezzanine debt market.

"For every mezzanine transaction, there are probably 10 parties bidding for it," says Balmain's Holm. "We operate in the mid-market at the A$3 million to A$50 million range, where there is less competition and we can get better yields."

However, Johansen believes there is a floor that the banks can reach with current loan pricing. "They are heavily regulated, there is a cost for their capital and they need to meet the (prudential) requirements of the regulatory authorities and the new global banking rules under Basel III," he says.

Johansen: borrowers now have more sophisticated capital requirements



Wood: sees a need for long-term debt capital

"It probably is a moment-in-time experience where the banks are competing for quality business and compressing margins, but we can contend because our deals will be structured differently and will have features that maybe the banks cannot offer."

Michael Weaver, portfolio manager with Sunsuper, an A$29 billion industry superannuation, says: "People shouldn't underestimate the challenge of competing against the banks. The banks do development project financing on relatively low return thresholds." Indeed, he notes the cyclical nature of the lending business and wonders aloud just how many non-bank lenders can run a sustainable business in this market.

Wood says Australian institutions have a "distinct advantage" over global offshore funds, which have been trying since the global financial crisis to crack the Australian market, because they don't have to deal with issues of tax and foreign currency risk. That may be so, but some superannuations, like Telstra and Sunsuper, find the market overseas more rewarding.

Sunsuper started investing in real estate debt offshore because of the more attractive risk-adjusted returns on offer. It has a real estate debt portfolio of around A$300 million invested mainly in the US and the UK

Weaver notes that banks in the UK and US markets were more seriously affected by the global financial crisis than Australian banks. However, as US banks have repaired their balance sheets, the opportunity for investing in US real estate debt has reduced, just as there are now fewer opportunities in Europe with the European banks also gaining strength.

Still, the offshore markets beckon. Quadrant, for example, is believed to have raised around A$1 billion from Australian institutions to invest in real estate debt markets overseas. How that affects Australia's nascent real estate debt market remains to be seen. □