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Real Estate Debt

From crisis comes opportunity

Consulting. Outsourcing. Investments.

Economic backdrop

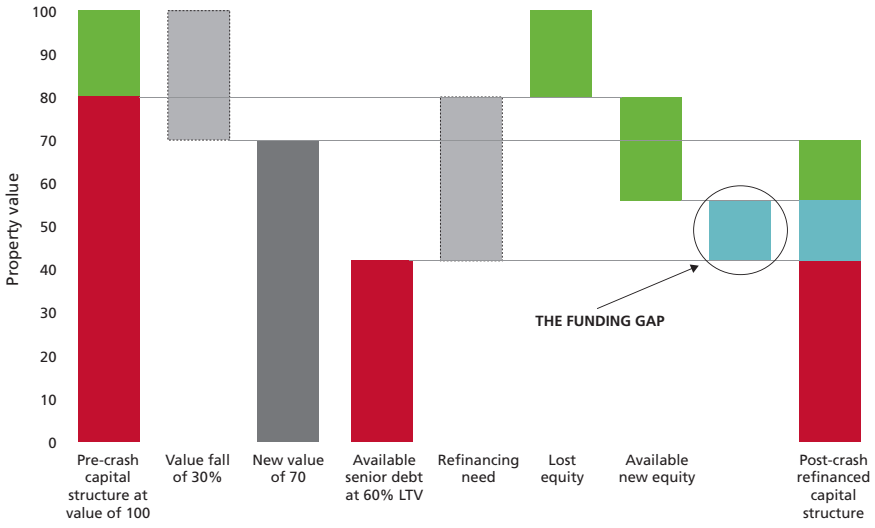
Recent economic events have served as a stark reminder that we operate in a truly integrated global financial system. The collapse of the US subprime mortgage market, the ensuing credit crisis of 2007 and the economic meltdown of 2008 indiscriminately affected investors around the world through the failure of key businesses, material declines in consumer wealth, a significant slowing of economic activity, and extensive government intervention in several of the world's largest economies.[1]

While these events resulted in significant value destruction, they also created investment opportunities. This paper examines the opportunities that exist in real estate debt and highlights why, in today's volatile environment, real estate debt investments should be considered by institutional investors.

The new landscape for real estate debt – The funding gap

In the aftermath of the widespread economic meltdown, material structural changes have occurred in the global real estate market. The magnitude and character of these dislocations vary by region, but they are caused by one or both of two factors: falls in real estate capital values and/or failures of debt service due to underlying tenant distress and falls in rental income. Exhibit 1 illustrates the story.

Exhibit 1: The funding gap and the opportunity for nontraditional lenders



[1] Examples include the Troubled Asset Relief Program, the Term Asset-Backed Securities Loan Facility, the Asset Guarantee Program and the Public/Private Investment Program (US); the SoFFin (Germany); the Asset Protection Scheme (UK); the Orderly Bank Restructuring Plan (Spain); the Emergency Credit Guarantee Program (Korea); and the National Asset Management Agency (Ireland).

In most developed markets, real estate capital values fell by up to 40% and have recovered somewhat, with values currently at, say, 20% below their peak values. At the peak of the market, banks would lend senior debt at up to an 80% loan-to-value (LTV) ratio. As LTV covenants were breached, lenders may have adjusted terms and widened margins, but in many cases the underlying rental income has not been compromised and the loan continues to be serviced.

The fall in value has had a knock-on effect on the banks lending the outstanding senior debt. Regulatory changes around the world have labeled these loans as higher risk, and the amount of capital that needs to be reserved against them has increased, reducing the amount of capital available for refinancing. Concurrently, the commercial mortgage-backed securities (CMBS) market has shrunk significantly in North America and all but disappeared in Europe, further reducing the supply of debt capital.

Maximum LTVs for senior debt on stable core real estate are currently around 70% in North America, 60% in Europe, 30%–35% in Asia, and 80% in Australia, leaving a significant requirement for capital when loans come to be refinanced. Not only must the original loan be repaid, but 35%–40% of the reduced capital value remains to be financed by the borrower. Many borrowers cannot finance this out of equity, and this is the so-called "funding gap."

Borrowers can bridge the gap in two ways. One option would be to bring in another equity investor on a side-by-side basis and share the equity risks and returns. Another option would be to obtain higher coupon-enhanced senior or mezzanine debt, paying a relatively high coupon but retaining the asset and keeping the majority of capital growth for themselves.

The new landscape for real estate debt – Widened spectrum of opportunity

The previous section outlined how falls in real estate capital values and/or failures of debt service due to underlying tenant distress and falls in rental income have created an increased requirement for nonbank lenders to bridge the funding gap. However, these two factors have not necessarily occurred together everywhere.

In many parts of the world, we have seen an increase in levels of "normal" distressed debt, in which tenants have failed to pay, rental incomes have fallen and debt is not being serviced. The purchase and workout of nonperforming loans is a currently viable investment strategy, albeit with all the attendant significant execution risks.

However, in other parts of the world the recent economic dislocation was primarily a capital markets phenomenon, and the knock-on effect on the real economy was limited. In these locations, perhaps for the first time, we are seeing the widespread existence of loans whose LTV covenants have been breached beyond hope of recovery by recent capital value falls,

but which continue to be serviced – indeed, in some cases interest and debt service coverage ratios have risen. These are performing loans. However, when the borrower comes to refinance, there will be a significant funding gap and a requirement for new sources of capital. This new phenomenon can be characterized as undistressed debt with a distressed borrower, and it has opened up new investment strategies with risk/return characteristics very different from those of "traditional" distressed debt.

The spectrum of lending opportunities has thus widened at both ends, with an increase in the "traditional" purchase and high-risk workout of distressed and nonperforming loans, but at the other end, an increased need for low-risk senior and mezzanine debt. Exhibit 2 (on page 4) illustrates the spectrum.

Size and likely duration of the funding gap

Detailed information on the likely size of the funding gap is difficult to obtain on a consistent basis across countries. Estimates of the gap in Europe for 2010–2011 are over $195 billion if senior LTVs stay below 60%. Over a third of this is in the UK, with another fifth in Spain. There are much smaller requirements in France, Germany and Italy. In the US, the estimated gap for the next three years is $1.1 trillion if senior LTVs stay below 70%. And in Australia, the gap is estimated to be on the order of $8.8 billion, assuming 60% LTV.

The opportunities in debt should exist until the funding gap disappears, which will not be until those loans made at the top of the market in 2007 have all been repaid, refinanced, restructured or foreclosed. With an average loan life of, say, five years plus, say, two years to allow for the recent extensions, this opportunity is likely to extend into 2012–2014. Most of the funds being raised are five-year fixed. Most managers plan to raise one five-year fund at a time and, as soon as that fund is fully invested, raise a follow-on fund, and thus address the continuing pipeline of opportunities.

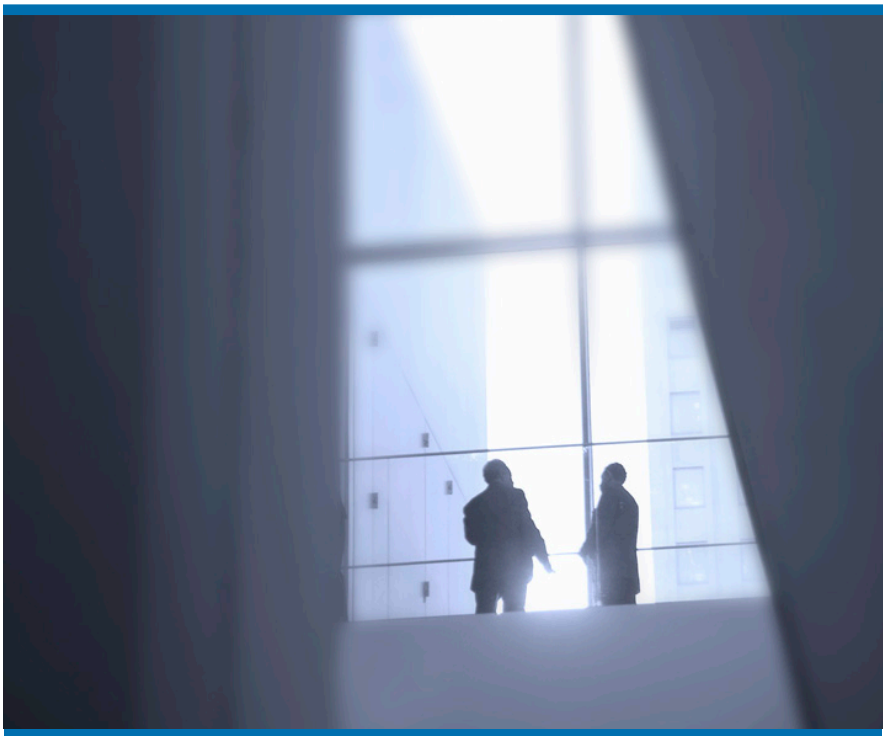
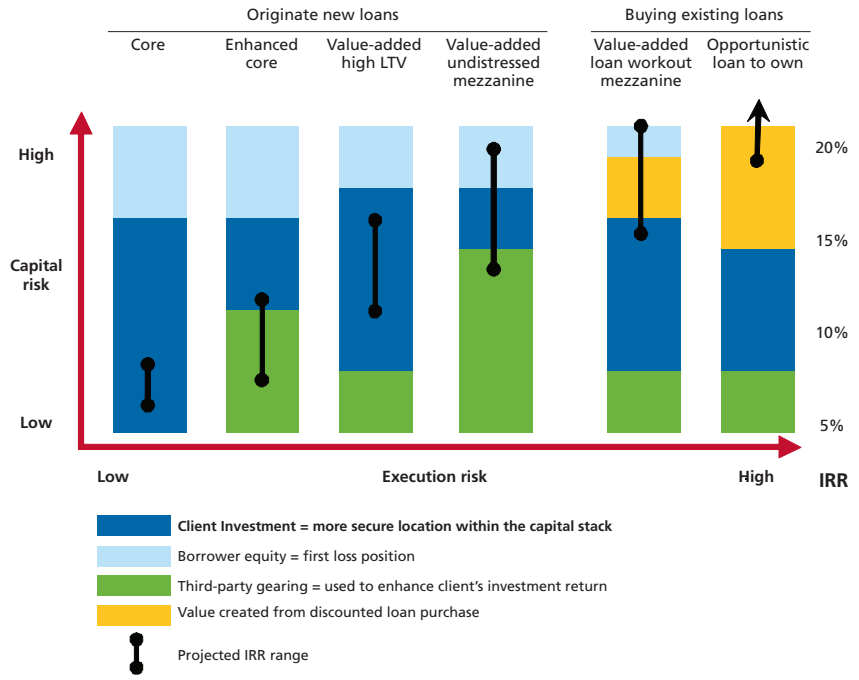


Exhibit 2: The spectrum of lending opportunity



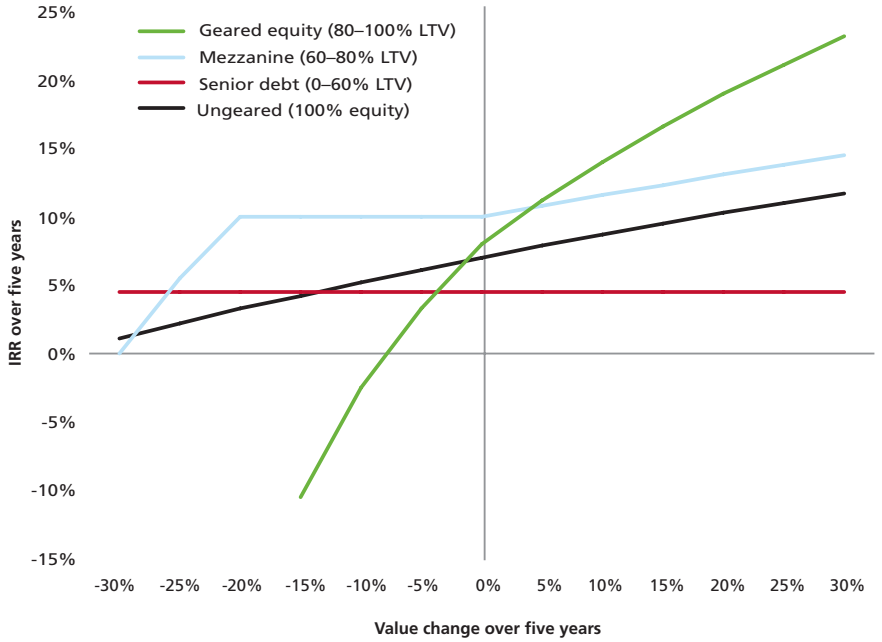
	Originate new loans on undistressed real estate		Buying existing loans on distressed assets
Strategy	Core senior	Enhanced Core Value-Added high LTV and undistressed mezzanine "Undistressed asset, distressed borrower"	Distressed senior and mezzanine
Sources of return	Coupon Arrangement fees Early repayment penalties	Mostly high coupon Arrangement fees Minimum multiple / early repayment penalties Share in any capital growth through warrants	Buy at a discount to face value and: ■ Sell back to borrower at a premium to purchase price ■ Restructure, package and sell ■ Foreclose, reposition and sell property
Sources of risk	With good property and tenant under-writing, low risk and high degree of capital protection, except under extreme value-fall scenarios	With good property and tenant underwriting, low risk and high degree of capital protection, except under extreme value-fall scenarios	Execution and legal risk Lumpy returns, timing uncertain Low / no income or high but uncertain income, back-ended capital growth
Risk style	Core	Enhanced Core / Value-Added	Value-Added / Opportunistic
Target return	5%–7%	10%–20%	15%–25%+
Leverage	0%	0%–50%; generally less than 25%	0%–50%; generally less than 25%
Fund life	7–10 years	5–10 years	7–10 years
Regional availability	North America	North America Europe, including UK Asia	North America Europe, including UK Asia

The funding gap upsets the risk/return hierarchy on undistressed real estate

The increase in demand for debt financing to bridge the funding gap has meant that providers of this financing are able to command premium prices, upsetting the risk/return hierarchy for as long as the funding gap lasts.

To illustrate the positive impact of the funding gap on returns for mezzanine, Exhibit 3 shows the IRR obtainable from different parts of the capital structure for newly issued debt on undistressed real estate under different value growth/fall scenarios over a five-year hold period.

Exhibit 3: Risk/return characteristics of different parts of the undistressed capital structure



Input assumptions

ASSETS	Value	Yield	Income
Property	100	7.00%	7.00
	100		7.00

FINANCED BY	Value	Coupon	Interest/distribution
Equity	20	8.00%	1.60
Mezzanine debt	20	12.00%	2.40
Senior debt	60	5.00%	3.00
	100		7.00

A five-year hold period is assumed and, in addition to the 12% coupon, the mezzanine has a 20% participation in any capital growth over the period, usually structured as a warrant that survives the loan in the event of early repayment. Minimum multiples and prepayment penalties are also in place.

What is immediately striking is the relatively high return available from mezzanine debt, mostly in the form of income, and the high level of capital protection from the equity cushion unless values fall by more than 20%. Even under an extreme value-fall scenario of 30%, return is still positive because of the high income. Under all illustrated scenarios, the return from mezzanine debt is higher than from unleveraged investment in the underlying property.

Distressed debt

Alongside the new market for debt to bridge the funding gap on undistressed property, opportunities still exist to invest in "traditional" distressed debt. Investment here takes the form of a purchase of the debt at a discount, and returns are realized in one of three ways:

- Sell the debt back to the borrower at a discount to face value but a premium to the discounted purchase price (for example, buy at 50 cents on the dollar, sell back to the borrower at 65 cents, the investor gets a 1.3 multiple, and the borrower is released from 35% of the outstanding loan).

- Restructure the debt so that it becomes performing (extend, profit share, payment in kind, etc.) and then either hold to maturity or sell, perhaps as part of a securitization.

- Foreclose, reposition and sell the property ("loan-to-own").

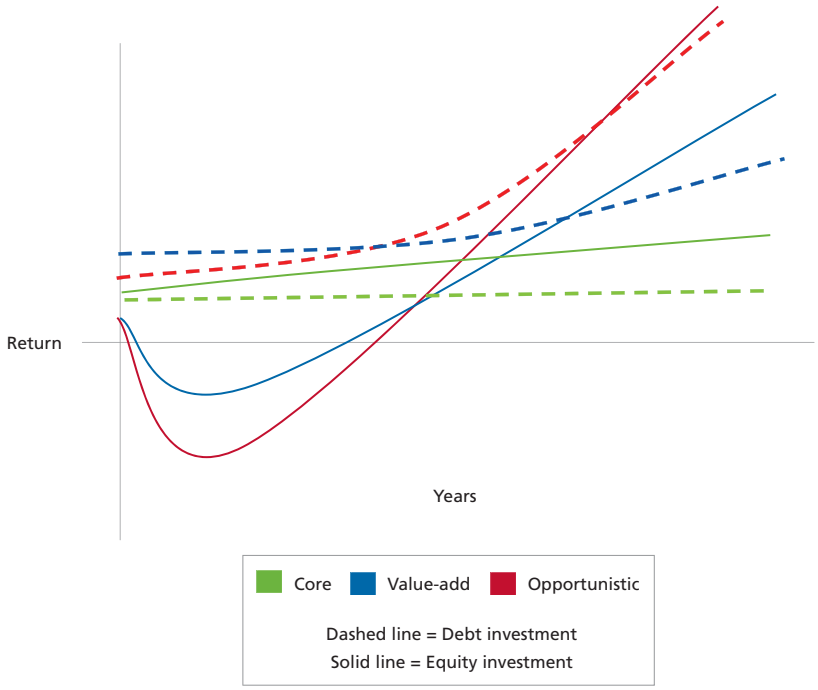
Risks for this strategy are higher than for originating undistressed loans, particularly for "loan-to-own," where execution risk (particularly that of getting stuck in a court battle in some jurisdictions) is significant. However, returns can be commensurately high, sometimes reaching unleveraged IRRs of 30% or more. Returns come mostly in the form of back-ended capital returns, with income returns dependent on the characteristics of each investment.

Debt might be the new equity, but safer

With a favorable return outlook and a more secure position within the capital stack, real estate debt appears to offer a compelling investment case compared to traditional real estate equity. Return expectations along all points on the risk/return spectrum indicate that debt is expected to perform in line with equity, but with a higher income component and a capital cushion generated from the borrower's equity. Further, with economic uncertainty lingering across the globe, debt provides an investment vehicle that is fundamentally tied to real estate, but less correlated to economic conditions. Even if the global rebound slows, or even reverses into a decline, debt's position within the capital stack should enable investments to help avoid impairment in all but the most extreme conditions.

A final benefit of debt investing is its reduction of the "j-curve" effect on invested capital. Typical equity real estate investing requires additional capital injections into a property after purchase, and with the combination of management fees, negative returns are generated during the investment period of a fund's life. With debt, because of arrangement fees and coupon payments from the borrower, positive returns are generated immediately on called capital. Exhibit 4 illustrates the reduction in the j-curve.

Exhibit 4: Debt investing reduces the j-curve compared with equity investing



Summary – Debt versus equity

In summary, debt investments in real estate offer similarities to and differences from equity investments in the following ways:

Risk

- The income component of return for real estate debt investments is typically over 70% of the total return across all risk spectrums – much higher than all but unleveraged core equity strategies.

- Debt investments are real estate investments, but in more secure positions within the capital stack – valuation and cash flow declines impact equity first, then debt.

- Like traditional direct real estate investments, real estate debt has a comparatively low volatility and low correlation to equities and bonds – fluctuations in the capital markets have less direct influence over existing debt investments.

- Debt investments exhibit lower volatility because capital market impact on property valuations is reduced.

- Debt investments are similar to fixed-income investments in that rising interest rates will negatively impact real return.

- Unlike real estate equity investments, most debt investments do not provide direct inflation protection.

- Like direct real estate investment funds, debt funds are typically closed-ended with lock-up periods of five to 10 years.

- No established real estate debt investment benchmarks exist, making comparisons across investment funds difficult.

Diversification

- Like equity real estate funds, debt funds provide diversification by geographic location, property type and absolute number of investments.

- As with equity investments, debt investments have various risk/return levels ranging from high-quality core to higher-yielding but riskier enhanced, value-added and opportunistic.

- Debt investments show low correlation with other asset classes – underlying investment is real estate and returns will correlate to the real estate asset class, especially in the higher-risk strategies.

- Lower-risk debt strategies become increasingly correlated with fixed income investments.

Managers

- Significant alpha-generating opportunities exist in debt, especially in the higher-risk strategies.

- Debt may require a more hands-on approach to asset management by an investment manager – real estate acumen is an absolute must.

- Risk in higher-return strategies lies with the manager's ability to negotiate a new structure with the borrower, or to take title to the property.

- Managers must have demonstrated experience in deploying debt capital.

- Debt and equity managers have different avenues for deal sourcing; one cannot do the other easily.

- Debt investments require knowledge of loan documents and lender rights.

- In both debt and equity investments, if there is a default by the borrower, a manager who understands real estate will stand a better chance of recovering capital.

Many managers in Mercer's rated universe have good core real estate underwriting skills, and many are skilled at structuring mezzanine debt or working out distressed debt. However, it is rare to find a manager who combines debt-structuring skills with core property underwriting skills, and Mercer is currently building its universe of such managers.

Conclusion – To invest or not to invest

Many investment strategies, regardless of their asset class, can be viewed as attractive purchases if they are acquired below their fair values during a down market and are predicted to return to their true fair values once the down cycle reverses. With this in mind, the broad reasons for investing in real estate debt are compelling in the current environment; most developed countries – Australia being a notable exception – are currently operating in a low-interest-rate environment, there is a general demand for liquidity across various property markets, and the most recent correction in the real estate sector has left valuations at historic lows in many regions. Investors who are currently contemplating an investment in real estate debt could do so in a period where property assets are generally priced below their intrinsic values and real estate funds are in a favorable position to negotiate debt terms with borrowers.

It must be stressed that, as with any other investment choice, investors' decisions to invest (or not to invest) in real estate debt must be carefully thought out, reviewed with the investor's investment consultant, and analyzed and considered within the specific context of the total portfolio, its time horizon, liquidity constraints, regulatory obligations and overall risk tolerance. Additionally, as true free lunches are rare, investors should place much emphasis on the review and selection of managers and be comfortable with the various degrees of credit or idiosyncratic risk associated with the four main real estate debt strategies (Core, Enhanced Core, Value-Added, Opportunistic). As part of the decision-making process, investors should also seek to establish, vis-à-vis their portfolio objectives, constraints and proposed allocation size, how they can best structure their real estate program and, consequently, whether one or more of the four types of debt funds would be most appropriate for their plan's exposure to real estate.

Important notices

This paper was prepared by members of Mercer's Real Estate Boutique and Kweku Obed of the Real Estate Strategic Research Team.

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About Mercer's Real Estate Boutique

Taking manager research to the next level

Mercer's global manager research team has been transformed into four boutiques covering equities, bonds, real estate and alternative assets. In order to provide in-depth, comprehensive product research, the Mercer manager research team has become increasingly specialized in its organization. The move to boutiques reflects the need to focus on depth of expertise and Mercer's desire to remain close to its clients, bringing innovations to their attention in a timely fashion and being the first call for any manager bringing products to market.

Mercer's real estate boutique is responsible for research and advice in all aspects of real estate investment, including:

- Structure of real estate allocations
- Research on real estate investment trends and opportunities
- Due diligence on managers and strategies
- Performance reporting
- Due diligence and assistance with fee and mandate negotiation
- Ongoing monitoring of investment managers and client portfolios

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03843B-IC-281010