



ENHANCING RETURNS AND MITIGATING RISKS IN AUSTRALIAN COMMERCIAL REAL ESTATE DEBT

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There is a sound underlying driver of returns in CRE debt

Introduction

Worldwide commercial real estate debt (CRE debt) is a large asset class. In Australia alone it is estimated to be at least \$500bn with up to \$100bn in loan transactions closed annually¹. Since the Global Financial Crisis (2008), interest in this sector has risen as investors search for investment opportunities with predictable yields and capital stability. As yields on CRE debt typically vary with a bank bill index, the variable interest rate provides considerable inflation protection.

Over recent years commercial lending markets in Australia have changed dramatically. There are fewer lenders and with new capital constraints on the remaining participants (particularly the banks), CRE finance has become harder to obtain. Investors now enjoy significantly enhanced returns with variable rates of up to 3.5% over bank bills from a senior CRE debt program. Conditions further favour investors as loan leverage is lower and interest cover is substantially higher than for many years prior to the GFC.

Investment in CRE debt provides a strong underlying structural return. Once acquired, however, the loans require specialised management expertise to extract returns and ameliorate risk.

This paper draws insight from the lending practices of the Big 4² banks, as well as those of institutional lenders in major offshore CRE debt markets. It considers the merits of large loan versus mid-cap loan programs, the pros and cons of allocations to senior, stretch senior and mezzanine loans³, and the characteristics of a core-plus CRE debt program that includes construction lending. It also explores the essential foundations of a CRE debt program and addresses the role of active management.

Throughout, the paper provides lists of key issues which might be considered in the nature of checklists for investors. The more complex and involved an area of decision-making the more valuable are simple checklists. This has been confirmed in piloting large commercial jets, in surgery, and in investing. Well-constructed and effective checklists reduce the incidence of unrewarded risks while enhancing the opportunities from rewarded risks. This is especially true in relatively new and multi-layered asset classes such as CRE debt.

The paper's key findings are:

- It is important to diversify exposures to CRE debt.
- Stretch senior loans offer both a higher yield on the senior debt component and returns commensurate with mezzanine for the stretch senior component, without being hampered by inter-creditor and priority documentation.
- Modest exposure to construction lending can add appreciably to returns with no significant uplift in losses from defaults.
- Construction lending can also enhance the quality and yield of a loan program over time as construction loans often convert to high yielding senior CRE investment loans with the most attractive loan security.
- Properly controlled loan origination is crucial to access quality loans in sufficient volume for institutional investment.
- Best practice demands the functional separation of loan origination, credit, investment management, and asset management and recovery.
- There is no substitute for credit experience acquired during both exuberant and constrained market conditions.
- Robust loan servicing, asset management, portfolio management and reporting infrastructure are essential.
- CRE lending is not set and forget. Successful CRE programs require on-going active management of individual loans and the overall portfolio.
- Asset management and recovery expertise available in-house ensures swift action to minimise losses when defaults occur.
- All economics in the lending chain should be disclosed and shared appropriately.
- Banking-style retention of economics in other loan categories, transactions or deposits can compromise risk and returns.

1 RBA, APRA & ABS; includes stock of owner-occupied property and advances secured by real estate for business capital purposes.

2 ANZ, Commonwealth Bank, National Australia Bank and Westpac.

3 Stretch senior lending is typically a first mortgage secured loan with an LVR (Loan to Value Ratio) of up to 75%. Mezzanine lending is typically second mortgage secured to similar levels.

As a new and multi-layered asset class, commercial real estate debt can be prone to unrewarded risks

Strategic Investment Considerations

CRE loans are not homogenous. While the underlying assets are income producing commercial real estate, different market segments have significantly different characteristics.

This segmentation provides scope to design a CRE debt portfolio which can best deliver desired risk and return requirements. In determining the specifications for a CRE debt portfolio, an investor should consider three strategic issues before resolving more granular points of portfolio design such as industry sector and geographic weightings.

The key issues are:

1. Will the portfolio be comprised of mid-cap loans or large cap loans (or a combination of these)?
2. Will the loans be senior debt, stretch senior or mezzanine (or a combination of these)?
3. Should construction lending form part of the portfolio?

Large-Cap Loans, Mid-Cap Loans or a Combination of Both?

Banks lend across the full spectrum of loan sizes which has proven an effective commercial strategy and delivered wide portfolio diversification. This approach has strong parallels with traditional equity and fixed income management. Few of these programs concentrate on just a handful of the largest issuers; rather they recognise there is merit in a broader base of exposures and the opportunity for active management to enhance returns in the mid-cap tiers.

Portfolios solely comprising large-cap loans⁴ have certain key advantages:

1. **Rapid deployment:** Large-cap loans allow rapid building of a portfolio of a given size provided that sufficient loans to meet the portfolio return are available.
2. **Readily identifiable borrowers:** There is less need for an origination network as the pool of potential borrowers of large-cap loans is much smaller and more readily identifiable than the pool of potential borrowers of mid-cap loans.
3. **Reduced resource and infrastructure demands:** A portfolio of a small number of large-cap loans will not require the same level of resources and systems for loan acceptance, credit underwriting, asset management and loan servicing.

Large-cap loans are often perceived to be blue-chip as the underlying security typically comprises investment grade assets that institutional investors are more familiar with. However the underlying assets in a large-cap loan portfolio can be subject to greater market volatility due to the smaller buyer pool. These portfolios also have heightened risk due to lack of diversity and greater exposure to single loan defaults. Large-cap loan portfolios are also more vulnerable to margin pressure due to competition from other lenders and the risk of early loan repayments which have a much greater impact on portfolio returns.

Portfolios of mid-cap loans have the following advantages:

1. **Borrower guarantees:** Guarantees are typically provided with mid-cap loans but are generally unavailable for large-cap loans. In the latter case this is because borrowers are usually SPVs, trusts or large corporates unwilling to furnish them. In the event of default or loan stress, personal and corporate guarantees improve borrower behaviour and the level of recovery.
2. **Improved geographic, security-type and borrower risk:** A portfolio of mid-cap loans contains a broader spread of geographic, industry sector (i.e. industrial, commercial, retail) and individual borrower risks.
3. **Lower risk of restriction on the use of secured property:** Properties securing mid-cap loans are typically adaptable to renewal, renovation or conversion/changes of use, and are less prone to significant unforeseen capital expenses.
4. **Lower competition from other lenders:** Infrastructure is required to gather suitable assets for a mid-cap loan program, which reduces competition. Further the demise of the 2nd tier banks, retail mortgage trusts and other capital market participants has reduced competition for mid-cap loans.
5. **Early repayments are less problematic:** The early repayment of a loan in a mid-cap portfolio has a minimal effect on returns.
6. **Higher, more resilient margins:** Higher loan margins are more sustainable as assets are harder to gather and margin compression is less apparent.

⁴ A large-cap CRE loan is one greater than \$30m while mid-cap loans range from \$2m to \$30m.

It is especially important to have diversified exposures to CRE loans

There are some disadvantages to mid-cap loan portfolios. They are slower to build to a given size. They require wide origination capacity, significant credit underwriting capability and a manager with diverse sector experience and geographical reach to effectively manage the assets. Mid-cap loan portfolios are more costly to manage and require a fund manager with scale and personnel to manage volume transactions.

Widely adopted lending practices are instructive. Life companies and pension funds world-wide are active in mid-cap CRE loans. Yet Australian superannuation funds, unlike their offshore counterparts, have only recently emerged as investors and have so far favoured large-cap loans as an entry point.

In comparison the Australian retail mortgage fund industry invested in mid-cap commercial mortgage loans⁵ for nearly 20 years. From 1990 to 2008 the major retail mortgage fund managers accumulated portfolios totaling over \$20b⁶ and achieved returns (excluding retail MER's) well in excess of prevailing bank bill rates. While retail mortgage funds have wound down due to their structural limitations (essentially borrowing short and lending long⁷), the major funds maintained capital stability (a \$1 unit price) during a variety of market conditions and returned full capital to investors. It was notable to industry-insiders that the primary investment failings of the major retail mortgage fund managers were commonly associated with large loans, approved during more exuberant times.

The experience of the Bank of Scotland International (BOSI) is also instructive. BOSI entered the Australian market in the early 2000's mandated to build a significant portfolio in a short period of time. BOSI favoured a large-cap loan program that included investment, development and corporate loans.

BOSI's well-documented retreat from the Australian market resulted in very substantial portfolio losses. While there are a number of reasons for loan losses in these portfolios other than the large-cap nature of BOSI's lending, there is no doubt that the size of the individual loan exposures (average in excess of \$30m) contributed to the losses incurred⁸.

Senior, Stretch Senior or Mezzanine CRE Debt?

CRE lending starts with senior secured first mortgage loans that historically advance up to to 2/3rds of valuation (also known as "trustee" lending). There is method in the 2/3rd's limit that has stood the test of time. In the event of default, lending to 66% allows approximately 10% to cover interest not paid, 10% for borrower litigation, 10% for market loss and 5% for costs. Another tenet of "trustee" lending is to lend only on non-specialised properties that are leased on terms that exceed the duration of the loan. Such common sense rules have stood first mortgage lenders in good stead for many years.

CRE senior lending complying with classic "trustee" style criteria is unlikely to yield enough to garner institutional investment in Australia. CRE loans to quality borrowers that comply with these conditions currently yield gross margins (in excess of bank bills) in the range of 1.75 – 2.50%. There is some opportunity for higher margins on loans of longer duration (out to 5 years) but a fund manager will likely have difficulty producing a net portfolio return in excess of 2% above bank bills while complying strictly with trustee lending criteria.

CRE debt investors can earn higher returns from stretch senior or mezzanine loans. During the height of credit market exuberance (2006-08) senior debt leverage (LVRs) moved significantly higher from 60 - 66% to 70 - 75%. Today senior debt leverage has retreated back to 66% and many senior lenders (especially the banks) are more comfortable at LVRs of 60% or lower. This trend is likely to continue for some time due not least to the capital impost on banks for holding higher leverage commercial loans. Stretch senior and mezzanine leverage now starts at closer to 65% LVR and stops at 75 - 80%.

5 AMAL Asset Management average loan size data for major mortgage trust investors 1994-2008

6 The major retail fund managers were Colonial First State, ING, Perpetual, AXA, Challenger and Australian Unity

7 Mortgage fund capital was raised from retail investors at call and lent onto CRE investors for terms of 1-5 years. During 2008 when retail investors called their investments, managers were unable to liquidate loan holdings and the sector subsequently closed for redemptions.

8 In 2012 Balmain was appointed by Morgan Stanley and Blackstone to manage the \$1.8 billion distressed commercial property debt portfolio known as Lawson that Morgan Stanley and Blackstone acquired from Lloyds Banking Group subsidiary, Bank of Scotland International (BOSI). The appointment followed the selection of Balmain to manage the \$685 million Gold Coast distressed asset portfolio known as Patterson that Morgan Stanley also acquired from Lloyds in 2011. The average loan sizes in the Lawson and Patterson portfolios were \$31m & \$37m respectively.

Stretch senior loans offer higher returns but significantly ameliorate the risk of a mezzanine loan position

Stretch senior CRE loans earn margins higher than senior CRE loans and the extent of the reward depends on the level of leverage. The senior debt component of a stretch senior loan may earn margins of up to 1% higher than for stand-alone senior loans, with the mezzanine component earning a whole rate of up to 25%. Investors should however recognise that these higher returns often entail higher risk.

In considering mezzanine loans an investor needs to be cognisant of a number of issues affecting second mortgage (mezzanine) lenders in the Australian CRE debt market:

1. Many senior lenders (most notably the Big 4 banks) will often decline to participate if mezzanine debt is required.
2. Where senior lenders will participate, their requirements in terms of loan documentation (second mortgage documentation including priority and inter-creditor deeds) have moved strongly in favour of the first mortgagee and provide the second mortgagee with very few rights in event of loan default.
3. Recent experience has shown that in the event of loan default many senior lenders (especially the banks) are slow to react. When they do move, they have tended to appoint receivers to manage the process. The combination of lethargy in deciding to act and the excessive fees charged by receivers can quickly erode any equity held by the mezzanine lender.

An investor should assess whether or not the returns from the mezzanine sector (currently in the range of 12% to 25% whole rate returns) justify the risk.

Stretch senior loans offer both a higher yield on the senior debt component and returns commensurate with mezzanine for the stretch senior component with a first mortgage security position (un-hampered by inter-creditor and priority documentation). Stretch senior loans thus avoid the generally weaker position that a mezzanine lender occupies.

A Core Plus Approach to Enhancing Risk Adjusted Returns through Construction Lending

Direct property investors have long adopted a 'core plus' approach that seeks enhanced returns by taking measured and complementary risks⁹. The exposure to these value added investments is typically at least 30% of the core plus property portfolio. The same opportunity avails itself in CRE debt by investing in certain types of construction lending¹⁰.

Construction loans earn higher loan margins than senior investment loans. There is significantly less competition in construction lending than pre-GFC and lenders can obtain loan margins between 2% - 3% higher than senior investment loans. Leverage has significantly reduced and security has improved markedly with lenders requiring pre-commitments in the form of pre-sales for residential lending and pre-sales or pre-commitments to lease in commercial, industrial and retail lending.

Construction loans are also an excellent source of high-yielding investment loans. Once construction is complete, borrowers often transition from a construction loan to an investment facility. Newly completed properties make attractive investment loan securities: frequently offering fresh tenants with current leases, longer WALEs¹¹, higher NABERS¹² ratings and lower maintenance costs, all of which can considerably enhance portfolio quality.

The principal disadvantage of construction loans is the risk that the borrower and builder fail to deliver on the project. Understanding, managing and mitigating completion risk is a specialised skill and requires a disciplined approach to lending based on strong market knowledge and sound construction lending disciplines.

9 A core plus fund will generally invest in core properties however some of these properties will require some form of enhancement or value-added element.

10 Construction lending can involve construction for sale and construction for investment. Construction for sale is mainly concentrated in the residential sector (although strata commercial and industrial construction loans form a minor part of this market). Unlike in the US and Europe, Australian investors tend not to hold residential assets as long-term investments. Investment construction is typically focused on commercial, industrial and retail assets.

11 WALEs is the weighted average lease expiry. This is the average lease term remaining to expiry across the portfolio weighted by gross rental income.

12 NABERS is a national rating system that measures the energy efficiency, water usage, waste management and indoor environment quality of a building or tenancy and its impact on the environment.

Modest exposure to construction lending can add appreciably to returns with no significant uplift in losses from defaults

Essential practices in construction risk management include:

- Lending on a cost to complete basis only and always ensuring borrower capital is contributed in advance of loan capital.
- Lenders having charges over any presale contracts and lease agreements and secure "step in rights" to the building contract under a tri-partite deed signed by all parties. This allows the lender unfettered access and control to complete the development in the event of issues or disputes.
- Lenders ensuring that loan conditions control project cost and project timing, so that any divergence from an agreed development program will at least constitute an event of review.
- Independent certification of costs by lender-instructed Quantity Surveyors & Engineers etc.
- Advances only made on work certified as complete and not against materials on site.
- Lenders should fund only borrowers who have significant construction experience within the relevant sector and who have engaged reputable and financially capable companies to deliver the project.

In today's market a component of construction lending in a CRE debt portfolio is well rewarded.

Foundations of a Successful CRE Debt Program - an Industry Checklist

Access to proven, repeat borrowers

Experienced lenders regard proven, repeat borrowers as one of their most important assets. Indeed, within the banking system, the term "new to bank" is often a catch cry for caution. One of the major challenges for new entrants is to avoid ending up with marginal, less established borrowers. The development of distribution infrastructure to access suitable loans in sufficient volume is important for success.

Construction of a well-balanced portfolio requires distribution (loan origination) to provide access to a flow of loans that includes industry sector, geographical and borrower diversity. Origination should be transparently remunerated with economics aligned to the long-term performance of the portfolio.

Separation of roles

Loan origination must have minimal contact with credit and be unable to influence the underwriting process. It is best to impose a firewall or intermediary function such as 'loan acceptance' between loan origination and credit underwriting. This is standard banking practice. The role of loan acceptance is to confirm that each submission is complete and conforms to portfolio guidelines. A loan must pass the "acceptance" filter before submission to credit for full underwriting.

Experience in credit underwriting

The primary control for protecting capital is the credit process and there is no substitute for experience in credit underwriting and collecting CRE loans. It is extremely important to have knowledge and experience of "challenging" periods such as the late 80's/early 90's when real estate markets were stressed as well as "exuberant" periods such as 2004 to 2007 when market conditions strongly favoured borrowers. The key processes in assessing credit in a CRE loan are to form an accurate understanding of "asset risk", "sponsor risk", "servicing risk" and "exit risk".

Swift action is required to minimise losses when defaults occur

Independent oversight

There is a strong case for independent oversight of critical credit and investment functions. Credit and investment committees should be populated with independent and experienced members who are responsible for oversight of all credit and investment decisions as well as reviewing the performance of the credit team.

Well documented processes

Lending procedures and processes must be well documented and understood by all participants in the program. Properly documented credit manuals and loan processes (for operations ranging from initial loan acceptance through credit underwriting, loan settlement and on-going management) are an essential point of reference for program control and quality.

Stand-alone servicing

It is best for loans within the portfolio to be serviced by a stand-alone organisation. Loan servicing¹³ is the process by which loan repayments are collected from borrowers and remitted to the lender. Having an experienced loan servicer separate from the portfolio manager provides an important additional layer of risk management. It also allows efficient transfer of the portfolio if it is necessary to replace the manager. Separate or back-up loan servicing functions are a standard requirement of any CMBS or RMBS loan program.

Integrated lending systems

Complex origination and credit processes require sophisticated administration systems driven by mandatory work-flow processes which ensure accurate capture of data and a consistent approach to risk evaluation.

Systems are essential to ensure:

- A reliable, single source of information on the portfolio as well as each loan and all related documentation.
- Web-enabled 'live-time' reporting.
- Audit and compliance of all systems, policies and procedures.
- Ready identification of credit trends and anomalies enabling 'pre-emptive' credit management on both an individual loan and portfolio basis.

Regular stress testing

CRE credit and investment markets are dynamic. Economic conditions affecting investment sectors change frequently. It is the role of an active and knowledgeable investment committee (separately constituted from the credit committee) to oversee portfolio performance as well as to set, monitor and amend sector allocations and risk limits in response to changing market conditions. It is a valuable investment function to identify and target sectors and loan types where credit risk is advantageously mispriced, and avoid segments where risk is not rewarded.

Having a well informed view of the market is essential and managers should test portfolios to identify stress points. If a particular real estate market is suffering from oversupply or a downturn, managers must ask what exposure the portfolio has in this sector and what actions are possible to reduce risk? A manager must have the capacity to effectively respond to answers to these questions. Being ahead of the curve is preferable to reacting months after default events have started to occur.

Asset management and recovery expertise

Any CRE debt portfolio will have defaulting loans. These defaults are either monetary or non-monetary in nature¹⁴. Asset management and recovery expertise should be readily available in-house to ensure swift action to minimise losses when serious defaults occur.

The majority of credit issues are minor and a well-structured and experienced credit team is usually able to solve them expeditiously. However when a serious default does occur, the loan file should be promptly transferred to a separate asset management and recovery function. Fresh eyes and a fresh approach are required following a serious default so that existing relationships with the borrowers do not hamper recovery actions.

13 Loan servicing is a specialised role and typically performs the functions of interest collection and charging, account administration, arrears management, transaction processing and portfolio reporting.

14 Monetary defaults involve the borrower's failure to pay interest or meet capital repayment commitments. Non-monetary defaults are technical in nature and involve the breach of loan covenants or conditions e.g. maintenance of Interest Cover covenants or provision of financial information etc.

CRE lending is not set and forget; active management has a critical role to play

CRE lending is not set and forget

CRE lending is not set and forget. Successful CRE lending requires on-going active management of individual loans and the overall portfolio as follows:

- Identifying and targeting market segments where credit risk is advantageously mispriced and avoiding segments where risk is not rewarded.
- Stringent management of repayment/ re-lending to minimise liquidity drag.
- Optimising loan terms, with a preparedness to lend longer to capture higher margins.
- Flexible structuring of individual loan terms and conditions to maximise returns and protect against default.
- Optimising the components of individual loan pricing including establishment fees, loan margins, default fees and early repayment fees.
- Monitoring the cash flow from the underlying real estate security to ensure that asset value is maintained during the term of the loan and where cash flow is under threat taking action (with the borrower or without) to repair issues.
- Monitoring of loans to “predict” defaults¹⁵, enabling early intervention to prevent a default or mitigate its effects.
- Maintaining a regular dialogue with the borrower during the loan term to ensure any loan or borrower issues are well understood and managed.

The foundation components outlined above are the minimum competencies a fund manager requires to enhance returns and ameliorate risks in a large scale CRE debt program. They are no less than the minimum requirements of a warehouse bank for a CMBS or RMBS loan program manager or the minimum investor requirements for correspondent lenders¹⁶ to life company programs in the United States. Experience both in Australia and overseas shows that managers without the levels of capacity described are prone to failure.

Extracting the Most Advantage from Individual Loan Economics

The nature of commercial mortgage lending is similar to direct property investing in that different fees and charges are paid and received during the term of a CRE loan. These economics must be disclosed and shared with investors according to pre-agreed protocols to align the investment manager and loan origination with the investor's investment objectives.

To ensure transparency fees should be controlled by the trustee of any investment fund before remittance to investors, the loan originator and the investment manager. A less transparent approach may result in erosion of some of the economics which an investor should receive.

The following fees are relevant:

1. **Non-default interest:** This is interest paid on a loan that is not in default. The lender/investor should receive 100% of non-default interest.
2. **Loan establishment fees:** A borrower usually pays a loan establishment fee as consideration for a loan being established¹⁷. This is typically shared between the loan originator and the lender for the work each has done in sourcing, assessing and preparing the credit submission. Sharing should be according to a pre-agreed formula so there is no scope for any arbitrage against the interests of the lender/investor. For instance, the loan originator should not be able to increase the loan origination fee if a lower lending margin is achieved. Protection of the interests of the lender/investor is enhanced if the investment manager has full visibility and control over the loan origination network and all fees paid.
3. **Early repayment fees:** A borrower who repays a loan prior to its agreed repayment date is usually charged an early repayment fee. The lender/investor should receive 100% of any early repayment fees.

15 For example, failure to pay statutory charges is often a leading indicator of future loan defaults. Lenders should seek regular and timely confirmation that all statutory charges and insurances are up to date.

16 In the United States a correspondent lender is a mortgage manager that originates and manages CRE debt portfolios on behalf of Life Company investors. This is a \$280b sector in the US.

17 The size of the loan establishment fee is determined by the market and negotiation between the lender, the loan originator and the borrower. It is typically in the range 0.25% to 1.0% of loan principal.

All parties should be aligned to the long term performance of the loan program

4. **Default income:** In the event that a borrower is in default of its obligations (e.g. has failed to pay interest) usually the lender will typically levy default (or 'higher rate') interest as well as additional fees and charges to the borrower. An investor should have complete knowledge and control of any default income received from the portfolio.
5. **Origination service fees:** During the life of a loan the loan originator will usually charge the borrower a service fee for assisting the borrower to comply with the terms of the loan. This will include activities such as assisting with annual loan reviews, coordinating property inspections, obtaining updated tenancy schedules and insurance certificates, and helping ensure compliance with loan covenants¹⁸. There should be disclosure of origination service fees and no scope for any arbitrage against the interests of the lender/ investor. In the event of a loan default, the interests of investors are best served if, thereafter, the origination service fee is withheld from the loan originator until full repayment of the loan.

A Final Word on Alignment and Transparency

CRE debt is a specialised and multi-layered asset class. Hidden costs and fees are rife, and investors should have a good grasp of the complete economics of a loan program. All parties must be appropriately and transparently remunerated so that they are aligned to the long term performance of the loan program. It is helpful to align the interests of all parties, as follows:

1. Seek co-investment by the investment manager along-side the investor/ lender. Alternatively defer a substantial portion of the manager's fees into a loss reserve¹⁹ that is only repaid at the end of a program's life once all capital has been repaid to the investor/ lender.
2. Ensure a similar alignment from origination so that upon default of a loan all fees payable to originators are likewise deferred to a loss reserve.

3. Have firm rules that ensure the investor/ lender participates in all loans underwritten by the investment manager or is otherwise not disadvantaged by their exclusion.
4. Individual loans should be priced on their own merits and there should not be any cross-subsidisation of economics in other loan categories, transactions, deposits or relationships.
5. A complete embargo on related party lending.

Conclusion

The investment attributes of CRE debt make it attractive for institutional portfolios. It is a substantial asset class providing consistent and reliable income returns with low levels of volatility and high levels of capital protection. Market conditions which are enhancing the appeal of the asset class are driven by fundamental market changes and the opportunity is expected to continue.

In designing a CRE debt program, investors should review the different potential loan strategies and determine how well the risk-return characteristics of each fit with investment objectives. Before committing, investors should develop a solid understanding of the credit and management processes that will be applied to deliver portfolio returns.

¹⁸ A typical origination service fee is up to 0.25% p.a. of the loan principal.

¹⁹ A portion of fees may be set aside to a loss reserve to cover potential losses in the loan portfolio. In the event of defaulted loans, interest and principal repayments are recovered from the loss reserve.

About Balmain Investment Management

Balmain Investment Management Pty Limited (Balmain) is the institutional funds management arm of the Balmain Group, Australia's leading non-bank secured private debt group. The Balmain Group has been operating for over 30 years and its sole focus is commercial real estate debt. Balmain is one of Australia's largest and most experienced secured private debt fund managers. The Group is also the largest distressed debt portfolio manager in Australia currently overseeing more than \$3 billion in distressed loan assets on behalf of a variety of investors including Morgan Stanley, Blackstone and Deutsche Bank.

In 2011 Balmain established a joint venture with Brookvine Pty Ltd to facilitate institutional investment in Australian secured private debt. Brookvine is an independent Australian investment advisory and marketing business.

By partnering with Balmain, institutional investors gain access to:

- A granular portfolio of mid-cap commercial real estate loans with an average size of \$5m - \$10m.
- The most significant source of secured commercial real estate loans outside of the major banks.
- An established, vertically integrated full service provider, with single point responsibility and accountability for all fund and loan services.
- An independent and cycle-experienced funds management team, with dedicated in-house credit, portfolio management and asset recovery functions.
- A fully aligned and transparent funds management model with a strong focus on governance and independent oversight.
- A range of investment options, including the Secured Private Debt Fund and Separately Managed Accounts.

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