

Transcript

The Ideas Exchange

Episode 8: Accessing income through commercial real estate debt

September 2021

Voiceover Welcome to the Monthly Ideas Exchange podcast brought to you by ASX, The Heart of Australia's financial markets. Each month we'll connect you to a range of leading industry experts who'll give you a look into the finance industry and deliver valuable insights, hear about important market events, industry research, tips for your own market research, as well as innovative products to help you diversify your investment portfolio.

Martin Dinh Hi, everyone, welcome to another episode of the Ideas Exchange podcast. As interest rates reach all-time lows, investors are actively searching for investments that can provide them with a reliable and consistent income to help them fund their living expenses, lifestyle and retirement. For investors looking for income, commercial real estate debt is an asset class that they may consider, given this asset class aims to provide them with regular and consistent income. To help us learn more about the investment opportunities behind the commercial real estate debt asset class, I'll be joined by Yin-Peng Chiew, Director of Strategy at Qualitas, one of Australia's leading alternative real estate investment managers. So a fun episode lined up. Come join Yin and me as we explore the world of commercial real estate debt.

Martin Dinh Hi Yin, welcome to the Ideas Exchange podcast. It's great to have you here today.

Yin-Peng Chiew Thanks, Martin. It's really fantastic to be able to join the podcast this time.

Martin Dinh So in today's episode, we are going to be covering the commercial real estate debt asset class, short for CRE Debt. It is an asset class that can provide investors with exposure to the property asset class without actually owning it. This asset class is particularly interesting, given it specifically aims to provide regular and consistent income and is relevant in today's low interest rate world. So I guess a good place to start Yin, for those that are not too familiar with what CRE debt is. Can you tell us or provide us with a quick overview of what it is?

Yin-Peng Chiew Sure. So CRE debt is essentially a loan that's provided to finance real estate, both for investment and development purposes. We all know that real estate is an asset class that is heavily borrowed against. And in fact, it is quite rare that with regard to real estate, it's purchased outright by one hundred percent equity. So there's always going to be borrowings against property. And so this is that unique opportunity around the CRE debt, specifically the borrowers of CRE loans. They are distinctly commercial. That is, they are wholesale. They're typically

property developers, private corporations, high net worth groups and individuals that own and develop properties for commercial purposes. It's important to note that these are not home loans to retail borrowers, such as individual owner occupiers and investors. Importantly, CRE loans, they are secured by real property mortgages, meaning if the borrower cannot repay the loan, the lender has the right to sell the property to recoup repayment of the loan. And this is the capital preservation feature of this asset class that is so desirable. And just lastly, recapping on the income aspects of CRE debt. The income is actually generated from the borrower's paying loan fees and regular interest payments at agreed rates.

Martin Dinh So I think that's a great summary about CRE debt and the two kind of main points that I really take away from it is firstly that CRE loans, they are loans to commercial borrowers. They're not your retail borrowers like owner occupiers and your investors. So commercial borrowers, like you mentioned, are property developers and property investors, I assume probably also rates as well, and probably large corporations. Another interesting point is that CRE loans, you mentioned they are all secured by real property, real security property. So I guess, you know, that kind of has like a capital preservation feature to that particular asset class. Now, in terms of the CRE debt market landscape. How big is the CRE debt market?

Yin-Peng Chiew Look, the CRE debt market in Australia, we estimate that to be around three hundred and eighty billion of which the banks have a ninety three percent market share. They're predominantly the main providers of CRE debt. And the remaining 7% gap is actually provided by alternative lenders such as Qualitas, and this represents the private CRE debt market and this is around twenty five billion. This CRE debt market actually continues to grow year on year by about two to four percent in recent years, which has been as a result of low interest rates, natural population growth and urban expansion. What is quite remarkable about the dynamics at play within the CRE debt market is that there has been a permanent structural shift whereby alternative lenders are increasingly gaining market share as a result of bank pullback of CRE lending, over the last decade. Since the GFC, the banks have been subject to increasing prudential regulation and stricter lending requirements, thereby reducing the appetite to CRE lending.

Martin Dinh That's a particularly interesting point about the CRE debt and particularly the private CRE debt market and the growing, I guess, growing market for alternative lenders. And I think you mentioned a really interesting point about some banks pulling away from CRE lending due to, I guess, increased regulation from, I guess, regulatory bodies. So I guess it is clear that CRE debt market is an asset class that's growing. Now, one of the most common ways for investors to get exposure to this growing asset class is through a fund structure such as a ASX listed investment trust, which they can buy through their broker. Now, what I've always tried to get my head around, though, when I did a bit of research about this topic is how exactly does a fund that invests in CRE debt actually generate income for its investors?

Yin-Peng Chiew Sure. So CRE debt can be accessed typically through a fund structure, and that is a managed investment scheme which can be listed or unlisted. And investors can purchase units to invest in these vehicles and those particular vehicles will invest directly in CRE debt. So an investment manager is typically appointed to manage the fund, the investment manager has a specialised skill set in the underlying asset class and will invest the pooled investor equity capital into CRE loans on a discretionary basis. The underlying CRE loans they typically generate loan interest and fee income for the fund, which in turn is paid as a regular cash distribution to investors, typically monthly, in line with the interest payment frequency. And the role of the investment manager is quite an important one because the investment manager will source and originate all lending opportunities, undertake the loan assessment and due diligence process to ensure that it meets the investment objectives and mandate of the fund. The investment manager also undertakes active management of the loan throughout its life cycle to ensure risk and manage such that it will not impact the performance of the loan. That is, the ability of the borrower to make payment of interest and loans principal when due.

Martin Dinh Yes, I think that really clarifies the mystery, right. So if I was an investor and I wanted to invest in a listed investment trust that invested in CRE loans, I'd buy it from my broker. The capital then goes to a investment manager. The investment manager then uses that capital to invest in CRE loans, which in turn then they provide CRE loans to borrowers. And the borrowers in turn will then pay, I'm assuming, loan fees and the loan interest repayments to the lender who then in turn passes it on to the investor as a regular income. So that kind of clarifies that mystery. So in the entire investment universe for income, there are a range of options that can provide income that ranges from term deposits, bonds, property equity, and each of those have varying degrees of risk and returns. So when you look at the investment universe for income, can you tell me where you think CRE debt sits in the risk and return scale?

Yin-Peng Chiew Sure. With regards to private CRE debt, it could actually provide some really attractive risk adjusted returns relative to other income focussed investments. So CRE debt risk and returns. They're usually higher than corporate bonds and loans, but we believe they are much lower than hybrid's and equities or owning property, which is higher up on the risk curve. So we're looking at the capital structure and the wind up of a company or sale of assets. Secured debt is always repaid first, followed by unsecured debt, subordinated debt hybrids, and then lastly, equity. And this particular key feature of CRE debt is that it's classified as secured debt. So it has the highest priority in the capital structure and those investors will always get their money repaid first. So it's a really good indication of where it sits on the returns or the risk scale. And in terms of the return, it's commensurate with sort of a moderate risk compared to other income focussed assets.

Martin Dinh So I think when I try to remember what I've learnt in university, you've said that CRE loans fall under the secured debt category. So from memory, that means that CRE investors or CRE holders, they tend well, they will get paid first, I guess, in the repayment priority in the wind up of a company's assets, because I think it goes secure debt, unsecured debt, subordinated debt, hybrids

and then equity. So I thought that was particularly interesting, something that I wasn't really familiar with. Now, in terms of asset allocation, where does CRE debt sit in an investor's portfolio, i.e. does it sit within the equity bucket, the property bucket alternative's or fixed income bucket?

Yin-Peng Chiew We believe that CRE debt is quite unique in that it can actually fit into three asset classes. Firstly, being fixed income given credit is a credit instrument and it generates a fixed level of income from a great interest in fees and also benefits from less capital volatility because of the real property security. And there's also no secondary market trading of private CRE debt. We believe it's on par with fixed income. Secondly, we think it also fits into property given it provides exposure to the property market, given the underlying secured properties. And lastly, CRE debt can also be classified as alternatives since it doesn't exactly fit into the other traditional asset classes. So I guess whilst the determination of asset class allocation is based on individual investor profiles, CRE debt provides additional diversification regardless.

Martin Dinh Yeah, it's probably one of the most unique asset classes in terms of at least the asset classes that I've learnt about at my time at ASX. Most asset classes generally either sit in the equity property, fixed income alternative's bucket. But CRE debt kind of is unique. You can see it in the fixed income bucket can in the alternatives, and it could also sit in the property asset class as well. So I guess, you know, for those particular reasons, it can be a great asset class to add diversification to a portfolio. So we've kind of covered where CRE debt sits in the investment portfolio. Can you outline any reasons or the particular reasons why investors should consider investing in the CRE debt asset class?

Yin-Peng Chiew Sure. Look, we think that investors who prefer less capital volatility or have income targeted strategies such as retirees, they are often attracted to CRE debt. And in terms of the benefits we summarise, this as first that there there's a stable operating environment for alternative lenders. Alternative lenders have been operating for more than 30 years in the Australian CRE debt market. So the market is quite stable and in fact, growing. Secondly, it's quite an accessible asset class or investor types, whether you're institutional, wholesale or retail. It provides regular and at a level of predictable income, given the loan interest and fees are agreed and known and the risk adjusted returns can be quite an attractive premium to the current low cash rate, knowing that the premium is commensurate with the risk undertaken. It also provides excellent capital preservation characteristics as all loans are secured by real property mortgages and also has the benefit of exposure to the property market without the equity risk of actually owning the property. But most importantly, it's a very simple credit strategy. It's very easily understood compared to other more complicated investments such as hybrids or ETFs, and can actually provide diversification to an investment portfolio.

Martin Dinh Yeah, I appreciate that, that you've gone through a lot of the benefits, which I think I think when I think about it, what type of investor that may be attracted to this asset class is probably like you have investors that seek reliable income, less capital volatility, and investors that want exposure to the property asset class. You can almost think that this might be suitable for those

investors. Looking for those qualities in examples could be like retirees, people at the latter stages of their lives that can't afford to take risk and lose capital. So this could be a useful asset class for those particular investors that are looking for investments with those particular features. So we've covered a lot of the basics of the credit asset class. So I wanted to move on to a more practical example of how investors can get exposure to the credit asset class, namely by buying units in the Qualitas Real Estate Income Fund under the ASX Ticker QRI through their broker. So could you give us a quick overview of the investment strategy of QRI?

Yin-Peng Chiew So QRI has a very simple and focussed investment strategy of investing only in CRE loans predominantly in Australia, which are all secured by real property mortgages. And as mentioned before, CRE debt is a very specialised asset class and distinct from equities, bonds and corporate loans. QRI's portfolio is currently comprised of 32 loans, which are ninety one per cent senior first mortgage and nine per cent mezzanine second mortgage. The portfolio is very well diversified across loan type, borrower geography, and property sector in terms of loan types. For example, so QRI, they invest in investment loans, residual stock loans, construction loans and land loans.

Martin Dinh So QRI it is structured as an ASX listed investment trust, i.e. a closed ended fund. What are some of the reasons why Qualitas has decided to structure QRI as a listed investment trust?

Yin-Peng Chiew Look, that's a really good question and it relates to having successfully established a wholesale property debt funds platform over the last decade within our business. And we have senior and mezzanine debt strategies. And I suppose we want it to further diversify our investor base and bring a similar CRE debt offering to the retail market in a listed and liquid form. Being listed means investors can buy and sell units readily and provide them access to liquidity. We also felt the LIT structure was beneficial to investors as there is no tax on the trusts income and therefore all income can be paid out to investors in the form of distributions.

Martin Dinh I think there are some great points of why you mentioned QRI structured as a as a listed investment trust and I specifically work with fund managers to help list ETFs. And I can tell you in the ETF structure, we wouldn't allow an ETF to hold CRE loans because it is a liquid asset class. So this particular asset class actually fits quite neatly in the listed investment trust structure. And I think what's really interesting about the listed investment trust structure is that it does allow investors to get exposure to asset classes, that they can't get access to their own because they can access the expertise of investment managers like Qualitas, like yourselves, because that's the only way to get access to that asset class. So, yeah, particularly interesting insights of why you structured QRI as a LIT. Now with any investment, I think it's important to understand some of the key risks, in the context of CRE debt. What are some of the main risks that investors should be aware of?

Yin-Peng Chiew With any investment I suppose that is defined as two aspects. So specifically the loss of capital and the loss of income. So in the context of CRE debt, loss of principal, of loan principal, this is a risk that the borrower cannot

actually repay the loan and the security property value declines and it's insufficient to actually meet for repayment if that security is in force. So that's the loss of principal component with regard to the risk around loss of income. This is a risk that the cash flow from the property or other borrower sources will be insufficient to pay the loan interest and fees that is due to the lender. So in terms of managing some of the inherent risks of CRE debt, we kind of group this into two areas. We specifically classify them as, one, a credit risk or whether it's a valuation risk and credit risk is essentially the determination through assessment of the credit worthiness and the ability of the borrower to service the loan. And what factors can affect such a service loan such as the financial standing, the experience and track record, the underlying property performance and market conditions and credit risk is quite important for identifying all known risks to a transaction so the loan can be appropriately priced relative to the risk. And just really quickly, the valuation risk is the risk that the security property value is insufficient to cover repayment of the loan. And what underpins the valuation risk is essentially four factors being the strength of the underlying property cash flow, which supports the property yield and can impact any change in rental rates, occupancy and vacancy. Secondly, the point in the market cycle for that sector based on economic conditions, has the property performance be impacted by macroeconomic conditions. And thirdly, market conditions such as supply and demand dynamics. For example, take a look at residential undersupply can be due to high demand for a particular location or under building, and therefore that can underpin the property valuation. And lastly, where investors are investing their capital impacts the relative asset yields between property and other asset classes.

Martin Dinh That's a great summary of some of the risk that you've mentioned that's related to the CRE debt asset class. And I kind of take to the two main points from it. I guess the main risk in CRE debt is credit risk, which is basically the assessment of the credit worthiness of the borrower, but also the security property value, as well as the valuation risk. Just making sure that you understand what is the sort of factors that may impact the potential property valuations. I guess when I look at some of those risks that you mentioned as an investment manager, are you like actively insuring that you're monitoring each lending opportunity and just making sure that you can anticipate some of the valuation and credit issues earlier just so it doesn't impact the performance of the loan. Do you guys do that?

Yin-Peng Chiew Yeah, for for sure. As an experienced CRE debt manager, we firstly identify all known risk by undertaking very extensive due diligence through a rigorous credit and valuation assessment process, which involves scenario analysis and stress testing on various conditions. We also seek to mitigate those risks by ensuring we are structuring the terms of the loan commensurate with the risk appetite and return that we are prepared to accept. For example, when we look at loan to value ratio, we ask ourselves how comfortable are we to lend against a property and what specifically do we want as the equity buffer to manage times of volatility where we feel there's risk to that property valuation. We also look at what is the appropriate tenure, which is important to managing the credit risk, because the longer that we expose to that particular loan, there's market risk and other factors that might impact performance. So will always best match our loan tenure to the risk appetite. When it comes to construction loans,

we look at the minimum level pre-sales for residential projects before funding can commence and pre-sales are very important to be able to prove out the viability of the project and ultimately the end value that's realised to repay the loan. So I guess in summary, not only is the initial credit assessment and loan structuring important for managing credit risk, it's actually very important for lenders to undertake ongoing management of each loan to anticipate these issues earlier and ensure loan performance is not impacted and hence preserving investor capital and investor returns. And at Qualitas, we undertake individual loan reviews of each loan in the QRI portfolio on a monthly basis and more frequently if required, for deals that are of heightened risk.

Martin Dinh So I guess on the topic of risk, you know, it was only just a year ago that we saw a major sell off due to the fears of the covid-19 pandemic. What was the overall impact of the equity market sell off on QRI?

Yin-Peng Chiew Yeah, look, before I go into what actually happened to QRI's unit price when covid hit, especially just to recap on QRI's trading performance since the IPO in November 2018. QRI was actually trading quite well it was predominantly trading at a premium to its nav of a dollar 60. And like all listed vehicles, QRI was not immune to covid-19. And this induced market actually caused QRI unit price to decline by about 35 per cent to unit price of around a dollar 10 at its lowest point in March 2020. And this was quite a significant dislocation to QRIs NAV. Now, net asset value, which had remained stable with no impairments since the IPO or throughout the covid-19 period.

Martin Dinh Yeah, I think those are great insights in terms of what happened to QRI during the equity market sell off and where it is today. And when I think about listed investment trust structures, you know, there's a I guess, a myth that if you're in that structure and you have a discount to your NTA, that you're in there forever. But I guess like it if you have, like a lid and you have a fund manager that knows what they're doing, you know, it is possible to close that gap because those gaps tend to arise due to the mismatch between supply and demand. Now, final question before I let you go. You know, it's been a very interesting topic. It is quite complex. And I'm sure that a lot of our listeners will have some further questions about the CRE debt market. So for those looking to learn a bit more about it as well as QRI, where can they head to?

Yin-Peng Chiew We're very passionate with educating our investors on CRE debt. And we actually have quite a suite of materials available on QRI's website. www.qualitas.com.au/QRI, which also includes the CPD accredited content for financial advisors and investors, can also access all QRI ASX announcement and fund performance updates on our website. All investors can also contact us directly by email. QRI@qualitas.com.au.

Martin Dinh Yeah, well, that wraps up today's episode. It was really fun chatting and I wanted to thank you for taking your time out of your day and sharing your knowledge on the often under invested debt asset class. We look forward to having you back down on the road.

Yin-Peng Chiew Thanks, Martin, thanks for allowing me to contribute today.

Martin Dinh Well, that concludes today's episode. It was a fun episode, learning about the commercial real estate, debt, asset class and how it can be suitable for investors looking for an investment that generates regular income and less capital volatility. In next month's episode, I'll be joined by Meaghan Victor, head of SPDR ETF Asia-Pacific at State Street Global Advisors. As we celebrate 20 years of ETFs and learn about how the ETF market started, how it has evolved and what the future looks like until then, thank you for listening. And we look forward to you joining us next month.

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