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The lowdown on commercial real estate lending

Lending to commercial real estate can provide a stable and low-risk opportunity for investors. Here we look at the benefits of this asset class and dive into some of the biggest trends in commercial real estate.

AMID CONTINUED market volatility, how can investors find stable, low-risk opportunities which still deliver income?

According to one manager, commercial real estate lending may present an opportunity to achieve just that.

The manager, Metrics Credit Partners (Metrics), runs a number of ASX-listed and other retail and wholesale funds. One area that makes up a large part of Metrics' business is commercial real estate (CRE) lending.

What is CRE lending?

Commercial property investment can encompass the fast-growing real estate debt market which offers a different means to generate a return.

A real estate debt investment aims to produce a higher yield than cash with less volatility than equity and fixed-income bond investments.

These funds seek to generate income by providing loans to borrowers who require capital for commercial real estate activities. The returns to investors are generated from the interest and fees paid by those borrowers, minus fund costs.

RANKING – INTERESTS/DISTRIBUTIONS AND CAPITAL RETURNS

Highest priority Lowest risk	**Senior debt**	• Superior position in the capital structure • First-order claim on assets and/or earnings of a borrower • Can be either secured or unsecured • If secured, can enforce claims ahead of unsecured creditors
	Subordinated/ junior debt	• Junior or second-order claim on assets and/or earnings of a borrower • Generally higher yielding than senior debt • Can benefit from upside via equity instruments attached to the debt structure
	Preferred equity	• Receives preferred payment in respect to dividends • Rank ahead of common equity in an insolvency situation
Lowest priority Highest risk	**Common equity**	• Unlimited upside but no downside protection • No right to contracted or preferred distributions • Typically, first loss in an insolvency or corporate reorganisation

Typical borrowers include companies involved in the development, ownership or management of office, industrial, retail or residential property.

Loans can be used for different stages of a property project – including land purchase, pre- construction activities, construction itself or completion and settlement.

"The role of real estate debt is to provide investors with access to stable capital, lower risk, and an attractive income," says Andrew Lockhart, managing partner at Metrics.

What are the risks?

Debt, Lockhart explains, sits further up the capital structure than equity. Senior secured debt is the least risky, getting paid first in the event of a default, while mezzanine or subordinated debt sits further down the capital structure, but commands higher returns.

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Returns for this asset class, he says, are dependent upon the risk and the available capital.

He explains that in real estate, the transactions generally price over the bank bill swap rate. In Australia, that is currently around about 4.35 per cent, similar to the RBA's cash rate. Fees and margins are also applied to reflect the risk profile.

"The risk is about the certainty that a lender is going to have around repayment," Lockhart says.

There is also the risk around construction and delivery, such as the ability of the developer to deliver a good quality project, on time and on budget.

"Our role as a lender is to understand that risk, seek to find ways in which to reduce or to mitigate that risk, and then charge the appropriate margin," he says.

As an example, he says a well-diversified portfolio comprised primarily of senior secured CRE debt instruments could generate between 9 per cent to 11 per cent per annum net to investors.

In mezzanine debt, returns are higher because of the subordinated position in the security structure. Generally, mezzanine debt pricing starts at around 15 per cent per annum.

Metrics also acts as an equity participant to support clients who are looking for access beyond debt. In these cases, it's the investor's capital that's at risk – and therefore comes with an element of capital gain. This might mean returns of over 20 per cent per annum.

"When we provide financing through equity, we're looking for investors to allocate away from, say, public market shares," Lockhart adds.

He explains that real estate debt lending is different to other well-known real estate vehicles like real estate investment trusts (REITs), which give an investor access to operating assets where return is generated from the rents.

He explains income from REITs can vary depending on the attractiveness of the property to tenants, and the ability of the manager to rent out the property. They're also susceptible to rising costs and rising interest rates that can impact the net return.

"Often when people invest in REITs, they're taking equity market risk to generate income," Lockhart says. "Our view is that you can get a more certain income for lower risk by investing in the debt."

In Lockhart's view, real estate debt very much fits into the defensive part of a portfolio.

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Andrew Lockhart
Managing partner, Metrics Credit Partners

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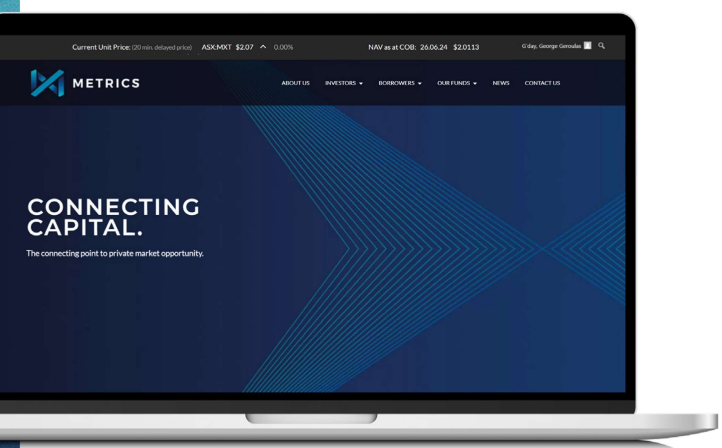
Where could CRE debt sit in an investment portfolio?

"CRE debt is designed to be an alternative to traditional fixed income such as hybrids or bonds," he says. "For some that have got the risk tolerance, it might even be an alternative to cash REITs, or infrastructure."

However, mezzanine and subordinated debt can also act as an equity replacement.

To learn more about Metrics Credit Partners, click here



"What we say to people is we can provide an equity-like income for lower risk. And for investors in public market equities who are looking to reduce volatility in their portfolios."

The same goes for real estate private equity, which can be a good investment for those willing to take a bit more risk, and who are looking to lower their equity market weightings.

Where are the opportunities in CRE lending?

When it comes to which sectors of commercial real estate are the most attractive right now, Lockhart points firstly to short-term residential projects, such as large land subdivisions in areas like Western Sydney.

"We see continued strong immigration flows, low unemployment rates, rising property prices, low vacancy rates and increasing rentals," he says.

"There's a significant demand for residential property that is currently outstripping supply."

Hotels are also an opportunity, he says.

While they look at every transaction on its merits, Metrics has tended to stay out of commercial office real estate. While Sydney has experienced a boost from the construction of the metro line, he sees a longer-term change in demand for commercial real estate in Australia's service-based economy as technology drives reduced headcounts and other efficiencies.

Lockhart says Metrics has a number of investors from different countries, such as Japan or northern Europe, which he believes confirms the attractiveness of the Australian commercial real estate lending market.

"But equally, it's an important source of capital to support Australian companies to grow and to finance their activities as well." ●

About Metrics

Metrics is a leading Australian non-bank corporate lender and alternative asset manager with in excess of $19bn in AUM and a greater than 11-year track record of performance and capital preservation. Through its managed funds, Metrics offers a range of investments across private debt and private equity. Find out more at www.metrics.com.au