US AND EUROPEAN REAL ESTATE DEBT MARKETS

DEFENSIVE SENIOR DEBT STRATEGIES IN A ZERO YIELD ENVIRONMENT

Man | Global Private Markets

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February 2017

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EXECUTIVE SUMMARY

The low returns world we currently live in has presented significant challenges for institutional investors. As yields on high quality sovereign and corporate bonds stay persistently low, and even negative, pension deficits are increasing, endowments are struggling and sovereign wealth funds are struggling to generate their target returns. We strongly believe that real estate debt may provide a potentially compelling solution for institutional investors looking to make new allocations under these circumstances. As we will outline, Aalto's conservative approach seeks to mimic the risk profile of conventional investment grade securities, whilst providing a potentially superior return stream to that which investors have become accustomed to from traditional liquid investment grade bonds.

Aalto first entered the real estate debt markets in early 2010, when both the European and US markets were dislocated following the Global Financial Crisis ('GFC'). Today, these same areas are characterised by a diverse group of lenders, including banks, asset managers and other institutional investors. There is also considerable divergence between opportunities in different geographies, and across different types of real estate assets. Across both the US and Europe, vast changes in financial regulation over the past few years are having a material impact on bank lenders' lending appetite in the market, thus creating dispersion in certain real estate assets or market segments.

Real estate markets have broadly improved over the last 3-4 years (i.e. assets have become more expensive). At Aalto, we have responded by steadily reducing our risk appetite to help ensure that our real estate debt investments provide our investors with a margin of safety should the market environment change in coming years. In practice, this has meant focusing on defensive direct loans with lower loan-to-value ratios, strong equity sponsors and ongoing maintenance covenants. Our investment focus revolves around sourcing loans backed by quality core and core+ real estate assets, and in targeting a portfolio level average loan margin of 300-400bps over LIBOR with moderate upfront lender fees. Our lending is mainly focused on floating rate and relatively short duration opportunities for our pension fund clients and more weighted towards long-dated fixed rate loans for our insurance clients.

KEY FACTS

- We believe real estate loans are attractive in the current market environment:
  - Senior loans, secured by quality real estate assets that can be underwritten in detail
  - Floating rate with short duration
  - Large market with ample potential opportunities – USD 2.9 trillion in the US and EUR 1.1 trillion in Europe[1]
- Aalto's focus is aligned with these areas:
  - Geographic focus on US, Europe and UK
  - In terms of capital structure we look for senior secured debt at 50-60% LTV
  - We lend to institutional borrowers backed by what we perceive to be high quality real estate
  - Our portfolio seeks a material yield pickup to traded corporate debt of comparable credit quality
  - The portfolio's yield profile is complimentary with direct real estate investment

COMMERCIAL REAL ESTATE ('CRE') DEBT MARKETS: WHO ARE THE MARKET PARTICIPANTS?

The European and US commercial real estate debt markets stand at EUR 1.1 trillion[2] and USD 3.6 trillion[3] of outstanding debt, respectively. Real estate debt lenders and investors can broadly be categorized as follows:

Banks: Traditionally the European markets have been dominated by bank lenders, whereas in the US they have represented a smaller share of lending (around 40-50%)[4]. Since the Financial Crisis, the banks' appetite to lend has been heavily influenced by regulation and de-leveraging, especially in Europe. CRE lending remains a core activity for banks across both regions and they remain committed to lend through the cycle given their focus on client relationships and cross-selling that they can offer to the same real estate borrowers. This can lead to build up of risks in the sectors particularly favoured by the banks.

Capital markets (e.g. commercial mortgage-backed securities (CMBS) market): The CMBS market currently represents around 25% of new lending volumes in the US but almost nothing in Europe. In the US, typical investors in CMBS bonds are insurance companies and asset managers. Most of the bonds are backed by a large number of individual property loans, over 100 in many cases. This means that transparency may be lacking which can make it difficult to underwrite the bond on a single asset level. The bonds are predominantly fixed rate, with a typical maturity profile usually set at between 7-10 years[5], in order to make them appealing to

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1. CBRE and Morgan Stanley Research. **2.** "European Commercial Real Estate Finance 2016 Update" by CBRE. **3.** Morgan Stanley Research. **4.** Source (for all statistics around market shares): (US) Wells Fargo and (Europe) "De Montfort University Commercial Property Lending Market Report" and "CRE Debt in the European Economy 2016". **5.** Source: Bloomberg.

insurance companies. European CMBS markets have not had significant new issuance since the GFC, as both insurance companies and banks have pulled from the market off the back of regulatory restrictions, such as Solvency II.

Insurance companies: Insurance companies in the US market represent 10-20% of the new lending volumes. Insurers in Europe have traditionally been less active in the space, but in recent years have started to enter with meaningful volumes as zero yields in investment grade bonds, alongside Solvency II regulatory considerations, drive them to diversify their investments. Today, insurance companies in Europe account for a similar share of new lending as they do in the US. In both geographies, insurers are looking to use direct real estate lending within their asset/liability matching frameworks. This generally means that they seek long-dated (10-20 year) fixed rate loans which can be matched with their long-term life insurance liabilities. This activity requires very specific underlying real estate, with long-term lease cash flows, and an owner of the assets that is committed to holding them for the duration of the financing.

Other Lenders: Since the Financial Crisis, pension funds, asset managers, university endowments and sovereign wealth funds have also invested in real estate debt markets, with differing risk/reward appetites. Often these types of investors/lenders have a certain minimum return target. They can also be less sensitive to risk and more focused on headline target returns. In addition, many of them participate in the mezzanine, second lien, 'stretched senior' markets.

In the US specifically, US government sponsored entities (i.e. Fannie and Freddie) are also active participants in the commercial lending markets, with a market share of around 10-15%. Almost all of this lending relates to government entities guaranteeing multi-family (apartment) loans originated by banks, however. In effect, since the crisis the government has been supporting investors in the multi-family market without providing much assistance to those building single family residential ('SFR') units.

REAL ESTATE MARKET ENVIRONMENT

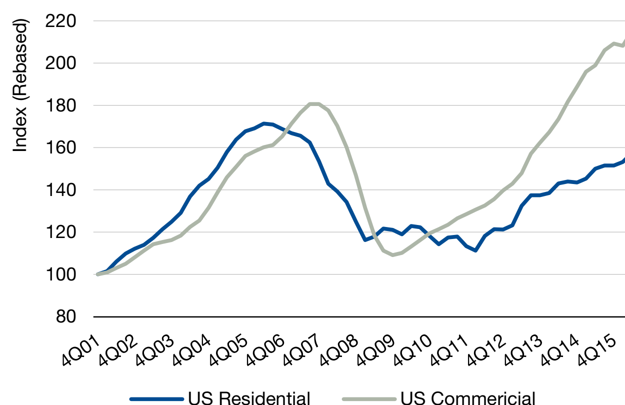
Real estate debt markets are driven by underlying real estate market cycles, and by the broader credit markets. It is fair to say that both of these markets are now at a mature stage of their respective cycles, having bottomed out at the depth of the GFC in 2009.

While the overall real estate markets, both in Europe and the US, are at or above last cycle's peak in terms of overall valuation, there is a significant dispersion of valuations within these markets. The primary 'gateway' or 'global' cities have outstripped everything else by some margin, enjoying significant increases in asset value and, correspondingly, yields are now at all-time lows despite rent levels being at all-time highs on a cash flow basis. Somewhat unsurprisingly, these cities have attracted significant interest from lenders, most notably insurance companies and banks.

On the European side, London provides a pertinent example of the large moves that certain cities have enjoyed. Prime, fully-let offices have benefited from both all-time low cap rates (in the City these have fallen from 5% in 2007 to 3.5% in 2016) as well as significant rental growth (West End of London rents are now 60% higher than in 2007)[6].

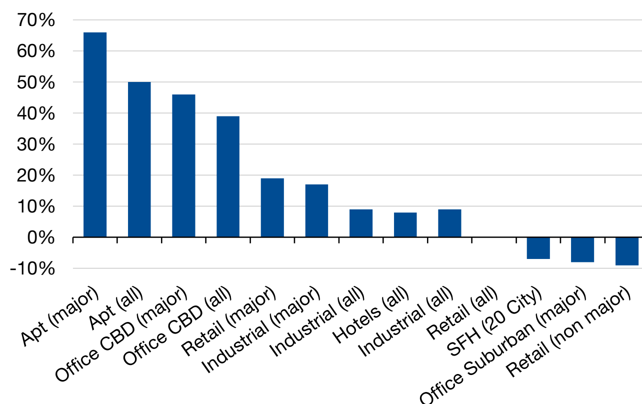
Figure 1 illustrates the difference between US commercial and residential property in capital value terms. Both segments declined by 35-40% during the GFC. Today, however, commercial real estate values have significantly exceeded their prior peak, whilst the housing market is still slightly below the last peak. It is worth noting that these indices are nominal, meaning that, from an inflation adjusted perspective, residential has had even less of a recovery.

Figure 1. US Real Estate Capital Values[7]



As previously alluded to, however, the headline story is not necessarily reflective of the way sub-asset classes have performed. Figure 2 shows selected US real estate sectors relative to their pre-crisis peak. As is clearly illustrated, there has been significant variety in speed of recovery, with SFR, suburban offices and small retail all still languishing below their previous highs. The difference between city offices and suburban offices provides a further illustration of the way in which gateway cities have outstripped other locations.

Figure 2. Current Asset Valuations Relative Last Peak[8]



It is also important to note that US valuation growth has been powered by an increase in rental income. The overall market's average yield stands at 5.9%, compared to 5.6% at the peak of the previous cycle.[9]

REAL ESTATE DEBT MARKET ENVIRONMENT

Today, the real estate debt markets are generally well-functioning, with institutional quality assets attracting lending capital from various providers at competitive rates. There are two main differences today compared with the mid-2000s. First, levels of leverage are considerably lower and, secondly, the range of loan pricing across sectors is relatively wide. The first of these differences is demonstrated in figure 3, which illustrates the amount

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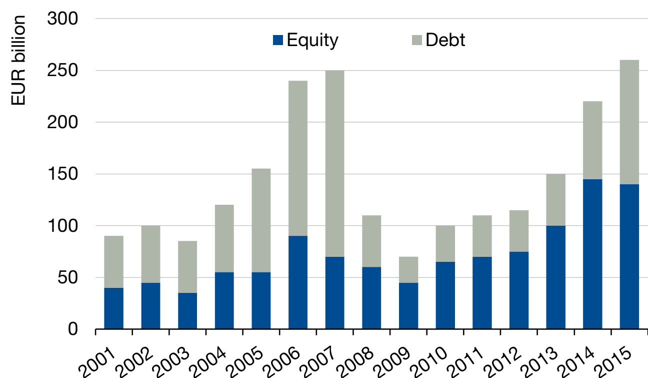
6. JLL Central London Office Market Report, Q4 2015 for real estate data Moody's / RCA and S&P/Case-Shiller. **7.** Moody's / RCA and S&P/Case-Shiller.
8. Morgan Stanley Research CRE Tracker. **9.** NCREIF (a 4-quarter moving average).

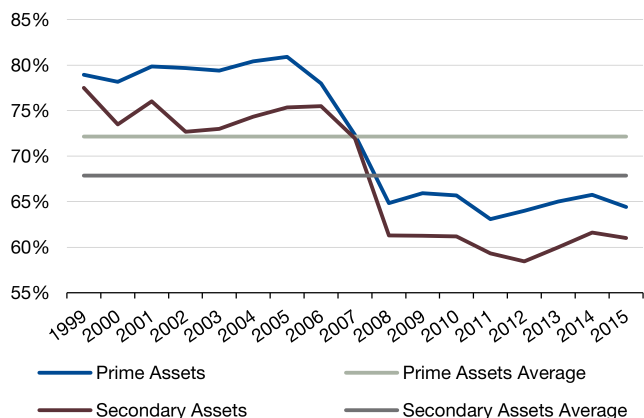
of equity and debt used in European real estate acquisitions over time. As can be observed, the pre-2008 era was marked by considerable use of debt on a proportionate basis, whilst today the market is much more balanced, with many transactions providing a significant equity buffer, helping give greater downside protection to senior debt providers.

Figure 3. European Real Estate Acquisitions: Debt vs. Equity[10]



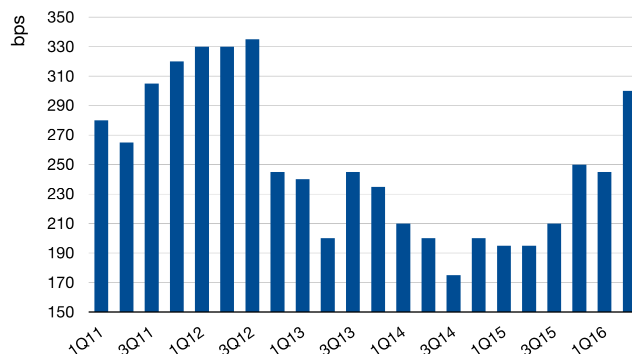
The presence of available equity capital, combined with a more conservative lending environment, has helped lower risk across real estate debt markets, relative to the year leading up to the GFC. As figure 4 demonstrates, in the UK market, for example, loan-to-value ('LTV') ratios are currently near or at all-time lows on average. Currently, a normal senior loan will typically have an LTV of around 60%. By contrast, in the years prior to the credit crisis, it was common to see banks' lending at LTVs as high as 80% of the value of the property.

Figure 4. UK LTV ratios[11]



As with other debt instruments, the returns on real estate loans are based on either a fixed rate coupon (more typical in the US market) or on a floating rate over LIBOR/EURIBOR (more common in Europe). The lender will also usually receive an upfront fee (typically 0.25%-1.0%). In the US, 2016 has seen spreads widening as regulators have curtailed the ability of smaller regional banks' to further increase their lending in commercial real estate markets (see figure 5). Moreover, the 'covenant light' type loans that banks wrote pre-2008 are almost non-existent. This has led to more lender-friendly opportunities with greater protections for investors in real estate debt.

Figure 5. US Office Loan Spreads[12]



In terms of variations across real estate sectors, the markets both in Europe and in the US have bifurcated due to various factors. Here are a few examples:

US Senior Lending Opportunities

Medium to large sized regional office lending: As we have already alluded to (see figure 2), regional office market valuations remain at a meaningful discount to offices within the large gateway cities. The lack of recovery after the GFC has been driven by the fact that the larger national banks and insurance companies have not paid much attention to the sector. This has left the smaller regional banks to fill in the gap but, now that these participants are slowing activity due to their regulatory burdens (as discussed above), the segment has been left underserved. The result today is that the margins on new loans in the area are being pushed upward. We believe that this has made lending conditions for medium to large core+ assets more attractive within the regional office market.

Lending on investor-owned SFR units: The granular nature of the market has meant that the sector has not been aggressively targeted by banks, and medium sized borrowers who are generally too big for local banks but too small for securitizations have been particularly underserved. This has led to marked opportunities for investors such as Aalto, in our view. Strategies such as this represent a way in which pension funds and other institutional investors can access potential return streams in excess of the current yields they receive on the investment grade portion of their fixed income investments, whilst still providing a comparable level of downside risk protection to conventional investment grade securities.

Construction and development lending: This sector was particularly affected in the US during the GFC. In the aftermath, the robust regulatory response meant that the sector continued to be under-served by bank lenders. This has been particularly evident outside the largest cities like London and New York. The overall lending market in this area is still 50% below the level of lending during the mid-2000s (see figure 6).

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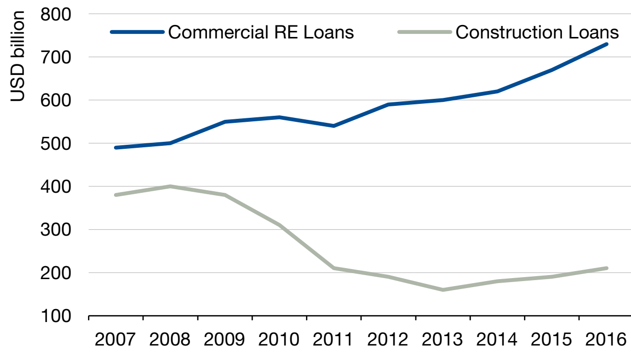
10. CBRE European Commercial Real Estate Finance 2016 Update. **11.** De Montford Survey, December 2015. **12.** Morgan Stanley Research CRE Tracker.

Figure 6. US CRE and Construction Loan Volumes[13]



European Senior Lending Opportunities

Holland: The fortunes of the Dutch commercial real estate markets have been particularly varied. Whilst local and German banks have re-entered the market in volume over the past 24 months, they have generally limited their focus to prime or trophy assets. The rest of the market is significantly starved of debt financing and can thus present potentially attractive opportunities for lenders. Aalto has been active in this market since early 2010. Investing here is not easy –the regional office market has significant oversupply of assets, for example, picking the right lending opportunities is therefore crucial – but for investors with the requisite skills and experience, we believe the area can be a source of potentially attractive returns.

Irish residential construction finance: The Dublin and Irish housing market bottomed in 2012, having fallen by 56% since the peak in 2006. Irresponsible lending by the local banks in the 2000's, means that today almost all institutional lenders are in balance sheet repair mode, with little capacity or appetite for new lending.

The housing market in particular has seen virtually no new construction for several years. We think that this has created an opportunity to provide relatively lower-risk and shorter-duration senior debt (at around 30-40% LTV) to experienced home building companies to construct new houses and apartments which are then sold to consumers. This is a strategy that Aalto has been actively pursuing since early 2015.

UK: The lending market has cooled considerably since the Brexit vote, and asset values have started to normalise, correcting modestly downwards. In our opinion, we are still at a very early stage of the Brexit process and are not, therefore, aggressively pursuing opportunities until the horizon becomes more definite. Over the next 1-3 years, however, we expect the market to provide much better lending opportunities than those have seen in the last 24 months. For income focused investors looking to make direct real estate investments in the UK prior to Brexit vote, we belive the senior lending route might now offer more attractive risk/reward than investing directly.

OUR APPROACH TO REAL ESTATE DEBT INVESTING

Our view is that we are currently at a late stage of the credit market cycle. This consideration coupled with mounting geopolitical uncertainty and the economic difficulties of living through a low return environment, means that we have been approaching the real estate debt markets with significant caution over the past 2-3 years. Prior to that, when asset values were historically attractive and lending margins high, our risk appetite was significantly higher. Our priorities in the current market environment are:

1. Capital preservation through conservative senior lending with lower LTVs. Our approach is driven by seeking to minimize risk for a given target return as opposed to seeking target returns irrespective of risk
2. Providing our investors with short to medium term flexibility whilst seeking to harvest an illiquidity premium in direct loans. Given that we are in a lower yielding environment, and 8 years since the last credit market bottom, we expect the markets to correct and re-price risk over the near to medium term. We do not know what will trigger the next cycle but we believe the mean reverting arc of history shows it to be inevitable. We do not, therefore, consider it to be prudent to commit to long-dated illiquid loans backed by highly valued assets. Insurance companies are particularly aggressive in the long-dated real estate lending markets and we are happy to let them compete in their regulation-driven asset/liability matching game.
3. Control lending through privately originated loans. This keeps control of any possible restructuring with us and our investors. Similarly, we focus on lending on assets where we think our investors would be willing to own as direct real estate investments if required following a cyclical downturn or other adverse market event.

REAL ESTATE DEBT ALLOCATION CONSIDERATIONS

We believe that investors considering making an allocation to real estate debt markets should look for the following:

1. Acceptance of relatively low spreads on a core part of the portfolio
2. Potential yield enhancement via tactical allocations to specific opportunities. These include, for example, shorter-term senior secured construction with lower leverage
3. Risk mitigation by ensuring 'control of lending'. This means avoiding broadly syndicated transactions in favour of direct loans with full lender control. Lessons learned in the previous downturn show that, in a broader syndicated loan, the lenders' risk preferences often diverge from each other. Our view is that this can result in sub-optimal outcomes during a restructuring process for those investors that are not forced sellers
4. The importance of diversification. Senior lending provides no real control of the underlying real estate asset while the loan is performing. The lender only obtains control if the loan covenants are breached. Given the lack of control relative to owning the asset's equity, from a portfolio construction point of view we believe that diversification is even more important in real estate debt than it is in direct investing

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13. Wells Fargo CMBS Research.

Mikko Syrjänen

Co-Head Real Assets

Mikko is Co-Head of Real Assets at Man GPM and a member of the Man Group Executive Committee. He is one of the founders of Aalto Invest and was previously their Chief Executive Officer and responsible for the real estate debt strategy with a particular focus on loan sourcing, underwriting and portfolio construction. Previously, Mikko co-headed Cheyne Capital's team responsible for real estate debt investments and illiquid alternative strategies. Prior to that, he was a vice president at Morgan Stanley's Investment Banking Division in London. He graduated from Helsinki School of Economics with a MSc in Finance.

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- An investment in an Alternative Investment is not suitable for all investors. Only qualified eligible investors may invest in an Alternative Investment.
- An Alternative Investment's offering documents may not have been reviewed or approved by federal or state regulators, and it may contain privately placed interests which are not federally or state registered.
- Some Alternative Investments may be illiquid and there may be significant restrictions on transferring or redeeming interests in an Alternative Investment. There may be no secondary market for an investor's investment in an Alternative Investment.
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- An Alternative Investment may have little or no operating history or performance and may use performance which may not reflect actual trading of the Alternative Investment and should be reviewed carefully. Investors should not place undue reliance on hypothetical, pro forma or predecessor performance.
- An Alternative Investment's manager or advisor has total trading authority over an Alternative Investment. The death or disability of the manager or advisor, or their departure, may have a material adverse effect on an Alternative Investment.
- An Alternative Investment may use a single advisor or employ a single strategy, which could mean a lack of diversification and higher risk. An Alternative Investment's performance may be volatile.
- An Alternative Investment may involve a complex tax structure, which should be reviewed carefully, and may involve structures or strategies that may cause delays in important tax information being sent to investors.
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- Alternative investments may not be required to provide periodic pricing or valuation information to investors.
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