

Jameson Educational Series:

'More than return':
managing risk in real estate private credit

June 2023

**Jameson
Capital**

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Key points:

- Commercial real estate debt can offer investors asset-backed security and compelling risk-adjusted returns in rocky and uncertain times, due to the strong investor protections which can be embedded within loan agreements.
- Credit markets are no different to any other market. In aggregate, changes in the supply of credit and demand for credit determines the market price to be charged (ie. the interest rate).
- As the supply of credit dwindles, the price paid (interest rate) to secure credit is projected to increase, which provides an investment opportunity for investors in commercial real estate debt.
- Fund managers can employ a number of measures to reduce risk to an acceptable level and deliver more return to investors for each unit of risk assumed.
- The ability to achieve disproportionately high risk-adjusted returns are typically short-lived and fleeting. History has shown us that these times can sometimes be ideal to make outsized risk-adjusted returns by capitalising on opportunities as and when they arise.

As we have covered in previous articles, commercial real estate debt can offer investors asset-backed security and compelling risk-adjusted returns in rocky and uncertain times, such as those which we are facing into at present.

As fund managers and investors, we are primarily concerned with two aspects when deploying capital: **risk** and **return**. In this article we will further discuss the risk and return dynamics within the private real estate debt market at present with a specific focus on the instruments and tools that we at Jameson TTB use to minimise risk and protect capital for our investors.

The 'economics' of private credit – who sets the price?

Read the introductory chapter of any economics textbook and most – if not all – will make reference to 'scarcity' as being a key tenet in the teaching of the topic. Just like any other resource, the supply of capital (what is commonly referred to as 'lending' or lending capacity) is also a scarce and finite resource... and in the current economic climate the availability of that resource from traditional sources is receding.

As a brief recap on how prices are established in markets, Figure 1 illustrates the relationship between demand and supply. In summary:

- As the price of a good or service increases, so too does the willingness of providers to supply that good or service (*if you're a provider, why would you not want to sell more widgets at higher prices?*);

- As the price of a good or service increases, the demand for said good or service decreases (*if you're a consumer, why would you want to buy more widgets at increased prices?*).

In Figure 1 let's assume that the line 'S' represents the supply of credit (ie. willingness of lenders/investors/banks to lend money) and 'D' being the demand for credit (ie. the need to borrow money by borrowers, businesses and property developers).

There are two key outcomes of a reducing supply of credit (depicted below as the 'S' line shifting to 'S1'):

1. The price of credit/borrowing (ie. the interest rate) increases, shifting upward from 'P' to 'P1'; and
2. The amount or volume of lending/borrowing reduces shifting from 'Q' to 'Q1'.

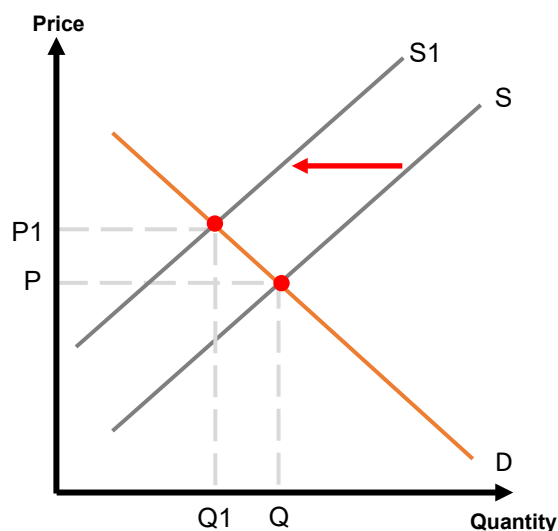


Figure 1: a graphical depiction of the impact on price and quantity on reducing supply.

We can see in Figure 1 that a reduction in the supply of credit leads to higher interest rates and a reduction in the amount of lending, which are: (1) ultimately good for investors as they are able to command a

higher rate of interest on their capital lent out; but (2) impacts on the profitability of property development projects and businesses as financing costs have increased.

We have touched on how interest rates have increased in the current environment due to a reduction in the supply of credit, which have obvious implications for lenders/private debt investors (positive) and borrowers/property developers (negative). **Let's now delve a little bit deeper into how fund managers and lenders can guard against risk in the prevailing environment to deliver strong risk-adjusted returns to investors.**

How do fund managers reduce and/or mitigate risk in a heightened risk environment?

Surprisingly, the answer to this question should be the same regardless of the prevailing risk environment, as good debt managers should always plan for and structure a loan based on a 'worst case scenario'. Good debt managers take the approach: *"expect the best, but plan for the worst"*.

There are two primary ways that private debt fund managers can reduce or mitigate risk in lending:

1. In the first instance, completely avoid deploying capital into investments with sub-optimal risk/return characteristics; or
2. Reduce the risk to an acceptable level by reducing gearing (as discussed in previous articles) or by embedding additional investor/lender protections to guard against - and

reduce the impact of - negative events on the borrower's serviceability of the loan (eg. via instruments that transfer risk on to another party such as derivatives/ forwards/futures or by including additional protections in the loan facility agreement).

A common statement that investors who are new to real estate debt commonly mention is that *"it sounds risky."* **As with any investment there are risks.** It is the job of the fund manager that you choose to partner with to determine: (1) which risks are worth taking; and (2) if investors are being fairly compensated for assuming that risk. This is commonly referred to as 'risk appetite'.

As we have discussed in previous articles, an investment in real estate debt actually ranks ahead of equityholders and – all things being equal – is actually a less risky investment than investing in equity/shares. Despite this, we observe a lot of investors avoiding investing in real estate debt as it is not as familiar to them

as (perhaps) share investing is. This is despite the fact that investors in shares rank lower in repayment priority in the event of wind-up, not to mention that the return profile of share investments are much more volatile and uncertain. In addition, share investments are not directly secured by physical assets, unlike real estate debt which is typically asset/real estate backed which provides an additional layer of capital protection for investors.

To further demystify real estate debt and explain some of the risk-reducing safeguards that quality CRE debt managers put in place, following we have outlined a non-exhaustive list of some of the legal instruments that we employ at Jameson TTB to ensure that our investors' capital is protected to the maximum extent that is practical. The sole objective of these measures is to manage, transfer and reduce risk whilst delivering the stated target investment return:

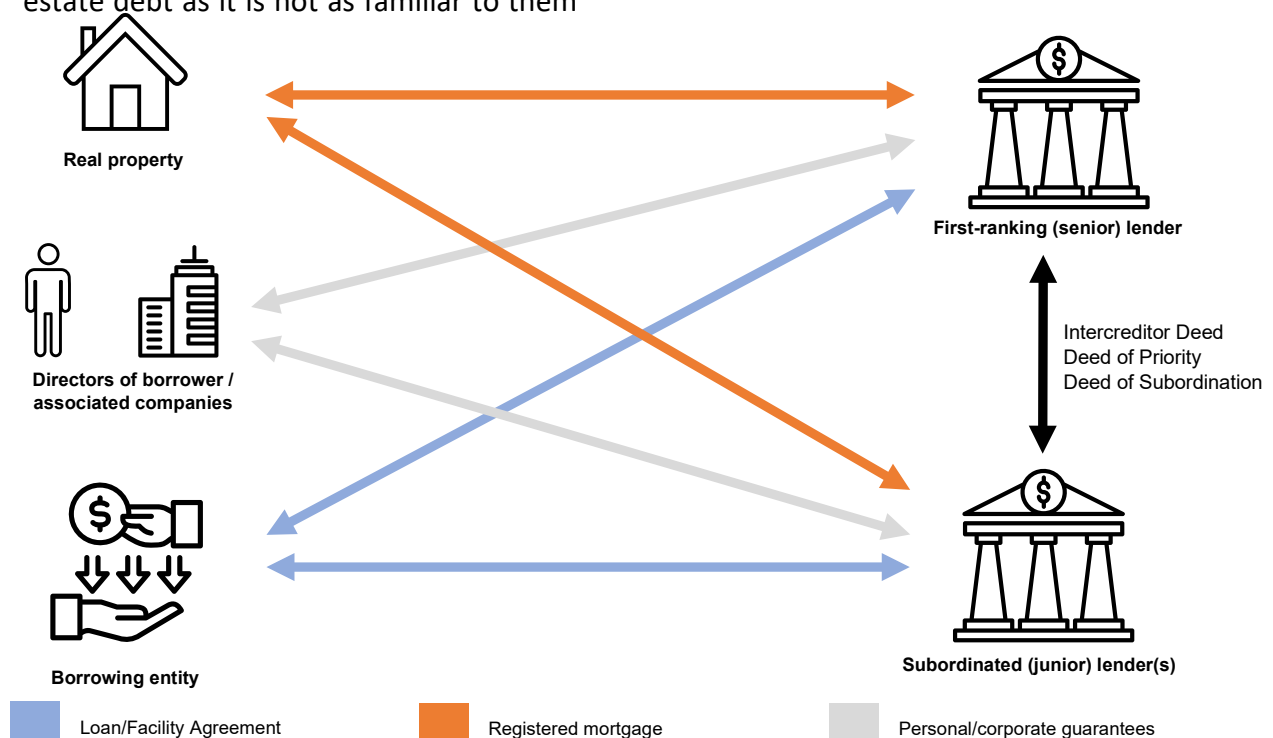
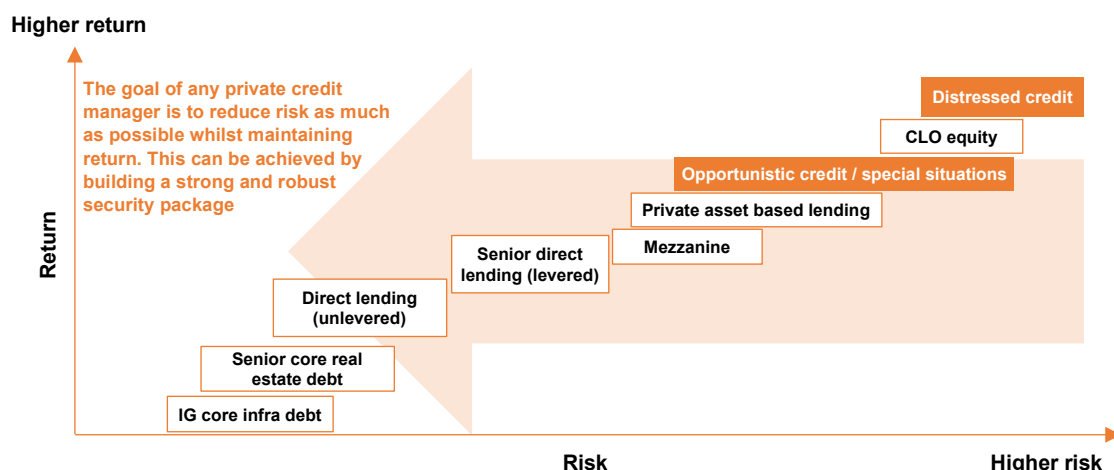


Figure 2: a depiction of the many potential legal agreements that can be implemented by stakeholders to protect investor capital.

Legal instrument utilised for risk reduction	Definition and purpose
Between lender and borrower	
First-ranking registered mortgage security	A first mortgage is a first-ranking charge over real estate owned by the borrower. If there is a default in repayment of the loan, the borrower can take possession of the property and liquidate (sell) it in order to recover the outstanding debt balance owed. The mortgage is 'registered' in that it is formally recorded on the title of the property with the local land registry (or equivalent) and transfer of the property to another party cannot be enacted until the debt is extinguished by the borrower or approval is granted by the mortgagee/lender on record.
Second-ranking registered mortgage security	A second mortgage is a second-ranking charge over a property that already has another mortgage on it. Second mortgages are riskier to lenders than first mortgages and typically command a higher return to investors as compensation. This is because in an event of a foreclosure sale, the first mortgage gets paid off first. The mortgage is 'registered' in that it is formally recorded on the title of the property with the local land registry (or equivalent) and transfer of the property to another party cannot be enacted until the debt is extinguished by the borrower or approval is granted by the mortgagee/lender on title.
Personal/director guarantees	A personal guarantee is a legally binding commitment made by a natural person (usually a director of the borrowing company) to assume responsibility for the debt or other financial obligations of another party (either individual or company).
Corporate guarantees	A corporate guarantee is a legally binding commitment made by a company on behalf of another party, usually a subsidiary or affiliate company, to assume responsibility for the debt or other financial obligations of that party.
General security deeds	A general security deed is a legal document used in circumstances where the lender wishes to secure not only an interest in personal property but also an interest in other types of property except land (eg. interests or shares in private companies, water rights and fixtures).
Debt sweeps (or cash sweeps)	A debt sweep (or cash sweep) is the mandatory use of excess free cash flows of the borrower to pay down outstanding debt rather than distribute it to its shareholders.
Between lenders (eg. amongst first-ranking mortgagees and second-ranking mortgagees)	
Deed of Priority	A document to change or regulate the ranking of security interests granted by a borrower to its lenders, where those security interests secure the same collateral.
Deed of Subordination	A document to change or regulate an arrangement between lenders that are owed debts by a common borrower, under which one lender agrees to defer payment of its debt in favour of the debt of another lender(s).
Intercreditor deed	A document that combines both a Priority Deed and a Subordination Deed, used when lenders want to change or regulate the ranking of security interests granted in their favour by a borrower and regulate the debts owed to them by a common borrower in the one document. Usually, the rights the contract regulates include rights to receive payments (such as principal, interest and fees prior to any enforcement of security) from, and rights to enforce security over the assets of, a common debtor. The intercreditor deed also usually includes clauses that restrict the borrower from entering into new contractual arrangements where the lender's position is diluted or further subordinated and - in the event of default - also regulates maximum rates of interest that senior lenders can charge, the enforcement process and potential 'take out' rights.



Figures 3: stylised representation of risk/return characteristics. Source: Frontier Advisors.

The benefits of being opportunistic

History has taught us that some of the best investment opportunities arise when markets and sentiment are at heightened levels of despair (think the depths of the Global Financial Crisis and COVID-19 as examples). In the investment world, these opportunities are generally short-lived and fleeting but have demonstrated the very real potential to deliver outsized and abnormal levels of risk-adjusted returns to investors that are wise and experienced enough to capitalise upon them. Warren Buffett's oft-quoted saying *"be fearful when others are greedy, and greedy when others are fearful"* is arguably a prime example of why he has been a very successful investor over a long period of time and over countless market cycles.

On the return side – with benchmark yields and risk-free rates elevated and near the highest levels in decades – in the prevailing market we are seeing some of the best absolute income returns on debt investments in decades. This means that by reducing the levels of risk by constructing strong security packages utilising some of the methods discussed

previously, we are able to deliver disproportionate risk/return outcomes for our investors.

Figure 3 depicts risk versus return for a number of public market and private market fixed income alternatives. By 'bulking up' and building a robust security package, investors are effectively achieving high levels of return, but with lower levels of risk – a desirable objective for any investor.

It is important to note that private credit markets – given their inherently bilateral nature – allow lenders and borrowers to negotiate loan terms specific to a transaction, which means that the lender is able to dial up/(down) the level of risk by reducing/(increasing) the stringency of the security package.

Generally, when the supply of credit is in short supply (as it is becoming increasingly so) risks shift in favour of the lender/investor. Conversely, when the supply of credit is in abundant supply (as has been the case since the onset of the pandemic, due to extraordinary monetary and fiscal stimulus) risks shift in favour of the borrower. **We believe that we are at**

an inflection point where these risks shift significantly in favour of lenders/investors.

As we have demonstrated over our trilogy of articles, private commercial real estate debt offers a compelling 'diversifier' in

investment portfolios and presents a strong risk-adjusted investment opportunity. We invite you to contact a member of the Jameson TTB team should you wish to learn more about what we do and some of the current and upcoming investment opportunities in this space.

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