

Jameson Educational Series:

'Special Situations' lending:
What is it? Why now?

November 2023

**Jameson
Capital**

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What are 'Special Situations'?

Special Situations credit strategies aim to deliver investors an equity-like return, but with debt-like downside protections. In credit strategies, a 'Special Situation' usually involves lending money to generate a high risk-adjusted return in scenarios where a prospective borrower is experiencing financial stress, distress or where a prospective borrower requires a lending solution in an event-driven scenario. **Before we continue, it is important to distinguish that stress, distress and event-driven scenarios are catalysts for 'Special Situations' lending scenarios and that lending in these scenarios does not automatically equate to higher credit risk or an increased risk of capital loss.**

In 'Special Situations' scenarios – we seek to earn a higher asymmetric return for a given level of risk, or an acceptable return for a lower level of risk.

Special Situations investing is a well-trodden path for investors in the US and Europe, however – with the portfolio benefits of alternative assets and private market transactions becoming better understood domestically – we are beginning to see an emerging interest in these types of strategies from sophisticated and opportunistic investors within Australia.

The conditions that we look for in special situation investing are **very different** to equity investing and/or more 'vanilla' private debt strategies. After all, our objective in special situations is to achieve a unique outcome of delivering outsized returns from a given level of risk.

'Stress' or 'distress' is a self-explanatory concept where a borrower requires funding because they are in some sort of financial difficulty. But, *what are event-driven situations?* 'Event-driven situations' is a

deliberately vague and all-encompassing 'catch all' term to describe a lending opportunity which arises – as the term suggests – as a result of some event or a confluence of factors.

Commonly, some event-driven credit opportunities involve lending money on a secured basis by:

- Providing liquidity to a fund manager of a frozen fund, to facilitate the payment of redemptions to the Fund's investors;
- Funding the exit of a business partner where the business partnership has fractured or there is a dispute between business partners;
- Funding and re-activating a property development which has stalled due to non-payment of sub-contractors or builder failure;
- Plugging 'shortfall funding gaps' in developers' capital stacks due to the reduced availability of senior debt or equity capital; or
- Refinancing an existing lender in a stalled or delayed development at a discount to generate liquidity.

The above list is not exhaustive and there are countless other scenarios which would fall under the definition of 'special situations' or 'event-driven' lending opportunities.

Why Special Situations now?

Special Situations lending is not an evergreen lending strategy that is suitable for all types of markets and economic conditions. There is typically a point or period in the economic cycle where special situations strategies thrive and that time is typically when:

1. economic growth is slowing;
2. financial stresses are rising; and
3. the availability of credit is contracting.

That time is now.

Following, we have outlined a list of what we at Jameson TTB look for when determining whether the time is right for a special situations lending strategy.

Condition	Why are these conditions conducive for 'Special Situations'?	What we are currently observing?	Special Situations criteria satisfied?
Increasing financial stresses and cash flow issues	Increased incidence of financial stress/distress equates to an increased need for genuine solutions and a willingness of borrowers to accept them.	An increase in the mix of stressed and distressed borrowers seeking funding solutions. Via the Jameson Special Situations Fund 1, we have observed average quarterly deal values in the pipeline increase from ~\$66m in FY20 to ~\$203m in FY23 – an increase of ~207%.	✓
Reduced or reducing availability of credit	All else equal, reduced supply of credit equals higher interest rates for lenders/investors and increased incidences of lending opportunities in the non-bank sector.	Increased demand for non-bank lending solutions due to Authorised Deposit-taking Institutions ('ADIs' or 'Banks') reducing the supply of credit.	✓
Economic slowdown or stagnation	Slower economic growth equates to lower levels of pre-committed tenants and asset sales activity.	Anaemic economic growth, declining productivity and negative per capita GDP growth.	✓
Persistent inflation leading to sustained higher interest rates	Increased/more persistent inflation means increased base interest rates and a 'higher for longer' interest rate environment.	Elevated level of interest rates with futures markets and government bond yield curves indicating a 'higher for longer' interest rate environment.	✓
Potential for value creation	Stronger future growth prospects mean more upside/profit/equity buffers in projects equating to reduced lending risk.	In Australia, strong demographic fundamentals will support property prices for the residential, industrial and government-linked sectors (aged care, childcare, specialised disability accommodation). Construction input prices pressures are beginning to abate. These two factors lead to more profitable property development projects to lend against.	✓

Following, we delve into the above criteria deeper with supporting charts and evidence for our view on why a special situation debt strategy is an investment strategy for the times.

Financial stress and cash flow issues

Via our Jameson TTB Special Situations Fund 1 (“JSSits1”), we have seen a noticeable uptick in requests for finance from property developers in the past 3-4 quarters as demonstrated in Figure 1 below. Whilst an increase in funding requests doesn’t necessarily equate to financial stress, distress or cash flow issues, we have noticed a change in the mix of deals to include increasing numbers

of stressed or distressed deals and increasing incidences of property developers requiring ‘stretched senior’ or mezzanine debt funding where: (1) senior debt financiers have reduced their loan-to-value ratios; or (2) where the Sponsor is unwilling or unable to raise additional equity capital which has created shortfall funding gaps in capital stacks.

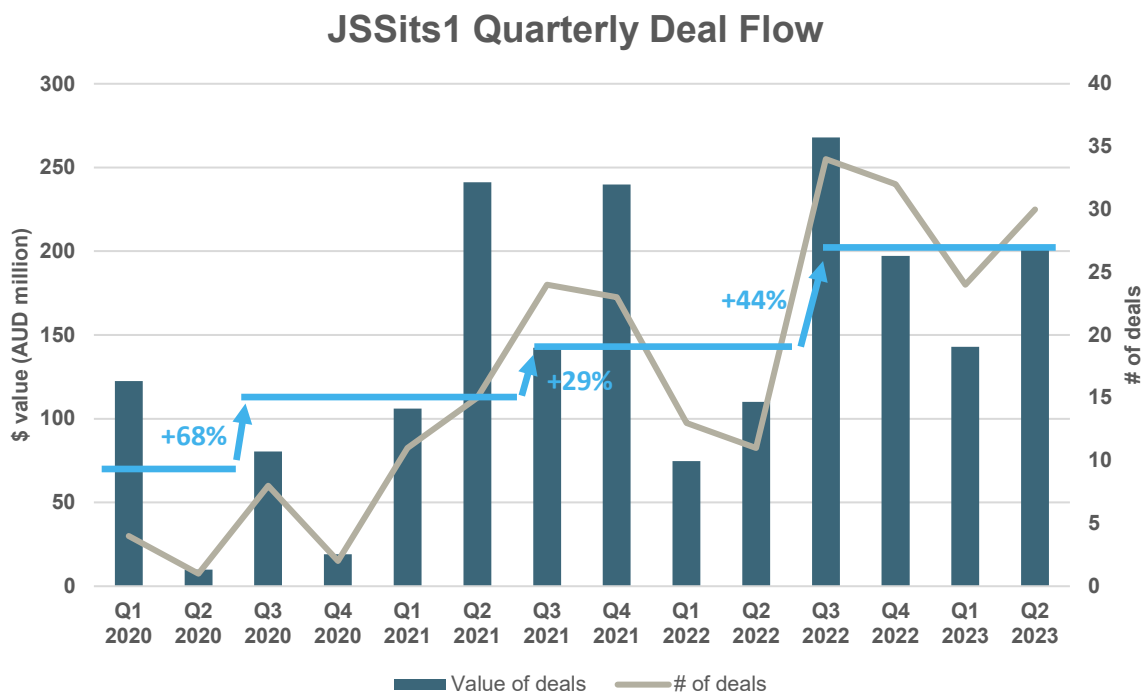


Figure 1. Source: Jameson TTB

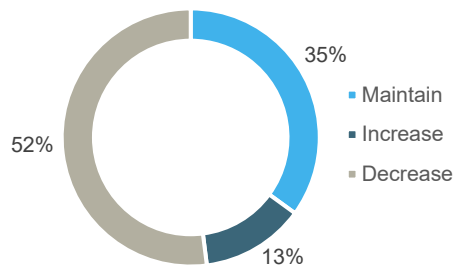
Availability of credit

Economics tell us that all things being held constant, the reduction in the supply of a good or service will increase the price of it. **Credit is no different.**

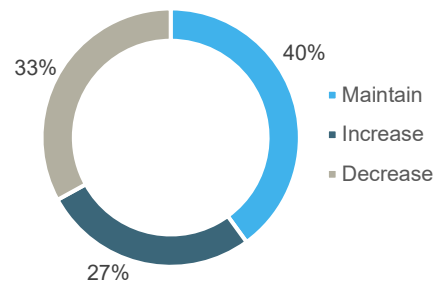
In the 2023 edition of their annual Debt Capital Markets Report, Stamford Capital surveyed over 100 lenders in Australia. The

survey showed that 87% of major trading banks are expecting to maintain or decrease their lending to the real estate construction sector in 2023 whilst 73% are expecting to maintain or decrease their lending for real estate investment purposes. 46% of survey respondents also “expect major trading banks to tighten investment loan credit, and non-banks are likely to follow suit.”

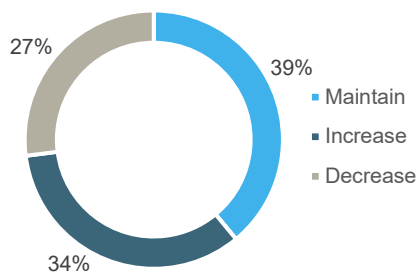
Construction lending activity
Major trading banks are expected to decrease construction lending activity in 2023.



Investment lending activity
Major trading banks are expected to decrease or maintain investment lending activity in 2023.



Non-bank lenders are more like to increase or maintain construction lending activity in 2023.



Non-bank lenders are more likely to increase or maintain investment lending activity in 2023.

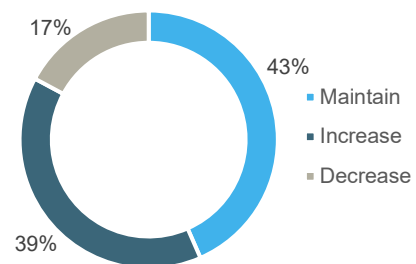


Figure 2. Source: Stamford Capital

On the 'front line' we are witnessing the hurdles being raised to fund real estate debt deals, which has the effect of reducing credit supply in the sector. This is further reinforced by the Figures 3 and 4 below which demonstrate the availability of credit

from traditional financiers (banks) is dwindling.

Reduced supply equates to higher prices, which – in credit – is represented by the rate of interest to be paid by the borrower for the benefit of the lender/investor.

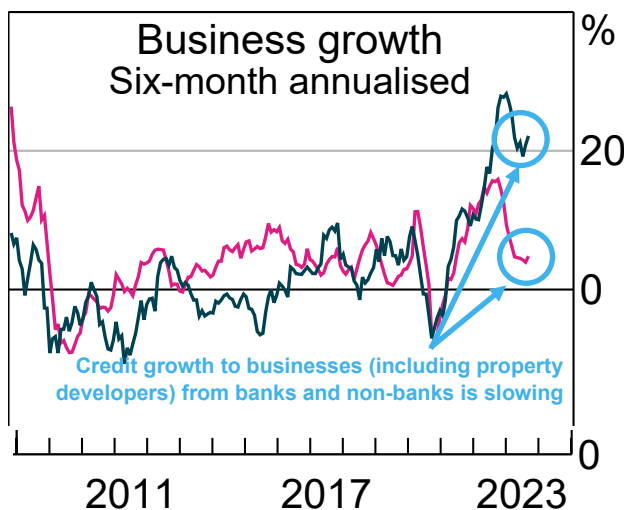


Figure 3. Sources: APRA, RBA

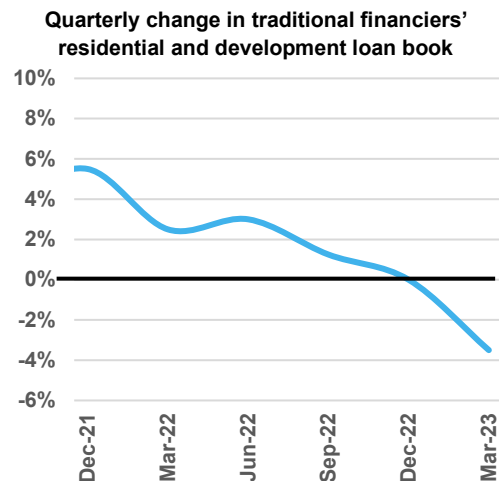


Figure 4. Source: APRA Quarterly authorised deposit-taking institution property exposures statistics March 2023

Economic downturns and point in the cycle

Slower economic growth has impacts on all facets of the economy. Generally, in economic downturns unemployment increases, household spending reduces,

business investment declines and the general level of financial stress tends to increase. Whilst this is obviously unfortunate for those impacted, it does produce a thriving and rich opportunity set for special situations lenders to deliver unique, structured lending solutions.

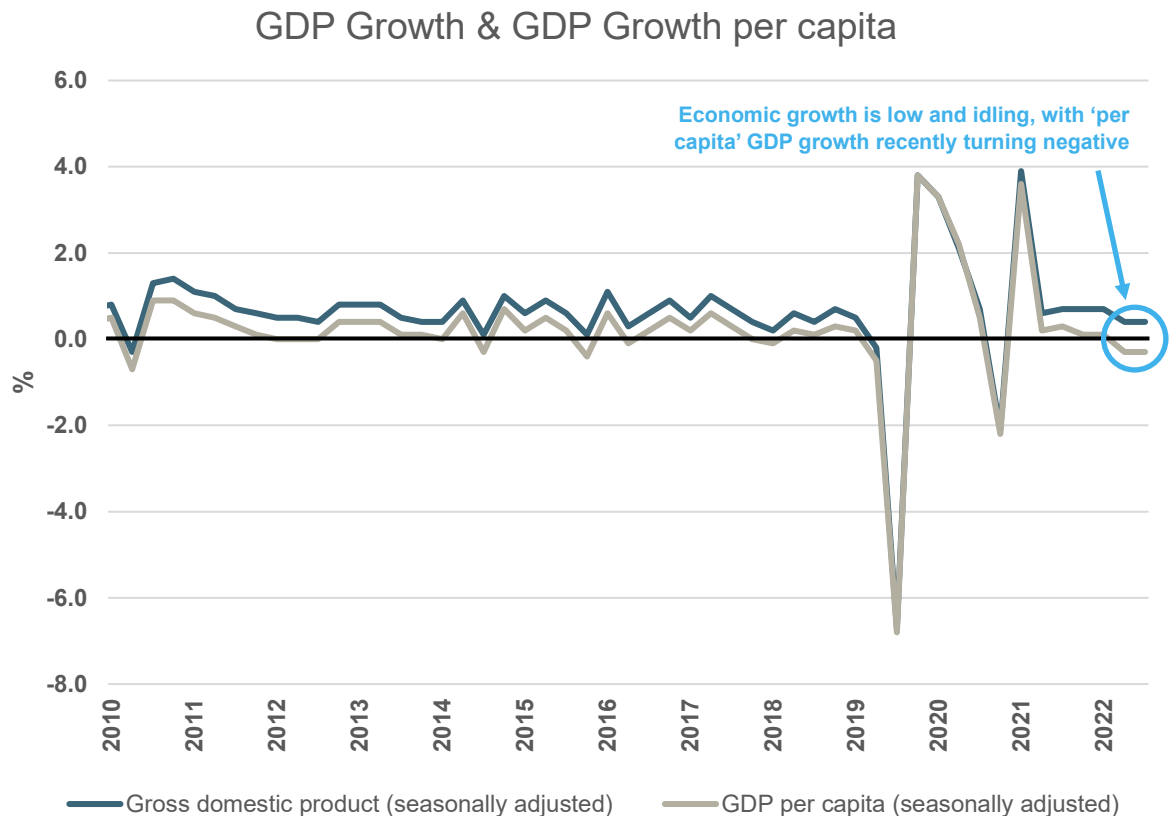


Figure 5. Source: ABS

Inflation

Much has been written about the elevated levels of inflation experienced both in Australia and globally. Arguably, the burden of this inflation has fallen disproportionately on the construction industry, especially volume builders with a number falling into

voluntary administration. This has primarily occurred due to the significant inflation in the cost of building materials driven by both supply constraints and demand factors which caught a number of builders by surprise and reduced a number of marginal builders' profitability levels to unsustainable levels.

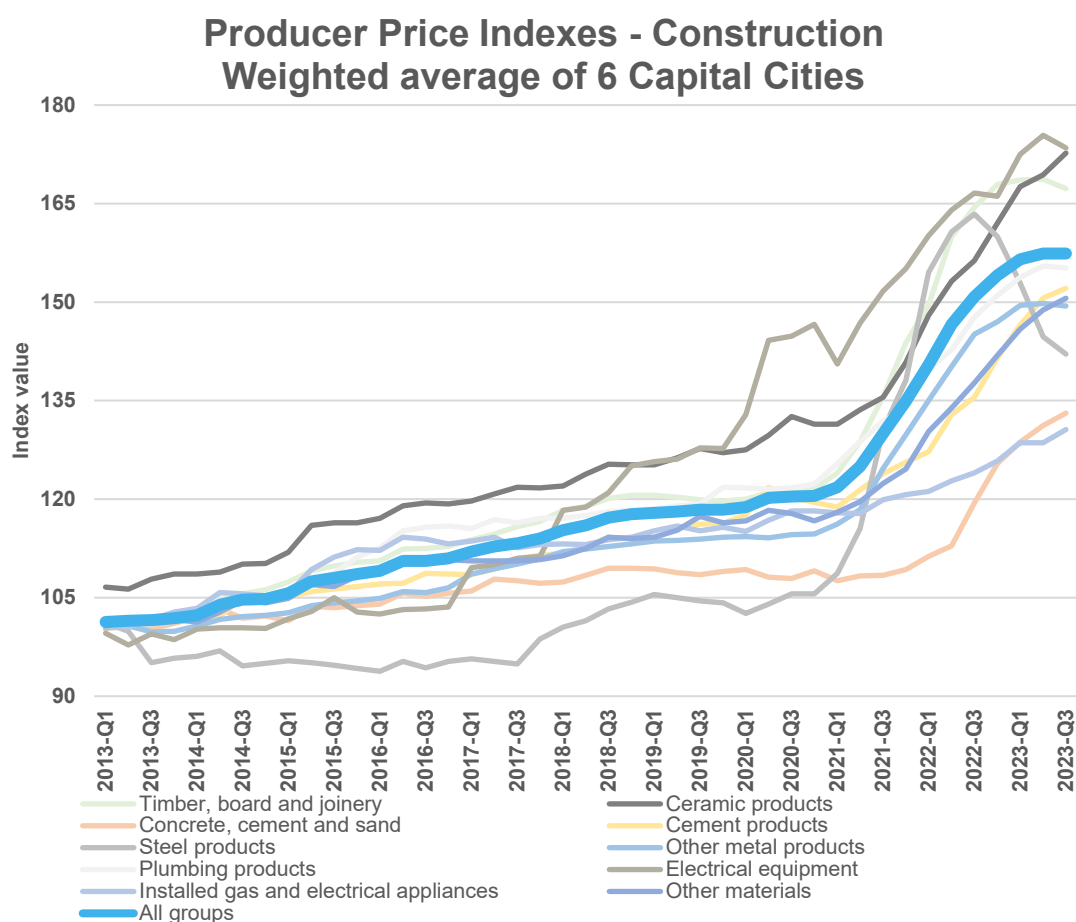


Figure 6. Source: ABS

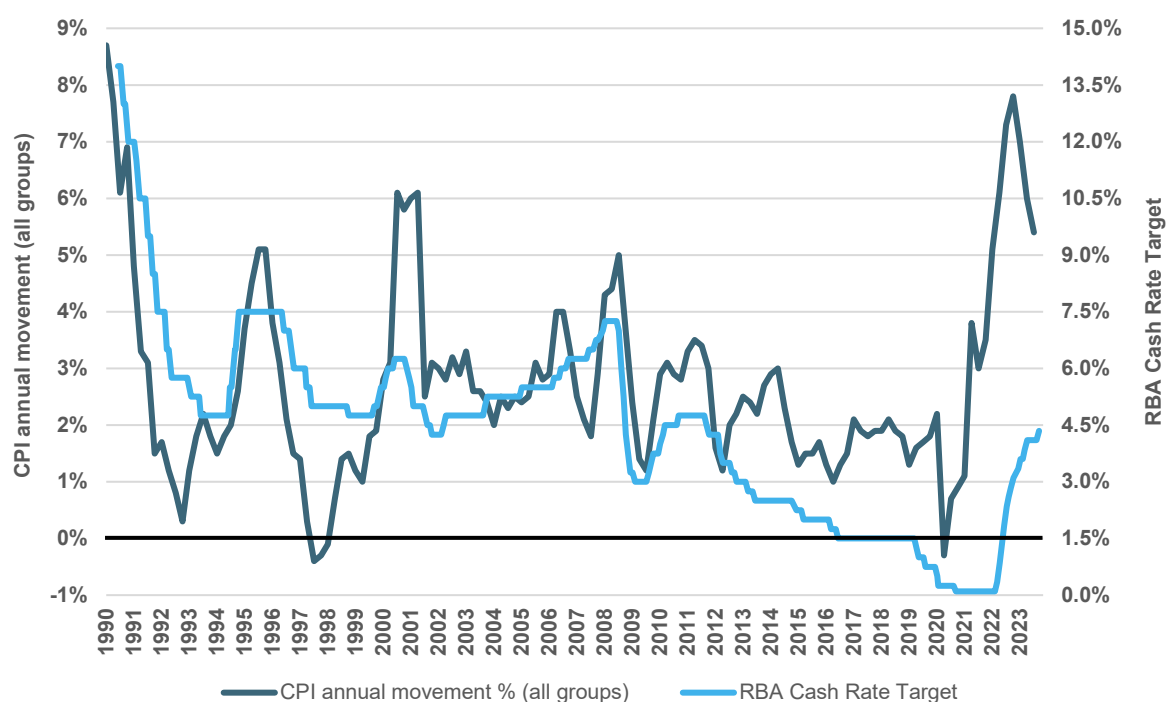


Figure 7. Source: ABS, RBA

With 425bps of cash rate increases over an 18-month period – positively – we are beginning to see the ‘green shoots’ of slowing and plateauing construction input inflation which will increasingly support construction feasibilities and profitable real estate development projects. Whilst a reduction in inflation is welcome, current market expectations (such as those

represented by Australian government bond yields in Figure 8) are for a ‘higher for longer’ inflation environment which we believe will see elevated levels of interest rates for an extended period – this will help to support lender/investor returns in the real estate private credit sector via higher benchmark interest rates.

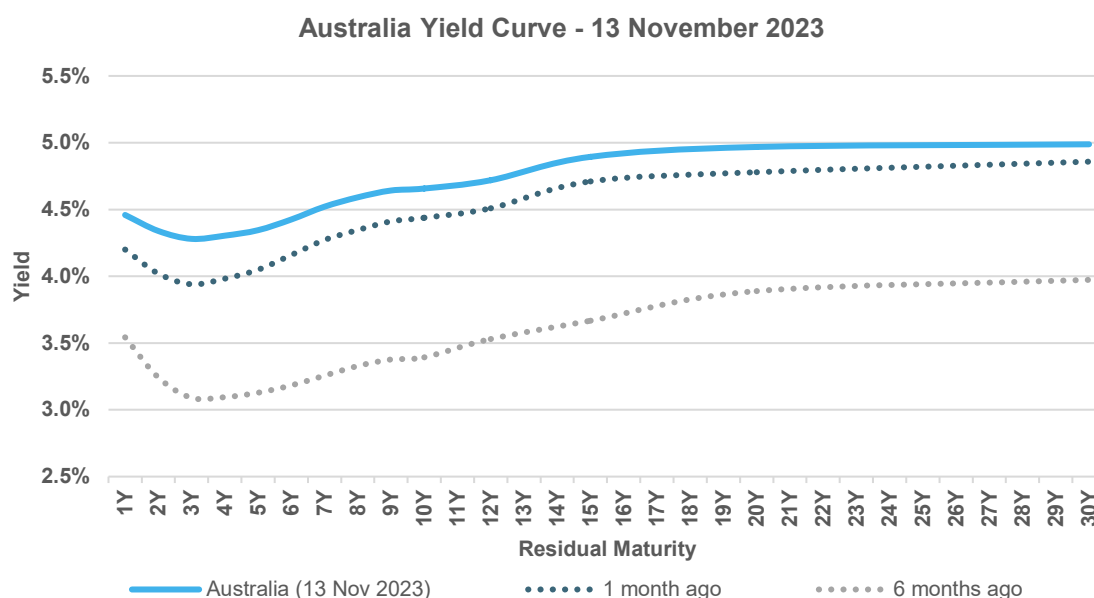


Figure 8. Source: [worldgovernmentbonds.com](https://www.worldgovernmentbonds.com)

Potential for value creation

The Centre for Population estimates that Australia is on track to record a population of 30 million by 2032-33¹. This forecast is based on the assumption that the population will grow at an average annual rate of approximately 380,000 people - consisting of approximately 250,000 in net overseas migration and approximately 130,000 in natural increase².

For the twelve months to 31 December 2022, actual population increase totalled

~496,000 consisting of 386,000 in net overseas migration and 110,000 in natural increase³. This significant spike in population will require significant new housing supply to be added. On the supply side however, new building approvals are currently tracking near 2012 lows of ~13,500 per month.

If we use population growth as a proxy for housing demand and new building approvals as a proxy for housing supply, we can see there is a significant imbalance in the amount of new housing stock coming

¹ https://population.gov.au/sites/population.gov.au/files/2023-05/budget_2023-24_national.xlsx

² https://population.gov.au/sites/population.gov.au/files/2023-05/budget_2023-24_national.xlsx

³ <https://www.abs.gov.au/statistics/people/population/national-state-and-territory-population/dec-2022>

on to the market relative to the pace of population growth. Whilst this dynamic is negative for housing affordability due to increased prices, it is a positive for lenders to the residential real estate sector as this demand/supply imbalance – until corrected – will assist in supporting and setting a floor for housing prices, thereby reducing credit risk for lenders. It also ensures that property developers have a sizeable and increasing addressable market to sell their products to and which provides real estate lenders a clearly defined exit strategy.

In Figure 9 below, we have graphically represented the demand for housing

(represented by the population) and the supply of new housing (represented by new building approvals). It is clear that not enough additional housing stock is coming online to cater for the current population and projected future population growth. This is compounded by the fact that – leading into this significant post-COVID surge in population – vacancies were already at low levels and with new housing supply not keeping track with population growth, this will likely see the housing affordability crisis worsen before it gets better.

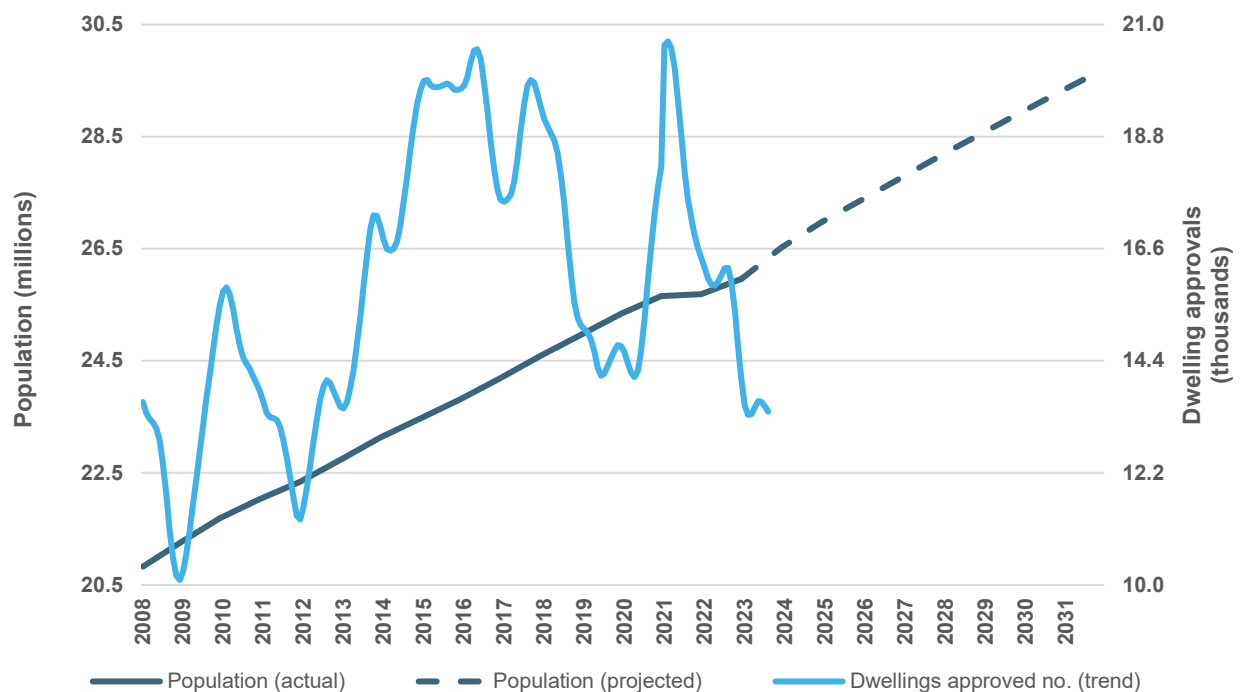


Figure 9. Source: ABS, Centre for Population, World Bank

To tie it all together, if we are observing a moderating of inflation in construction inputs (the largest cost of property developers) and an increase in housing prices (the largest item of revenue property developers), then by extension, the potential for widening margins, increasing profit, value creation and increasing equity buffers for lenders is meaningfully positive.

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A low-angle, upward-looking photograph of several modern skyscrapers with glass facades, reaching towards a clear blue sky. The perspective creates a sense of height and architectural grandeur.

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