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Accessing Private Debt
Through Commercial Mortgages

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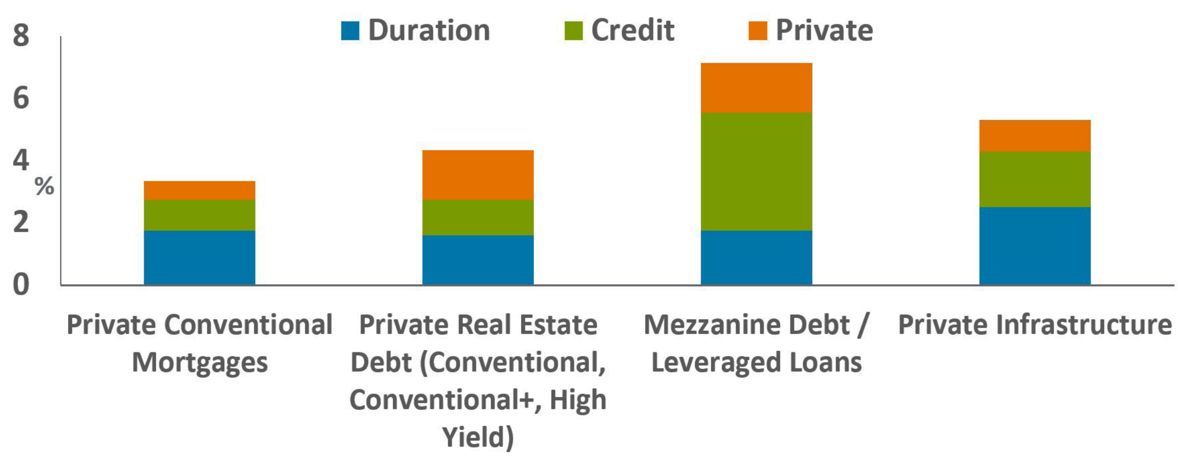
In today's current low yield and low return environment, investors are searching for opportunities to enhance the performance and diversification of fixed income portfolios. As a result, many are turning towards private debt to achieve these goals.

Fixed income portfolio returns are largely driven by three factors: duration premium, credit premium and private premium. While duration and credit premiums can be accessed through traditional fixed income securities, such as government and corporate bonds, private premiums are attained by investing in private debt, which is generally not traded in public markets. Investors who have exposure to private markets demand a higher premium for equal levels of risk given infrequent trading, complexity of access and lower levels of competing capital. This additional yield is the private debt premium over duration and credit.

Private debt comes in several forms, including infrastructure debt, mezzanine debt, leveraged loans, direct corporate lending and real estate debt (i.e. commercial mortgages). Although each type provides investors with some exposure to the private premium, other yield factors also tend to be embedded in private debt premiums, resulting in exposure to duration and credit risk. By breaking down the premiums generated by different types of private debt, it is possible to understand the yield factors associated with each type and the respective risk and return profiles. This exercise can be done by backing in public market spreads to isolate the private premium and can help to determine the most effective way for investors to access the private premium based on their specific risk and return objectives.

For instance, given the long-term nature of infrastructure assets, a significant component of the yield is achieved through duration and credit as opposed to the private premium. Although that would result in a higher level of interest rate exposure, given the importance of matching a plan's duration profile to its cash flow requirements, infrastructure debt may be compelling for defined benefit plans that typically have long-dated liabilities. Mezzanine debt and leveraged loans also offer attractive yields; however, a significant component of the yield is achieved through lower quality (i.e. high yield) credit, which would impact the risk profile of a fixed income portfolio and potentially increase correlation to equity returns, an important concept in the context of a balanced portfolio. This type of lower quality credit exposure can also typically be accessed through traditional high yield bonds, which generally provide a higher level of liquidity than private debt.



Source: Greystone Managed Investments Inc. Indicative spreads based on recent market transactions for private spread. Duration Calculated based on 5-yr Canada yield for short and 30-Yr Canada for long duration. Credit premium based on investment grade and high yield bond spreads. Public premiums as at Dec 31, 2017.

Assessing Private Debt Through Commercial Mortgages

CONTINUED FROM PAGE 8

The real estate debt market (i.e. private commercial mortgages) provides an interesting case study on the different levels of private premiums available within a single asset type. Many investors consider the private real estate debt market to consist of only private conventional mortgages, which are typically secured by income-oriented real estate and have maturities of between five and 12 years; however, private real estate debt, in fact, consists of several sectors or segments of the real estate market, each with a different risk and return profile.

There are three main sectors within private real estate debt, namely: conventional mortgages, conventional plus mortgages and high yield mortgages. Importantly, the underwriting criteria for each loan type tends to differ depending on its unique loan characteristics. That said, a unique attribute of all commercial mortgages is the underlying real estate; ensuring that mortgages are secured by high quality real estate should result in capital preservation, regardless of loan type.

By investing in all sectors of the real estate debt market (i.e. conventional, conventional plus and high yield), investors, such as defined benefit pension plans, can effectively incorporate an attractive private premium into a fixed income portfolio that will enhance returns without significantly impacting the risk profile. As will be discussed later, this private premium can also provide investors with the same diversification benefits to a balanced portfolio more commonly associated with traditional fixed income assets, such as government and investment grade bonds.

Private conventional mortgages are typically longer-term loans with a first charge on a commercial property that is occupied by a tenant base and is generating a stabilized income stream (i.e. office, retail, industrial and multi-unit residential). In the current market environment, conventional mortgages are generally being priced at spreads of between 160 and 200 basis points above Government of Canada bond yields of similar maturities.

Private conventional plus mortgages are loans with a first charge on real estate at earlier stages of the real estate life cycle, before the property reaches stabilization. Conventional plus loans generally include land, land servicing, construction and interim/bridge financing for lease up periods or to facilitate a repositioning strategy. These types of loans are generally shorter-term, floating rate loans with lower loan-to-value ratios and greater recourse to the borrower to reduce the risk profile.

The supply of capital for these shorter-term loans tends to be lower than for conventional loans, which allows lenders who participate in this space to command higher spreads. Conventional plus mortgages are currently being priced at spreads of 225 to 400 basis points above Government of Canada bond yields of similar maturities. Also, as floating rate mortgages, they have a duration that is close to zero as the amount of income they generate tends to be based on the prime rate (i.e. when the prime rate increases, the income generated by floating rate mortgages increases as well). Therefore, they help to reduce the overall interest rate sensitivity within a real estate debt portfolio.

Conventional plus mortgages can be used as an effective lever to reduce the interest rate risk of a fixed income portfolio and to actively manage the portfolio's risk profile in response to changes in the economic environment. For example, exposure to conventional plus mortgages can be adjusted to either increase or reduce interest rate sensitivity. For defined benefit pension plans, both conventional and conventional plus loans can be integrated into a fixed income portfolio in order to provide investors with a yield enhancement while maintaining a target duration in order to match longer-term cash flow requirements (more on this below).

Importantly, the underwriting process for conventional plus loans is more complex and requires a deeper understanding of the underlying real estate in order to ensure that risk-adjusted returns are being maximized. That said, an ability to underwrite with strong covenants can result in high quality exposure within conventional plus sectors. Unlike corporate bonds, private debt assets are not rated, therefore, to better understand the risk profile associated with a private debt strategy, such as a real estate debt portfolio, investors can compare historical loss rate data of corporate bonds to that strategy.

The third sector within the private real estate debt market, high yield, consists of **subsequent priority mortgages** (i.e. mortgages with a second charge on the underlying real estate) as well as high ratio mortgages, which tend to have loan-to-value ratios greater than 75%. These loan types are being priced at spreads that exceed 400 basis points above Government of Canada bond yields and, as such, can act as a source of value add for a real estate debt portfolio. They may, however, also be associated with higher levels of risk as they tend to have more credit exposure. When participating in this segment of the market, it is important for investors to ensure that they are being compensated for the amount of risk being taken.

Assessing Private Debt Through Commercial Mortgages

CONTINUED FROM PAGE 9

Real estate debt strategies that access all segments of the real estate debt market and invest in different loan types (i.e. conventional, conventional plus and high yield) can therefore provide an attractive yield to investors and have the potential to enhance the returns of a fixed income portfolio.

Moreover, the integration of real estate debt within a core plus bond strategy can be an effective way to enhance yield without changing a desired or target duration profile. Core plus bond strategies retain the FTSE TMX Canada Universe Bond Index while incorporating investment opportunities found outside the benchmark to enhance yield.

These strategies hedge all external risks, such as interest rate and currency, when opportunities are sourced globally. Using private premiums as the lever for enhancing returns against a universe bond benchmark is a highly compelling opportunity when compared to using global or high yield bonds.

While traditional higher yielding fixed income assets that are typically used in core plus strategies (i.e. high yield bonds, global bonds and emerging market debt) tend to have a positive correlation to equity returns, some types of private debt, such as commercial mortgages, tend to be negatively correlated to equities, thereby enhancing the diversification and reducing the volatility of a balanced portfolio. Put another way, during periods of equity selloff, a core plus strategy that integrates high yield bonds, global bonds or emerging market debt will likely underperform, exacerbating a balanced portfolio's negative returns.

Private debt, in contrast, may help to temper a portfolio's returns in a risk-off market environment. Further, we believe that we are entering the later stages of the economic cycle. As we approach the pre-recession phase, it is important to keep in mind that it is at this stage of the economic cycle when credit tends to underperform.

Fixed income tends to act as an anchor for portfolio volatility and a hedge against equity selloff within a balanced portfolio. It is important, therefore, to understand the risk and return profiles of the various components of a fixed income portfolio in order to ensure that investors are not exceeding their overall risk budget.