AUSTRALIAN AND NEW ZEALAND PRIVATE DEBT
QUARTERLY MARKET INSIGHTS – MARCH 2019

Having held the first close of the Revolution Private Debt Fund I (the Fund) in December 2018, we welcome you to the first quarterly update to keep you informed on the progress of the Fund as well as to provide insight into the market dynamics and opportunities available within the Australian and New Zealand private debt markets (AU & NZ private debt).

Fund achievements to date

Much of 2018 was spent connecting with the market regarding the first Fund, and pleasingly, the Fund had its first close at approx. A$200m, with commitments from both institutional and high net worth investors. The Fund will have a further two scheduled closes, April and June 2019, with significant interest and due diligence being conducted by potential investors. A larger Fund size will allow Revolution to deploy greater volume per transaction, which facilitates earlier engagement in new transactions, and the ability to influence terms and demand greater economics for the benefit of all Fund investors.

After extensive research and due diligence, the Fund made its first investment in mid-December, shortly after its first close. The investment is an Asset Backed Security across a combination of BBB and BB credit rated notes with a blended margin of 473 basis points – in line with our stated Fund objectives.

Favourable relative value to be found within the AU & NZ markets

Revolution's investment philosophy is built around the view that senior secured AU & NZ private debt offers investors greater relative value than offshore private debt markets. In the US for example, approximately 90% of private debt funding is being provided by non-bank institutions whilst the remainder is provided by banks. This has led to a rise in competition for private debt investments in the US market and consequently the erosion of key characteristics we look for in making investments such as yield, covenants and upfront fees paid to lenders/investors. Conversely, the AU & NZ private debt market is still in its infancy with the market being dominated by banks. In summary, the local private debt market offers investors superior credit margins, upfront fees and covenant packages in transactions relative to offshore markets.

Below is a review of the current market dynamics and factors that investors should be aware of across our preferred AU & NZ private debt market sub-sectors.

1. LEVERAGED BUY-OUT (LBO) & PRIVATE COMPANY LOANS

- *LBO debt is debt provided to private equity firms to facilitate the acquisition of a target company.*
- *Revolution targets a 40% portfolio allocation to LBO and private company loans.*

Giant wave of private equity capital to deploy

In Revolution's opinion one thing appears certain, there are likely to be more deals in the market in 2019 as private equity firms with record levels of dry powder look to deploy capital. Revolution estimates that at least A$9 billion of funding is available for investment today within the Australian private equity market. The Australian private equity market is a mature market and consists of many participants, many of which Revolution will support, having long standing and deep relationships with firms such as KKR, The Carlyle Group, BGH Capital, Quadrant, TPG, Pacific Equity Partners (PEP), Blackstone, Affinity, CHAMP, Archer Capital and other smaller participants. The typical private equity LBO capital structure is approximately 50% debt / 50% equity, suggesting there is likely to be a significant pipeline of LBO debt opportunities in the years ahead.

Key protections being stretched

Revolution has recently observed transactions in the market where key terms and leverage are being stretched, making them less attractive to lenders. In a period of expected gradual economic slowdown, these transactions are increasingly susceptible to underperformance without the benefit of key structural protections including regular financial covenant testing and scheduled amortisation and/or cash flow sweeps. With over 50 years of combined experience, the Revolution investment team has seen these trends before and remains focused on finding the best risk-adjusted opportunities, whilst maintaining a high level of discipline.

Public-private take-outs

In the first quarter of 2019, there has been a surge in the search for financial sponsor financing. This involves the large private equity sponsors including Apax, BGH Capital, Brookfield, KKR and TPG utilising LBO financing to back public-to-private take-outs with enterprise values of A$1 billion or more. In each case, the sponsors have been granted due diligence access by the respective Boards of the target companies, with several of these transactions approaching conclusion.

This is a notable change given that over the last decade private equity firms have had little success in swaying Boards and target company shareholders to accept their proposed acquisition terms. This means the potential pipeline for origination in this part of the market looks increasingly healthy.

Private and public company debt finance

From a debt financing perspective, Revolution has observed financial sponsors being opportunistic, considering the positive and negatives of:

- traditional bank/holding company mezzanine market;
- the APAC uni-tranche market;
- the offshore capital markets.

The US & EU leveraged finance and the APAC uni-tranche markets have seen the most activity thus far, given their flexibility in contractual terms and market capacity, though Revolution expect the local bank market to be more active in 2019, after a quiet 2018, with discussions already taking place on various transactions.

The opportunity awaits

Revolution is currently seeing a large pipeline of opportunities across multiple sub-sectors of the Australian and New Zealand private company and LBO market. While the expectation of transactions following a more traditional bank financing structure is welcomed, capital protection and risk management remain at the core of Revolution's DNA. Revolution will continue to focus on stable, defensive businesses and industries financed through traditional bank syndicates, while businesses operating in cyclical industries with high debt loads will continue to be avoided. Structural protections are key features in the market that the Revolution investment team highly value, and while we may participate in TLB or unitranche transactions (which are typically characterised by slightly higher leverage and softer structural protections), we will only extend such liberties to those companies that pass our detailed and stringent due diligence process.

2. ASSET BACKED SECURITIES (ABS)

- *Asset Backed Securities (ABS) are the preferred method for smaller banks and specialty finance companies to finance pools of familiar asset types, such as auto loans, credit card receivables, mortgages, and business loans.*
- *Revolution targets a 40% portfolio allocation to ABS.*

Despite weakening conditions in broader credit markets in 2018, demand for ABS investments remained strong as spreads drifted modestly wider over the course of the year. The combination of the Royal Commission and tighter regulations has significantly impacted the risk appetite and overall credit growth within the banking sector. Consequently, public issuance in the Australasian ABS market was down around 20% in 2018, but this has been offset by significant growth and activity in the private ABS warehouse space, driven by the non-bank originators. On this front, Revolution has signed non-disclosure agreements and commenced due diligence on three private ABS warehouses investments in Australia and New Zealand and the expectation is that opportunities will remain compelling in this sector going forward.

Why is AU & NZ ABS an interesting opportunity for investors?

In the non-public ABS market (warehouse transactions), there are very few players. This is a function of few investment managers having the skill, experience or the mandate to asses, internally rate and provide funding for private ABS warehouses. This creates an inefficient market thus creating a significant and attractive investment opportunity for Revolution given the experience, track record and long-standing relationships with sponsors in the ABS space. Revolution’s investment team utilises proprietary models consistent with external ratings agencies to internally credit rate all ABS transactions. The fact that there are very few players in the space in Australia and New Zealand adds further weight to the opportunity for compelling risk adjusted returns.

Fund target ABS transactions

The Fund targets well established non-bank originators of loans that have a demonstrated long track record in their chosen sub-sector of ABS. For an investment to pass due diligence, an ABS warehouse transaction requires significant alignment through ‘skin in the game’, typically provided via first loss equity from the originator in each transaction. As the non-bank sector is growing rapidly as a result of the banking royal commission, the investment team remains extremely cautious on newly established and rapidly growing originators and fintech companies, those of which may not have the required governance, infrastructure and access to capital and can potentially translate into greater risk when investing in warehouse funding vehicles.

Australian residential housing market and the implications for residential mortgage-backed securities (RMBS) investments

There is significant commentary around the bearish outlook for residential property in Australia, especially in the major cities of Sydney and Melbourne. In a recent report, Fitch Ratings notes that weaker housing market conditions and modest increases in interest rates could put some upward pressure on mortgage arrears, but not enough to cause a significant deterioration in RMBS or covered bond performance. They expect national house prices to drop by 5% in Australia in 2019, a similar pace to last year, taking the peak-to-trough decline to 12%.

Considering this, Revolution is avoiding high loan-to-value pools with significant concentration to inner city apartments and loans that have a lower level of seasoning within the pool.

What is important to note regarding the risks around RMBS, is that the Fitch Ratings report states that "the most expensive quartile of properties has experienced the largest declines with falls of 9.5 per cent nationwide". Most of the underlying loans in RMBS are in the $400k to $500k total loan size, which is well below the threshold for the most expensive quartile. Additionally, there is a penalty applied in RMBS rating criteria for larger loan balances, which means they tend to be originated and funded on balance sheet by ADIs and never securitised in RMBS. The report also states that the price declines are likely to be sharper in Sydney and Melbourne, the cities where gains over the previous five years were strongest and affordability has become most strained. A mitigating factor to this risk in RMBS, is that Victoria and NSW have the lowest levels of unemployment in the country after the ACT, as shown in the table below.

Unemployment rates by state

State/Territory	Unemployment Rate (%)
ACT	3.6
Victoria	4.2
NSW	4.3
NT	5.0
South Australia	5.9
Tasmania	5.9
Queensland	6.1
Western Australia	6.3

Source: Australian Bureau of Statistics.

Varying levels of credit enhancement in a typical structure

Cumulative Credit Enhancement

Class A Notes (AAA) 81.0% - 86.5%	Subordination level: 13.5% - 19.0%
Class AB Notes (AA) 6.5% - 8.0%	Subordination level: 7.0% - 11.0%
Class B Notes (A) 3.0% - 4.0%	Subordination level: 4.0% - 7.0%
Class C Notes (BBB) 2.0% - 3.0%	Subordination level: 2.0% - 4.0%
Class D Notes (BB) 1.0% - 1.5%	Subordination level: 1.0% - 2.5%
Class E (NR) 1.0% - 2.5%	Subordination level: 0.0% First tranche in the asset pool to incur losses, retained by the originator
Credit enhancement available to all notes	
Excess Spread	The difference between the interest rate charged on the mortgages, and the interest cost paid to the RMBS note holders. This can typically range from 2.0% to 4.0%. This provides a buffer to losses before they reach the pool tranches.
Lender's Mortgage Insurance (LMI)	High LTV loans are covered by LMI, with each LMI policy covering up to 100% of the outstanding principal balance, plus reasonable costs of enforcement.
Borrower's Equity	This is where any losses would be first absorbed. Assuming a weighted average LVR of 70%, borrower's equity would be 30% and form the first loss piece. If losses exceed this, the above forms of credit enhancement come into effect.

Target Investment

Source: Revolution Asset Management.

Whilst Revolution agrees with Fitch's positive view on RMBS performance, the investment team remains cautious on RMBS and will continue to focus on the originator's track record and the underlying structure and will favour other types of non-residential ABS such as credit cards, personal loans and equipment loans. This caution on RMBS will remain until the full effects of changing credit standards and wash up of the Banking Royal Commission are evident. These non-residential mortgage transactions are typically of shorter tenor with greater structural protections and credit enhancement.

The road ahead

The very first investment the Fund made was an ABS transaction, with a second transaction due to follow in the near term. There is a strong pipeline of potential investments currently undergoing due diligence with well-established originators that have strong governance, track record and structures – an opportunity set that has the potential to offer investors compelling risk-adjusted returns.

3. REAL ESTATE LOANS

- *In the real estate debt segment of the portfolio, Revolution will focus on lending to stabilised properties with high occupancy, long weighted average lease expiry and low to moderate gearing.*
- *Revolution targets a 20% portfolio allocation to real estate loans.*

Revolution <u>does not</u> invest in residential, construction or development loans, particularly in an oversupplied apartment market.

Senior Real Estate Debt

The Senior Real Estate Debt sub-sector is involved in providing loans to stabilised commercial (office, retail and industrial) properties and portfolios of properties. This lending is based on a combination of cash flows generated by the properties and the underlying value of the asset/s in question. This type of lending is viewed as relatively low risk because the properties have long, stable tenant profiles (supporting cash flow generation) and are generally geared to less than 70% providing a material equity cushion.

The Fund only lends to stabilised property assets with high quality lease tenants in commercial office, retail shopping centres and industrial properties with gearing levels up to 70%. In addition, financial covenants will be in place to test interest cover and LVR on a quarterly basis. This ensures an adequate level of equity and cashflow remains throughout the term of the loan. Should the market deteriorate or there be a covenant breach, the investment team (alongside other lenders) will have the option to enforce security and commence proceedings to sell the secured property and have the loans repaid.

Construction / development loans – an area of concern

The Australian big four banks have made a concerted effort in proactively reducing their exposure to real estate due to an over concentration in the sector. In doing so, the most acute shortage of debt capital has been to construction and development loans for new residential dwellings, which are considered higher risk/return in the asset class. The residential property market boom from 2012 to 2017 was led by a significant acceleration in development activity in Sydney, Melbourne and Brisbane, particularly in apartments. During most of this period, the bank lending appetite was strong with significant competition for loans.

In December 2014, the financial regulator APRA imposed a 10% speed limit in growth of investor loans to cool the housing market via macro prudential controls. There were further changes in March 2017 to limit interest only loans. Previously there was no differential in interest rates for owner-occupied versus investor loans – whereas today, there is a differential with investor loans typically paying around 50 basis points to 150 basis points more than owner-occupiers. Secondly, foreign buyers of residential property were no longer able to obtain finance from local banks due to increased scrutiny on income verification under new bank policies introduced in 2016. This has taken significant demand for new properties out of the market.

Ultimately the construction and property boom has led to an over-supply of residential property, particularly apartments in Brisbane, Melbourne and certain pockets of Sydney. This has coincided with cooling demand and now falling property values. This trend looks set to accelerate in the aftermath of the Banking Royal Commission, where banks now need to adhere to more stringent loan underwriting standards around serviceability. This may lead to greater pressure when many new developments reach settlement, as it will be difficult for purchasers to gain final credit approval for loans that were conditionally approved at the time of purchase (which may have been 2-3 years ago, when the borrowing environment was significantly different).

From a macroeconomic standpoint, the full effects of the construction slowdown in Australia are yet to be realised. We monitor key signals such as retail sales, consumer and business confidence (to name a few) to determine the trajectory of the economy.

Attractive opportunities are emerging

The commercial real estate loan market continues to evolve, with prudential regulation continuing to transform the composition of bank balance sheets. The Fund seeks investments in stabilised commercial real estate loans across office, retail and industrial properties, where cash flows and capitalisation rates can be modelled and underlying property fundamentals can be analysed. While opportunities in this sector continue to emerge, the investment team believe the market will continue to evolve further throughout the year.

About the Authors

Bob Sahota
Managing Director and
Chief Investment Officer
26 years experience

Simon Petris Ph.D.
Executive Director and
Senior Portfolio Manager
16 years experience

David Saija CFA
Executive Director and
Senior Portfolio Manager
16 years experience

For more in-depth analysis or additional insight into the Fund's investment process, please get in touch.

Andrew King	William Stephens	Byron Slessar	Luke Mandekic
Head of Distribution	Head of Institutional & Family Offices	Distribution Director	Distribution Director
+61 2 8669 3912	+61 2 8669 3913	+61 2 8669 3916	+61 3 8580 0006

distribution@channelcapital.com.au
www.revolutionam.com.au