OAKTREE INSIGHTS

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A PLACE FOR REAL ESTATE DEBT IN GLOBAL CREDIT INVESTING

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KEY POINTS

- Oaktree's global credit investing platform spans numerous liquid credit asset classes and geographies. In this paper we put a spotlight on one sub-sector of liquid credit investing: real estate debt.
- Real estate debt, along with related credit instruments (e.g., RMBS, CMBS), has received increasing focus from investors for its potential to offer attractive yield with less-than-commensurate risk relative to traditional corporate debt given the downside protection offered by its real asset-based collateral. This attractive profile is further enhanced by the more conservative loan-to-value ratios we see in real estate lending today.
- Oaktree *Insights* sat down with Bruce Karsh, chief investment officer and head of our global credit platform, and Justin Guichard, co-portfolio manager of our Real Estate Debt and Structured Credit strategies, to discuss today's real estate debt landscape. The following is an edited excerpt.

Q: Could you walk us through how you think about global credit investing and where real estate debt comes into play?

Bruce Karsh: Our aim for the global credit mandate is to bring together multiple key asset classes within the global credit universe and manage them dynamically to earn attractive total returns with current income, while limiting volatility through diversification. The global and multi-strategy nature of this platform enables us to consider a wide range of liquid credit asset classes. We employ a bottom-up approach in the selection of individual investments, as well as in relative-value assessments that inform our allocation decisions. This relative-value perspective is quite important, in our view. We believe the ability to flexibly pivot our capital deployment to the most attractive opportunities developing at any given time is a key driver of success.

Real estate debt is one component of the global credit umbrella, and within this allocation we invest in traded securities. These include real estate-related structured credit, such as commercial mortgage-backed securities (CMBS), and other real estate-related debt instruments. We think this segment of the market is particularly compelling today, especially given the late-cycle position of the economy and the reasonable fundamentals of the real estate market.

Q: You mention the late cycle of the economy. We can't talk about today's investing environment without recognizing a weakening global economy in which industrial activity is slowing and financial markets are being buffeted by trade tensions. Given that backdrop, what do you see as the merits of real estate debt and the potential benefits of investing in it?

BK: Downside protection is a valuable potential benefit offered by real estate debt. We know the economy is in the later stages of a growth cycle. It's hard to imagine that asset prices in general will continue to grow at the pace we've seen over the last several years. So, to be defensively positioned and to sharpen the focus on risk control — which is one of Oaktree's core investment tenets — we consider real estate debt as a significant protective force, especially in the context of its place within a multi-strategy platform. While there may be volatility in the broader market, this sector may not experience it to the same degree, as it's backed by hard assets with reasonable loan-to-value (LTV) ratios.

Justin Guichard: I agree. We believe a more defensive approach is warranted as the growth cycle extends, and this conviction is reflected in the fact that our investments in real estate debt are characterized by a significant margin of safety, as indicated by LTV ratios of about 65% on our positions.

In addition, the current-income aspect of this debt is appealing. As Bruce said, asset prices today are generally high across the board for real estate, or for anything else, frankly. An investor in a creditor's position can look to secure returns in the form of current income, as opposed to banking on price appreciation.

We also consider the very low yield coming from much of the traditional fixed income world, plus the growing pool of negative-yielding debt in certain non-U.S. bond markets. The International Monetary Fund in its October Global Financial Stability Report (GFSR) mentions the phrase "search for yield" at least 15 times — all to describe how today's persistent low rates are fueling risk-taking by investors — and raises the concern that this intensifying pursuit of yield is rendering some markets overstretched and vulnerable. Interestingly, that phrase was not mentioned once in the issue of GFSR just preceding this one, which was published in April. So this is definitely top-of-mind currently for a lot of market participants and organizations globally. In this context, we at Oaktree think that an investor pursuing yield alone is likely turning a blind eye to true value and risk. And we think that, for the reasons mentioned earlier, real estate debt can provide an intriguing middle ground between the low-yielding vehicles and the unduly risky and illiquid assets some investors are seeking. We think the real estate market in the U.S., for instance, is characterized by still-strong fundamentals and an opportunity for continued growth. Plus, it's a jurisdiction that respects creditor rights.

BK: I would add that, even if we're not talking about an outright replacement of allocations, real estate debt can be a useful complement to existing fixed income holdings. We consider relative returns across numerous global credit products, including high yield bonds and senior loans, and we see that real estate debt can present comparable returns, likely with less risk and volatility, as well as with a lower probability of loss and low correlations to corporate credit markets.

"Real estate debt can be a useful complement to existing fixed income holdings . . . it can present comparable returns, likely with less risk and volatility, as well as with a lower probability of loss and low correlations to corporate credit markets."
– Bruce Karsh,
Co-Chairman and Chief Investment Officer

Q: The following question is perhaps more about the real estate debt market as a standalone asset class than about its place within a global credit mandate, but we nonetheless view it an important point in understanding the investment environment. How is the real estate debt market different today from that of pre-Global Financial Crisis (GFC) days?

JG: Real estate today is not the real estate of 2007. It's not an overstatement to say that real estate was the poster child for the issues that led to the GFC. Since then, regulators have been focused on not repeating the mistakes of the past. New regulations include risk-retention rules, which require banks or qualified purchasers to have "skin in the game" when it comes to the debt they originate and to hold a portion of their loans on their balance sheet for five years or until maturity. Another impact of the post-crisis regulatory pressure is that banks typically cap their lending around 60% to 65% of the value of the underlying property, due to higher capital charges for higher-risk loans.

The regulatory focus on real estate finance and the banking industry, a carryover from the GFC, has curbed many of the irresponsible lending practices we once saw in real estate and are now witnessing in other sectors. We believe the "hangover" from the challenges in real estate finance during the crisis has dissuaded some investors from participating in the sector; to us, a less-invested-in market translates to more opportunities for outperformance.

BK: I agree. A key difference between today and the mid-2000s is that the excesses in the current financial markets are not in the area of real estate. There is less commercial mortgage debt outstanding today as a percentage of GDP than in the prior cycle. If anything, frothiness is found in corporate debt, particularly the lower-rated issues. I think the fundamentals of real estate debt today are actually quite strong and the leverage in the system is conservative.

Q: What primary risks in real estate debt investing is Oaktree looking out for today?

JG: Real estate debt isn't immune to any of the risks that pertain to general financial markets. One of the major risks today is that underlying asset prices are at an all-time high. How long can assets continue to appreciate? For real estate debt, though, we don't need prices to appreciate in order to receive our coupon and be paid off at par. Another risk is that lending standards generally decline as new entrants come into the market. We're starting to see that: people taking on more leverage with fewer covenants. And there's the broader risk of public market volatility. Investors may trade out of names they don't know or understand as well, putting more pressure on some instruments than others. Our highly granular approach to underwriting assets gives us confidence to invest when markets are more volatile.

Q: Are there any market inefficiencies that could be capitalized on?

BK: An area of global credit investing that looks interesting today is real estate-related debt in Europe. Europe was late to the real estate party, so to speak. This means its real estate cycle is less advanced than that of the U.S., and thus there's more room for future growth. The European market also has changed dramatically since the credit crisis, with greater opportunity now for institutional, non-bank capital to be active in the market in scale. We believe there's opportunity in select European markets to pick up some additional yield spread. The key lies in taking a relative-value approach and applying bottom-up fundamental analysis, just like we do in any other credit investment, to help us source compelling potential investments there.

Q: What is a key aspect of real estate debt within the context of global credit investing that you'd most like to emphasize?

JG: The power of the Oaktree platform is noteworthy. The real estate team's status as the largest investment group at Oaktree, comprising more than 50 investment professionals, enhances Oaktree's ability to analyze real estate-related securities.

The real estate debt team benefits from residing within the global credit platform. This means we can channel the credit expertise of other strategies throughout the firm in order to evaluate opportunities and take a dynamic and flexible approach to investing throughout market cycles. We are also able to focus on higher-conviction names and invest in more concentrated positions. This is possible precisely because the real estate debt strategy is part of a broader global credit portfolio.

BK: Regardless of the asset, whether it be corporate debt, CMBS or some other sort of securitization, our approach is always the same: bottom-up, fundamental real estate analysis. The emphasis is always on knowing the value of the collateral underlying our investment.

ABOUT THE AUTHORS

BRUCE KARSH

Co-Chairman and Chief Investment Officer

Mr. Karsh is Oaktree's Co-Chairman and one of the firm's co-founders. He also is Chief Investment Officer and serves as portfolio manager for Oaktree's Distressed Opportunities, Value Opportunities and Multi-Strategy Credit strategies. Prior to co-founding Oaktree, Mr. Karsh was a managing director of TCW Asset Management Company, and the portfolio manager of the Special Credits Funds from 1988 until 1995. Prior to joining TCW, Mr. Karsh worked as Assistant to the Chairman of SunAmerica, Inc. Prior to that, he was an attorney with the law firm of O'Melveny & Myers. Before working at O'Melveny & Myers, Mr. Karsh clerked for the Honorable Anthony M. Kennedy, then of the U.S. Court of Appeals for the Ninth Circuit and retired Associate Justice of the U.S. Supreme Court. Mr. Karsh holds an A.B. degree in economics summa cum laude from Duke University, where he was elected to Phi Beta Kappa. He went on to earn a J.D. from the University of Virginia School of Law, where he served as Notes Editor of the Virginia Law Review and was a member of the Order of the Coif. Mr. Karsh serves on the boards of a number of privately held companies. He is a member of the investment committee of the Broad Foundations. Mr. Karsh is Trustee Emeritus of Duke University, having served as Trustee from 2003 to 2015, and as Chairman of the Board of DUMAC, LLC, the entity that managed Duke's endowment, from 2005 to 2014.

JUSTIN GUICHARD

Managing Director and Co-Portfolio Manager

Mr. Guichard joined Oaktree in 2007. He is a managing director and co-portfolio manager for Oaktree's Real Estate Debt and Structured Credit strategies. In addition to his strategy management responsibilities, Mr. Guichard is responsible for investing capital for Oaktree's Real Estate Debt, Real Estate Income, Real Estate Opportunities, Structured Credit and Global Credit strategies. Prior to Oaktree, he worked for Barrow Street Capital which, he joined in 2005. Mr. Guichard began his career in Merrill Lynch & Co.'s Real Estate Investment Banking group. He received a B.A. degree from University of California, Los Angeles, where he was an Alumni Scholar, and an M.B.A. from MIT's Sloan School of Management.

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