PRIVATE DEBT SECURED BY **COMMERCIAL PROPERTY LOANS POST GFC** - OPPORTUNITY OR NOT?

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OPPORTUNITY

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COMPLETE LOAN MANAGEMENT

About Balmain

Balmain is the region's leading non-bank commercial loan manager. With over 30 years of experience and $2b in assets under management, Balmain has a proven track record that encompasses all aspects of the commercial loan lifecycle including loan origination, credit underwriting, mortgage fund management and asset recovery.

Balmain's volume of transactions and credit cycle experience is unmatched in the non-bank sector. With over 140 staff in 8 offices throughout Australia and New Zealand Balmain has the experience and capacity to develop and manage a wide variety of commercial loan portfolios.

About AMAL

For over 16 years AMAL has focused on providing the most efficient and cost-effective loan servicing solutions to its clients in Australia and New Zealand. And with over $A6 billion of assets under administration on behalf of over 30 clients, AMAL is the leading commercial loan and receivables servicer in the region.

AMAL's specialist team, customisable systems platforms and rigorous focus on quality, risk-management and compliance have resulted in a service offering trusted by some of the region's and the world's largest financial institutions.

Balmain is a founding and significant shareholder in AMAL Asset Management Ltd.

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Pre GFC

For the five years to the end of 2007 Australian and New Zealand property investors were spoilt by the simplicity and availability of property finance. In Australia for instance the four major banks (the so called four pillars) dominated the financial landscape and the three second tier banks (St George, Bankwest, Suncorp) each had aspirations for growth and property lending featured prominently in their strategy. These seven banks, a variety of third tier bank lenders both on and offshore, a $30 billion mortgage trust sector plus private and niche lenders combined to provide a plethora of lending balance sheets with diverse approaches to risk and lending terms. Many of these lenders were chasing volume growth and were often willing to soften credit criteria to win transactions. The same was true in New Zealand, with a mixture of on and offshore bank lending competing for growth together with a well developed but in hindsight poorly regulated private lending market.

Pricing and leverage was used to attract transactions with what seemed like a never ending downward spiral to thinner margins and an acceptance of increased risk as expressed by loan to value ratios.

With cheaper and easier credit being made available, borrowers were prepared to pay ever higher prices for properties, forcing yields down to irrational levels as low as 5% and so fuelling a commercial property bubble in both Australia and New Zealand. The apparent rise in property values gave lenders comfort and continued to support still cheaper and easier credit. Not only was the initial credit approval easier, so too the loan conditions and post-settlement monitoring with property valuations accepted at face value, scant draw down controls and often a willingness to waive initial approval criteria. In Australia, lending grew by about 12% per year in the five years to 2007 outstripping the growth of bank deposits and with it Australian banks' growing dependence on wholesale funding. These conditions would not last and today have created both far reaching consequences and opportunities.

The GFC

Along came the GFC and the music stopped.

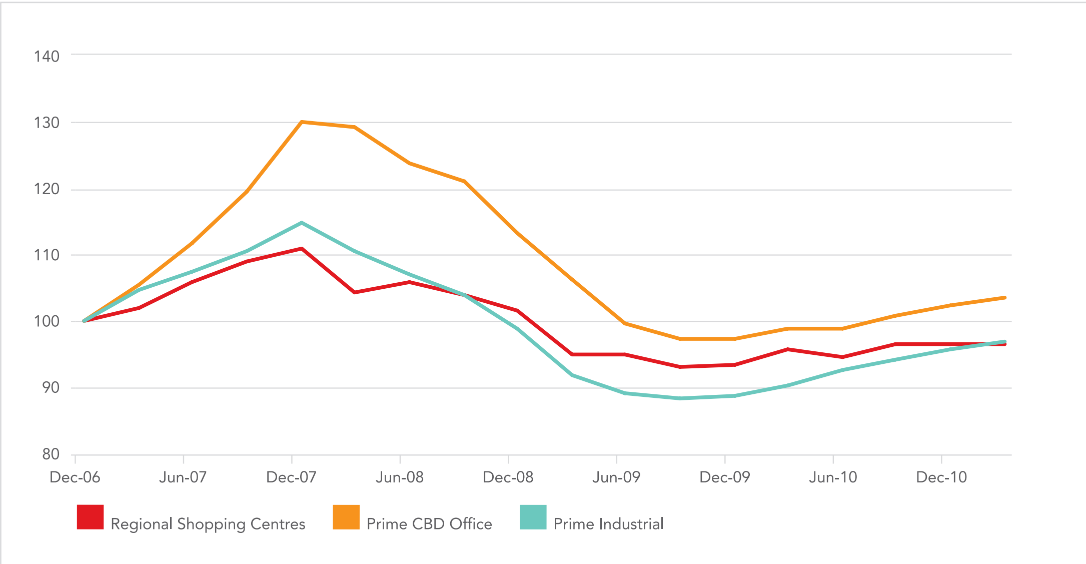
- The Collateralised Debt Obligations (CDO) market collapse in mid 2007 put the first tremors through financial markets and indicated a heightened risk of interbank lending.
- Bear Stearns faltered which resulted in a hurried sale to JP Morgan in early 2008 at less than 10% of its previous years market value.
- Lehman Bros burdened with toxic CDO asset exposures faltered in late 2008 and was allowed to fail.

These and a host of other related events triggered a near breakdown of the global financial system that was only averted by the rapid and concerted monetary policy efforts of the major developed countries (slashing cash rates) and the provision of sovereign guarantees for their respective banks.

The GFC led to a breakdown in interbank lending and a halting of wholesale funding (bank bond issuance). Economic optimism quickly changed to pessimism for lenders worldwide, including in Australia and New Zealand, as they struggled to fund existing loan portfolios, let alone credit growth. The lack of funding availability had an immediate impact with demand for property assets declining. This, together with a realisation of over valuations resulted in a 15-30% drop in commercial property values (witnessed by the rapid expansion of commercial property yields to 8-9%) and an even sharper decline in the values of vacant land.

FIGURE 1: CAPITAL VALUE INDEX - NATIONAL AVERAGES AUSTRALIA - DEC 2006 = 100

Source: Jones Lang LaSalle Research

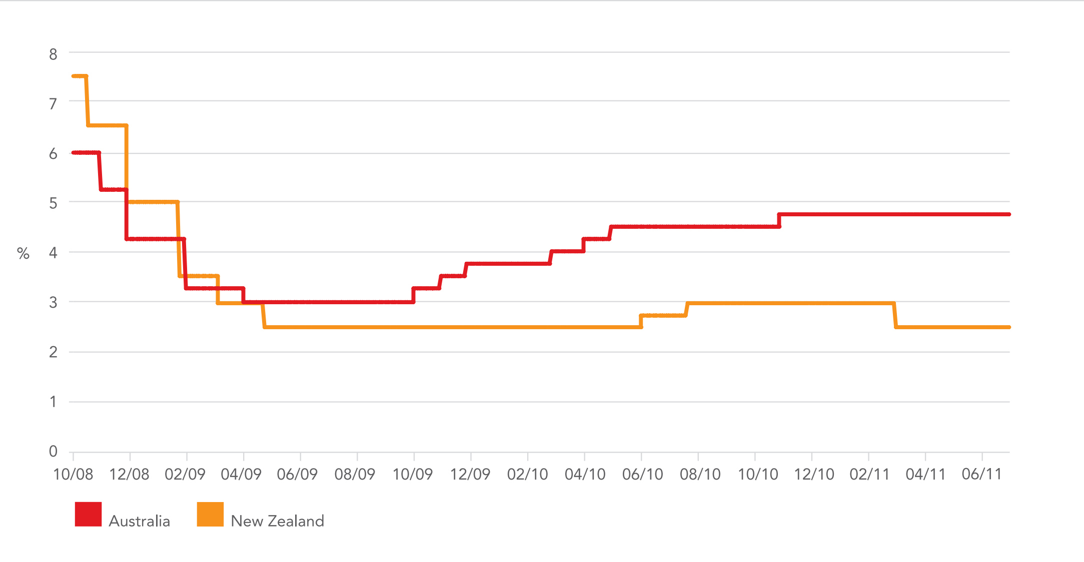


Banks immediately tightened conditions on existing loans, called for new valuations, insisted on fresh equity contributions to remedy gearing breaches and reviewed loan pricing dramatically upward. New credit applications were mercilessly cut off, even in many cases to banks' existing clients. Property investors and developers had no certainty of obtaining loan funds and so were unable to transact.

Starved of wholesale funding, St George, Suncorp and Bankwest suffered in particular and ultimately were acquired and / or rapidly withdrew from commercial property lending, although we note that in Australia they have been tepidly re-emerging in recent months.

The foreign banks ceased lending in Australia and New Zealand and repatriated capital to their domicile (in some cases this was a requirement of their respective sovereign support). In Australia the RBA in an effort to stimulate the faltering economy slashed the official cash rate by 4.25% from 7.25% to 3.00% in just 5 months by Feb 2009 (currently 4.75%). Whilst in New Zealand, the Reserve Bank cut rates from 8.25% in June 2008 to 2.5% by April 2009. It is worth noting that this was in part to absorb the shock to borrowers of the 1-2% increased cost of bank funds that was passed to borrowers in the form of higher loan margins.

FIGURE 2: AUSTRALIAN AND NEW ZEALAND INTEREST RATES



In Australia the Government gave very clear and unlimited support to the Australian banks and approved deposit institutions which allowed them to emerge strong, dominant and in the case of the Australian banks globally well regarded. It also contributed to the issues faced by Australian mortgage trust lenders, who were not included in the guarantee. In New Zealand all retail deposits in participating New Zealand-registered banks and retail deposits by locals in non-bank deposit-taking entities, including building societies, credit unions, deposit-taking finance companies and cash PIEs (portfolio investment entities) sponsored by qualifying institutions were included in the scheme.

In Australia the Mortgage Trust sector could be clearly divided into two categories; the professionals (roughly $20b of a $30b sector) who were skilled and genuine fund managers and the others who were poorly skilled and dissembling to risks taken such as: related party transactions, disguised fees, lending well beyond prudent levels! Following Government support of the banking sector the non-bank sector saw a call on funds that they could not meet which resulted in the entire sector being frozen to redemptions. It is worth noting the professional mortgage fund sector has suffered little if any real losses, met income distributions and returned 50-60% of underlying investor's capital. Contrast this with the other sector where, investors have had no income for 3 years, little to no return of capital and are facing capital losses of 40% to 60% and in some cases higher.

It is clear that in Australia the non-bank lenders (the professional mortgage trust managers) which were a main stay of the High Net Worth/non AREIT borrower market have suffered by not being covered by the government support offered to ADI lenders. As a consequence they have been forced to stop significant lending activity, build liquidity from loans as they were repaid and in the case of mortgage trusts enter into a planned redemption program to investors.

Post GFC

From a borrower's perspective, the most dramatic consequence of the GFC is the deeper concentration of power within the banking sector. In both Australia and New Zealand the four majors now control about 90% of property funding (residential and commercial) and are clearly in a position to dictate terms. The banks are again lending but their pricing and their conservative credit terms are generally aligned one to the other. Mortgage trusts, non-bank institutions and private lenders still account for approximately $20 billion in property loans but have been subdued for the last three years. It is unlikely that they will re-emerge using the business models of the last 20 years.

In this environment, demand for debt outstrips supply and lenders are very particular about what they will consider. Assessment criteria typically cover the borrower group in great detail, asset marketability, strength of servicing, lease quality and tenor and the possibility of additional fee revenue from the borrower. On top of all this, the bank approval process is torturously slow and unreliable.

The significant decline in the number of lenders post GFC has added to this. There are now NO foreign banks lending on commercial property in Australia and New Zealand and the total number of lenders in Australia has declined to around 40 from say 150 pre-GFC. In New Zealand, the number of lenders. declined from approximately 75, including larger finance companies, to 15-20 today. Of this, we estimate that no more than 4 or 5 are capable of lending in volume. As well, borrowers seeking longer term loans will find the banks are generally uninterested beyond 3 years unless there are significant reductions in LVR / DSCR risk.

All of this is occurring against the backdrop of a property sector that has faced significant value decline and for new purchasers provides vastly superior risk reward outcomes than those available 3 to 4 years ago.

So in summary in Australia and New Zealand we have a senior secured private debt market characterised by:

- Reduced risk, both in terms of asset value and loan conditioning (terms) provisions
- Significantly reduced lender competition
- Borrowers seeking both alternative lenders and lending solutions
- Loan interest margins 2 – 3 times higher than pre GFC

Opportunity or not?

According to a recent presentation to the PCA Capital Markets Leaders Summit there is more than A$20 billion in commercial property debt maturing in the A-REIT 200 index alone, of that $17B expires in 2011 and 2012.

In the non A-REIT sector borrowing demand is high but satisfaction low, due to the banks desire to limit lending due to aggregation (borrower, sector and State), limited capital (over reliance on offshore funding) and Basel III regulatory and capital adequacy issues.

Given this, Balmain is of the view that this sector is ripe for Institutional investment. In this regard, it is worth noting that Australia and New Zealand are somewhat unique in that Institutional involvement in senior secured private debt lending is very low compared to North America and Europe.

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