REAL ESTATE REVISITED

Investing outside of traditional debt and equity offerings can pay handsomely in this sector.

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Investors are increasingly partial to real estate financing vehicles because they are more stable than stocks and less risky than real estate equity investments. Moreover, the potential of the real estate financing market is considerable, since the purchaser of a building generally makes an equity investment of 25% to 40%, and finances the remaining 60% to 75%.

CDP Capital – Real Estate Group believes investors will show a sustained interest in real estate financing operations in the years to come; accordingly we have developed a strategy to diversify its real estate financing portfolio by incorporating various financing vehicles: interim and long-term mortgage loans, mezzanine loans and subordinated tranches of commercial mortgage-backed securities (CMBS). The resulting asset class will generate better returns than fixed-income securities, while involving less risk than real estate equity investments.

The mix and management of a diversified real estate financing portfolio involves a very large transaction volume and leading-edge expertise in several areas. They also require considerable time and resources and are therefore costly and not accessible to every investor.

LONG-TERM MORTGAGE LOANS

First mortgages are traditional mortgage loans used on various types of real estate properties. The interest rates are fixed or floating, the terms generally range from one to 10 years and the amortization period may be as long as 25 years.

INTERIM MORTGAGE LOANS (FOR CONSTRUCTION)

This vehicle is used for short-term financing of buildings under construction or redevelopment, and is available in various sectors of real estate, from project start-up until eligibility for long-term financing.

BB, B PIECES AND NON-RATED TRANCHES

A CMBS issue is a pool of individual mortgages converted into bonds and sold by tranche to investors. The credit quality and maturity date of each tranche is different. Thus payment of the capital of each tranche of the bonds does not take place at the same time but on a top-down basis, from the highest tranches (AAA) to the lowest (B and non-rated). Conversely, the allocation of losses begins with the B pieces and non-rated tranches. The BB and B pieces and non-rated tranches offer the highest return but present greater risk. Still, the risk is mitigated when the acquirer of the non-investment grade tranches is also the underwriter of the loans involved in the issue.

MEZZANINE LOANS

This financing vehicle bridges the gap between the equity investment and the first mortgage required for a real estate project. A mezzanine loan is used in addition to a traditional loan and offers a loan-to-value ratio up to 90% or even 95% in certain cases. Such loans are not yet widely used in Canada and rare in Europe, but very popular in the United States.

ISSUING CMBS AND ACQUIRING NON-INVESTMENT GRADE TRANCHES

For the past 10 years, CMBS have become an increasingly popular investment vehicle for bond holders. For fixed-income investors, CMBS are an interesting complement or alternative to bonds, since they provide diversification, an attractive yield and predictable cash flows, combined with high credit quality. For corporations, they provide a reliable and competitive source of funds. They also introduce a more transparent and structured environment to the mortgage market. Finally, for investment bankers and lenders, CMBS are value-creation tools used to convert an illiquid instrument, with a certain level of risk, into an easily accessible vehicle. ▮