OAKTREE INSIGHTS

NOVEMBER 2020

THE CASE FOR PRIVATE DEBT IN REAL ESTATE INVESTING

OAKTREE

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THE CASE FOR PRIVATE DEBT IN REAL ESTATE INVESTING

In today's world of low yields, high asset prices and high uncertainty, private markets may provide relative value as they tend to be less efficient than public markets given the relationship-based nature of private transactions.

In the following Q&A, Oaktree's Real Estate Debt team discusses a variety of topics, including the relative-value proposition offered by private real estate debt, loan structures that we're focused on today, and factors we believe are important to consider in private real estate debt investing.

What does the commercial real estate private debt landscape look like today?

U.S. commercial real estate (CRE) private lending makes up a very large market, with about $3.7 trillion in mortgage debt outstanding. The lender base is quite diverse and includes banks, agencies, life insurance companies, commercial mortgage-backed securities (CMBS) issuers, debt funds and mortgage REITs.

Banks have the biggest share of the outstanding debt at 39%, followed by agencies (20%), and insurance companies (16%). It's worth noting that the market share of debt funds and mortgage REITs, while small today, is growing. Their proportion has grown fourfold between 2009 and 2019 to about 10%, largely due to the regulatory pressures on other major players.

We anticipate significant debt maturities approaching. The current shape of the "wall of maturities" indicates about $400 billion to $450 billion of CRE loans will mature on an annual basis for the next handful of years (see Figure 1). At the same time, CRE lending standards among banks are significantly tighter today, primarily as a result of the impact of Covid-19 on real estate and the broader economy. These market dynamics suggest a less competitive, and therefore more attractive, investment environment for private debt going forward.

What relative value does the private real estate debt market offer compared with other areas of corporate credit investing?

Oaktree's broad range of credit strategies affords us a unique vantage point from which to compare relative value, and we believe that private real estate credit presents an attractive proposition. We see very low interest rates around the globe, with $16 trillion of negative-yielding debts and the 10-year U.S. Treasury returning less than one percent. Consider also the recent policy actions aimed at cushioning the impact of Covid-19, mostly for the benefit of the corporate market. These factors have driven prospective returns from risk assets to all-time lows.

In some of the higher-yielding corners of the market, BB-rated corporate bonds are trading at around 4.5% yield-to-worst, and B-rated bonds are in the 4-6% range. Publicly traded CMBS are faring slightly better, with single-asset single-borrower B-rated bonds trading in the 6-7% YTW context. Compare those with private real estate loans, which are anticipated to be performing throughout their term and are regularly pricing in the 5-8% range for first mortgages and the 9-12% range for more junior positions in the capital structure.[1]

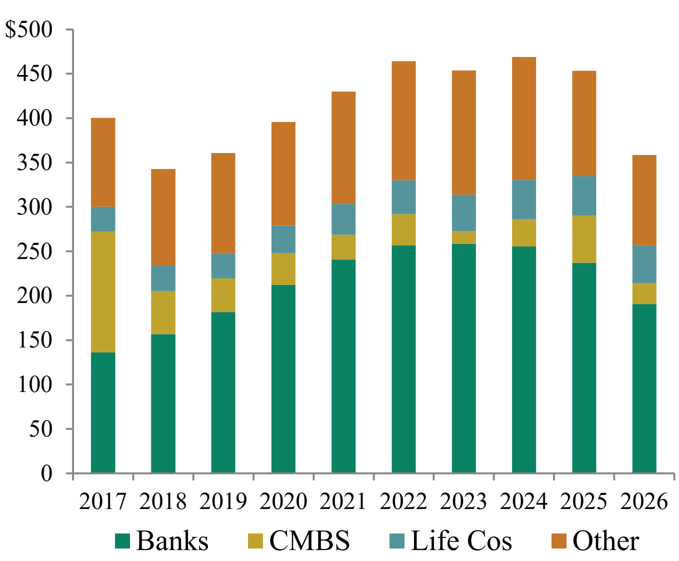
These are the options available to investors in today's environment. As you would expect, higher-risk and distressed deals have materially higher anticipated returns. The return premium in private credit is a function of the market's inefficiencies relating to access to capital, relationships, and a fully integrated debt-and-equity platform. We firmly believe that private real estate offers very attractive risk-adjusted returns in today's market.

The economic fallout from the pandemic and related disruptions has had a significant impact on CRE asset prices. What opportunities might be found amid the challenges?

The CPPI All Property Index, which is a blend of prices across all property types, is down about 8% since Covid started. Also down are transaction volumes. Across property types, transaction volumes for the first half of 2020 were significantly lower than those for the first half of 2019.

Still, few investors have so far had to sell in distressed situations. But if the crisis continues, we would expect more owners to be forced to take a loss through distressed sales, prolonging the current downward pressure on prices. In this environment, we expect to see higher

Figure 1: Wall of maturities ($ in billions)



As of June 30, 2020, the latest data available
Source: Morgan Stanley, Federal Reserve Senior Loan Officers Survey

refinancing volumes, including cash-in refinancings, where borrowers need to put in capital to pay down loans to a level that lenders believe to be appropriate.

As we consider the environment for private real estate lending today, in many ways it feels like the early days coming out of the Global Financial Crisis (GFC). Based on our experience through that downturn and many other cycles, we believe there could be some very interesting opportunities for well-capitalized debt investors. In particular, debt funds that have complementary equity platforms may have an advantage, as these organizations have a deeper familiarity with a broader range of business plans, and can leverage data across a broad set of owned assets and debt investments across global markets to make better investment decisions. Also, the cycle in real estate private lending plays out more slowly compared with other markets; as such, we anticipate a multi-year opportunity set in both performing and non-performing debt.

What loan structures stand out today as attractive opportunities?

In CRE, we are looking closely at three areas: first mortgages, subordinated secured debt (or "B-notes") and mezzanine loans.

a) CRE first mortgages are first lien, secured claims on commercial real estate properties. They fall on the safer side of the risk spectrum because investors have a priority claim on all assets, including cash flows associated with the property following a default. Also, in a default-and-foreclosure scenario, a first mortgage will typically wipe out any subordinated debt, which affords the lender ample time to wait out an economic cycle and maximize value. With that seniority and level of protection often come lower prospective returns than what might be offered by higher-yielding and higher-risk products in private or public credit. The first-mortgage opportunity set for debt funds is quite compelling today, as there is a significant and growing funding gap between the financing capacity of traditional lenders and the demand for new CRE loans.

b) B-notes are called such because they're the subordinated secured portion of the first mortgage, ranking behind a senior A-note. It's worth emphasizing that B-notes are part of the first mortgage, meaning there's only one mortgage from the borrower's perspective. B-notes are structurally attractive as they offer higher yields than pure first mortgages, and they also provide optionality to control workouts on behalf of the entire mortgage, subject to the B-note being "in the money." The B-note market came to a grinding halt after the GFC, and there's been generally little activity since then, but we're now seeing a pickup in these transactions.

c) Lastly, mezzanine loans are generally the most junior part of a debt capital structure — while maintaining its senior position to equity. Mezzanine loans offer higher yields than first mortgages, while potentially providing attractive optionality in the event of default. The collateral for mezzanine loans is technically the equity interest in the mortgage borrower, and it has a subordinate claim, relative to the mortgage, on cash flows. In other words, when you foreclose through a mezzanine loan, you will own the equity and the assets, but subject to the senior mortgage in place. The regulatory environment brought on by the GFC has kept banks from originating new mezzanine opportunities, which has meaningfully opened the pipeline for non-bank lenders. We have already seen a significant number of mezzanine loans come to market at opportunistic prices. We anticipate these numbers will only increase as the cycle continues.

"The return premium in private credit is a function of the market's inefficiencies relating to access to capital, relationships, and a fully integrated debt-and-equity platform."

We also see opportunities in residential first mortgages. These are first lien, secured claims on residential assets and make up a $10.7 trillion market. This universe is dominated by Fannie Mae, Freddie Mac and Ginnie Mae through the agency MBS markets, and by banks through the prime jumbo market. We view non-qualified mortgages (non-QM) as the best pocket of opportunity in this space. These are loans on investor properties or loans for self-employed borrowers who fall outside of the traditional financing framework. Non-QM borrowers typically pay an interest rate around 5-6%, materially higher than what an agency borrower might pay. We're particularly interested in the lower-leverage sub-sector within the non-QM space, and we're working on a handful of initiatives to increase our pace of capital deployment there.

Further down the road, we expect to see opportunities in non-performing residential loans. Wall Street research forecasts an additional $100 billion of non-performing loans by the end of 2022. Investments in this space may prove attractive for opportunistic vehicles going forward.

What about private lending opportunities outside of the U.S.?

In Europe, we focus on the northern and western jurisdictions, which are underpinned by stronger GDP and are generally more creditor-friendly than the southern markets. Across Asia and in performing loans, we have been most active in South Korea, and are seeing attractive debt investments in Australia as well.

Outside the U.S., real estate finance is primarily a bank-led market. But we see greater opportunities for non-bank lenders as banks retrench and the maturity wall mounts. Since the GFC, European non-bank lending activity has grown from a nominal percentage to around 7-10% of CRE loans today. In terms of the maturity wall, a recent Cass Business School report suggests $43 billion of UK real estate loans are due for refinancing in the next two years, suggesting more opportunities in Europe for debt funds like ours.

We see examples of interesting risk-adjusted returns in Eastern European countries like Poland and the Czech Republic, as well as in southern geographies including Spain and Italy. However, these markets tend to be less liquid in challenging times, and lenders have fewer tools with which to successfully navigate the creditor process. Therefore, loan-to-value ratios are lower in these markets.

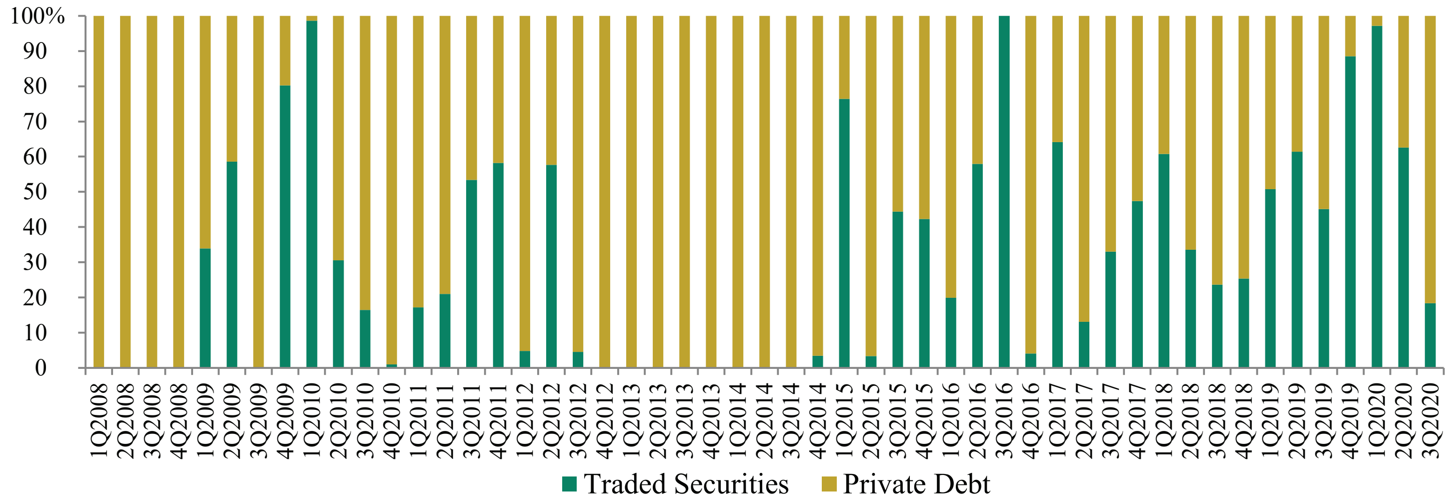
Our team's global footprint provides us insight into local market dynamics and real-time information advantages as we evaluate lending opportunities around the world.

How does Oaktree's current private real estate lending activity compare with historical patterns?

Our investments in response to the liquidity crisis in March were primarily in traded securities. More specifically, 84% of Oaktree's transactions in the real estate sector since the beginning of 2020 have been in debt, with 71% of them in traded securities. In the last few months, though, we've seen a significant increase in our private debt pipeline, including rescue capital opportunities, which we expect will grow as forbearances expire. This change came about as strong technicals and a global search for yield have pushed prices higher and yields lower on the securities we target. Figure 2 contrasts our deployment in our closed-end funds between traded securities and private debt since 2008.

Figure 2: RE debt allocations (private debt vs. traded securities)

(% of real estate debt transactions)



As of September 30, 2020.
Includes all Real Estate-led transactions across Oaktree completed from January 1, 2008 through September 30, 2020

What does it takes to invest successfully in the private real estate debt universe today?

It boils down to three things: significant access to capital, a robust network of industry relationships, and a fully integrated real estate platform.

Lenders need significant capital in order to finance high-quality, sophisticated borrowers who themselves have access to extensive capital.

Having a robust industry network — including strong relationships with banks, brokers and sponsors — is paramount for differentiated deal flow. These relationships matter. The stronger the lender's relationships across the real estate landscape, the more opportunities that lender will be privy to, for both marketed and direct deals. Our relationships with this community stem from Oaktree's fully integrated platform, which was launched at Oaktree's inception in 1995. This leads to the third point.

A fully integrated equity-and-debt platform serves as a major advantage for a lender in its sourcing and underwriting activities. Such platforms enable lenders to build relationships at a scale that is likely unachievable with a debt platform alone, and they help ensure consistent deal flow into the pipeline. We at Oaktree are fortunate to have tremendous expertise and a broad range of experience on our real estate investment team. Also, our sizable portfolio of owned and financed assets offers us a look into massive amounts of property-level data. We can access real-time information on leasing trends, supply/demand dynamics, and competitive strengths and weaknesses of properties — all these pieces of information ultimately form valuable insights that inform our underwriting.

It will take time for global economies to work through today's downturn and for real estate markets to find their footing. Meanwhile, private lenders who have deep and broad relationships in the market and the ability to prudently manage their investments will be well positioned to access compelling deals and create incremental value.

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.

WARREN MIN

Managing Director

Mr. Min returned to Oaktree in 2013 and invests primarily on behalf of Oaktree's Real Estate Debt strategies. He is responsible for sourcing, underwriting, negotiating and structuring debt investments across all geographies and debt products, including private loan originations, CMBS securities, high yield bonds, and corporate platforms. Prior to first joining Oaktree in 2008, Mr. Min worked for Citigroup in the Global Real Estate & Lodging Investment Banking group, where he advised real estate companies on M&A and capital raising transactions. Mr. Min received an M.B.A with distinction from Harvard Business School, and a B.A. in economics and mathematics magna cum laude from Yale University, where he was elected to Phi Beta Kappa.

BILL LOSKOTA

Managing Director, Real Estate Product Specialist

Mr. Loskota is the product specialist for Oaktree's Real Estate strategies. In this capacity he is responsible for various aspects of Real Estate product marketing, investment strategy updates, portfolio communications, and management of the firm's Real Estate investors committees. Mr. Loskota is also intimately involved in Real Estate product development and client solution initiatives. Prior to joining Oaktree in 2011, Mr. Loskota worked at UBS, where he focused on portfolio reviews, investment manager due diligence, and portfolio construction. Mr. Loskota received a B.S. degree in business administration from Pepperdine University and an M.B.A. degree from the Graziadio School of Business and Management at Pepperdine University.

END NOTES

[1] Yield data for BB- and B-rated bonds are from the respective rating components of the J.P. Morgan U.S. High Yield Index. The SASB B-rated bonds data is from J.P. Morgan. The private real estate loans data represent the approximate yields on recently priced real estate private credit transactions.

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