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Cheyne Real Estate Debt Fund: Cheyne Capital Management

Europe represents a €1.4 trillion ($1.8 trillion) real estate debt market. For those looking for investment opportunities, the fact the market is structurally dislocated means it offers attractive yields with strong downside protection.

For the Cheyne Real Estate Debt Fund this seems to be the perfect combination. The fund allocates to real estate debt structures with the majority of assets under management (AUM) invested in the 'Barbell' class, a mix of senior and more junior bonds.

In charge of the portfolio are Shamez Alibhai and Ravi Stickney. Together they lead a team of five dedicated investment professionals with expertise in idea generation, property valuation, loan and bond analysis and investment sourcing.

Both Alibhai and Stickney see opportunities in the European real estate debt market. The fund invests in European real estate securities, backed by commercial and residential real estate. "Typically in these types of deals senior bonds have about a 50% LTV [loan to value] and are fairly defensive in their risk profile and the junior bonds have an LTV of around 70% to 75% and have a higher yield. So with the barbell strategy we mix 65% of the senior bonds and 35% of the junior bonds. This gives a portfolio that has both defensive elements and attractive yields," explains Alibhai.


Ravi Stickney and Shamez Alibhai

The team uses a fundamental research process to identify mispriced securities. It maintains detailed valuation models on the underlying real estate assets, the tenant base, the loan structure and the bond waterfall. Deals focus mainly on commercial real estate in the UK, Germany and the Netherlands.

The fund concentrates on these three markets for a number of reasons, says Alibhai. "We're very much focused on the underlying real estate, so we want to make sure that the underlying real estate has value and will maintain that value," he explains. "You can say that about the UK and northern Europe. It's a little bit more difficult to say that about southern Europe. That's the first element: the physical real estate and the value of the physical real estate.

"The second is we want to find jurisdictions that are creditor-friendly and not borrower-friendly. There are a lot of stories about of people in southern Europe being caught up in the courts for a long period of time because you can't enforce on your security. That's less of a problem in northern Europe and in the UK. So those are the geographies where we tend to focus."

Fund facts

Fund name	Cheyne Real Estate Debt Fund
Portfolio managers	Shamez Alibhai and Ravi Stickney
Management company	Cheyne Capital Management (UK)
Contact information	Cheyne Investor Relations (+44 (0)20 7968 7380; CheyneInvestor.Relations@cheynecapital.com)
Launch date	August 2009
Assets under management	$575 million ($474 million in the Barbell share class)
Target net return	10%-12%
Annualised cumulative performance since inception	14.5%
Year-to-date return	4.5% (end March 2012)
Sharpe ratio (since inception)	2.0
Strategy	fixed income credit, real estate
Share classes	sterling, euro, US dollar
Administrator	Citco Fund Services (Dublin)
Auditor	KPMG
Custodian	BNY Mellon
Legal counsel	Dechert (US/UK); Mourant Ozannes (Cayman Islands)
Domicile	Cayman Islands
Management fee	1.5%
Performance fee	20% back-ended (payable on redemption)
Minimum investment	£100,000 (or euro/US dollar equivalent)
Managed accounts	yes
Lock-in	no
Redemption/liquidity terms	monthly liquidity with 30 days' notice

The team selects bonds for investment where it has high confidence in the downside protection, even under pessimistic scenarios. Because of its connections to the real estate market, Cheyne is often the first to be offered attractive bonds for investment.

While some investors may still be wary of the real estate market, Stickney thinks it offers significant value with little risk. "When we go into any one of these deals, we tend to underwrite the deal in its entirety. We're not just underwriting the senior bonds on a risk-reward basis. There are also the junior bonds, the entire capital structure. In some instances we find that the money is good or the very defensive profile extends not just to the senior part of the capital structure but right through into the mezzanine bonds as well. Blending the yield 8% to 10% for seniors and into the teens for the juniors gives the investors a very healthy blended return of low teens," says Stickney.

The barbell portfolio tends to hold short-weighted bonds with an average life of 2.7 years and a weighted average expected yield of 14.7%. The portfolio is highly diversified, holding around 151 bonds. The allocation is roughly 65% to senior bonds and 35% to more junior bonds.

Because European commercial mortgage-backed securities (CMBS) are supported by a small number of loans, Cheyne is able to make a precise analysis of each property and its tenants, every loan structure and the CMBS bond waterfall. The company maintains models on around 90 of the 120 European CMBS structures available.

Investors, notes Stickney, are buying into Cheyne's underwriting expertise. "The alpha comes from a combination of four key skillsets. The underwriting of the property, the underwriting of the loans itself, the underwriting of the bond structures, which is quite complicated, and finally being able to trade these bonds in the market. That is the alpha. That's probably the biggest reason why we've been successful for the last three years," he says.

The fund opened to investors in 2009, possibly not the best time to enter the market in the eyes of some investors. Alibhai reflects that at that time "ABS was a four-letter word". From a humble beginning AUM of $25 million, the funds managed by the pair in the real estate debt area are more than $1 billion. Alibhai attributes the success to the performance of the fund. "We've been able to deliver our investors. Those first investors who came in August 2009 have seen returns of about 40% net of fees. They've done very well. I think that's been able to attract a tremendous amount of capital into the strategy."

Making money from real estate deals, however, is not easy. Many companies have crashed and burned. Stickney is aware of the dangers. He points out that making money from equity in physical real estate is difficult. However, the fund does not buy the real estate but takes a defensive position on the debt where there is a buffer against the downside. This produces a yield that is in excess of what investors would normally expect to make by buying equity or the real estate itself.

Alibhai says there are number of features in the commercial real estate markets that should bring value to the fund. "There is a lot of investor demand and appetite for core-plus assets. You've seen this in London, in the City of London, with sovereign wealth funds, high-net-worth individuals buying some very 'trophy' style of assets," he notes. "That's a trend that has been accelerating as people rotate their portfolios away into something that is asset backed or something that has an inflation element to it – something that is real."

What applies to London applies to Germany, according to Alibhai. Both markets have seen a flight to quality and large capital inflows of capital. "If you look away from those prime or core-plus type of assets, you are seeing in our view a lot of softness. That gap is going to continue to widen."

The markets are being driven by weakening economic outlook "which may not be able to support the rents that these properties have. There is also a tremendous lack of financing in the secondary and tertiary markets. That means if you're an equity investor and you're looking to invest, without the same level of debt that you were getting in 2007, for you to make the same returns, the price has to drop. You have to be very cognisant in today's markets of where you're investing, how much debt is available and what is going on in the underlying commercial real estate markets," concludes Alibhai.

For Stickney the perfect deal for the fund to be involved in is where there is a lack of understanding in the market. "The most intellectually exciting deals for us are the ones that are the least understood deals in the market." He says they frequently find investors may understand the physical real estate side but come undone when it comes to the loan and bond structures and understanding how the market actually trades.

"Once you open up a bond document which runs into six different documents each going on for about 200 pages, a lot of real estate investors just get lost," says Stickney. "They want to get their hands on the underlying assets but they just find it difficult to understand the structures. For us, the perfect deal is where the structures are just poorly understood."

Sourcing deals takes time. "In this environment, which is so dislocated, not just in our market but in the wider high-yield and high-grade fixed income markets, the last thing you can do is wait for deals to come to you," explains Stickney. "It doesn't work that way."

The value he and the team add is knowledge. Over the last few years the team collectively has underwritten most of the deals coming to market. The documents for each deal can run to 200 or more pages with multiple papers attached to each one. Over the course of their careers the team already knows and understands the detail of these deals. "When people come to us, we're ready to go. We're ready to bid and provide liquidity to the market."

The most challenging aspect of the market for the team at the moment is mark-to-market valuations. "Markets are phenomenally volatile right now," notes Stickney. "The high-yield market on a monthly basis compresses or widens 200 basis points. Even the high-grade indexes are widened by 50% to 60% in the space of a month. We are sitting in a time where volatility is on a day-by-day basis." Prices, he admits, can change over a short space of time.

"We are confident and have high conviction in our credit underwriting skills but how do you manage the mark-to-market volatility? That is the biggest challenge right now."

To cope with this Cheyne has been actively hedging the portfolio. For example, explains Alibhai, the fund will use something like the iTraxx Main to hedge. As investors become more risk averse around Europe, credit spreads in Europe generally tend to widen. This then follows through to the real estate debt market with the correlation.

"We've hedged that widening of credit spreads in Europe using the iTraxx Main. That's been very successful. We put on a hedge in March when the Main was around 120 basis points. Today it's around 180 basis points. That's been a very positive outcome for us and has offset some of the mark-to-market losses in the bond portfolio," notes Alibhai.

The team also manages the cash balance on the portfolio. "If we think that the market is going to go into a period of stress, we'll go longer cash versus our normal running cash rate. By doing these things, we've been able to post reasonable good numbers," he says.

Looking ahead Stickney sees the biggest opportunities for the fund coming from two directions. "We're talking about very defensive credits for yields that are an order of magnitude two or three times what you get in the corporate bond market. Where are the opportunities going to come from? The relative value between those two products has not closed, so the opportunity is still there," he says.

"The other transmission mechanism of the eurozone crisis is that it forces the banks to offload good-quality paper at any price they can get. I think that will be the biggest source of opportunity going forward," Stickney notes.

"What happens next week I can't say. But I know the transmission mechanism we saw last year from the eurozone crisis into the banking crisis into our markets, I would say there's a high probability it happens again this year. In fact it's already happening now. We are positioned well for cash and we are hedged quite well. So to the extent the bonds trade off or become cheaper, we'll get excited about that," he concludes. ■