# THE CASE FOR INVESTING IN COMMERCIAL REAL ESTATE DEBT

Is now a good time to invest?

**HIGHLIGHTS INCLUDE**

Understanding Commercial Real Estate Debt

The Commercial Real Estate Debt Opportunity

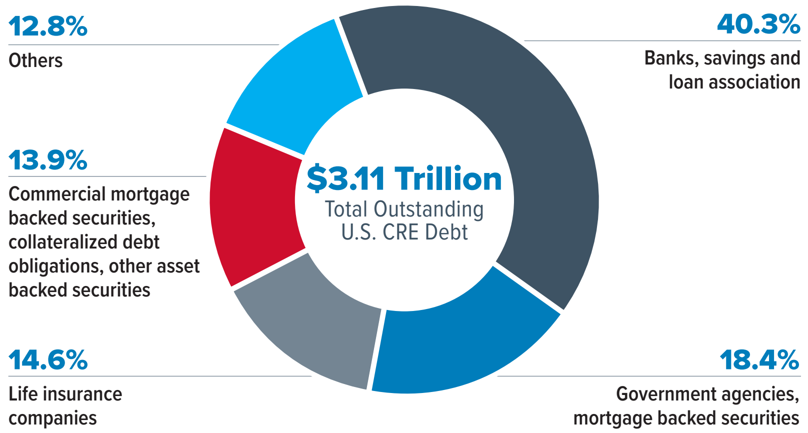
Portfolio Allocation to Commercial Real Estate Debt

Demand for commercial real estate (CRE) debt appears to be increasing. Over the last two years, the number of real estate institutional investors targeting debt strategies nearly doubled to 26%.[1] This increase may be explained by the potential for CRE debt to generate favorable risk-adjusted returns while providing possible downside protection in times of market volatility.

Large investors—pension funds, endowments, banks, insurance companies, government agencies and real estate managers—have long invested in CRE debt. Today, sustained low interest rates and the search for yield are leading individual investors to also consider adding CRE debt to their portfolios.

But what is CRE debt? And is now a good time to target this strategy?

**OUTSTANDING U.S. CRE DEBT**




Source: Mortgage Bankers Association, Commercial/Multifamily Mortgage Debt Outstanding, by investor group, Q3 2017.

1) Preqin, September 2017.

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To learn more, please contact us at **877.227.4141** or visit **www.CCREIFund.com.**

## Understanding CRE Debt

While mortgage loans may date to the 15th century,[2] it was not until about 40 years ago that debt investing became a popular strategy within the real estate asset class. Since then, the U.S. commercial real estate debt market has grown dramatically – increasing from $500 billion in the 1980s to more than $3 trillion in 2017.[3]

Not all debt investments—or returns—are the same. From senior loans to common equity, each layer, or tranche, of the capital structure delivers a different risk-return profile.

### Risk-returns within the capital structure

CRE debt's position within the capital structure may provide a layer of protection against losses in times of volatility and is one of the key reasons we believe investors favor utilizing CRE debt to generate risk-adjusted returns. However, CRE debt focused investments may involve various risks, including but not limited to unfavorable market conditions, loss of principal and limited liquidity.

#### TYPICAL CRE CAPITAL STRUCTURE

| | | |
|---|---|---|
| CRE Debt | Senior<br>Subordinate | **Senior debt/first mortgage** is the most senior tranche of the capital structure with the highest priority of repayment in the event of default and the lowest premium. Senior loans are collateralized by stabilized, income-producing assets and can be split into A-notes and subordinate B-notes. |
| CRE Debt | Mezzanine | **Mezzanine** is typically secured by a pledge of equity interests in a borrower who owns the real estate. Mezzanine lenders can exert a high level of influence and control in the event of foreclosure, but require capital and specialized skills to handle default situations. |
| | Preferred Equity | **Preferred equity** is usually structured as partnerships with the common equity, investors are paid a preferred return after all debts are satisfied, but before any equity distributions. |
| | Common Equity | **Equity,** or common equity, is the ownership interest in the property and is subordinate to all debt and preferred equity tranches. |

Senior loans tend to be the safest position in the capital structure—if a borrower defaults, these loans are paid back first. For investors targeting the more junior parts of the capital structure, such as preferred equity investments, there is a greater risk of non-payment in the event of default or under performance.

#### RISK-RETURN SPECTRUM WITHIN THE CRE CAPITAL STRUCTURE

Lowest Risk/Yield – Last Loss ← → Highest Risk/Yield – First Loss

| Senior | Subordinate | Mezzanine | Preferred Equity | Common Equity |
|---|---|---|---|---|
| Senior, first mortgages | Often B-Notes or senior mezzanine in structure | Often B-Notes, mezzanine, junior mezzanine or preferred equity in structure | Most often preferred equity in structure and high risk in nature | Ownership interest in property and subordinate to all debt and preferred equity tranches |
| Generally, last dollar exposure of 40% to 70% LTVs | Generally, last dollar exposure of 50% to 60% LTVs | Generally, last dollar exposure of 65% to 85% LTVs | Generally, last dollar exposure of 85%+ LTVs | Highest risk |

Source: CRE Finance Council: Investing in U.S. Commercial Real Estate Debt Products. Returns are the opinions of CREFC panel, 2016.

**While CRE debt investments may provide greater downside protection than CRE equity investments, they vary in degree of risk depending on their place within the capital structure and may decrease in value, lose value or fluctuate.** 2) Oxford English Dictionary. The origin of mortgage, Late Middle English: from Old French, literally 'dead pledge', from mort (from Latin mortuus 'dead') + gage 'pledge'. Late Middle English, defined as 1150-1500. 3) Mortgage Bankers Association, Commercial/Multifamily Mortgage Debt Outstanding, Q3 2017.

The risk-return profile of CRE loans is also impacted by whether mortgages are fixed or floating-rate. Fixed-rate loans, which move the risk of rising interest rates to lenders and investors by locking in a fixed interest rate for the duration of the mortgage, charge higher rates than variable-rate, also known as floating-rate, mortgages and generally impose significant prepayment penalties.

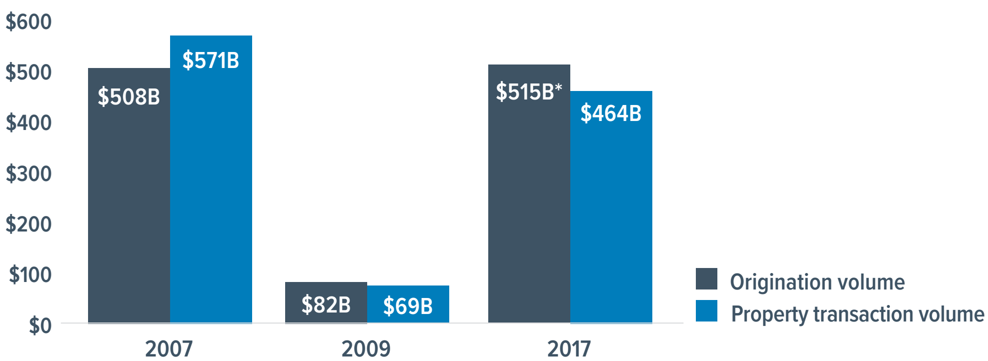
Floating-rate financing typically does not have prepayment penalties but provides lenders and investors protection from interest rate and inflation increases by moving in lockstep with government lending rates. Floating-rate loans are tied to the London Interbank Offered Rate (LIBOR), the interest rate that the largest international banks charge each other for loans.

## The CRE Debt Opportunity

Following the global financial crisis, the CRE debt market changed dramatically. In the years following the crisis, banks, insurance companies and investors in commercial mortgage-backed securities (CMBS) significantly scaled back their origination activities and lending activity dropped by more than 80%.[4] By 2009, government agencies such as Fannie Mae and Freddie Mac represented half the market.[5]

Today, CRE debt and equity markets have largely stabilized. Still, lenders and lender appetites are substantially different compared to the prior peak, creating an imbalance that may present attractive investment opportunities.

**CRE ORIGINATION VOLUME** (2007–2017)




Sources: Origination volume: Mortgage Bankers Association, October 2017 and NAIOP, June 2016; Property transaction volume: Real Capital Analytics, U.S. Capital Trends report January 2018. *Forecast.

**CRE LENDER COMPOSITION** (2007–2016)


Source: Real Capital Analytics U.S. Capital Trends Report, February 2017.

4) Mortgage Bankers Association, CREFC, May 2014. 5) S&P Ratings Report, "The U.S. Banks Are Increasing Their CRE Lending, But At What Risk?" May 2017.

### How has regulation impacted lenders?

The scale of the losses from the financial crisis coupled with increased regulatory scrutiny—not least of which followed the introduction of the Dodd-Frank Wall Street Reform and Consumer Protection Act—has helped sustain conservative underwriting of property loans in two key components of risk: loan-to-value (LTV) and debt service coverage ratio (DSCR).

LTV is the ratio of a loan to the value of an asset. This ratio is commonly used to represent the relative risk of an investment, with a higher LTV being riskier for lenders. DSCR is a measure of available cash flow to pay current debt obligations. During the underwriting process, lenders will assess a property's DSCR to determine the potential for default, with a DSCR closer to 1 representing greater risk to a lender.

Currently, LTV is significantly below 2007 levels and DSCR is higher than 2007 levels, denoting a comparatively safer lending environment.[6]

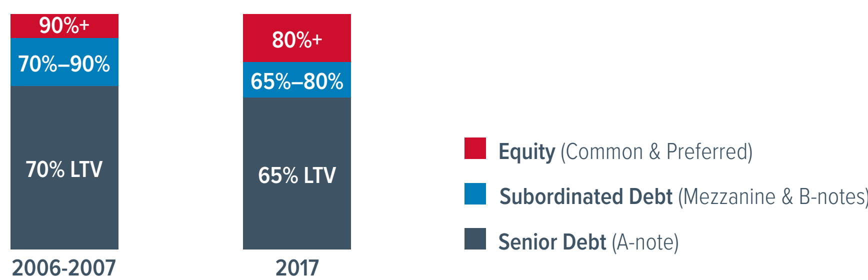
#### LENDER UNDERWRITING STANDARDS (2007–2017)

**2007**
**69.5%** LTV
**1.40x** DSCR

**2017**
**57.1%** LTV
**2.50x** DSCR

Source: Trepp, November 2017. CMBS average weighted loan-to-value and debt service coverage ratio.

#### EVOLUTION OF MAXIMUM LTVs WITHIN CRE CAPITAL STRUCTURE (2007–2017)




For illustrative purposes only. Sources: Cushman & Wakefield, 2017; CREFC, 2016; BlackRock, 2012.

### Has risk appetite changed?

Traditional lenders are actively lending again, but are more selective and conservative. They have increasingly focused on lower leveraged, stabilized, income-producing assets in major markets. As a result, properties outside major markets, or those in need of value-add work such as repositioning or redevelopment, have less access to financing. Construction and development projects face similar constraints.[7]

#### DECLINE IN NON-STABILIZED CRE LOANS BY FDIC INSTITUTIONS

**2008** **$591B**

**2016** **$313B**

Source: S&P Ratings, 2017. Construction and development loans held by all FDIC Institutions, C&D loans range from undeveloped land to transitional properties, according to S&P.

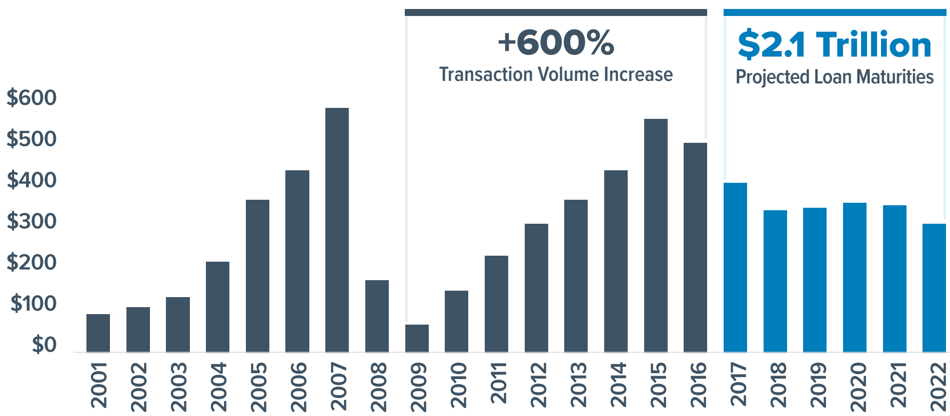
6) Trepp, November 2017. 7) S&P Ratings Report, "The U.S. Banks Are Increasing Their CRE Lending, But At What Risk?" May 2017.

**Will the CRE debt opportunity last?**

Demand for CRE financing is expected to remain robust, driven by both property transaction volume returning to pre-crisis levels[8] and the need to refinance maturing loans.

While property sales have reduced from their 2015 peak, institutional investor demand for real estate shows no signs of slowing. Target allocations by institutional investors to real estate surpassed 10% in 2017.[9] In addition, over the next five years, maturing CRE loans are valued at more than $2 trillion,[10] providing potential attractive financing opportunities for CRE lenders.

**CRE TRANSACTION VOLUME & PROJECTED CRE LOAN MATURITIES** ($ IN BILLIONS)




Sources: CRE transaction volume: Real Capital Analytics, through year end 2016. Based on independent reports of properties and portfolios $5 million and greater. CRE loan maturities: Federal Reserve, Trepp, Morgan Stanley Research as of March 2017.

## Portfolio Allocation to CRE Debt

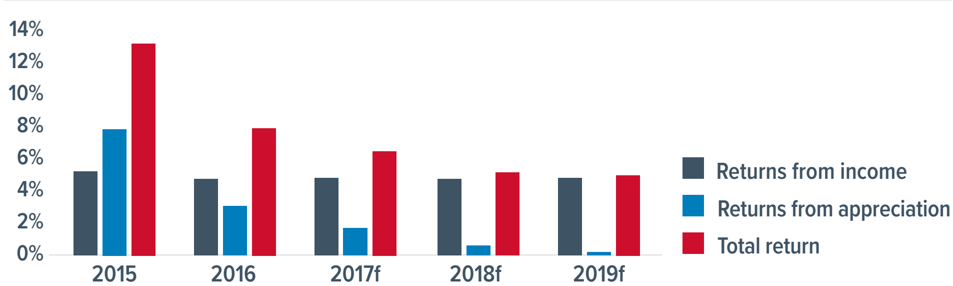
We believe three fundamental factors drive CRE debt allocations—potential for income, portfolio diversification, and the ability to generate risk-adjusted returns.

**Income**

Returns on real estate equity investments are driven by two components: income and capital appreciation. During market recoveries, returns from capital appreciation are typically higher than those from income. As the real estate cycle matures, income becomes paramount. In the U.S., CRE appreciation returns have started to slow significantly and are expected to be close to flat by 2019.[12]

27% of all investor fund searches and mandates issued in Q3 2017 included plans to invest in real estate debt.[11]

**CRE RETURNS** (2015–2019)

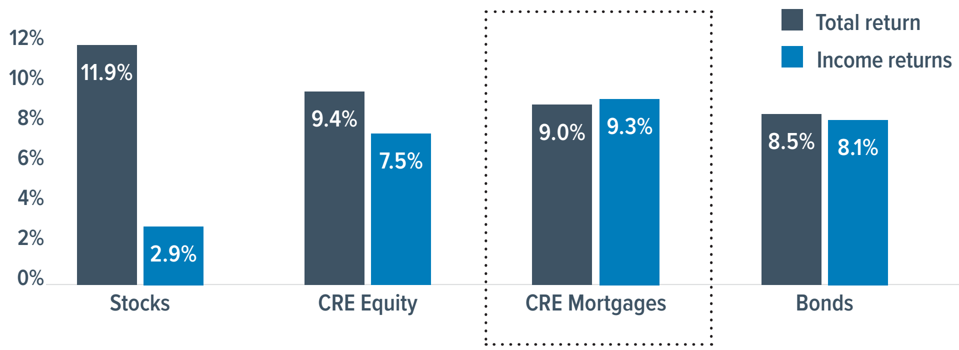



Sources: NCREIF Property Index (NPI) for 2015-2016; PREA Consensus Forecast for 2017-2019.

Past performance is no guarantee of future results. 8) Real Capital Analytics U.S. Capital Trends Year in Review 2016 report, January 2017. 9) Cornell University, Hodes Weill Associates Institutional Real Estate Allocations Monitor 2017. 10) Federal Reserve, Trepp, Morgan Stanley Research as of March 2017. 11) Preqin, September 2017. 12) PREA Consensus Forecast Q3 2017.

CRE debt is another story. For CRE loans, historic performance has remained strong, with mortgage income returns outperforming returns for stocks, bonds and real estate equity over an almost 40-year period.[13]

**AVERAGE ANNUAL RETURNS** (1978 Q4–2016 Q4)




Sources: S&P 500 Index, NCREIF National Property Index, Gilberto-Levy Commercial Mortgage Performance Index, Barclays Investment Grade Corporate Bond Index and Principal Real Estate Investors. Past performance is no guarantee of future results.

CRE debt may be an attractive option when crafting a sophisticated, diversified portfolio.

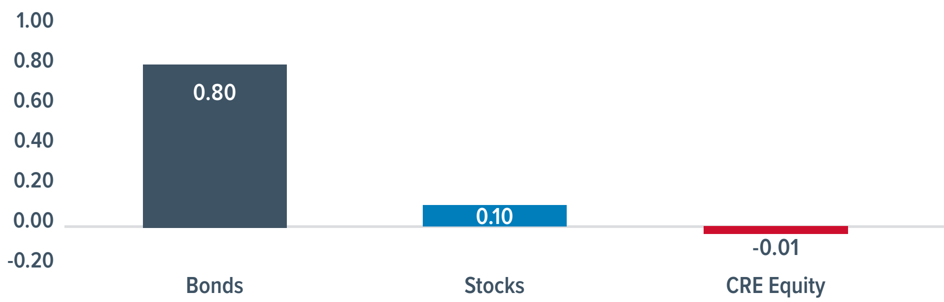
### Diversification

By including assets which have lower correlation to the broader stock and bond markets, investors may be able to reduce portfolio risk by avoiding the sharp highs and lows associated with investing in higher correlated asset classes.

CRE debt is highly correlated with corporate bonds, in part because both assets are affected by changes in underlying Treasury yields. Similar to corporate bonds, returns on CRE loans have a low correlation to stocks and CRE equity returns.

**CORRELATION OF QUARTERLY TOTAL RETURNS** (1978 Q4–2016 Q4)

CRE MORTGAGES VS. OTHER INDICES




Diversification does not eliminate risk and does not assure better performance. Sources: Gilberto-Levy Commercial Mortgage Performance Index, Barclays Investment Grade Corporate Bond Index, S&P 500 Index and NCREIF National Property Index and Principal Real Estate Investors. Past performance is no guarantee of future results.

13) Gilberto-Levy Commercial Mortgage Performance Index, Barclays Investment Grade Corporate Bond Index, S&P 500 Index and NCREIF National Property Index and Principal Real Estate Investors as of December 31, 2016.

**Risk-adjusted returns**

As with all investment opportunities, there are embedded risks to investing in CRE debt including the relative illiquidity of the underlying assets and the impact of market cycles.

To address risk concerns, investors may look to the structure of CRE debt—with lenders sitting below the first-loss position of borrower equity—to seek a level of protection from declining property values.

**CAPITAL PRESERVATION AMID VALUATION GAINS & DECLINES** ($ IN MILLIONS)


This illustration is hypothetical in nature and is provided for informational purposes only. Investing in CRE debt focused investments involves various risks including but not limited to unfavorable market conditions, loss of principal and limited liquidity.

Conservative LTVs also help the sector to potentially withstand further valuation declines by providing additional cushion between the first and last loss positions. Bank loss and delinquency rates for CRE debt are currently at their lowest levels since the depth of the financial crisis.[14]

**HISTORICALLY LOW CRE LOSS & DELINQUENCY RATES**

2009/10
**3.00%** LOSS RATES
**8.76%** DELINQUENCY RATES

2017
**0.04%** LOSS RATES
**0.76%** DELINQUENCY RATES

Source: Federal Reserve. 2009/10 loss rate, as of Q4 2009; 2009/10 delinquency rate, as of Q2 2010; and 2017 loss and delinquency rates, as of Q3 2017. Past performance is no guarantee of future results.

14) Federal Reserve charge-offs and delinquency rates of commercial real estate mortgages, all commercial banks. Latest data Q3 2017.

## The Case for Commercial Real Estate Debt Investing

CRE debt provides investors with a unique asset allocation strategy, combining the potential for current income, favorable risk-adjusted returns and portfolio diversification through a more defensive position in the CRE capital structure.

We believe those characteristics, combined with healthy commercial real estate fundamentals and demand for debt financing, will continue to encourage investors to include commercial real estate debt in their portfolios for the long-term.

### CONTACT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## MASTER-FEEDER STRUCTURE

CC Real Estate Income Fund* is an unlisted, closed-end fund that intends to invest primarily in a diversified portfolio of CRE and real estate-related investments including CRE debt, CRE securities and CRE equity. *CC Real Estate Income Master Fund (CCREI) is a master fund in a master/feeder structure, which pools investor capital raised through its feeder funds, CC Real Estate Income Fund, CC Real Estate Income Fund-T, CC Real Estate Income Fund-ADV and CC Real Estate Income Fund-C (each a Fund, and together the Funds). Each Fund invests substantially all of its assets in CCREI. **Investors in a Fund are purchasing shares of a feeder fund, not CCREI.** The investment results of each of the Funds are directly dependent on the investment results of CCREI, which seeks to execute the investment strategies described in each Fund's prospectus.

## RISK FACTORS

**An investment in CRE or CRE debt can vary in degree of risk and may decrease or fluctuate in value. As with any investment, there are various risks that investors should consider, including but not limited to unfavorable market conditions, loss of principal, limited liquidity and increased risk. An investment in a Fund is not a direct investment in CRE or CRE debt and is significantly different than investing in traditional investments such as stocks and bonds. An investment in a Fund is subject to fees and expenses that do not apply to such direct investments.** An investment in a Fund involves a high degree of risk and may be considered speculative as well as illiquid and a prospective investor should invest only if they can sustain a complete loss of their investment. The following are some of the risks involved in an investment in a Fund: (i) only a limited number of each Fund's shares may be eligible for repurchase under a Fund's share repurchase program, and the share repurchase program may be terminated at any time. As such, you will have limited to no access to the money you invest for an indefinite period of time; (ii) no guarantee of distributions, and it is expected that some of the Funds' distributions, if any, may be paid from the proceeds from the offerings. It is expected that for a period of time, which time period may be significant, substantial portions of distributions may be funded through the reimbursement of certain expenses of, and the payment of additional support to, the Funds and CCREI by an affiliate of Colony Capital, Inc, NorthStar FV Holdings, LLC. While the purpose of this arrangement is to seek to minimize the extent to which any portion of distributions will be characterized as a return of capital, such distributions may still be characterized as a return of capital, which may reduce an investor's overall return. Additionally, for Fund-T, Fund-ADV and Fund-C investors, a distribution and servicing fee is paid out of the applicable Fund's assets on a monthly basis, increasing the cost of an investment in Fund-T, Fund-ADV and Fund-C, respectively, over time; (iii) as shares are not listed on an exchange and it is not anticipated that a secondary market will develop, investors will have limited liquidity and may not receive a full return of their invested capital if they sell their shares; (iv) the Funds are recently organized companies and have limited operating history; (v) investors will incur immediate dilution as a result of any selling commissions and dealer manager fees paid by an investor and offering expenses the Funds will incur; (vi) no guarantee that the investment objectives of the Funds will be attained; (vii) payment of fees and expenses will reduce the cash available for investment, the net income generated, the cash available for distribution and the book value of the shares; (viii) financial risks associated with real estate investments, including the inability to dispose of certain assets at a fair price; and (ix) CCREI may make investments in below investment grade securities, which are speculative and may be illiquid and difficult to value.

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