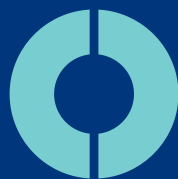
Schroders

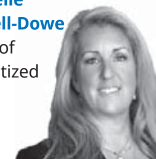
For Financial Intermediaries, Institutional and Consultant use only.
Not for redistribution under any circumstances.



Fool's Gold: Mining for "True" Value in the US Commercial Real Estate Debt Market

Distinguishing between income oriented investments with a safer risk profile and investments which offer yield, but have highly binary potential outcomes, is crucial in today's lower yielding environment. The concept of proper compensation for risk should have been the primary lesson learned post global financial crisis. But after nearly 10 years, the market has lost its memory and many investors are now combing through riskier securities in a search for yield. In many cases, we believe investors will end up with "fool's gold".

Michelle Russell-Dowe
Head of Securitized Credit

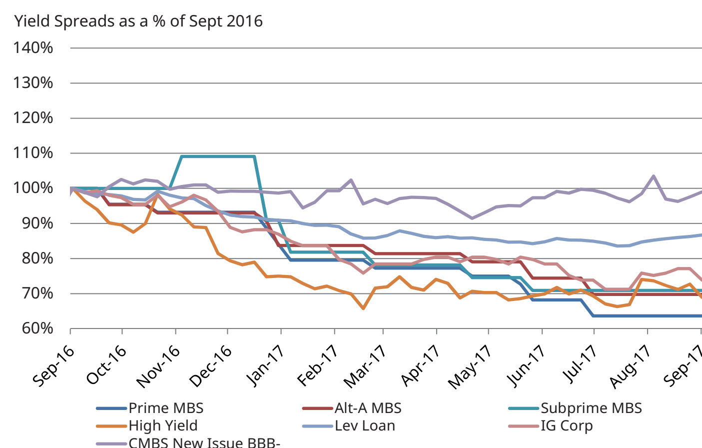


Jeffrey Williams, CFA
Fund Manager, Securitized

"Fool's gold" was the nick-name given to a common mineral that was often mistaken for gold. During the California Gold Rush, pyrite dashed the dreams of thousands of prospectors. While pyrite has a color and a metallic luster in common with gold, the similarity in characteristics, and in value, ends there. Pyrite has tricked countless prospectors into thinking they'd found something valuable when they had not.

With central banks having flooded the market with liquidity, compensation for risk has declined. There is little compensation for volatility, which is low, for term risk, and compensation for credit risk has declined substantially (Figure 1).

Figure 1: Broader asset types shows systematic decline



Source: Data within JP Morgan markets. Yields fluctuate over time.

Investors are the prospectors

As yield has declined many investors are reaching out into more complex sectors and securities in search of yield. But, our concern is that in the search for yield, investors may have forgotten the lessons learned over the past decade. Like the California prospectors, they may have found something that looks like gold, but isn't.

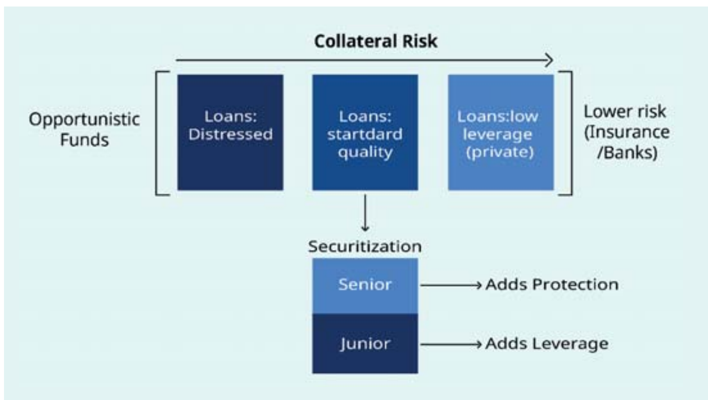
Background

Securitization is the act of taking an income stream and creating securities. The process introduces an element of complexity to what is otherwise a fairly straightforward repayment of a secured loan. Loan repayment is a cash flow. Securitization takes that single stream of cash flow from one loan, scales it up (many loans) and divides it based on a priority. The first priority, or the most certain cash flow, is often called the senior class. Typically, the senior class gets its capital back before the more junior classes receive return of capital. In this way, the junior classes "protect" the senior class by acting as a shock absorber during times of uncertainty or stress.

As the "shock absorber" the junior class is also more sensitive to any changes in risk. In this way, it has more leverage, or sensitivity, to risk factors. The division of the cash flow can be more or less complicated, but the goal is to create a distribution of cash flows that may appeal to investors with a variety of risk tolerances.

As markets move through the credit (fundamental) cycle, there are times when an investor's preference should be to add protection (owning a senior class). There are also times in the credit cycle when their preference should be to add leverage (a more junior class) and there are times when their preference should be to provide liquidity (owning the unstructured loans/receivables).

Figure 2: The risk profile of a typical securitized investment



Source: Schroders. For illustrative purposes only. Senior securitization protection referenced herein refers only to the relative capital loss potential in the event of a negative credit event, not a guarantee of capital protection.

Today, we believe that for the US, major commercial real estate markets are nearer the top of the real estate cycle. As such, it is not a time to add junior classes; rather we believe it is a time to benefit from inefficient markets and provide liquidity to fill "gaps" in financing created by regulation of banks.

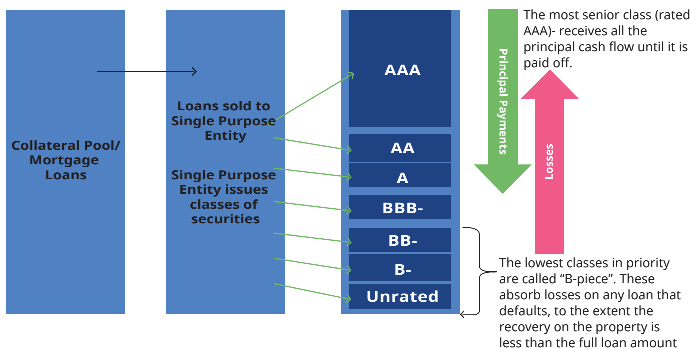
While most credit investments have seen substantial yield spread reductions, commercial mortgage-backed securities rated BBB minus (BBB-) have not.

We are very concerned that CMBS securities, even those rated BBB-, are mispriced and likely incorrectly rated, and stand to disappoint investment prospectors down the road.

CMBS – Understanding the terminology

To appreciate the problem, we need a lesson in terminology. First, a mainstay of CMBS issuance is the "multi-borrower", or conduit, market. These "**conduit**" deals are typically arranged by Wall Street, and they pool together a diverse group of loans made to different borrowers, secured by different commercial real estate properties. The CMBS issuing trust issues multiple classes of securities, called a **senior-subordinate** structure.

Figure 3: A typical CMBS deal structure



Source: Schroders. For illustrative purposes only.

The senior subordinate structure means one class is a senior class. The senior class is protected by more junior classes, or "the shock absorbers". Together, all the classes are referred to as the capital stack. The three classes lowest in priority (BB-,B- and NR in Figure 3) are often referenced as a group and called the 'B-piece.'

The class just above the B-piece is the BBB- class. In our view, the BBB- class is where there's the greatest illusion of safety, given that these bonds are considered investment grade by the rating agencies.

Using a numeric example, the BBB- class generally has credit support from the B-piece, which is just 7%[1] of the capital stack. This means that after loan losses reach 7%, all the shock absorbers (B-piece) for the BBB- class will be gone, having experienced a full loss of par. Any loan loss greater than 7% would result in a loss of principal for the BBB- class. If the BBB- class represents 3% of the capital stack, the BBB- class would experience a full loss of principal once loan loss reached 10%.[1] In the case of such an event, the BBB- would receive no principal repayment. This was common in the vintages from 2005-2008.

In our securitized jargon, we call the subordinate classes structurally leveraged exposures. It means there is little "protection" from the securities more junior, AND, the class itself is a "shock absorber" for a more than 90% of the issued securities. As a result, a relatively small variation in lifetime pool losses can have a disproportionate impact on the investment.

During the Global Financial Crisis, the B-piece and BBB- securities were among the worst bonds to own, suffering near complete loss of principal. Figure 4 below illustrates the principal loss percentage for securities, by vintage and rating. It is clear that even for securities rated as high as A- or BBB-, the principal loss experience was severe (50%-100% of par was lost)

Figure 4: CMBS cumulative loss rates by original rating by Vintage leading up to the financial crisis

Original Rating	2005	2006	2007	2008
AAA	0.02%	0.21%	0.18%	1.58%
AA-	5.78%	23.46%	33.52%	40.35%
A-	19.85%	61.11%	56.01%	68.13%
BBB-	70.37%	93.68%	86.38%	81.79%
BB-	87.24%	99.51%	93.95%	100.00%
B-	97.47%	100.00%	100.00%	100.00%

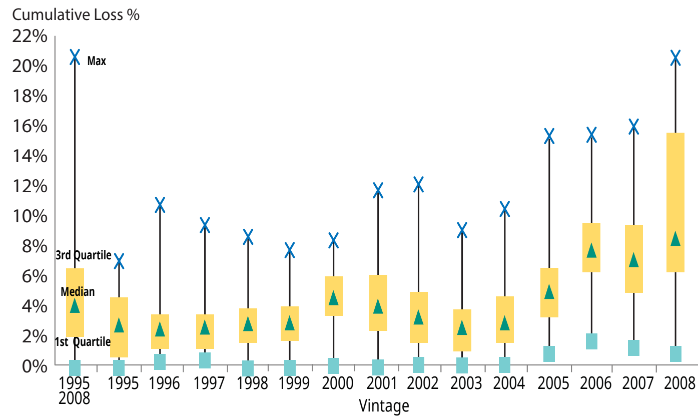
Source: Wells Fargo, May 2017

Do you feel lucky?

The securities issued in the years of the most aggressive underwriting (above) 2005-2008, are clear examples of negative outcomes. But, even in years with less aggressive lending we see that losses on individual pools have varied substantially. In Figure 5 on the next page, the green triangle indicates the average pool loss for each issuance year, and the "X" indicates the loss for the weakest pool. A range of 0% to 10% for pool loss has not been uncommon.

1 These numbers are specific to each pool, and are illustrative in this example.

Figure 5: CMBS conduit cumulative loan pool losses by Vintage

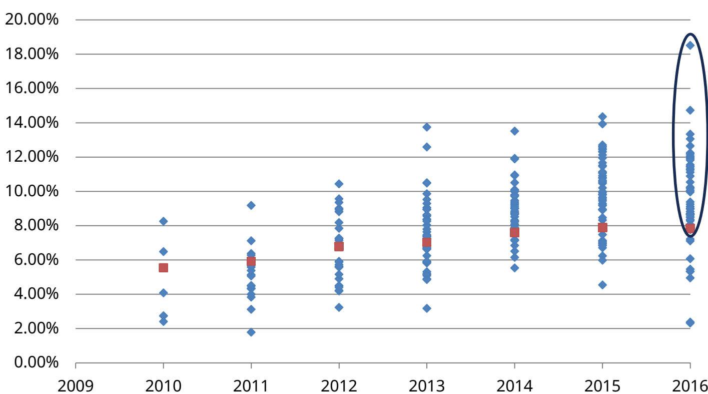


Source: Intex Solutions, Inc. and Wells Fargo Research, May 2017

For example, in Figure 5, the average loss for pools in 2008 is about 7.75%, but even at that level, the BBB- investor saw loss of principal if the credit protection was only 7%. As well, the average doesn't matter to the investor in the pool with 18% loss. In this example, the investor would suffer a 100% principal loss in their BBB- class.

Looking back provides a good lesson. But looking forward, we see trouble as well. In Figure 6, for each issuance year following the Global Financial Crisis, we plotted the potential loss projections for each CMBS deal (blue diamonds), in addition to the average credit support/loss protection for the BBB- rating (red squares). According to our calculations, more than two-thirds of the BBB- bonds issued after 2012 could incur a loss of principal. The BBB- classes with expected loss are represented by the blue diamonds that sit higher than the related red diamond (circled in the 2016 vintage).

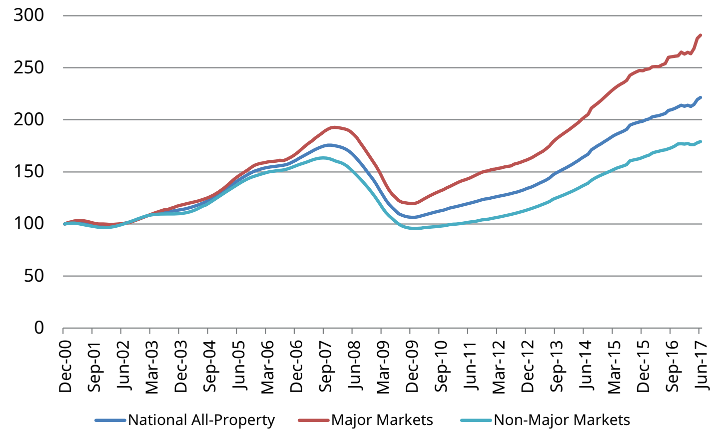
Figure 6: Our projected CMBS conduit cumulative losses by Vintage



Source: Schroders, as of June 2017. The views and opinions herein are those of the authors and are subject to change over time. There can be no guarantee that these, or any, forward-looking investment results will occur in the future. Please refer to the back of this report for important information

Truth be told, owning a leveraged risk exposure, like a BBB- class, may be justifiable when the credit cycle is healthy and property values are expected to appreciate. In Figure 7, for the 2003 issuance year, pool losses were lower than 4% for all but the worst quartile. Prudent credit work, and a supportive real estate market make decent opportunities possible. But, today, we believe that we are closer to the top of the market than to the bottom. The rapid price appreciation of the commercial real estate market is clearly illustrated below.

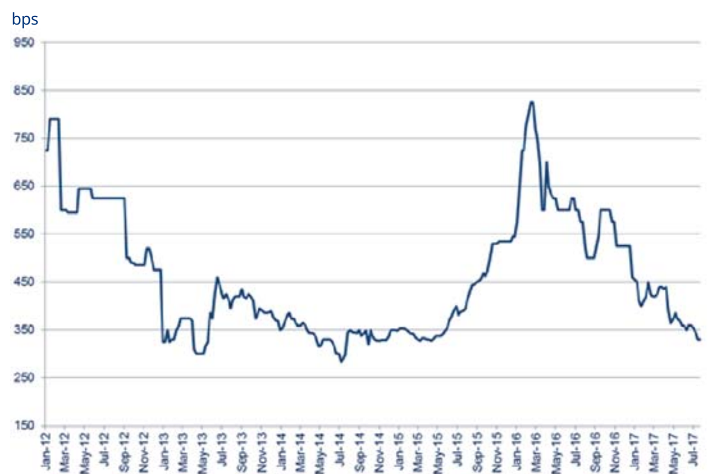
Figure 7: Historical commercial real estate prices



Source: Moody's/RCA CPPI Index through December 2016. Rebased to 100.

This cycle has expanded well beyond prior peaks and is occurring at a time when the level of compensation offered by yields on CMBS subordinated classes is notably low (Figure 8).

Figure 8: Historical CMBS spreads

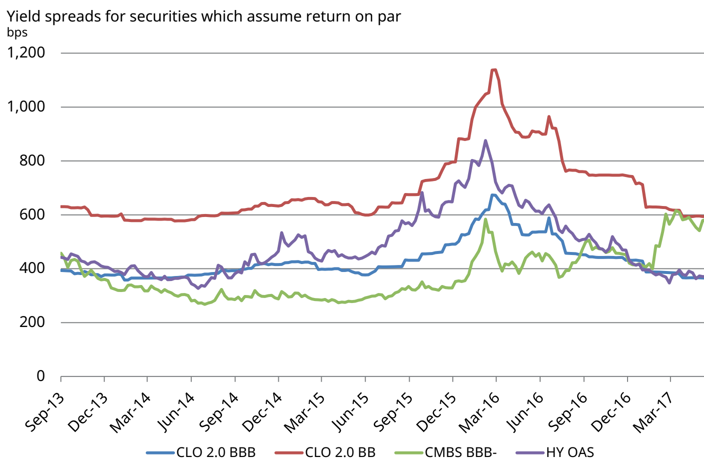


Source: JP Morgan, July 2017

CMBS BBB- bonds currently trade with a spread of 335 basis points, which represents a yield of less than 5.75% for a 10-year bond. To put this in perspective, in the corporate credit world we estimate that bonds with similar structural leverage characteristics (where reasonably foreseeable increases in defaults are likely to generate no recoveries) would not even qualify for a CCC rating, and would be expected to currently trade with a yield much higher than 6%.

In our view the publicly-traded, subordinated securities, such as the BBB- CMBS bonds, do not adequately compensate investors for the current risks. CMBS are not the only junior investments. Other subordinated securities, are common, like BBB or BB Collateralized Loan Obligation (CLO) classes. These classes have similar structural leverage and relatively low levels of compensation. But CLOs do not generally have individual loan concentrations that are high, the bank loan portfolios are generally well diversified whereas some CMBS loans can represent more than 10% of a pool. As well, CMBS are static pools, whereas a CLO structure has some management flexibility which allows managers to monitor tail risk and to make adjustments.

Figure 9: Historical yield spreads between illiquid and traditional fixed income asset classes



Source: JP Morgan, Morgan Markets, July 2017. Yields fluctuate over time.

So where do we look for value?

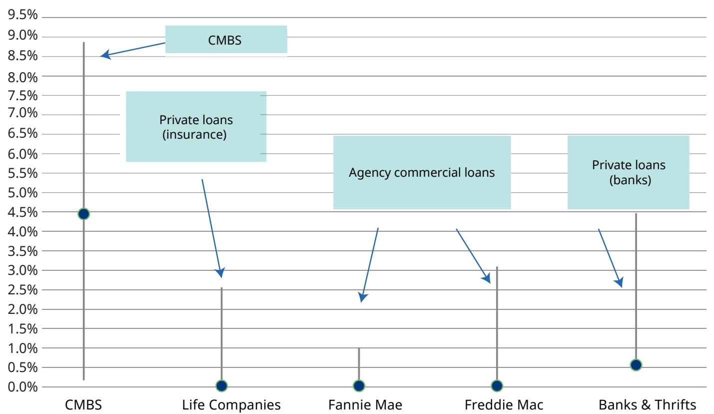
In the light of the combination of high valuations and low risk compensation, we believe safer opportunities can be found in providing capital where regulation has limited lending or financing.

We believe there are a few attractive options.

1. Lending in the private commercial mortgage loan market where loan size is less than $50 million has become less efficient. Regional banks have been limited by their regulator, and the larger private equity and debt firms are not efficient enough to underwrite and originate smaller loans.
2. With regulation, the size of each CMBS deal has declined, which has displaced loans over a certain size (typically $100mm). These loans are relegated to a “single-asset deal” and the rating agencies severely limit loan leverage due to the lack of diversity. This limitation opens up the ability to provide gap financing on high quality properties with longer operating histories.

In essence, avoid the crowds in the credit trade. We see opportunities to find secured real estate exposure through private loans with current yields that range from 6% to 10% on low leverage, secured, private commercial mortgage loans. Private loan loss experience has been much better than that of CMBS loans in general, based on the default experience of life insurance companies or banks (Figure 10).

Figure 10: Loan delinquency rates and range since 1996



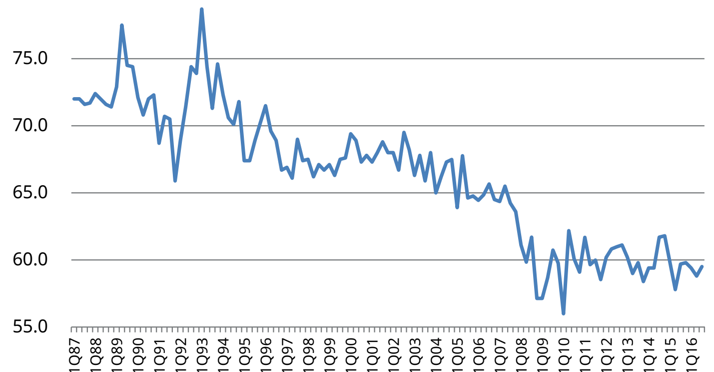
Source: (US) Mortgage Bankers Association, June 2017

Other credit factors

Supporting the positive credit story of private loans versus CMBS is the former’s lower leverage, as indicated by lower loan-to-value ratios, shown in Figure 11. In recent years, even lower leverage in the private loan market has been driven by regulation in response to the Global Financial Crisis.

After the financial crisis experience, many real estate owners prefer to borrow outside of the CMBS market. The rigid rules around servicing for CMBS limit workout options and flexibility. Many better-quality borrowers with other options now seek financing outside the CMBS market.

Figure 11: Historical life insurance company loan-to-value ratios



Source: Morgan Stanley Research, ACLI, March 2017

In addition, many borrowers don’t fit the “one-size-fits-all” definition for loans financed by the CMBS market. Borrowers will look for loans in the private market, including bridge loans, which provide a bridge to a new permanent loan as a property is stabilized. These purposeful loans are often the meaningful solution for a property that was overleveraged in a CMBS deal, and was subsequently purchased at a discount in a liquidation. These low leverage loans are typically 3-5 years and typically yield LIBOR + 5% at a 60% loan-to-value ratio.

Chart 1: A comparison of Loans and CMBS securities

Attributes	First Mortgage	Second Mortgage	BBB-CMBS
Investment Type	Private Loan	Private Loan	Security
Loan-to-Value: Collateral*	60%	75%	100%+
Structural Leverage	None	4x	9x
Control Loan Servicing	Yes	Yes	No
Yield	6.25%	10.00%	5.50%
Interest Rate Duration	None	None	9 years

*CMBS LTV is the rating agency LTV

Source: Schroders. Loan types and securities shown are for illustrative purposes only and do not serve as any recommendation to buy or sell any security. Yields are not guaranteed and are subject to change over time.

As a liquidity provider, you have lower risk and earn higher income, but private mortgage loans are not as liquid as CMBS bonds. While loans trade in the secondary market transactions, these settlements and negotiations are longer, measured in weeks rather than days. That said, for some types of syndicated loans, a recent phenomenon has resulted in the use of an ISIN/CUSIP which allows trading on similar terms to a bond.

Conclusion

All that glitters is not gold. It seems that some investors have forgotten the lessons of the past as they prospect for yield. Indeed, we would argue that historically low interest rates have pushed investors to prospect for yield in complex securities with exponentially higher risk. This yield seeking has impacted many securities markets, and has the potential to create particular trouble in the CMBS market, where structural leverage, peaking loan leverage and concentration risks are all coming together at once.

In our view, more compelling risk and return opportunities exist in private commercial mortgage loans. This segment of the market provides the ability for investors to be more appropriately compensated for risk by committing capital to a lower leverage investment, and allowing investors to carefully select property and location. History demonstrates the superior performance of private loans compared to CMBS loans. For those willing and able to do the necessary real estate credit work – and with the courage to avoid the crowds – we believe loans are an attractive investment alternative in today's low-yield environment.

Schroders

Schroder Investment Management North America Inc.
7 Bryant Park, New York, NY 10018-3706

schroders.com/us
schroders.com/ca

@SchrodersUS

Important information: The views and opinions contained herein are those of the Schroders Securitized Team and do not necessarily represent Schroder Investment Management North America Inc.'s (SIMNA Inc.) house view. These views and opinions are subject to change. Companies/issuers/sectors mentioned are for illustrative purposes only and should not be viewed as a recommendation to buy/sell. This report is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for accounting, legal or tax advice, or investment recommendations. Information herein has been obtained from sources we believe to be reliable but SIMNA Inc does not warrant its completeness or accuracy. No responsibility can be accepted for errors of facts obtained from third parties. Reliance should not be placed on the views and information in the document when making individual investment and / or strategic decisions. The opinions stated in this document include some forecasted views. We believe that we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee that any forecasts or opinions will be realized. No responsibility can be accepted for errors of fact obtained from third parties. While every effort has been made to produce a fair representation of performance, no representations or warranties are made as to the accuracy of the information or ratings presented, and no responsibility or liability can be accepted for damage caused by use of or reliance on the information contained within this report. All investments involve risk, including the risk of loss of principal. Past performance is no guarantee of future results. SIMNA Inc. is registered as an investment adviser with the U.S. Securities and Exchange Commission and as a Portfolio Manager with the securities regulatory authorities in Alberta, British Columbia, Manitoba, Nova Scotia, Ontario, Quebec and Saskatchewan. It provides asset management products and services to clients in the United States and Canada. Schroder Fund Advisors LLC ("SFA") is a wholly-owned subsidiary of SIMNA Inc. and is registered as a limited purpose broker-dealer with the Financial Industry Regulatory Authority and as an Exempt Market Dealer with the securities regulatory authorities in Alberta, British Columbia, Manitoba, New Brunswick, Nova Scotia, Ontario, Quebec and Saskatchewan. SFA markets certain investment vehicles for which SIMNA Inc. is an investment adviser. SIMNA Inc. and SFA are indirect, wholly-owned subsidiaries of Schroders plc, a UK public company with shares listed on the London Stock Exchange. Further information about Schroders can be found at www.schroders.com/us or www.schroders.com/ca. Schroder Investment Management North America Inc. (212) 641-3800.

WP-FOOLSGOLD