Getting comfortable with CRE CLOs

As videos of youngsters spending the night in retail stores unnoticed go viral, **Värde Partners** gets comfortable in commercial real estate another way, through CLOs

One of the many casualties of the financial crisis was the size of the commercial mortgage backed securities (CMBS) market. These securities, which were typically issued by bulge bracket banks, were a major source of financing for the commercial real estate (CRE) industry prior to the crisis. But as banks were forced to tighten their balance sheets in response to increasingly strict regulations and capital requirements, many pulled back from the CMBS market.

According to the Commercial Mortgage Alert, CMBS issuances during 2017 totalled $95bn, a far cry from 2007 when an all-time high $230bn of deals were securitised. Top CMBS lenders predict that CMBS volume will continue to shrink in 2018, dropping to as low as $75-$80bn.

This decline created a capital gap for real estate investment firms and property developers that depend on longer-term fixed rate conduit loans to fund acquisitions and other growth-oriented deals. Fortunately over the last few years, non-bank lenders have stepped in to fill the void as a source of capital for the CRE market. However, instead of copying the banks' business model and continuing to offer long-term fixed rate loans, these non-bank lenders have filled a different need by offering shorter-term floating rate loans to 'bridge' a borrower's business plan to either a sale or a longer-term refinance option such as CMBS. These loans can then be aggregated by the non-bank lenders and sold into the capital markets through a CRE CLO.

These CRE CLOs, which are a hybrid of a traditional CMBS and a corporate CLO, are fundamentally different than what bond investors may be used to from pre-crisis times, in part because the issuers (i.e., non-bank lenders) are not solely focused on generating fees but rather on using these transactions as a financing tool for their business. Notably, instead of selling the whole loan into a trust and realising the gain on sale, the aforementioned financing angle means the issuer is typically retaining the below investment grade bonds, assuming the first loss position instead of selling it to a third-party 'B-piece' buyer. This approach creates an alignment of interests between issuers, bond investors and borrowers, helping ensure each party can meet its objectives through the transaction.

As a result of this and other factors, CRE CLOs are becoming more widely understood and are now attracting strong demand from bond investors, who continue to search for yield and are attracted to the floating rate nature of the product, yet want to stay shorter-dated based on where we are in the economic and commercial real estate cycle. Värde Partners closed a CRE CLO in February, which is one of six CRE CLOs this year, totalling a combined size of $3bn.

To further understand the investment opportunity and what bond investors should know about CRE CLOs, this piece will provide answers to four important questions.

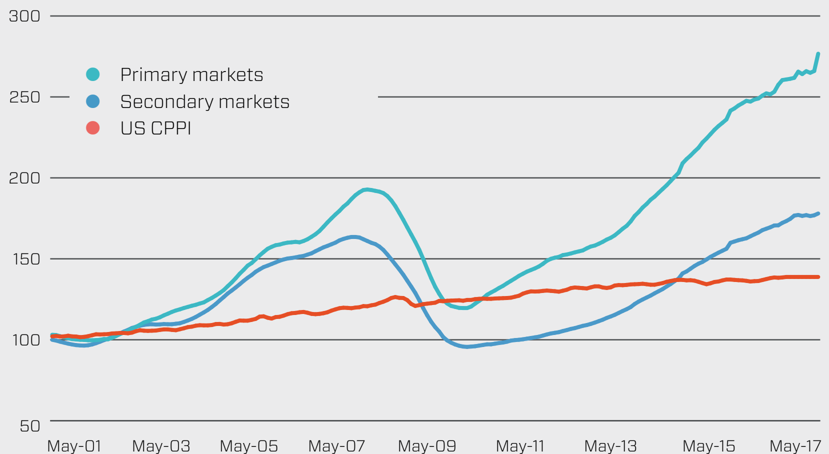
Why is the current market environment favourable to CRE CLOs?

To answer this question, one needs to look at underlying CRE fundamentals which drive demand for CRE loans, which ultimately are contributed into CRE CLOs. The CRE market has largely recovered since the financial crisis, buoyed by strong US and global economic growth. According to a recent *RCA US Capital Trends Big Picture* report, CRE transaction volume in the third quarter of 2017 came to $114bn, making it the 13th straight quarter to pass the $100bn mark. As a comparison, the 10 quarters between Q2 2008 and Q3 2010 failed to pass even $50bn in CRE deals.

Additionally, CRE prices have steadily increased every quarter, according to data compiled by the Federal Reserve Bank of St. Louis. This increased level of transactions

means increased lending opportunities. Although there is growing trepidation that the nearly 10-year-old bull market may have peaked, we believe there is still room for CRE prices to grow. This is particularly true of 'non-gateway' (or secondary) markets that may not have rebounded as quickly. According to RCA, the six largest 'gateway' CRE markets have seen CRE values rise 44% above [2007] vs all other US market which are up only 9% above 2007 levels.

As a result of this growth in short-term floating rate CRE lending by non-bank lenders, CRE CLOs have also enjoyed strong growth during this period. CRE CLO issuance, peaked with a post-crisis supply high of $8bn in capital raised across 19 deals in 2017, representing a nearly fourfold increase in issuances in 2016, according to data from Moody's. This activity is expected to continue into 2018 as bond investors become more familiar with the asset class and the tailwinds fuelling its growth.



How are CRE CLOs today different compared to pre-crisis CRE CDOs?

The CRE CLOs of today offer a number of structural advantages. For one, these types of CLOs are typically backed by first-lien whole loans, which offer improved collateral and require less leverage than the 'kitchen sink' of products contributed to legacy CRE CDOs.

In addition, CRE CDOs of the past were typically 'managed' in nature, allowing collateral managers to actively buy and sell the underlying exposures during a revolving period without a well-defined box of what managers could purchase into the structure. CRE CLOs today are largely structured as 'static' transactions with a defined pool of assets that investors can underwrite upfront. Any deals structured as 'managed' have well-defined, tight standards of what could be purchased as the initial assets repay.

Today's CRE CLOs also offer improved alignment between investors and issuers in that issuers are required to abide by risk retention rules to maintain at least 5% of the structure's value or place it with a 'B-piece' which is typically a sophisticated mortgage investor. Market practice has largely been to maintain all of the below investment grade bonds by sponsors.

Why may bond investors find CRE CLOs attractive?

Investors looking to optimise the fixed-income portion of their portfolio have a universe of options to consider. With some market indicators suggesting we may be near the end of the credit cycle, many investors are concerned about their fixed-income investments and are seeking shorter duration assets.

For these investors, the CRE CLO market offers several advantages over other fixed-income instruments that should help to allay those concerns. For one, these CLOs tend to be short-term in nature with short-duration cash flows of only two to three years, compared to 10 years or more for a typical CMBS. This helps limit bond investors' exposure, and therefore risk, should the credit cycle unexpectedly flip.

In addition, these CRE CLOs tend to be backed by strong collateral in the form of CRE properties such as office buildings, multi-family apartment buildings, industrial properties and flagged hotels.

When compared to legacy CRE CDOs where bond investors may have had trouble understanding the underlying collateral, CRE CLOs are transparent and easier to evaluate.

What should bond investors look for in a CRE CLO?

Like many investments, bond investors should know that no two CRE CLOs are going to be alike. But there are several qualities or characteristics of CRE CLOs that may indicate a potentially attractive investment opportunity.

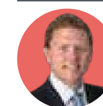
First, bond investors should consider the background and expertise of the issuer. An issuer with deep credit and CRE expertise is important given the hands-on nature of the collateral that often requires both real estate knowledge and asset management capabilities to underwrite and work through business plans with the borrower post-closing. An issuer's track record, platform capabilities and historic performance are thus critical.

Second, bond investors should evaluate the underlying loans in the CLO to ensure it is properly diversified across property types and geographies. For example, a CLO providing significant exposure to retail CRE properties likely carries significantly more risk than investors are looking for in today's market. Similarly, a CLO with significant exposure to a particular geographic area may be susceptible to local economic changes and swings.

Finally, bond investors may consider looking for institutional asset managers who have stable capital and are likely to be repeat issuers of CLOs. It goes without saying that most investors conduct extensive due diligence on any potential investment opportunity, including evaluating the issuer and its platform. If an issuer has an established track record in the capital markets, investors will be able to focus their due diligence on evaluating the collateral of each deal.

Conclusion

The CRE CLOs of today are drastically different than the CRE CDOs that were prevalent before the financial crisis and may offer a shorter-term more attractive yield vis-à-vis CMBS. Bond investors looking to diversify their portfolios and increase cash flows should look carefully at CRE CLOs as a potential source of strong risk-adjusted returns.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