Blog February 19, 2021

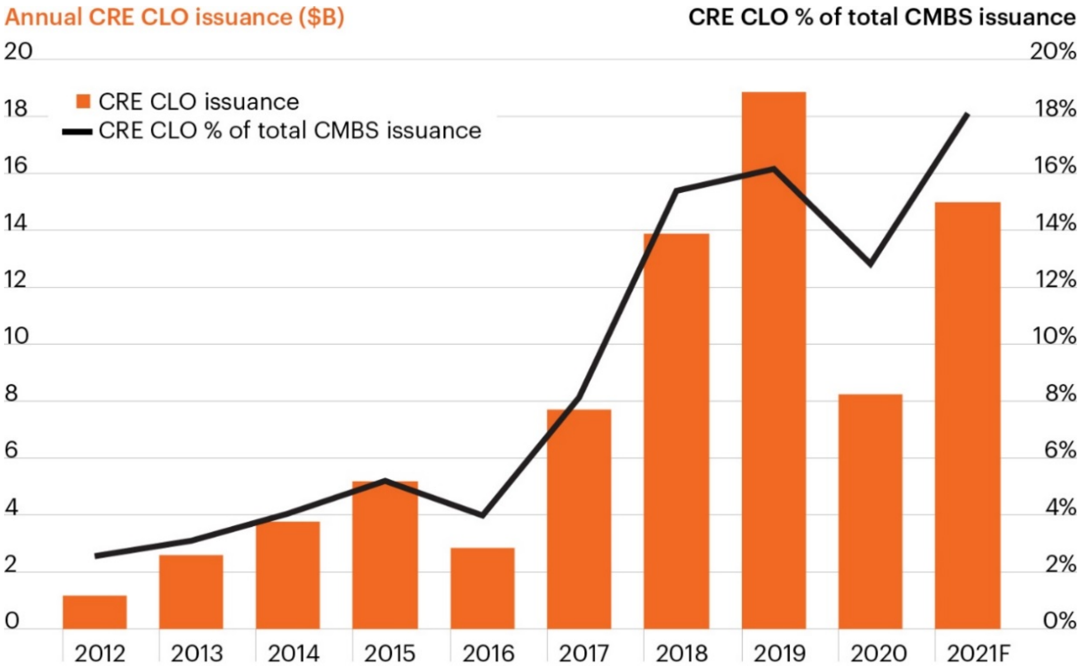
An age-old tale: The veteran vs. the newcomer

What does Super Bowl LV have to do with the commercial real estate lending space?

What sports fan doesn't love a classic rising star vs. veteran matchup? Prior to the actual game, Super Bowl LV was heralded as potentially the greatest of all time—the plucky upstart, Patrick Mahomes, going head to head with the grizzled veteran, Tom Brady. And while one side didn't seem to show up for the showdown in Tampa Bay, a parallel matchup is developing in the commercial real estate (CRE) lending space that may entertain investors for years to come.

When it comes to commercial real estate debt securitization, most investors are familiar with the veteran, the commercial mortgage-backed security (CMBS), but far fewer have exposure to the relative newcomer, the commercial real estate collateralized loan obligation (CRE CLO), which has been gaining market share in recent years.

CRE CLO annual issuance grew at a fast pace before slowing down in 2020 due to COVID-19



Source: J.P. Morgan, Bloomberg Finance, L.P.

Both vehicles were put to the test last year during the market gauntlet of COVID-19. Before we get to the outcome, it is important to set up the backstory.

The veteran: CMBS

While the CMBS market had already been around for many years, it emerged as a dominant source of financing just prior to the Global Financial Crisis, with annual volume reaching $229 billion in 2007 before falling to just $3 billion in 2009. The excesses of that time were quickly exposed as many pre-crisis deals struggled to control losses and issues with the structure became apparent. After years of limited activity, CMBS 2.0 was born with more restrictive structures, risk retention requirements and more conservative lending practices, leading volumes to recover after many years of limited issuance.

What is important to know about most CMBS securitizations is that the pools of loans that go into these vehicles are often from multiple lenders. To make these loans more easily securitized, there are certain standard terms that are used across the board. Importantly, the underlying loans are typically fixed rate loans with terms often ranging from 5 to 10 years. For this loan type, the underlying collateral generally consists of fully stabilized properties across various CRE sectors, from office to hospitality and retail. Once the loans are identified and the pool is fixed, there are no major changes to the collateral securing the CMBS bonds going forward.

Ultimately, when the loans are packaged up and securitized—with market participants buying various tranches of bonds—the first-loss position (known as the B-piece) is often purchased by a third party that may or may not have contributed loans to the pool. The B-piece buyer will have some control rights over the pool, including the ability to select certain administrative parties, such as the special servicer who addresses problem assets, as well as the ability to influence the mix of loans in the overall pool.

The challenger: CRE CLO

While CRE CLOs are not a completely new animal, they are very different from CMBS in a number of key ways.

- **Floating rate loans, transitional assets:** The underlying assets of a CRE CLO are short-term floating rate loans collateralized by transitional properties. Transitional properties span a wide range, basically running the gamut from a lease-up on new construction to fully stabilized. Light transitional assets may include an office property with some significant near-term lease turnover that needs to be managed or a multifamily property undergoing a light refresh of units to increase rents. Heavy transitional assets may include more significant repositioning or a full lease-up. As a result, these loans are much more highly structured and customized to individual business plans, giving lenders tight controls on borrower activities and property cash flows.
- **Managed deals:** Unlike the pools of loans in a CMBS transaction, which are largely static (i.e., set it and forget it), the trend in the CRE CLO market has been toward managed deals where the sponsor/manager of the pool is permitted to add and remove loans during a specified reinvestment period. This feature provides an additional layer of safety as managers have the ability to actively manage the pool of loans backing the CLO, giving them a much greater degree of control compared to a static CMBS transaction. This helps align managers and investors, as managers with better track records tend to be rewarded with lower costs of capital over time (they can sell bonds at lower interest rates).
- **Balance sheet financing:** While the first-loss piece in CMBS offerings is often sold to a third-party investor that may not have been involved in originating the underlying loans, CRE CLOs are often used as a balance sheet financing tool for the loan originator. In other words, the first-loss risk of the loans in the pool remains with the party that originated the loans. As a result, the CRE CLO manager is likely to have much more familiarity with the underlying properties, a closer relationship with the borrowers and a more hands-on approach to managing the underlying loan pool.

Collateral characteristics	CMBS	CRE CLO
Property type	Stabilized	Transitional
Interest rate	Fixed	Floating
Typical term	5–10 years	3 years
2020 stats		
Loans per deal	43	30
Loan size	$24M	$24M
Retail + hospitality	23.20%	6.10%
Structure		
Typical use	Stand-alone structure	Balance sheet financing
Loan contributors	May be multiple origination platforms	Typically, the sponsor of the vehicle
Equity holder	Third-party "B-piece" buyer	Typically, the sponsor of the vehicle
Loan management	Third-party servicer	Sponsor/originator
Management	Static pool	Managed or static pool

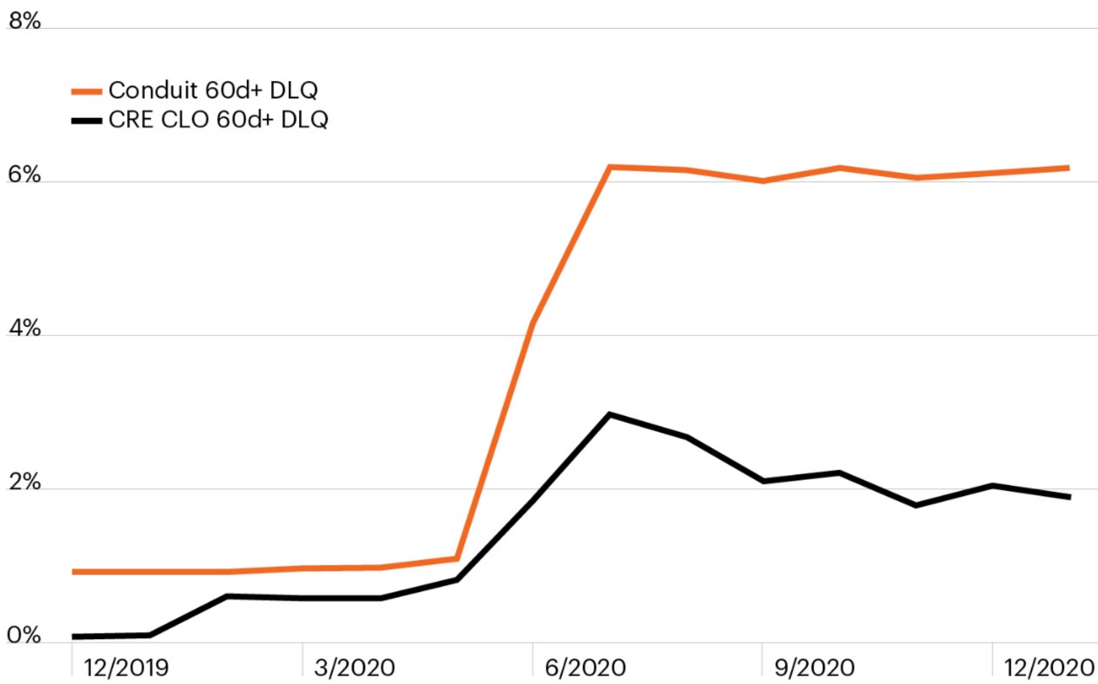
Source: FS Investments, Morgan Stanley, J.P. Morgan.

So now that we've reviewed the backstory, how did these two competitors stack up in 2020?

Game time

Although the pandemic is not yet over, 2020 served as an important test of how these loans and structures are able to hold up during times of stress. Based purely on delinquency stats, there is a fairly stark contrast between the two vehicles. Delinquency in the CRE CLO market has remained below 3% since March while CMBS has climbed to over twice as high. Other stress factors, such as modifications and special servicing, have also remained relatively muted in the CRE CLO market.

CRE CLO credit performance held up well since the pandemic, while conduit CMBS and SASB saw delinquencies soar



Source: J.P. Morgan, Trapp.

So, why is this?

There are a number of factors that could be at play. As we covered above, CRE CLO managers are generally able to be more active in managing their portfolios and may have closer relationships with borrowers that allow them to better manage through times of distress. Second, the loans underlying CRE CLOs typically have significant reserves in place as part of the overall business plan for the property, which may be tapped to cover interest shortfalls in times of stress. Third, the sector has more limited exposure to the most highly COVID-impacted sectors, lodging and retail.

The takeaway here? Not all commercial real estate securitizations are created equal. The market is constantly evolving, and investors must understand the key differences between these two distinct CRE lending markets and securitization structures.

Conclusion

Unlike the outcome in Super Bowl LV, the upstart CRE CLO market appears to be drawing away from the veteran CMBS in terms of performance. That being said, we believe there is more action to come in this battle, and we won't know the true winner until COVID is under control. Stay tuned.

Matt Malone
Managing Director

Matt is Managing Director, Real Estate at FS Investments, where he focuses on the growth and management of our real estate platform. His prior experience as a lawyer specializing in alternative investments and Head of Due Diligence at FS Investments informs his unique perspective on the industry. Matt is the former Chair of the CFA Society of Washington, D.C., and serves on the Board of Directors of the Alternative & Direct Investment Securities Association.

Learn more

Read more from Matt Malone

Sign up to receive our latest Insights

Investment Research

Robert Hoffman, CFA
Managing Director

Lara Rhame
Chief U.S. Economist
Managing Director

Andrew Korz
Associate

Kara O'Halloran, CFA
Associate

Contact
research@fsinvestments.com

BLOG-CRE-02-2021