Commercial Mortgage-Backed Securities

Ebb and Flow

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With CMBS issuance dropping off due to competition from banks and insurers, investors are turning to CRE CLOs.

Private-label conduit CMBS year-to-date new issuance fell by 13 percent to $29 billion compared to the same period last year. CMBS conduit lenders are facing stiff competition for loans from banks and insurance companies that can offer better pricing—a lower loan spread to the benchmark—despite the fact that spreads on AA to BBB-rated conduit bonds have compressed to post-crisis tights. In conduit pool composition, the total amount of retail loans contributed rose in the third quarter to 29 percent on average, compared to 22 percent for the first half of 2018. Given the pressure on bricks-and-mortar retail from the rise of e-commerce, our investment activity in conduit has been restrained.

In our view, the biggest area of opportunity in commercial real estate securitized markets is in commercial real estate collateralized loan obligations (CRE CLOs). CRE CLOs are pools of 15–30 commercial real estate loans that commonly require capital expenditures to bring the property's rental revenue in line with the surrounding market. Year-to-date CRE CLO issuance is $10 billion, compared to $7 billion for all of 2017. For context, projected CRE CLO issuance for all of 2018 is $15 billion. Favorable features of CRE CLOs include floating-rate coupons and shorter-term, relatively low retail exposure; high credit enhancement; high sponsor retention; and excess cash flow triggers that divert cash flow away from noninvestment-grade tranches if a deal starts to underperform (see chart, top right). Despite these attractive features, potential opportunities must be carefully vetted for strength and experience of the deal sponsor, loan borrower, loan leverage, loan debt service coverage ratio, and loan debt yield. Both static and managed CRE CLO AAA-rated bonds enjoy a spread pickup relative to benchmark conduit AAA-rated last cash flow bonds (see chart, bottom right). As such, investor demand for CRE CLOs remains high. Managed deals tend to price wider than static deals as they typically have a two-year non-call period, and the reinvestment capability leaves investors partially blind to the loan pool at issuance.

We continue to favor more defensive, loss-remote, principal-bearing bonds, along with senior interest-only bonds in conduit CMBS, as well as both static and managed CRE CLO investments with strong deal sponsors at spreads similar to or better than conduit spreads.

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CRE CLO Features Are Attractive Relative to Conduit Features

2018 Average

	CRE-CLO	Conduit
Coupon	Floating	Fixed
Term	1-5 years	10 years
AAA Credit Enhancement	50%	30%
BBB Credit Enhancement	~22%	7.5%
Average Stabilized Loan to Value	65%	54%
Cash Flow Diversion Tests	Yes	No
Sponsor Retention	~22%	5%
Collateral Type	Bridge Loans	Stabilized Loans
Top-Three Property Types	Multifamily (46%), Office (23%), Hotel (16%)	Office (30%), Retail (23%), Hotel (14%)

Source: Guggenheim Investments. Data as of 9.30.2018.

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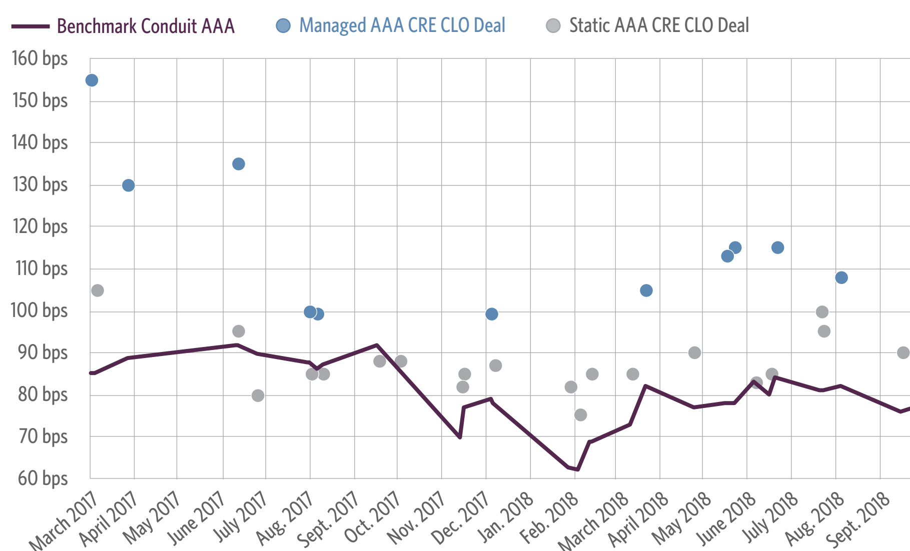
CRE CLO Spreads See Pickup Relative to Conduit Benchmark

Conduit Spread to Swap, CRE CLO Spread to One-Month Libor



Source: Guggenheim Investments. Data as of 9.30.2018.

Both static and managed CRE CLO AAA-rated bonds enjoyed a spread pick up relative to benchmark conduit AAA-rated last cash flow bonds. New issuance does not change a static deal's pool of loans, whereas managed deals allow deal sponsors to reinvest loan repayments for a one- to three-year period.

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