Performa Market Perspective

April 6, 2017

Commercial Real Estate as the Next Shoe to Drop, What are you Yellen?!

The U.S. commercial real estate market accounts for over $2 trillion of associated debt with 23% of that found within Commercial Mortgage Backed Securities (CMBS). We have long been participants in the CMBS sector as it often provides both diversification within the broad fixed income market as well as compelling relative value versus other sub-sectors. Despite the clear benefits, we must be diligent when analyzing potential CMBS holdings as they are slightly less liquid than corporate bonds and while they may look homogeneous on the outside, the securitized deals themselves have unique collateral as well as structural differences.

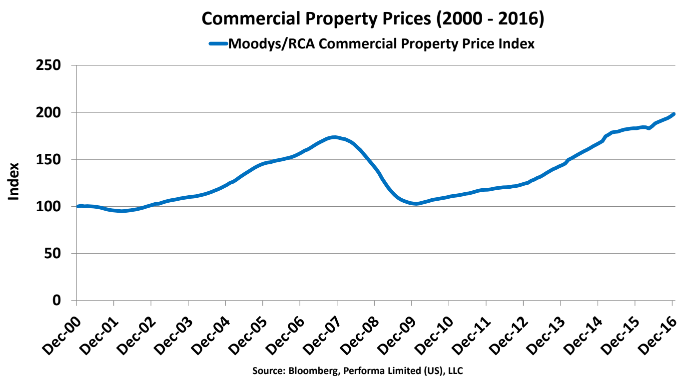
We are highlighting the CMBS sector since it has come under a bit of scrutiny this year and we believe some opportunities may arise in the near term.

Taking A Look In The Review Mirror

Looking back to the Great Recession, the consensus view was that CMBS would suffer a similar fate as the sub-prime and residential mortgage (RMBS) market, an implosion that brought down Bear Stearns and Lehman Brothers. While there were some similarities, namely overvalued properties and overleveraged owners, CMBS was not the next shoe to drop as some had speculated. Sure commercial property values had soared from 2001 to 2007 and property prices fell hard in the aftermath of 2008, but it was not Armageddon as fewer than expected forced sellers came into the market.

Unlike single family homes, commercial real estate produces rental income. Since leases are usually long-term commitments, owners have a built-in cushion that buys them time during periods of market stress. It takes a significant loss of tenants in a short period of time to bring a commercial mortgage underwater. Despite the extreme financial stress associated with the Great Recession, this did not broadly occur post-2008.

With that being said, CMBS prices performed worse than the underlying properties during the financial crisis because it was the only part of the market banks could try to use as a hedge. Prices for valuing holdings can be quite different than prices of actual transactions – especially if no one is buying commercial properties or trading many CMBS bonds in the shadows of a crisis. Valuations eventually realigned, however, and both the real estate and CMBS markets recovered within a few years at a faster rate than residential property prices.

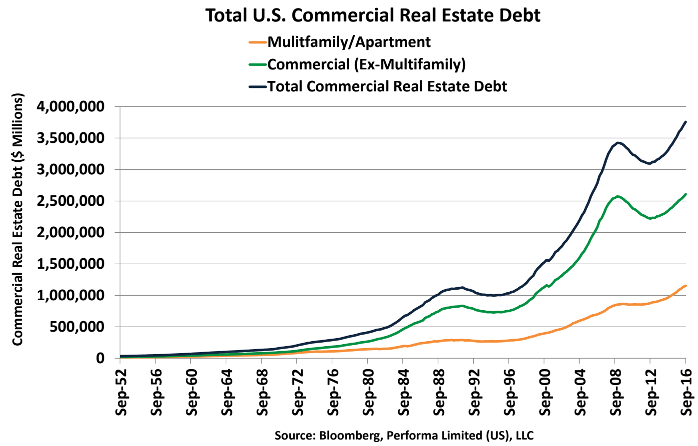


Additionally, rock bottom interest rates provided multiple opportunities to refinance commercial mortgages, giving property owners another way to make it through to better times. In turn, all the positive cash flow generation attracted a broader buyer base hunting for yield.

The upshot is that commercial property, on average, is now worth more than twice its value from the lows – a star performer in the land of physical assets.

Today – Prices Are Running Hot

Janet Yellen, Chair of the Federal Reserve, voiced her concerns about rising commercial property prices during her visit to Capitol Hill last month. The CMBS market shuddered slightly in response. What Chair Yellen did not mention was the Fed's own culpability for fueling over-heated prices in many markets. By leaving interest rates low for so long the Fed crowded investors out of traditional markets and sent them on a hunt for yield. Capital eventually found its way to the commercial property market and prices have increased. While commercial property prices look to be a little frothy, we see a few reasons why this trend will likely slow.



Property valuations and total debt are at all-time highs. There is also the dual threat of rising interest rates and higher spreads resulting from tightening lending standards and new rules for securitizations. This makes refinancing less attractive and should reduce the velocity of property price gains going forward.

The retail sector of the economy also factors into our view that average property values have peaked. The continued maturation of internet-based shopping continues to cannibalize physical store sales and has led to chain store difficulties across the country. In turn, shopping malls and other retail related properties are suffering. Retail based properties are a large sub-group within the commercial real estate market and, by extension, some CMBS deals. It will take time to reposition malls and other retail oriented space. Life style projects are the theme du jour, but it will take time to know if this is the wave of the future, a fad or just wishful thinking.

Given this profile, where is there value in commercial real estate? Lending directly to a well-seasoned property operator with a recognized niche can still be an interesting investment for a long-term investor. Borrowing rates are still within the lower end of the historical range and the relative value over other fixed income instruments remains. Most fixed income investors, however, are not equipped to own loans outright and cannot lock up their clients' capital.

At Performa, we still favor investing within the CMBS sector. Maturing CMBS deals have outstripped new transactions, creating negative supply and a favorable technical landscape. This has been countered by lower CMBS bond trading liquidity due to the increased bank/broker-dealer regulatory capital requirements. Periodic supply/demand imbalances can create wide divergences from fair value, which creates pockets of opportunity at certain times and good exit points at others.

The Year Ahead

As weaker hands fold in response to negative headlines, we actually see some potential to add CMBS exposure at more attractive levels in 2017. Below we discuss several factors that will allow us to pick and choose deliberately.

Factor 1: Sometimes Older Is Better

We like to graze in the more mature, lush pastures. The CMBS market's best years in terms of new issuance and its worst in terms of underwriting, since the market went mainstream in the early/middle 1990's, was 2005 to 2008. Many of these deals have loans with balloon payments coming due in the next 24 months. The wall of maturities is not as dire as feared as elevated property values and interest rates that are still historically low will allow for successful refinancing. However, some of the delinquency numbers in these transactions are scaring off buyers - even before they look under the hood of a 1 to 2-year bond.

While 60-day delinquencies in pre-2009 deals are over 15% (scary to some), the loan balances are smaller after a decade or more of principal payments. So, the outright number of delinquent borrowers has not increased substantially, but their properties represent a growing percentage of a shrinking pool of loans (Source: Credit Suisse). The average CMBS deal has experienced only a 5.4% loss, (slightly higher for the later 2006-2008 deals according to Credit Suisse).

Even with large delinquencies, older CMBS deals provide more collateral protection today than at new issuance since they have been deleveraging. Avoiding deals with properties that face potential refinancing trouble still leaves us with a large enough buying universe for short-term, high quality bonds with attractive absolute yields.

Factor 2: Retail - Keeping The Tourists At Bay

The negative headlines from the retail sector keep coming, helping to create potential buying opportunities, as others leave the market. In the first two months of 2017 both JC Penney and Sears announced a combined 270 store closings and employee layoffs. Investors who only dabble in CMBS are shying away from new transactions with significant retail industry exposure. New, diversified CMBS deals average between 20%-30% of retail-based collateral.

While the overall decline in retail store space must be monitored, not all strip and shopping malls are the same nor will all of them board up. The property type, owner's track record and location are important differentiators as well as the mix of non-clothing and big box retailer tenants (food and service industry). For CMBS buyers, there are structural components within CMBS deals that protect investors beyond good property analysis, primarily in the form of overcollateralization, which protects bondholders at the higher end of the cash flow waterfall. In other words, the lower rated bonds within a CMBS deal support senior, higher rated bonds.

These deal enhancers allow us to focus on the highest quality portion of the market that offer the first claim of cashflows and around 30% additional protection from the features above even when real estate prices may not move much higher or, in a worst-case scenario, start to fall.

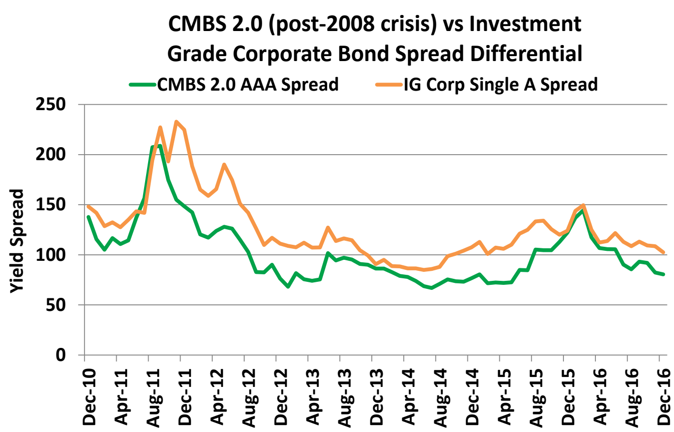
Using an example of the latest CMBS deal in the market, 100% of properties would have to default on their loans and be sold in foreclosure at a 30% loss before the senior (AAA rated) bond took a hit to its principal. Isolating just the retail loans, and defaulting of the entire 23% of retail property loans in that transaction, even with a complete loss in a liquidation, an investor would not lose one dollar in the highest rated bond principal. Are these draconian loss scenarios possible? Perhaps, but the pre-2009 CMBS deals offer some clues.

2008 vintage CMBS deals are the worst on record, with collateral losses averaging 11% of the original pool balance. For new deals, this still leaves around a 20% cushion for the senior bonds, which continues to grow back over time. In order to take broad senior losses, the market would need a recession event that tripled those experienced in 2008 and an acceleration in the timing of the losses. We view such an event as quite unlikely.

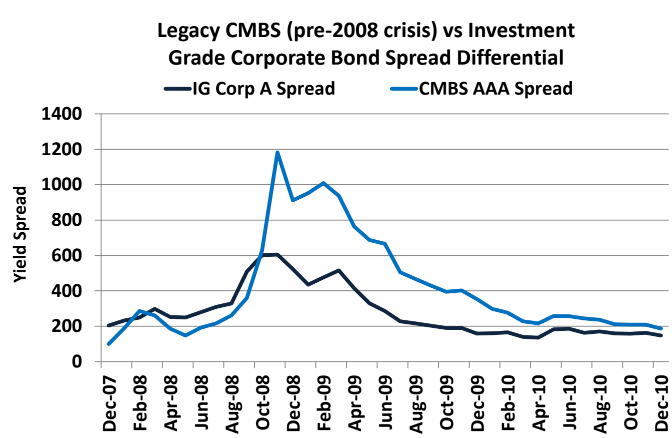
Factor 3: Relative Value

Finally, there is the relative value proposition. We have historically compared AAA rated CMBS bonds to their single A rated, Corporate bond counterparts. The chart below illustrates the correlation between them over the past six years with CMBS looking slightly on the rich side.

That said, the credit quality of the CMBS bonds are materially higher and the give up in yield is around 20 basis points per year. Looking at previous market pull backs, CMBS tends to dislocate briefly from its Corporate cousin - something we will continue to monitor (see charts below).



Source: Bloomberg, Performa Limited (US), LLC



Source: Performa Limited (US), LLC

It is fair to expect current unease in the retail space to be followed by an uptick in delinquencies. As these loans are worked out it is also our expectation that certain cross over buyers will pull back from the market and demand will wane. The decreased appetite for CMBS will result in wider spreads versus Corporate debt, which should create an opportunity that savvy investors will look to exploit.

Tying It All Together

Ultimately, we view the commercial real estate market as one that carries potentially significant risks, and with it, the opportunity to generate strong risk adjusted returns under certain circumstances. We do not view the sector as the next catalyst for a market meltdown. The securitized market will certainly see pockets of stress, highlighted by the retail sector, but supply in the overall market has remained largely constrained leading to favorable supply/demand technical factors. Away from securitization in the whole loan market, we are more concerned about the amount of existing debt and how the current business cycle may impact the value of current transactions in the future. That said, much of the debt outstanding is in the strong hands of investors with longer term investment horizons which should be able to withstand short to mid-term price volatility.

At Performa, we view CMBS as a valuable subsector within our overall Structured Product allocation. We have recently maintained a position between 5-15% within Fixed Income portfolios depending on market conditions, and concentrate on high quality structures (generally rated AA/Aa2 and above), that can offer interesting return profiles while also buffering from potential broader losses in the CMBS space. As bottom up investors with substantial experience over different market cycles, we are able to take advantage of attractive buying opportunities when the sector gets oversold.

So Janet… Please stop Yellen!

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ABOUT PERFORMA

Combining our extensive knowledge of the insurance industry with the institutional expertise of our investment team, Performa has been managing assets on behalf of captive and other insurance clients for 25 years.

Our capabilities include asset allocation along with active fixed income and equity management through diversified mutual funds or separate account portfolios. With offices in the world's largest captive domiciles, including Bermuda, Vermont and South Carolina, we are focused on delivering customized solutions to meet the unique investment objectives and liquidity requirements of our investors.

We are 100% employee-owned and have $3.73 billion in assets under management and advisement worldwide representing more than 65 captive client relationships as of February 28, 2017. Our investment philosophy is value driven and long-term in nature. Whether approaching asset allocation, fixed income or equities, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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