Hits to CMBS and CLOs Are Bad News for Commercial Real Estate Financing

The markets for both have pretty much collapsed in recent months, with defaults a particular threat to CRE overall

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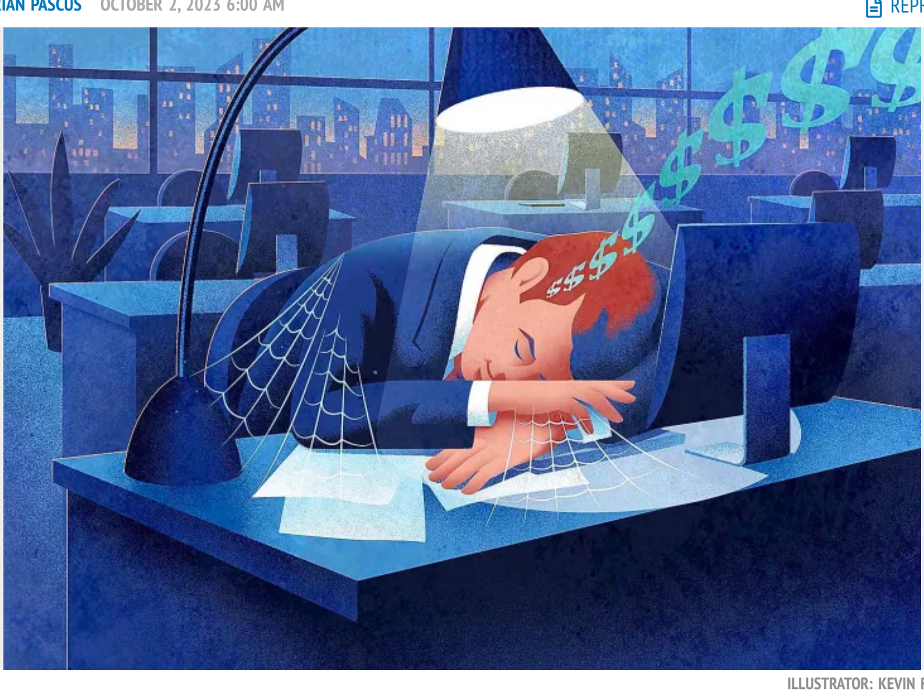

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If someone working in commercial real estate finance had fallen asleep in September 2019, a la Rip Van Winkle, they might have woken up assuming that two of the staid pillars of lending — commercial mortgage-backed securities (CMBS) and collateralized loan obligations (CLOs) — were as solid and useful as they had been the night they turned in.

Alas, like Van Winkle's rude awakening, they will shortly learn it's a different America.

While commercial lending has been relatively diminished since the regional banking crisis of this past spring, with alternative lenders and life insurance companies carefully picking their spots as the banks sit on the sidelines, the markets for CMBS and CLOs have almost completely collapsed — and that's putting it politely.

Private label CMBS and CLO issuance has declined by more than two-thirds in just the last year from $92.3 billion in September 2022 to $30.7 billion in September 2023, according to the Commercial Real Estate Finance Council (CREFC). Conduit CMBS — multi-asset, multi-borrower loans — issuance is down 27 percent on the year, while SASB CMBS — single-asset, single-borrower loans — has declined a whopping 73 percent.

"During the financial crisis 15 years ago, CMBS went from 120 mph to zero. It stopped," explained one investment banker, who requested anonymity. "Here, we're going from 60 mph down to 30 mph. It hasn't stopped, but what's made it slower, frankly, is interest rates being higher."

Perhaps most concerning are the defaults. After peaking at 10.31 percent during the depths of COVID in July 2020, monthly delinquencies for CMBS are ticking up again after declining until the end of last year. CMBS delinquencies reached 4.25 percent in August, the second straight month above 4 percent, according to CREFC.

"What we're seeing, as far as distress, is the most popular form of distress in conduit deals are maturity defaults. We're not seeing many term defaults at this point," said Matthew Halpern, a vice president of structured finance at Moody's Investors Service.

As for the CLO marketplace, that has essentially ground to a standstill. Once a well-oiled, productive machine, CRE CLO issuance has dropped from $28.9 billion in September 2022 to $4.8 billion by September 2023, a decline of 83 percent, according to CREFC.

There have been only nine CLO transactions brought to the market this year nationally, according to Moody's Deryk Meherik, senior vice president of the firm's investor services and structured finance group. The average CLO issuance fluctuates between $500 million and $600 million, he said.

"It's been really quiet on the CLO front," said Dylan Kane, managing director at Colliers Capital Markets. "They're definitely down. [There's been] less than one per month, and my guess is you'll only see one or two more before the year is out."

To understand why CMBS and CLO issuance has declined so significantly, and what that means for commercial real estate finance at a time of generational distress, one must peel back the layers of these nebulous securitization products to look at what they are, how they are made, and why they are the lending tools that can power capital markets — or stop those markets altogether.

Apples and oranges

First, an obvious point that might not seem so obvious: CMBS and CLOs are two completely different creatures.

While both are securitized products of pooled CRE loans used by lenders to generate a steady flow of capital that in turn allows for further originations, CMBS and CLO are structured in distinct ways and play their own unique role in the CRE marketplace.

A commercial mortgage-backed security is a fixed-income product that pulls together the originations of either a single asset or numerous stabilized assets — for example, a mall in St. Louis, a hotel in Reno and an office building in Philadelphia — and bundles them into a single bond, the CMBS security, that is placed in a trust and sold off to investors.

The traditional CMBS conduit deal is usually diversified by product type, sponsorship and geography, all of which create the supposed benefits of diversification. There can be either one originator or a handful of groups syndicating out the loan together.

The loans in the CMBS pool vary in terms of asset class, loan amount and other economics; however, the documents are otherwise drafted by lenders to follow prescribed guidelines and therefore the legal terms of CMBS loans tend to be quite similar, according to attorney Brian Cohen, a partner at Goulston & Storrs. Once a loan is closed and then securitized in a CMBS conduit deal, Cohen noted, modifying the loan is particularly challenging.

Even a single CMBS securitization is a proverbial hall of mirrors.

For instance, on Sept. 19, Bank of America, Morgan Stanley, Wells Fargo and Citigroup priced an $886.1 million CMBS conduit loan made up of 40 percent retail, 19 percent office, 16.5 percent hotels, 11.2 percent mixed-use assets, and numerous other asset classes. The largest loans in the pool include an $80 million portion of a $180 million loan to Brookfield on a retail complex in Richmond, Va.; a $75 million portion of a $275 million loan to Tishman Speyer and Silverstein Properties on a Manhattan office building; and a $45 million portion of a $242 million loan to Taubman Realty for a mall in West Hartford, Conn.

"The reason you're seeing all these groups here is because there's less securitization today, and they don't want to hold the loans they have made for long because they are taking market risk," explained Kane. "[As a bank], you want to minimize the warehouse risk. You securitize together so you can reach a threshold of size that allows you to securitize. Once you hit the threshold, you want to sell it."

Once a CMBS conduit deal is issued and sold on the market, its collateral is set. Its loans cannot be altered or replaced, and the returns generated by the yields given on different risk tranches (which vary from highest to lowest) are set by the loan agreement, making them attractive to investors of all risk appetites.

On the other hand, a CLO, which also securitizes a pool of CRE assets, carries no such stipulation of being set in stone once it is brought to market. In fact, the originator can pick and choose which assets should remain in the CLO up until a certain point, swapping out nonperforming assets for performing ones to reduce credit risk for themselves and their investors.

"It's not a fixed pool, so I can keep putting things in and out of my CLO," said Richard Fischel, a partner at Brighton Capital Advisors, a CMBS loan advisory firm. "It's usually for bridge lending and for properties that aren't stabilized."

As such, the assets within a CLO are usually non-stabilized, like a multifamily building in Missouri with 55 percent occupancy, or a shopping mall in California holding a few vacant storefronts, or a half-finished apartment building in Brooklyn. The CLO is financed by floating-rate debt and structures its bonds as investment grade (or above) assets, with protections in place for investors. When one part of the CLO becomes impaired, those cash flows coming to the seller from the retained notes and preferred shares are cut off and are converted to principal for the other participants.

Furthermore, due to the heavy turnover and short-term nature of the product, originators use CLOs as a finance mechanism to access the bond markets. Unlike CMBS originators, who sell off their security to third parties, the CLO originator remains the controlling class bondholder of the CLO, actively managing it and retaining significant exposure in the loan pool, usually by holding the first-loss position or a portion of non-investment-grade bonds.

"The entity issuing really stays in the mix in terms of managing the day-to-day interaction of the loan," said Kane. "People do securitized deals because they don't want to hold the risk themselves. They turn it into a bond and market the safe parts to hedge funds, pension funds — they make the sausage and sell it, and when they sell they do it at a profit."

One of the larger slices of sausage of 2023 came to the market on Sept. 18, when Benefit Street Partners floated a managing CLO offering sponsored by its REIT, Franklin BSP Realty Trust, at $896.6 million. Made up of 10 whole loans and 19 loan participations backed by 48 properties across 14 states (and D.C.), 66 percent of the CLO portfolio boasted apartments, while the rest was filled out by loans backed by hotels (20 percent), office (7 percent), mixed-use (4 percent) and manufactured housing (4 percent).

But the Benefit Street Partners offering has been a rarity in a market strapped for liquidity and reeling from high interest rates.

"It's barely a trickle," said Manus Clancy, senior managing director at Trepp, a commercial real estate analytics firm. "We've seen almost no issuance in 2023."

No good thief

If there's a culprit in the story of decreasing CLO and CMBS issuance, it's undoubtedly the pair of benchmark interest rates that determine the fortunes of so many futures in commercial real estate finance.

CLOs are backed by shorter-term, floating-rate debt pegged to the Secured Overnight Financing Rate (SOFR), the interbank lending rate. From 2018 to 2022, the CLO market exploded with activity: floating-rate loans were cheap, borrowing costs were low, and issuance skyrocketed.

But, over the last year, the 30-day average SOFR rate has jumped from 2.28 percent to 5.31 percent, in turn severely decreasing the appetite for investors to dance with floating-rate debt.

"People loved loading up on floating-rate debt from 2018 to 2022, and when rates went up they got burned," said Clancy. "[For many investors] an exit strategy is unavailable, and as a result the CLO market has gone bone dry. That product is no longer desirable because rates are so high."

Unlike the CLO market, the CMBS market is a fixed-rate product that trades off the 10-year Treasury. That benchmark has moved from 3.71 percent at this time last year to 4.64 percent today, a 15-year high. For much of the 2010s, the 10-year Treasury barely rose above 3 percent.

The drastic rate increase has had dire consequences for CMBS economics.

The cost of capital for CMBS originators is what they can sell the bonds for, so if bonds could be sold for an average coupon of 4 percent, CMBS originators could write the loan for 5 percent and make a 1 percent profit.

But the higher 10-year Treasury rate has thrown this arithmetic into chaos. To make a profit, the loan coupons on CMBS bonds have to carry a wide risk spread; and, because loans are priced against the 10-year Treasury, a riskier loan, with higher leverage, must carry a wider risk spread — sometimes 300 or 400 basis points over par. So CMBS borrowers are now being charged a higher loan coupon to justify the new cost of capital for the originators.

"To the extent that borrowers are willing to take out loans at 7 to 8 percent or so, there might not be much demand for CMBS at that rate," said Paul Fiorilla, director of research at analytics firm Yardi Matrix. "And I suspect a lot of loans coming due will result in negotiated extensions."

The higher interest rates have also changed traditional conduit CMBS from being a 10-year, fixed-rate product into a five-year product. Nearly half of CMBS issuance through mid-June 2023 was made up of five-year fixed-rate loans, according to Commercial Mortgage Alert.

"Today, where rates are high with a five-year forward curve, you don't want to lock in a long-term rate because you might be able to finance at a lower rate five years from now," said Kane.

War and peace

If CMBS conduit loans have seen their loan structures changed, then what has remained the same for borrowers are the myriad problems involved with the complex web of claims that emerge during CMBS workouts, modifications, defaults and foreclosures.

Suffice to say, the world of CMBS loan defaults is inherently complex, but the important point to remember is that upon default the loan is not serviced by its originator, or even a master servicer. It is now under the auspices of a special servicer.

This byzantine world of special servicing has become all too common as CMBS default rates have slowly crept up — especially for 10-year loans using 2013 vintage interest rates of sub-2 percent — with borrowers finding they can't refinance at maturity without putting new money into the property at a higher cost of capital, leaving their futures in the hands of a Delphic special servicer who they've often never met.

"These things move into CMBS purgatory, that condition where you've passed maturity date, can't refinance because you haven't been foreclosed on either, so they remain in limbo," said Clancy. "Limbo can last six months, a year, two years. These things take time to work out."

A game of chicken usually ensues, as the special servicer defends the rights of CMBS bondholders while the borrowers try to get the best deal they can, and the underlying property is used as both a pawn and the ultimate prize.

This has made alternative forms of CRE financing, even at higher interest rates from commercial banks or with greater risks of takeover from private equity debt funds, increasingly attractive for CMBS borrowers.

"In a period of distress, where a borrower wants to have a rational conversion, some borrowers aren't good borrowers and it's hard to have rationality, and it's hard to find a securitized lender who has authority and motivation to talk, as opposed to a regular conventional lender — an insurance company, a bank, a private equity fund — who you can sometimes have a rational conversation with," explained Jay Neveloff, a partner and the real estate practice chair at law firm Kramer Levin.

So what, if anything, keeps borrowers coming back to CMBS originations?

"It's pricing. The debt can often be less expensive," said Cohen of Goulston & Storrs. "One of the benefits of CMBS in this market is the economics might be better, and even more often the CMBS originators seem to be providing more loan to value [on the debt]."

Moreover, there are some crafty solutions to the problems inherent in CMBS workouts.

Michael Cohen, managing partner at Brighton Capital Advisors, has 26 years of experience in the CMBS space. He said that lenders are now doing more loan extensions with modified A-B note structures, where, for example, a $100 million loan is modified down to $70 million, it's restructured and extended, and the $30 million in the B piece will accrue interest for the lender on the backside. But that $70 million A note that's been restructured is also bringing in new equity partners to be the primary borrower, who are attracted to the restructured loan on a longer timeline.

"It's just starting to happen," said Cohen. "And that's a better thing for the borrower, but the borrower still needs to be prepared to come in with fresh equity and participate in this adventure."

John Wood, managing director and COO at Iron Hound Management, a CRE workout advisory specialist, said that even though lenders are still being difficult, they recognize refinancings won't happen amid nearly 6 percent interest rates, and that it's often sensible to compromise.

"Whether it's already a maturity default or an impending maturity coming up, we've been getting some two- to three-year maturity extensions on some of these CMBS deals," said Wood.

"There's been some subordinations, some interest rate relief, but the ones we've recently closed that have been the biggest piece are maturity extensions," he added.

As for the CLO space, even though that market has declined by leaps and bounds, a paradigm shift is underway amid its asset class composition.

Multifamily has become the property of choice of CLO originators, with almost 80 percent of CLO loan compositions made up of multifamily properties, as originators flock to their certainty of outcome from waves of renters and to the relief that their more affordable interest rate caps provide, according to Moody's Meherik.

"It's multifamily with a light sprinkling of industrial and some all-season resort-type hotels," said Meherik. "That makes up the vast majority of the CLO universe today."

But the CLO space is still "a dribble," according to Cary Carpenter, head of capital markets at Starwood Property Trust. Carpenter said there's not a lot of supply for investors, and he thinks that bond buyers are simply waiting for the SOFR to flatten out before they pour more capital into that space.

"CLO is sort of the redheaded stepchild of commercial real estate bonds," he said. "It's always the last one to come back."

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