Takeaways from CREFC Miami

Panelists View CRE CLOs as a Valuable Financing Option

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Morningstar Perspective

Securitizations on transitional real estate loans, known as commercial real estate collateralized loan obligations, have literally doubled in popularity. In 2018, CRE CLO new issuance reached $14 billion, compared with $7 billion in 2017, according to Kara McShane, who moderated the CRE CLO panel at the CREFC Miami conference and is a managing director at Wells Fargo.

Panelists generally agreed on the importance of CRE CLO as a financing option. Erik Gutman, managing director at Prime Finance, said that his firm views CRE CLOs as a "financing tool and optimization strategy." He added that they can be especially helpful when reaching capacity on warehouse lending or other private placements. Blackstone managing director Douglas Armer agreed, saying that CRE CLO is "the third leg in the stool" of its financing strategy. He also liked that the sector opens up a different investor base and facilitates a dialogue with the real estate capital markets.

However, increased competition in origination has made loans "a little bit more transitional," said Daniel Vinson, managing director at Barclays. He has seen a greater difference between the as-is loan-to-value ratios and the projected as-stabilized LTVs. "The amount of future advancing as a percentage of balance has increased a little bit," Vinson added. Both trends, in his mind, indicate "a little bit more transition." There is also less in up-front reserves, but Vinson doesn't find this to be alarming. Guggenheim Partners' Shannon Erdmann noticed a number of loans with debt service coverage ratios below 1.00x toward the end of 2018, which used to be unheard of. Erdmann explained that Guggenheim has been conducting debt yield tests for three scenarios. The first scenario is that the issuer calls the debt right away. The second explores what would happen if every loan was fully extended. The third assumes that every loan is paid off during its initial lifecycle and is reinvested again with the maximum term.

While issuance of CRE CLOs hasn't yet begun in 2019, Vinson believes these instruments will be met with investor demand. However, he is hoping that the first one of the year is "pretty vanilla" in terms of structure, so there is some clarity on pricing for the new year.

For more information on how Morningstar Credit Ratings, LLC plans to analyze CRE CLO assets, please read the proposed appendix to its U.S. CMBS Conduit/Fusion Ratings Methodology (November 2018). Morningstar is accepting comments on the proposed appendix to address CRE CLOs.

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