Takeaways From IMN's CRE CLO Conference 2019

The Continued Evolution of CRE CLOs

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MorningstarPerspective

Before IMN's first annual conference on commercial real estate collateralized loan obligations began, curious attendees gathered for an educational workshop to find out more about this growing market. Presenter Jodi Schwimmer, a partner at Reed Smith, described a CRE CLO in its most basic terms. "It's a company (SPV) that holds assets. These specific assets are loans… Instead of seeking financing from a bank, it is seeking financing from the capital markets," she said. Morningstar Credit Ratings, LLC's Kurt Pollem, managing director, went further. He mentioned that CRE CLOs are typically composed of bridge loans on transitional commercial properties, which are undergoing varying degrees of renovation or repositioning. They differ from conduit commercial mortgage-backed securities as the loan normally includes a future funding component to allow the sponsor to execute its business plan to stabilize the property, which is not permitted in a real estate mortgage-investment conduit. The loan term is also typically shorter, with an average initial term of two to three years with extension options available. Schwimmer highlighted another key difference between CRE CLOs and CMBS. In a CRE CLO transaction, the issuer has more skin in the game. CRE CLO issuers retain the all the non-investment-grade bonds, which is, on average, 20% of the pool's balance. A CMBS issuer is only required by Dodd-Frank's risk retention provision to retain 5% of a pool's balance.

Douglas Armer, a managing director at Blackstone, said in another panel on the structure of CRE CLOs that 2018 saw a pretty significant trend to managed pools from static pools, especially from repeat issuers. He believes that a managed deal can be an efficient financing vehicle for issuers that are able to take advantage of a managed pool's ability to replace loans as they mature. This flexibility does come at a cost though, as investors require a spread premium over a static transaction, albeit one that has begun to narrow. JP Morgan's Brennan Woods, vice president, echoed this statement. "I think there's been broader acceptance by investors of managed securitizations. It's certainly taken a lot of education."

How to Monitor Performance

According to senior vice president Greg Haddad, who leads the CRE CLO initiative at Morningstar, the managed pool aspect is an important consideration when analyzing a transaction's structure as well as for ongoing surveillance. "It really comes into how we assess what the potential credit migration of the managed pool could be over time." He added that Morningstar reviews the pool's initial composition and eligibility criteria to determine the potential for downward credit migration in the transaction (for example, transitioning from less volatile multifamily loans to those backed by hotels or retail properties). Rather than assuming only the worst-possible outcome, Morningstar attempts to determine the most probable one given a number of factors, including the length and flexibility of the pool's reinvestment guidelines as well as the issuer's prior performance. Based on this analysis, Morningstar designates the pool into one of three "boxes"--low, medium, and high migration. Depending on the box, Morningstar applies a fixed penalty, which is tapered linearly down the capital stack from AAA to B-.

Across multiple panels, participants agreed that ongoing surveillance of CRE CLO pools was a concern, as transitional loans are much "higher touch" than traditional conduit CMBS loans. The current reporting solution is using Commercial Real Estate Finance Council's investor reporting package for CMBS. Armer said it is "a work in progress," as the CMBS investor reporting package does not allow for the level of information transfer that is necessary to monitor transitional properties. David Putro, a senior vice president at Morningstar, moderated a panel on best practices for asset management, asking Brady Coperman, a vice president at Situs, if servicers have taken on a more bespoke approach to these transactions. Coperman reiterated the difficulty, saying that the issue is navigating the balance between opening up everything to investor scrutiny and some standardization. The best his company has come up with is a quarterly asset report that provides "financial performance [data], updates to the business plan, and market color." CREFC has an advisory board, which Situs is a part of, that is working to address this issue.

Effective Issuer Tiering

Another topic of interest among various panels was the limited issuer tiering or differentiation in pricing between seasoned CRE CLO managers and first-time issuers. In the morning workshop, Schwimmer said that over the past year the market has seen an uptick in first-time issuers and asked Pollem how the CRE CLO manager factors into Morningstar's analysis. Pollem said that similar to its approach to corporate CLO managers, Morningstar reviews each issuer and meets with the investment team to evaluate their industry experience as well as to understand their overall credit process and operational structure. Later in the morning, Armer said, "I don't think the market does a great job distinguishing among different issuers." He urged for more effective tiering.

The CRE CLO market has some hurdles to overcome as it continues to blossom into a long-term sustainable industry, but those at IMN's first annual CRE CLO conference seem ready for the challenge.

Have questions or feedback on CRE CLOs? Join the conversation at ratingagency@morningstar.com.

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