Expanding the Search for Yield: The Case for CRE CLOs

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REPORT SUMMARY

- The commercial mortgage-backed securities (CMBS) market has expanded into new sectors that may offer attractive risk-return prospects for investors with the flexibility to invest in out-of-benchmark sectors, such as commercial real estate collateralized loan obligations (CRE CLOs).

- The underlying assets of a CRE CLO are short-term floating-rate loans collateralized by transitional properties and, unlike other CMBS offerings, are often used as a balance sheet financing tool for the loan originator.

- Since entering the market in 2012, the CRE CLO sector has grown substantially—through the first half of 2021, new issuance totaled more than $20 billion, exceeding previous full year totals and representing 30% of total CMBS issuance.

- Investing in CRE CLOs requires extensive due diligence—investors should evaluate CRE CLOs by analyzing the transaction structure, the quality of the sponsor, and the underlying loan characteristics.

- While not immune to the credit deterioration caused by the COVID pandemic, the CRE CLO sector has performed exceptionally well, particularly against the CMBS conduit and Single-Asset, Single-Borrower (SASB) sectors.

- In the universe of shorter-duration (2-5 year) assets, CRE CLOs offer attractive relative value.

Understanding CRE CLOs

CRE CLOs are a distinct asset class within the CMBS market focused on lending to transitional properties — properties with plans for repositioning, renovation, or redevelopment. Unlike traditional CMBS that finances stabilized assets with long-term, fixed-rate loans, CRE CLOs are structured as shorter-term (3-5 year), floating-rate loans that provide the borrower flexibility to undertake projects to grow a property’s overall value. For example, think of a suburban apartment complex needing a refreshed exterior and modern interior finishes or an office building transitioning from single-tenant use to a multi-tenant configuration. While each business plan is unique, the borrower’s goal is to create economic value by achieving stabilized occupancy and cash flow. Transitional loans serve as a bridge from the beginning to the end of the value-creation process. Once a property has increased cash flow or stabilized, the borrower may sell the property or refinance into long-term, lower-cost take-out financing, like the CMBS market.

The flexibility embedded in the CRE CLO structure provides originators of bridge loans a capital markets alternative to traditional bank warehouse financing. Many sponsors use CRE CLOs to diversify their financing sources, which otherwise might include bank warehouse lines, short-term bank loans, and corporate debt. Key players in the CRE CLO market include large global asset managers, publicly traded REITs, middle-market-focused investment managers, and private real estate debt funds.

Aside from providing competitive pricing, CRE CLO structures typically provide funding mechanisms related to new leasing and buildout costs, better match-term funding for the assets (i.e., longer loan terms than bank warehouse facilities), are non-recourse to the sponsor, and are not subject to mark-to-market pricing. Furthermore, the structures provide more flexibility relating to asset management and potential workout activity than bank financing.
**Sector Overview**

In its tenth year, the CRE CLO sector has experienced substantial growth and has become a significant part of the CMBS market. From 2012 through the first half of 2021, there have been 149 transactions totaling over $82 billion of issuance. Year to date, CRE CLOs account for 30% of the total CMBS market with over $20 billion in new issuance, exceeding previous full-year totals in just six months.¹

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**CRE CLO Annual Issuance**

Sector issuance has grown significantly, representing 30% of total CMBS issuance through the first half of 2021.

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Strong performance through the COVID-19 pandemic, attractive funding costs, and a larger opportunity set for transitional properties in the wake of the pandemic contributed to record supply in 2021. Many types of investors participate in the CRE CLO markets, including insurance companies, banks, money managers, and hedge funds. Investors are attracted to the shorter-duration, floating-rate loan structures, strong performance (particularly during and after COVID), higher credit enhancement versus traditional CMBS, improving market liquidity, and relative value pickup versus other high-quality CMBS and corporate credit. Issuer count has also grown, with over 25 issuers in the market. As issuance has increased, so has the size of transactions and secondary market trading volume. Secondary market trading volume has increased to over $300 million per week from less than $50 million per week in 2019, with AAA representing the majority of trading volume.² Improving liquidity dynamics is a significant positive for the asset class and investors alike.
Key Investment Considerations

Investing in CRE CLOs requires extensive due diligence. The investment process should consist of analyzing the transaction structure, the quality of the sponsor, and the collateral characteristics of the portfolio. Let’s start with a review of the transaction structure.

 TRANSACTION STRUCTURE

The key features of the CRE CLO structure are: the structure type; the subordination and waterfall; and the note protection tests.

Structure type: Each transaction is classified into one of two structures: static or managed. The primary difference between a static structure and managed structure is the ability of the sponsor to change the collateral in the pool. Static transactions have a fixed pool of loans where change is prohibited, whereas the pool of loans in a managed deal can change significantly. While both structures have credit risk, managed transactions have an additional risk in the form of potential credit drift. Credit drift could result from the collateral pool shifting from more stable property types (multifamily, self-storage, industrial) to more volatile property types (lodging and retail). Credit drift could also result from lower leveraged assets being redeemed for higher leveraged assets. Given the significant flexibility in managed deals, the weighted average life profiles tend to be 1-3 years longer than those of static deals, with some deals stretching out to 5 years. However, managed deals also provide sponsor flexibility to replace delinquent loans with fresh collateral, which could be credit positive for the pool.

Subordination and waterfall: The illustration below details how cash flow is directed from the asset pool into the securitization vehicle. By offering investors varying levels of subordination across the investment-grade portion of the capital structure, credit risk is distributed based on investors’ risk appetite, with bonds at the top of the capital stack (AAA) having the most credit support, a senior priority on cash flow, and being last in line to absorb losses. Similar to a CMBS structure, CRE CLOs pay sequentially with interest and principal repaid top down from the most senior (AAA) bonds to the most junior (B) classes, which are held by the sponsor. Conversely, any losses are allocated in reverse-sequential order.

Hypothetical CRE CLO Structure

Similar to a CMBS structure, payment priority for CRE CLOs is sequential from the top down with any losses allocated in reverse order. Unique to CRE CLOs, the junior-most portion of the securitization (“manager retained”) is typically held by the sponsor.

<table>
<thead>
<tr>
<th>Class</th>
<th>Rating</th>
<th>Credit Support</th>
<th>Performing Interest</th>
<th>Performing Principal</th>
<th>Trigger Breached Interest</th>
<th>Trigger Breached Principal</th>
<th>Losses</th>
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<td>B</td>
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<td>D</td>
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<td>17%</td>
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Manager retained

Source: BofA Global Research (June 2021)
Given the transitional nature of the properties (less in-place cash flow due to upcoming rehabilitation), credit support for CRE CLOs is materially higher than traditional CMBS. For example, credit support for AAA-rated CRE CLOs is typically 45% compared to 30% for AAA-rated conduit CMBS. Credit support for low-investment-grade (BBB) CRE CLOs is typically 20% compared to 10% for similarly rated conduit CMBS. Higher subordination levels provide investment-grade bondholders more protection against weaker-than-expected credit performance or adverse changes in valuations.

The alignment of interests between investors and sponsors is a unique feature of the CRE CLO market. Given that CRE CLO securitizations primarily serve as a source of financing for sponsors’ businesses, the sponsors typically hold the junior-most portion of the securitization in the form of non-investment-grade bonds and preferred shares (the “manager retained” portion cited in the hypothetical illustration). Typically, the bottom 15-20% of the structure is retained by the sponsor, which ensures a material amount of “skin in the game” and ensures the sponsors’ interests are aligned with those of bondholders.

In addition to subordination, bondholders benefit from credit enhancement in the form of excess spread. Excess spread is the net amount of interest payments from the underlying loans after interest to bondholders and servicing fees/expenses have been paid. This may represent an additional 1-3% of credit enhancement on an annual basis.

**Note protection tests:** These tests are designed to benefit investment-grade bondholders should collateral performance deteriorate. The protection tests consist of an overcollateralization (OC) test and an interest coverage (IC) test. The OC test is a monthly calculation that requires the total collateral balance (numerator) to exceed the investment-grade notes (denominator) by a given ratio at each payment date. The IC test is an additional layer of protection, measuring how much “excess interest” the collateral is generating above what is required to pay interest on the senior notes. For most transactions, both the OC test and IC test are set at a minimum coverage ratio of 120%. Should either test fall below the required limit, the payment waterfall changes such that the distribution of interest payments to the junior and equity notes is used for the paydown of the senior-most notes until the OC and/or IC ratios are restored. This may result in faster paydown of the senior notes than would otherwise be the case.

**SPONSOR SELECTION**

With over 25 sponsors in the market, investors have many options. As mentioned, CRE CLO managers are diverse and consist of large global asset managers, publicly traded REITs, middle-market-focused investment managers, and private real estate debt funds. Given the inherent risk in non-stabilized assets, sponsor quality is critical. From an operational standpoint, an investor should evaluate the sponsor’s level of experience, scale, underwriting approach, servicing/workout capabilities, and financial strength. Key due diligence questions include: How experienced is the management team and how have they performed through cycles? Does the sponsor have adequate infrastructure to execute its long-term business strategy? Does the sponsor have an experienced, high-touch asset management/servicing team? Does the sponsor focus on a specific property type or market niche? How is the business capitalized and what is the financing strategy?

There is also a qualitative aspect to manager selection. Investors should strive to establish relationships with each sponsor they partner with, conducting face-to-face meetings or conference calls at least once a year to assess the leadership’s quality and transparency. Having direct access to sponsors regularly along with access to high-quality information are critical aspects of qualitative assessments.

Allocators must also focus on sponsor issuance and transaction sizes. Some issuers are programmatic (two or more transactions per year) while others issue on a one-off or opportunistic basis. Transaction sizes vary greatly with deals ranging from $250 million to over $1 billion. Senior securities from larger transactions are often seen to have better liquidity.
COLLATERAL CHARACTERISTICS

A thorough review of the collateral and underwriting approach helps ensure investors are exposed to a pool of loans that have a high probability of achieving cash flow stabilization and also have the quality and location attributes that give them a high chance of receiving take-out financing or, in a downside case, have a reasonable downside case liquidation value.

With each CRE CLO having a unique pool of loans, collateral characteristics can vary greatly. Key considerations include:

- The sponsor’s underwriting metrics
- Property type (with scrutiny on hospitality and retail assets)
- Diversification (a more granular pool is more favorable than one that is highly concentrated)
- Asset quality
- Location
- Business plan associated with each property (prefer light to moderate rehab vs. heavy reconstruction)

When provided, investors should also examine the borrower’s financial position, experience with transitional assets, and relationship with the sponsor. Digging a bit deeper, one could argue it is a credit positive when a sponsor’s collateral pool has exposure to repeat borrowers. In addition, acquisition financing is generally viewed favorably as fresh borrower equity creates an all-important alignment of interests between the lender and the borrower.

Performance History

Given the infancy of the CRE CLO sector, the COVID pandemic was its first significant test. And while not immune from credit deterioration, the sector held up exceptionally well, particularly against the broader CMBS market. Even at the height of the pandemic, CRE CLO 30+ day delinquency rates remained low at approximately 3% and considerably lower than the conduit and SASB sectors. This outperformance was driven by active portfolio management, high concentration in multifamily properties, and strong alignment of interests between the borrower and the lender (given that managers hold equity in their own deals, they are incentivized to maintain deal performance, enabling them to receive monthly interest payments and excess spread).

30+ Day Delinquency Rates

Even at the height of the COVID-19 pandemic, CRE CLO delinquency rates remained low at approximately 3% and considerably lower than the CMBS conduit and SASB sectors.

![Graph showing delinquency rates](Source: Intex, BofA Global Research)
Managers have several tools at their disposal to maintain adequate OC coverage. The first line of defense is the managers’ ability to modify loans, so long as the modification doesn’t materially reduce or delay the amount or timing of principal or interest due or impair the security of the loan. Loan modification options include payment extensions, temporary rate deductions, maturity date extensions, business plan updates, and reserve fund rebalancing. This collaborative negotiating between sponsors and borrowers has resulted in lower-than-expected loan default rates. Should loan performance deteriorate beyond the scope of a loan workout, the manager can also substitute a credit-impaired loan with a performing loan, and in some cases, the ability to buy a troubled loan out at par with cash. During the pandemic, substitution was used by a variety of managers to maintain adequate overcollateralization cushion, putting strong support behind their vested interest in the transaction.

CRE CLOs have also benefited from property type distribution. Multifamily properties account for almost 50% of the collateral in CRE CLOs, and have experienced one of the lowest payment default rates at 1% behind self-storage, with no payment defaults. In contrast, lodging and retail each accounted for less than 10% of the collateral backing CRE CLOs and had the highest default rates, at 11.4% and 6.3%, respectively.

**CRE CLO Payment Default Rate by Property Type**

Multifamily properties account for 50% of the collateral in CRE CLOs with a low payment default rate of 1% while lodging and retail each accounted for less than 10% of collateral and had the highest rates, at 11.4% and 6.3%, respectively.

Across the last decade, CRE CLO credit performance has been exceptional with no ratings downgrades or defaults in the CRE CLO market, which is a testament to the robust credit enhancement and investor protections. Of course, the COVID pandemic was a unique crisis, with a rapid decline and sharp recovery in the market. Credit performance may look different in a deep, protracted downturn, which the CRE CLO market has yet to experience.
Weitz Investment Management’s approach to every investment is to earn an adequate return based on our evaluation of the risks we are taking. In the case of CRE CLOs, we evaluate three primary risks: credit risk, extension risk, and liquidity risk. We also focus on diversification. Given that each loan portfolio is unique to a given sponsor, we seek to invest across a variety of sponsors to increase the diversification of loans by property type and geography. While our preference and primary focus is on static transactions with limited reinvestment capacity, we selectively invest in managed deals.

The primary determinants of credit risk include loan performance, positioning within the capital structure, the quality of the sponsor, property valuations, and the seasoning of the collateral.

Extension risk is an important consideration given the transitional nature of the underlying assets and the extension options available to the borrowers. The weighted average life for static transactions depends on four factors: the prepayment rate of the pool, proceeds from any defaulted or repurchased assets, the sponsor’s optional redemption feature, and borrower extension options. Weitz analyzes extension risk by modeling our base case weighted average life assumption using the fully extended maturity terms of all remaining loans, regardless of how each loan’s business plan has progressed.

In terms of positioning within the capital structure, in the new issue market, we have historically aimed to invest at or near the top of the capital stack. As a given transaction seasons, Weitz monitors the portfolio and, in many cases, can track how the pool is performing relative to the sponsor’s expectations. Over time, loans with business plans meeting or exceeding expectations are refinanced and paid out of the pool (resulting in increased credit enhancement for the subordinate tranches), or conversely, loans that are underperforming expectations may be added to the servicer’s watchlist, as they have a higher risk of delinquency or default. Our ability to perform active surveillance monthly allows us to target those CRE CLO transactions with improving credit profiles and avoid those with potential for increased credit risk.

With respect to liquidity, the broader CMBS market has deeper and more consistent secondary market liquidity. However, as the CRE CLO market has expanded, liquidity has improved. Today there are several large broker-dealers making secondary markets in CRE CLOs, and trading velocity has picked up. While liquidity proved elusive at times during the COVID pandemic, the longer-term prospects are favorable as the market grows and the investor base continues to expand.
In the universe of shorter-duration (2-5 year) assets, CRE CLOs offer attractive relative value. CRE CLOs offer much wider spreads than the SASB and conduit CMBS sectors, as well as 1-3 year and 3-5 year investment-grade corporate bonds. Considering the overall risk profile of CRE CLOs, including a liquidity premium, we view CRE CLOs as an attractive way to add yield and diversification to investor portfolios.

**CRE CLO Spreads and Relative Value**

CRE CLOs offer much wider spreads than the SASB and conduit CMBS sectors, as well as 1-3 year and 3-5-year investment-grade corporate bonds.

![CRE CLO Spreads and Relative Value Chart]

*Source: Wells Fargo Securities, Federal Reserve Bank of St. Louis, Weitz Estimates. (Sept 2021)*

**Conclusion**

With its significant growth and strong performance through the COVID pandemic, CRE CLOs have become an increasingly important sector within the CMBS market. There is a lot to like about CRE CLOs, including robust credit enhancement, strong investor protections, significant alignment of interest with the sponsor, and attractive relative value. With significant new issuance and larger deal sizes, secondary market trading liquidity has improved. Investors should understand and evaluate the different risk profiles between static and managed deals. There are many different managers to choose from with varying levels of experience, track records, and financial strength. Our approach is to invest across a wide range of CRE CLO managers in both the new issue and secondary markets, searching for the best risk/reward opportunities across the capital structure.

1. KBRA (July 2, 2021), *CRE CLO Loan Default and Loss Study*.
2. BofA Global Research (June 2, 2021), *CMBS Primer - An introduction to CRE CLOs*. 
The opinions expressed are those of Weitz Investment Management and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions, current through October 5, 2021, are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor’s specific objectives, financial needs, risk tolerance and time horizon.

**Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com.**

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