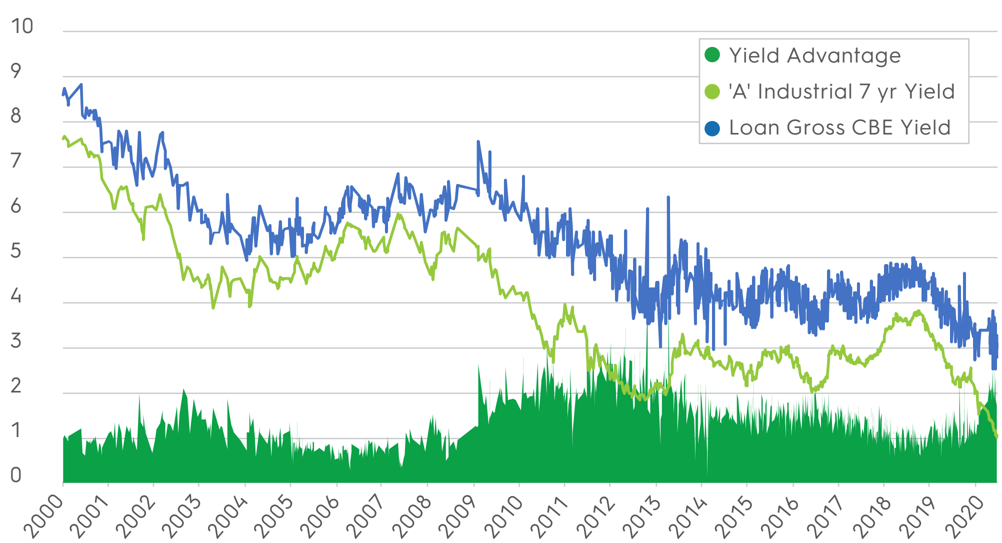
An under-appreciated private debt opportunity: Commercial Mortgage Loans

- **Institutional investors' ability to meet their fixed income performance goals has been seriously downgraded by the COVID-19 pandemic and global economic shutdown.** Historically low pre-pandemic rates are now lower for longer while credit outlooks have weakened.
- **Private commercial mortgage loans (CML) can serve as a complement to investment grade bond portfolios by providing a yield premium with similar risk.** The CML yield premium over corporate investment grade bonds has generally ranged between 100 and 200 bps over the last 20 years.
- **The middle-market segment of the CML market offers the best combination of portfolio diversification, risk management and returns.** Middle-market CML borrowers are located across the country and in all real estate sectors. The limited supply of mid-market lenders means yields are typically higher while lenders have greater control over loan terms.
- **Underwriting expertise and a proprietary deal sourcing network are necessary to successfully build a high-quality middle-market CML portfolio.** A well-diversified CML portfolio can only be built with the access to loan opportunities afforded by a strong deal network.

CHART 1: CML YIELDS AT A CONSISTENT PREMIUM TO INVESTMENT GRADE (IG) BONDS

Bond Equivalent Yield of Securian Asset Management Commercial Mortgage Loan Program vs. A-rated Industrial Bonds of Equivalent Duration (February 4, 2000 – July 9, 2020)



Source: Securian Asset Management, Inc. Securian AM Commercial Mortgage Loans as of 07/09/2020. Commercial Mortgage Loan Yield represents the gross current bond equivalent yield (BEY) of the Securian AM Commercial Mortgage Loans for this period. Commercial Mortgage Loan yield is net of fees, except Securian AM servicing fee. The 'A' Industrial 7-year index includes industrial sector fixed income securities rated A with a 7-year duration, as defined on Bloomberg under the code C0067Y. Yield Advantage represents the difference between the Commercial Mortgage Loan Yield and the 'A' Industrial 7-year yield. The Index is unmanaged and is not subject to fees and expenses. Investments cannot be made directly into an index. See additional disclosures at the end of the material. Past performance is no guarantee of future results. Lending involves many inherent risks. Loans can lose value, including the potential loss of the entire loan.

Institutional investors need higher fixed income yields...

A traditional fixed income portfolio today is likely to generate returns that fail to meet institutions' goals by a substantial margin. For example, the Bloomberg Barclays US Aggregate Bond Index yield to maturity at July 31, 2020, was 1.04% - a far cry from the 6% to 8% return most institutions need to meet their liabilities or spending objectives.

...without higher risk

Unfortunately, the risks of traditional investment-grade fixed income portfolios have risen at the same time yields have declined:

- **Credit risk has risen due to the pandemic lockdowns:** In the resulting recession, the credit risk of many businesses has increased sharply, even as interest rates and bond yields have declined.
- **Interest rate risk has also risen:** The Federal Reserve's unprecedented response to the pandemic has driven Treasury yields even lower than their previous historic lows. But when this external support ends, rates may rise quickly, especially if the massive pandemic fiscal stimulus leads to fear of inflation. Fixed coupon bonds are extremely exposed to rising rates – the duration of the Bloomberg Barclays US Aggregate Index is more than 6 years, for example – so investment grade bond investors could suffer serious capital losses.
- **Bonds' correlations with equities and other assets rose in the crisis:** Bonds failed to provide the stability in the crisis that institutional investors sought as a result.

Private commercial mortgage loans can serve as a sound complement to public investment-grade credit portfolios, adding a much-needed yield premium and strong capital protection, while also playing a portfolio diversification role.

CML: life insurers' "secret" asset class

For decades, life insurers have used high-quality CML to enhance income yield while matching their liabilities with high-quality credit. To date, among institutional investors, life insurers have had this asset class mostly to themselves: corporate, state and local pension funds, for example, only accounted for 1% of outstanding Commercial Mortgage Loans in a recent report.[1]

Commercial Mortgage Loans offer higher yields...

CML has historically provided a significant yield pickup over investment-grade corporate bonds of similar duration. That yield enhancement has averaged 137 basis points since 2000 and stood at over 225 basis points in July 2020.

CML programs can further enhance yields by underwriting loans with higher leverage or via mezzanine loans.

...and secured collateral

Commercial Mortgage Loans are secured by the underlying commercial real estate asset. CML lenders' claims for payment and collateral rank ahead of claims from bondholders and shareholders. As a result, the loss experience tends to be better compared to unsecured corporate bonds.

1. Source: Mortgage Bankers Association, "Commercial / Multifamily Mortgage Debt Outstanding, Q4 2019", page 6. (Note that the 1% number quoted is the sum of the entries on page 6 for "Private pension funds" and "State and local government retirement")

Commercial Mortgage Loans are a good match for institutions' longer time horizons

Loans are typically negotiated between the lender/investor and the borrower, with the involvement of a mortgage broker or banker to bring the parties together. As private loans, they are not liquid and hence best suit investors that will hold them from issuance until maturity.

Loan terms generally run between 5 to 15 years, although longer and shorter terms can occur as well. Interest rates can be either fixed or floating. The negotiated nature of CML means they can be tailored to the needs of both the borrower and the lender/investor.

There is greater likelihood of holding loans to maturity than for corporate bonds. Most corporate bonds can be called by the borrower via a make-whole payment calculated using a 50-basis point discount rate penalty. By contrast, many commercial mortgage loans use the relevant Treasury yield as the make-whole discount rate, creating a much stiffer call penalty for the borrower.

As a result, CML portfolios provide the long-term stable income that meets the needs of liability-driven investors, whether pension plans or life insurers.

Institutional investors have overlooked CML's many benefits

Institutional investors can reap the benefits of CML that life insurers have enjoyed for decades. There is a strong case for replacing a portion of an existing investment grade corporate bond allocation with a CML allocation.

Commercial Mortgage Loans add diversification benefits to any traditional institutional portfolio…

The traditional argument for a large institutional portfolio allocation to investment grade debt is that it provides an "anchor to windward" for portfolios, partly due to bonds' lower volatility than equities, and partly due to their historically low correlation to equities.

Historic volatility is also in line with the volatility of investment-grade bonds over the last 10 years (4.64% for CML vs. 4.96% for investment grade bonds)[2].

…while providing lower equity correlation than IG debt

CML can provide substantially more reliable portfolio protection against equity volatility than traditional investment grade debt does. CMLs' correlations with equity indices are less than half those of investment-grade debt.

In addition, there is low correlation with investment-grade debt itself (0.67 correlation with the Bloomberg Barclays US Aggregate over the past 10 years), which provides some diversification benefit within a fixed income portfolio.[3]

2. Source: Securian Asset Management, Inc. The index used for investment grade bonds is the Bloomberg Barclays US Investment Grade Corporate Bonds Index.

3. Source: Securian Asset Management

COMMERCIAL MORTGAGE LOANS ARE LESS CORRELATED TO EQUITIES THAN TRADITIONAL FIXED INCOME

CHART 2: 10-YEAR CORRELATIONS AS OF JUNE 30,2020

Source: Securian Asset Management, Inc and eVestment. Indices used were the S&P 500 and the MSCI ACWI ex-US ND. Shows 10-year correlation of monthly returns calculated as of June 30, 2020.

CML portfolios typically generate significant income

Loans generate steady cash flows through the monthly repayment of principal and interest. For life insurers with annuity liabilities and pension funds paying pensioners – particularly plans seeking to match liabilities and assets - the ability to build a CML portfolio that will reliably match scheduled outflows regardless of changes in the prevailing interest rate environment is highly attractive. The strong call protection noted earlier is very important in this scenario.

The CML middle-market "sweet spot"

Big loans are not ideal for most institutional investors...

Much of the CML market consists of large loans (over $100 million per loan), which are not suitable for most institutional investors' portfolios for three reasons:

- **Difficult to build a diversified portfolio:** Large loans limit the total number of loans that can be held in a portfolio, thereby inhibiting the ability to build a well-diversified CML portfolio.
- **Large Commercial Mortgage Loans are typically for office buildings:** Large commercial loan deals tend to focus on office buildings in the six major metropolitan areas of the country – locations and buildings that may not be an attractive proposition, particularly post-pandemic.
- **Tight pricing and terms:** There is high absolute demand for CML today. As a result, larger deals tend to be competitively bid, driving pricing down and pushing other loan terms to be more lenient.

Small loans are not great for institutions either

Conversely, the small loan segment of the CML market (under $3 million per loan) tends to involve significant credit risk, as the borrowers are often individuals and/or undercapitalized small businesses. The real estate underlying small commercial loans can also be relatively unattractive, limiting the ability of the lender to recover by foreclosing and liquidating the property.

The CML middle market is particularly likely to suit many institutions

The true “sweet spot” for CML, in our view, is the middle-market segment, or loans in the $3 million to $40 million range. We believe middle-market CML offer the best combination of diversification, risk management and returns.

A CML portfolio built of middle-market loans enables proper portfolio diversification by borrower, location and property type. Concentration risk is also reduced, while at the same time the borrowers are of sufficient size for credit risk to be effectively managed.

Positive mid-market supply/demand dynamic

Anecdotal information from mortgage brokers suggests that fewer than half of commercial mortgage lenders underwrite any loans below $20 million, and that fewer still make loans under $10 million. At the same time, even the largest CML borrowers often need loans in these modest amounts for specific projects, such as a property upgrade.

As a result of this dynamic, mid-market borrowers have to accept higher interest rates and stricter covenants than they would in a more competitive lending environment, such as the large deal space. Thus, Commercial Mortgage Loans often deliver higher yields and better credit protection in the mid-market.

It takes a strong middle-market deal pipeline to build a quality CML portfolio

An established network of trusted mortgage brokers and bankers is required for access to high-quality commercial lending opportunities of any size. As there are fewer middle-market CML lenders, brokers and bankers seek to partner with CML managers they know as trustworthy, and who offer reputable underwriting and closing processes.

Building a network of quality middle-market loan brokers takes time, and managers with such a network are far more likely to gain private access to sound opportunities. Brokers will often bring well-trusted CML managers exclusive, non-competitive lending opportunities, allowing the manager to obtain the best possible terms.

The CML middle-market provides opportunities for strong credit protection.

Bringing together the smaller supply of lenders in the mid-market, and the support a reputable CML manager has from the originating broker or banker, allows the lender to impose stricter loan terms and covenants, reducing credit risk. For example, Securian's CML portfolio average annual loss over 20 years of 0.012% is similar to that of AA+ bonds.

CHART 3: CAREFUL MIDDLE-MARKET CML UNDERWRITING PRODUCES SIMILAR LOSS EXPERIENCE TO AA+ RATED BONDS

S&P Corporate Credit Rating	Weighted Average Default Rate (%) (1981-2019)
AAA	0.00
AA	0.02
A	0.05
BBB	0.16
BB	0.61
B	3.33
CCC/C	27.08

Securian AM CML average annual loss 0.012%

Source: "Default, Transition, and Recovery: 2019 Annual Global Corporate Default And Rating Transition Study", S&P Global Ratings, April 29, 2020

https://www.spglobal.com/ratings/en/research/articles/200429-default-transition-and-recovery-2019-annual-global-corporate-default-and-rating-transition-study-11444862

Securian Asset Management, Inc. average annual loss data as of June 30, 2020

A quality mid-market CML portfolio meets many institutional investor needs

We only know one way to build a high-quality portfolio of middle-market CML: through a rigorous underwriting process drawing from a high-quality deal pipeline that is generated by an experienced, well-regarded CML manager's network. Such a high-quality CML portfolio can deliver many benefits highly sought by institutional investors:

- **Enhanced income yields** well above those of investment-grade corporate bonds,
- **Greater total portfolio diversification** because of very low correlation with equities, and
- **More reliable liability matching** thanks to CML's superior call protection.

About Securian Asset Management, Inc.

As a financially stable mutual company, we focus on the long-term and execute consistently for our clients. Our asset management business has been built with a risk and liability management focus, coming from our long, successful history investing for our parent company's general account. We stay true to our purpose, our values and our St. Paul roots, while being innovative and nimble to help prepare our clients to meet their investment objectives from a position of strength.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

Sources:

Securian Asset Management, Inc., eVestments, Mortgage Bankers Association, "Commercial / Multifamily Mortgage Debt Outstanding, Q4 2019", "Default, Transition, and Recovery: 2019 Annual Global Corporate Default And Rating Transition Study", S&P Global Ratings, April 29, 2020

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