CMBS and COVID-19: A Blueprint for the Path Ahead

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Executive summary

- In reaction to the COVID-19 pandemic, the commercial mortgage-backed securities (CMBS) sector was disproportionately punished by market participants.
- Risk has clearly increased, but 6+ months into the pandemic, fundamental impacts are much clearer while market efficiency is not—this is creating opportunity over the near to medium term.
- Longer term, in an income starved world that has experienced historic re-leveraging in corporate credit, CMBS deserves particular consideration for asset allocators.
- Always important in CMBS, security selection remains key against this backdrop. Voya's CMBS portfolio is well positioned to capitalize as efficiency in the market returns and prices begin to reflect the idiosyncrasies of the different investments across the broader CMBS market.

CMBS Has Been Equally Punished Despite Clear and Significant Differences

	30+ Days Delinquent			CMBS Size, $B
	Aug-20	Aug-19	Change	Aug-20
Industrial	1.2%	1.8%	-0.6%	$ 33.0
Lodging	23.0%	1.5%	21.4%	$ 92.5
Multifamily	3.0%	2.4%	0.6%	$ 338.6
Office	2.3%	2.8%	-0.5%	$ 171.1
Retail	14.9%	4.1%	10.8%	$ 140.1
Total	9.0%	2.5%	6.5%	$ 775.3

Source: Trepp. As of August 31, 2020. "30+ days delinquent" refers to the percentage of properties in each sub-sector where rent collections are more than 30 days late.

"Risk across the entire CMBS market is being viewed through the narrow lens of two troubled sub-sectors. While lodging and retail properties face significant challenges, other areas of CMBS remain intact. This has created a fertile environment to capitalize on opportunities with strong security selection."

How We Got Here: Forced selling created carnage (and opportunity)

A year ago, it would have been extremely difficult to envision a macro backdrop like the one the investing world currently faces. Key inputs into the outlook include an entirely new dimension – the pandemic – while monetary and fiscal policy have conspired to wildly distort risk compensation across the world. This has left investors crudely filtering around perceived sources of uncertainty for suitable risks in their portfolios.

"When a market experiences forced selling, the perceived quality and risk of an investment cease to matter—all that matters is how quickly a market participant can sell it to raise cash."

The CMBS market, through it all, has been "in play". Prior to the intervention from the Fed, the market was punished disproportionately with the collapse in liquidity. During the depths of the COVID-19 dislocation, the term "forced selling" was frequently used to describe market conditions. The price movement in the securitized market was described as "technical in nature" rather than a repricing that emerged from real fundamental risk. So what exactly would ***force*** someone to sell? And why exactly would someone sell when fundamentals suggest that it may not be in their best interest to do so? The answer: leverage.

Mortgage real estate investment trusts (REITs) represented one of the few bastions of outright leverage that remained in the securitized credit markets following the 2008 crisis. The business model of a mortgage REIT is to buy long-term residential and/or commercial mortgage-backed securities and apply leverage to them with short-term financing that is usually obtained from banks. Mortgage REITs post residential mortgage-backed securities (RMBS) or CMBS bonds as collateral to the banks in exchange for this short-term financing. The mortgage REITS then raise equity and debt capital from shareholders and earn money from the difference between the (lower) short-term borrowing rates and (higher) yields of the mortgage bonds.

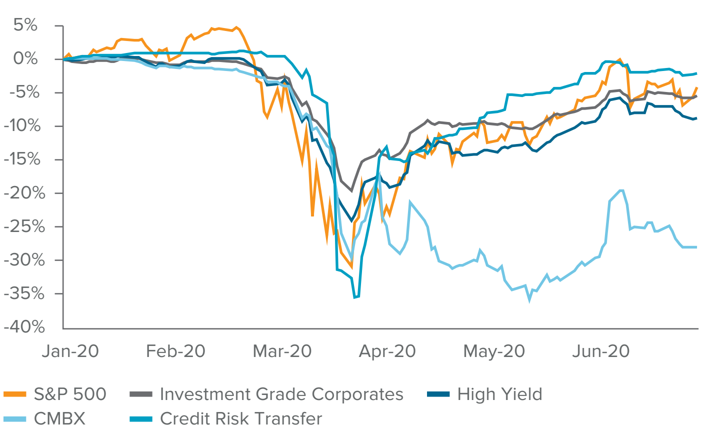
"In securitized credit, execution in the grab for cash was further impacted by CUSIP-level valuation components that became overlooked and are inherently less hedgeable, uniquely exacerbating the dislocation."

Like other forms of leverage, there are margin calls from lenders and if a mortgage REIT cannot meet a margin call, the collateral, i.e., the RMBS and CMBS, can be seized by the banks. As the COVID-19 market turmoil unfolded, mortgage REITs faced redemptions from shareholders and started receiving margin calls from the banks. Banks either seized the collateral and indiscriminately sold it or refused to accept the collateral from the REITs and demanded cash instead, which in turn forced the REITs to indiscriminately sell the CMBS and RMBS collateral to raise cash.

This vicious feedback loop was not contained to a single REIT. At the time of the COVID-19 dislocation, mortgage REITs held $500 bn in RMBS and CMBS collateral, which represents a sizeable portion of the overall market. As a result, this "forced selling" wreaked havoc across the broader RMBS and CMBS markets. This gave CMBS an extremely low starting point for the great retracement, one that has returned equity indices to new highs and pushed corporate credit yields in several large sub-sectors to all-time lows.

The Great Retracement: When will CMBS find a "V" to call its own?

Cumulative Performance January 1, 2020 – June 30, 2020



Source: BloombergBarclays, Markit, Standard & Poor's, Vista and Voya Investment Management. As of June 30, 2020.

S&P 500 as represented by the cumulative performance (price change only), IG Corp as represented by the BloombergBarclays Aggregate Corporate Bond Index excess return (over Treasuries), HY Corp as represented by the BloombergBarclays High Yield Corporate 2% Issuer Cap excess return (over Treasuries). CMBS-BBB as represented by the CMBX BBB CDSI S6 cumulative performance (price change only), CRT as represented by the total return for the Vista 2017 Vintage M Index.

So where does that leave CMBS? As with most environments, and this one in particular, the space faces a mix of key inputs both positive and negative to consider as we plot a course from an asset allocation perspective and invest from a security selection perspective.

"Fundamentals in CMBS remain relatively attractive versus corporate credit but security selection and correctly identifying winners and losers, which is always critical, has risen to a level of importance that is hard to overstate."

Prior to the COVID-19 forced selling, we were overweight CMBS and other securitized sub-sectors because of strong fundamentals. In the depths of the COVID-19 forced selling, we retained our conviction and described the environment as a buyer's paradise for long-term allocators of capital. Six months removed from the market dislocation, two questions are now top of mind for investors looking to allocate to the space: 1) Why has the CMBS sector lagged when others have bounced back and 2) What does the fundamental picture look like going forward?

The short answer for why CMBS has not bounced back as quickly is because it has not received the same level of fiscal and monetary support. The short answer for the fundamental picture is that we continue to believe fundamentals are attractive relative to corporate credit. That said, security selection and correctly identifying winners and losers, which is always critical, has risen to a level of importance that is hard to overstate.

Question #1: Everything else has bounced back, why hasn't CMBS?

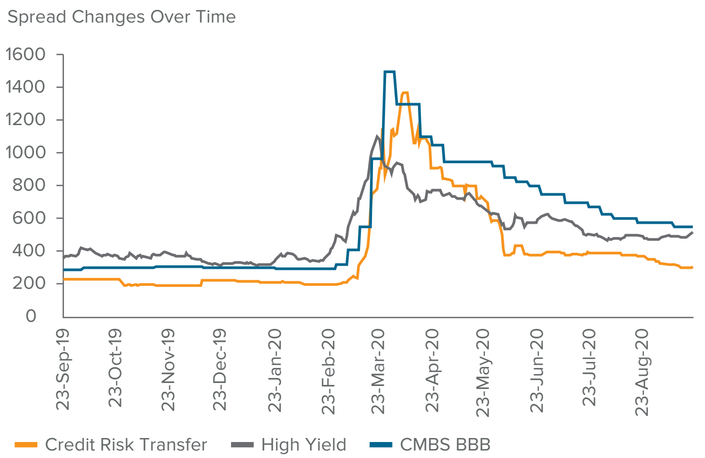
While CMBS has participated in the rally, it has been largely orphaned by the Fed and U.S. Treasury's largess, and has lagged most competing risk markets. Policies to bolster markets have been directly and disproportionately designed and implemented in support of corporate and municipal credit markets. Arguably, these are the places where direct aid was needed most urgently and critically in order to most efficiently bridge to the eventual re-opening of the economy.

"When considering the reward part of the classic risk-reward paradigm, the CMBS sector shines compared to other fixed income segments, offering attractive yield for what is likely to be a prolonged period of extremely low interest rates."

Conversely, fiscal- and monetary-policy-driven spending and programs directed towards securitized credit markets have been more limited in scope and slower, overall, to become active. The Fed's loan program targeting securitized markets became operational in late May and is relatively limited in its size ($100bn) and scope. On scope, the program's eligibility criteria is limited to senior securities rated AAA, and can only be applied in certain identified parts of the ABS, CLO and CMBS markets.

From a positive standpoint, when considering the reward part of the classic risk-reward paradigm, the CMBS sector shines, standing out against the overall fixed income market, with the Bloomberg-Barclays Aggregate yielding well under 1.5%. As evidenced by the below graph, spreads widened materially in the pandemic-inspired liquidity collapse and have significant room to tighten to approach pre-pandemic levels.

Relative Value: CMBS Offers Attractive Yields for the Zero Interest Rate Policy (ZIRP) World Ahead



Source: BloombergBarclays, Markit, Vista and Voya Investment Management. As of September 20, 2020.

This leaves the space attractively valued, at least on a nominal basis relative to other markets, both inside securitized markets and out – dramatically so in some cases. In a world of rates at or close to all-time lows, and the recent historic policy shift by the Fed to promote lower rates for longer, spread premium and income is a particularly valuable attribute to consider when allocating risk.

This premium has been maintained despite a persistent de-leveraging in the space, which has seen issuance volumes decline 29% year to date through mid-September. Now can the reward actually be realized?

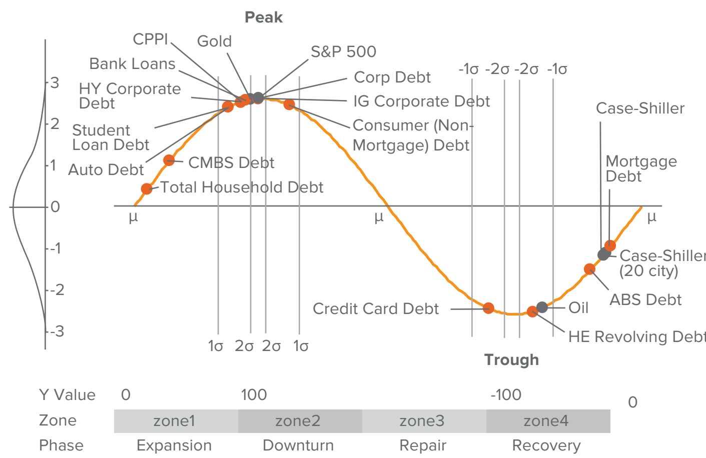
Question #2: Has the fundamental picture changed?

Before the COVID-19 pandemic, our relative overweight to securitized credit over corporate credit was driven, in part, by the differences in leverage between the two sectors following the 2008 crisis. Other diversifying components associated with the securitized space – especially the structural dimension – were regarded as positive risk mitigating attributes. However, as the pace of corporate issuance resumed its higher trajectory following the 2008 crisis, it outpaced growth in the economy, displaying characteristics normally associated with a market later in its cycle. Meanwhile, securitized sectors re-leveraged more slowly over the period following the 2008 crisis, reflecting markets relatively early in their respective cycles.

"Asset allocators can take comfort in the de-leveraging that is taking place in commercial real estate, which will ultimately leave the space earlier cycle than other markets that have already re-leveraged."

While the pandemic has been a game changer from numerous dimensions, importantly, largely thanks to the Fed's actions to support credit markets, the COVID-19 dislocation did ***not*** wipe away this leverage from the corporate credit arena—in fact corporate leverage has increased further relative to its long-term average on the heels of record 2020 issuance. Needless to say, with the historic re-leveraging that has occurred in corporate credit, this technical backdrop can be noted by asset allocators as favoring CMBS on a relative basis. Voya's proprietary cycle chart helps illustrate the more favorable market dynamics associated with CMBS.

CMBS and Other Areas of the Securitized Market Remain Better Positioned for the Long Term than Corporate Credit



As of June 30, 2020. Source: Bloomberg Barclays, S&P and Voya Investment Management. Representative cycles are normalized relative to nominal GDP. Each representative cycle incorporates all available data starting from the year 2000. Covered time frames and sample rates may vary depending upon availability of specific cycle data.

Given the limits of monetary policy tools, the uncertainty of further fiscal policy support and the uneven fundamental outlook across and within fixed-income sectors, we see the U.S. economy shifting into a "K-shaped" recovery. While the structural dimension provides a degree of cushion within CMBS transactions, the resulting uneven pressures will create winners and losers with broad strokes across the CMBS spectrum. Longer-term CMBS performance is inextricably linked to the re-opening of the broader economy. Given the potential for relative-value driven bounces, the current crisis has undeniable, damaging implications for parts of the CRE universe such as student housing, hotel and retail; and potential longer-term implications for office and multifamily segments.

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However, as economies slowly but surely re-open, this will inevitably favor "back to business" segments, improving CMBS volatility prospects relative to the overall market. The structural dimension, with its protective attributes, will help accelerate sponsorship and risk taking as uncertainty lifts with this backdrop. And on a longer-term basis, asset allocators can take comfort in the de-leveraging that is taking place in commercial real estate, which will ultimately leave the space earlier cycle than other markets that have already re-leveraged.

Putting this together, CMBS should command risk budget in a fixed-income portfolio. However, given the still elevated credit risk component, and crucially – the idiosyncratic nature of CMBS – a security selection-oriented approach becomes critical to optimize the opportunity the sector currently presents and bridge the allocation to a more fully recovered – and open – economy.

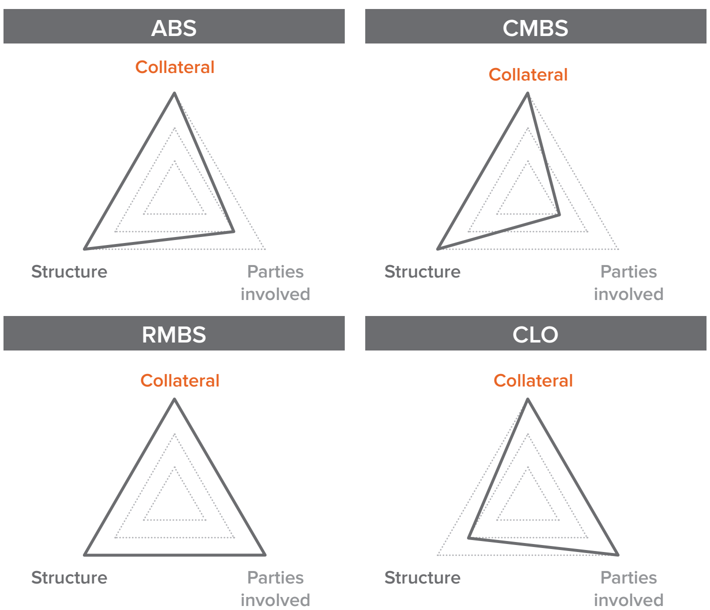
Separating the winners from the losers in CMBS

For those familiar with Voya's process for investing in securitized credit assets, the refrain of "through the cycle" investing may sound familiar. In the pursuit of identifying attractive long-term investment opportunities, security selection considers three key elements: underlying collateral, governing structure and the underlying parties that are involved. This analytical triumvirate ensures a complete measuring of risk by investors, no matter the sub-sector.

"Crucially, from a security selector's point of view, despite the presence of winning properties and losing properties, market treatment has not been sufficiently differentiated."

As the figure below highlights, the emphasis for these three primary dimensions (collateral, structure and third parties) will vary across the major securitized food groups and can shift over the course of the securitized credit cycle. Currently, collateral and structure are a particular emphasis for CMBS.

Collateral	■ Underlying real property or other assets a borrower pledges to secure a loan from a lender
Structure	■ Legal and contractual framework for allocation of fees, payments and shortfalls/losses. Typical structures have multiple tranches with varying risk/return profiles with credit enhancement a key dimension. Structure also includes documentation prescribing actions of related third parties
Third Parties	■ Loan servicers, asset originators, trustees, loan managers, risk retention providers, rating agencies, broker-dealer, et al.



Source: Voya Investment Management. For illustrative purposes only.

Peeling back the layers of the CMBS onion starts with the collateral. In today's environment, the property-type conversation in commercial real estate is at the forefront of assessing value and revolves around three main themes:

1) Seismic transitions (retail)

2) Forced de-leveraging (hotel)

3) Longer-term uncertainty (office)

Their relative cycles are in extremely different phases and in each case, there already are clear winners and clear losers. Of course, the structural dimension in CMBS is overlaid across these situations when assessing risk, but these themes must be thoroughly underwritten and expected to impact positioning.

With this backdrop, hotel and retail properties will NOT continue to command the benefit of the doubt as they are later in their respective cycles, albeit moving at extraordinarily compressed rates of change. By way of example, long-term retail industry participants talk about several years of transition occurring in a matter of months since the onset of the pandemic. Somewhat similarly, the hotel segment, which suffers from the uncertainty associated with nightly lease terms, has had its hand forced by the collapse in travel, the return of which is uncertain even in a post-pandemic landscape.

The office property type, conversely, has continued to command sponsorship, protected by their longer-term leases as well as a healthy mix of longer-term "office bulls" that believe in long-term demand supported by the corporate marketplace. This has been further supported by resilient payment performance by mortgage holders of office properties, barely budging since the pandemic. This is similar in behavior to other property types like multifamily and industrial.

Crucially, from a security selector's point of view, in each case of these "in play" property types, despite the presence of winning properties and losing properties, market treatment has not been sufficiently differentiated.

A closer look at retail properties highlight the idiosyncrasies of CMBS

To illustrate the opportunity for security selectors, focusing on retail, perhaps the most comprehensively punished portion of the CMBS universe, the differentiators are many and are extreme.

"Retail is a microcosm for what is transpiring across the broader CMBS space—all retail risk is being viewed as uniformly bad. When you dive deeper into the fundamentals, however, clear and important idiosyncrasies emerge across the different investment types."

Analysis begins at the specific sub-type of property – drug stores, neighborhood/convenience centers, shopping centers and malls. At a high level, most of these retail concepts remain extremely viable, if not systemic parts of the retail landscape. The key 'at risk' property type we highlight are the malls, given the transitioning nature of apparel consumption and 'non-essential' retail in the U.S., at least as deemed by policy makers in the context of pandemic-related, government mandated societal shutdowns.

"Like other areas of CMBS, there are winners and losers in the retail space and in most cases the losers are simply being affected by trends that were already in place and have accelerated because of the world's response to the pandemic."

Retail is a microcosm for what is transpiring across the broader CMBS space—all retail risk is being viewed as uniformly bad. When you dive deeper into the fundamentals, however, clear and important idiosyncrasies emerge across the different investment types. Like other areas of CMBS, there are winners and losers in the retail space and in most cases, the losers are simply being affected by trends that were already in place and have accelerated because of the world's response to the pandemic.

We have focused on these trends for over 10 years, given the transition in malls that has been ongoing, albeit at a slower pace pre-pandemic. Voya's portfolio has and will continue to benefit from the broader retail trends as efficiency in the market returns and prices begin to reflect the idiosyncrasies of the different investments across the broader CMBS market, and the retail segment in particular.

Tenancy

Tenancy is complex, but crucial in Voya's evaluation of collateral and parties involved dimensions of our underwriting process. Measuring the importance of tenants in retail properties is not always obvious – tenants take various amounts of square footage and pay rents specific to their lease in individual properties, but, in the case of a mall, may also tie to the rents paid by other tenants (co-tenancy clauses). This comes to bear most predominantly with the so-called big box department stores that have been in the headlines all too frequently in recent years, quarters and months. While our list of top tenants is not absent of concerns, it is not reliant on the rent paying capabilities of many of the "big box" department stores that have failed or are otherwise struggling to survive in the current environment.

This leaves our retail properties (and the transaction structures in which the tenant exposure is housed) better positioned to absorb fallout from closures associated with struggling businesses. Sizing risk here also benefits from an enlightened view on the solvency risk associated with some of these operators. Part of the investment process at Voya involves tapping the corporate credit teams' insights into the plans of these entities; winners and losers in retail can rapidly come into focus through this lens.

Location

The other major dimension for security selection within retail, which is germane to any commercial real estate discussion, is location. Considered down to the address level, using boots on the ground color where possible (see Voya's Real Estate Finance team and related mortgage broker network), winners and losers become apparent. This has driven improved positioning in currently distressed areas in NYC, for example, where we have maintained a structural bias against ground level retail in Manhattan since 2018. This view was driven by the extreme level of rents the market had moved to, despite an overall challenging retail backdrop and supply pressures. As vacancies balloon and rents reset, this bias has led to limited exposure to this vulnerable part of the CRE ecosystem in Manhattan. While not eliminating exposure to retail in the New York Metropolitan Statistical Area, which contains the world's largest urban landmass and is the most populous metro in the US, these steps promote a positive ultimate outcome in the broader NYC area as we emerge from the pandemic and the raw power of its consumer-driven economy re-engages over time.

Office properties face longer-term challenges

Transitioning to the office sector, which, as alluded to above has not experienced the distress associated with hotels and retail properties, does have longer-term questions. This portion of the CMBS market has been a post-financial crisis bastion of stability. Typically commanding strong ownership (crucial piece of the evaluation), LTVs are lower and rollover risk is well managed. Layering in a steadily growing economy with low unemployment and stable wage growth, the sector benefited from generally growing rents and increasing valuations, particularly in gateway markets like NYC and San Francisco, which are population centers that attract top companies. The CMBS market, with its larger size and ease of execution (in most market environments) is a natural fit for larger, Class A properties so common in these urban markets, generally a positive for credit quality and transaction liquidity.

However, the pandemic and the ensuing changes in the way the world has worked have thrown a monkey wrench into those dynamics. It creates questions and potential opportunities, which are being actively considered and decided upon by much of corporate America and may prove a longer-term headwind for this property type.

At the same time, many corporations are contemplating adding additional office space, either owing to social distancing considerations arising from the pandemic or seeking to increase their footprints as their businesses have grown. In still other cases, the normal churn in office space continues to occur as tenants seek to relocate to newer properties or into areas opportunistically to obtain favorable lease terms around expiring leases or new properties on the market. It is important to follow these movements closely, staying in front of shifting trends that may challenge the potential outcomes for loans that collateralize CMBS from a security selection standpoint as well as the collective impact of these factors in driving asset allocation to the CMBS market.

As alluded to, this includes office exposures in cities that have been disproportionately impacted by the pandemic as well as by social unrest and the related fallout that has correlated with increased crime and strains on financing with state and local governments. NYC again comes to mind, where office exposures are, perhaps predictably, commonplace in CMBS transactions, given its status as a financial capital and population center. Older properties with already levered borrowers (see WeWork) are the most poorly positioned within Manhattan and the surrounding boroughs and have been valued using higher cap rates when evaluating existing or new risk positions by Voya's CMBS team. Examining rent rolls for near-term maturities and concentrated tenant risk are also key ingredients that may exclude certain transactions from consideration for investment. Insulating the portfolio from potential losers in the future, no matter which way the office narrative evolves, is the goal with this approach.

Conclusion: Focus remains on “Through-the-Cycle” performance

Linking these observations together, it is crucial to tie together each driver of valuation to best position for the winners and losers in the economy, both near term and long term. Uncertainty won’t be completely eradicated but *overlaying the structure of the transaction and how credit enhancement afforded the tranche we are considering investing in* helps protect against the uncertainty that exists, allowing the targeted Through-the-Cycle outcome to be realized.

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