PRIVATE DEBT INVESTOR

Putting the heat back in real estate CLOs

By Irwin Speizer

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As investor appetite for securitization grows, commercial real estate Collateralized Loan Obligations (CLOs)– rarely seen since the Crisis – are in fashion again, with new CLO issues coming to market at a rapid clip.

On December 21, Blackstone Mortgage Trust Inc. closed a $1 billion CRE CLO, the largest issue of its type since the financial crisis. That was quickly followed by TPG Re Finance Trust Inc. which announced a $932.4 million CRE CLO on February 14. Other issuers have also jumped into the fray, including Varde VMC Lender, which launched a $368 million CRE CLO on January 25.

CRE CLOs had all but dried up after the financial crisis. Now they're back. Kroll Bond Rating Agency pegged new CRE CLO volume in 2017 at $7.7 billion, compared with $2.5 billion in 2016. Predictions for 2018 range from $10-$15 billion.

"CRE CLO markets have recently begun to heat up again," says Christopher Acito, CEO of Gapstow Capital Partners in New York, an alternative investment firm that allocates to credit strategies. "Markets are increasingly willing to securitize an ever-broader range of collateral, and securitization is finally providing better terms than other forms of financing."

Despite the growth spurt, CRE CLOs remain dwarfed by the broadly syndicated CLO market based on business loans. According to Fitch Ratings, there were 183 new, broadly-syndicated CLO issues last year totaling $103 billion, plus another $133 billion in other CLOs like resets and refinances. The $7.7 billion in CRE CLOs last year comprised just 17 new issues.

Growing appetite

But while the CRE CLO market may be comparatively small, its emergence suggests a growing appetite on the part of investors for securitized products. That trend has encouraged large, established asset management firms like Blackstone and TPG to bring more CLOs to market.

"The CLO market is booming," says Wade O'Brien, managing director for capital markets research at Cambridge Associates, an investment advisor to clients like pension funds and endowments. "Investors are looking for yield."

Shlomi Ronen, founder and principal of Dekel Capital in Los Angeles, which arranges financing for real estate developers and investors, says private debt funds now play a larger role in commercial lending than commercial banks. Securitization of loans is helping provide more liquidity to the market. "There is a growing acceptance of securitization in commercial real estate," Ronen says. "It brings more players into the space."

CRE CLOs are helping fuel a rush to originate loans, with an estimated 90 lenders now actively pursuing real estate bridge loans. For investors in CRE CLOs, due diligence carries some significant differences from broadly syndicated business loan CLOs.

CRE CLOs have a different risk profile from their business loan cousins. They can contain just a few dozen large loans for properties like shopping centers or office buildings, while broadly syndicated CLOs can comprise hundreds of business loans. The greater concentration in CRE CLOs can raise additional risk concerns, since a default on one large property can have a more dramatic impact on the entire CLO.

For example, the $1 billion Blackstone issue, BXMT 2017-FL1, contained 31 loans. The $932 million TPG issue, TRTX 2018-FL1, consisted of 26 loans.

Secular concerns in commercial real estate are also an issue. When retailer Toys ‘R Us recently filed for bankruptcy liquidation, its failure put stress on its extensive real estate footprint. At the annual Structured Finance Industry Group (SFIG) annual conference in Las Vegas this February, which was attended by 7,000 professionals, the commercial mortgage discussion looked at a number of issues, including rising commercial real estate vacancy rates and slowing rent and price growth.

The concentrated nature of CRE CLOs and the different considerations in real estate loans from business loans pose challenges for investors shopping CLO options. The broader loan portfolios of business loan CLOs and the often more granular business data available on companies holding the loans can make broadly syndicated CLOs easier to digest for investors.

Feeling bullish

But the overall mood about securitized products remains optimistic for 2018, thanks in part to the robust US economy.

In a review of the SFIG conference, Kroll Bond Rating Agency said that what stood out at the event was the “overwhelmingly bullish sentiment” about securitized credit. Kroll also noted the higher level of interest in CRE products at an event that historically focuses much more on other areas like Asset-Backed Securities (ABS). The focus of those CRE panels seemed to be less on worries about stress in the real estate sector and more on the strong investor demand for CRE CLOs. Two issues that stood out at the conference and remain hot topics for the CLO industry: changes to the risk retention rule for CLOs and the phase-out of LIBOR as a benchmark for floating-rate debt.

CLOs have been subject to a rule that requires 5 percent risk retention by managers, which has resulted in the creation of a subset of risk-retention CLOs to raise the needed capital. A court case that found CLOs would not need to follow the 5 percent rule was upheld on appeal in February. There is still a chance the ruling could be overturned on further appeal, but speculation at the moment is that the ruling will stand and become final by April.

How the elimination of the 5 percent rule could play out remains to be seen. One possibility is that the elimination of risk retention could be an incentive for players which were unable or unwilling to meet the requirement. “If risk retention goes away, it makes it easier for smaller managers which had been shut out to return to the market,” says Derek Miller, a managing director for structured credit at Fitch Ratings.

Miler estimated that about 20 viable managers had opted not to issue CLOs since the risk retention rules went into effect in 2015. Some of those might now be looking at returning to the market, while other new managers might be encouraged to participate.

If the ruling stands, by early April, “We will begin to see people maneuvering. It will be interesting to see how all these plans play out.” But Miller said he does not anticipate a dramatic rise in the number of managers issuing CLOs.

Even without a risk retention rule, investors may be reluctant to go back to managers which don’t offer some risk retention, having grown comfortable with the added security of retention. In its SFIG conference report, Kroll noted that it is unclear “whether investors will be willing to buy bonds from issuers which don’t retain any of the risk.”

The LIBOR issue, meanwhile, poses some operational challenges for CLO managers, as alternative benchmarks are being considered to replace the phase-out of LIBOR. Since broadly syndicated CLOs tend to be floating rate-based and tied to LIBOR, managers are scrambling to find flexible ways around the benchmark issue until an agreed-upon replacement is decided.

For CLO investors, one emerging issue is the potential weakening of underwriting and creditor rights in CLOs. As investors hungry for yield turn to structured products like CLOs, managers which enjoy strong investor demand may be tempted to water down investor rights and protections.

“The wild card that people are worried about is weakening documentation and creditor rights, and aggressive assumptions by underwriters in loans,” says O’Brien says. “Investors are desperate for yield, and issuers are getting increasingly aggressive about removing traditional creditor rights in documentation.”