Commercial Mortgage Loans:

A Mature Asset Offering Yield Potential and IG Credit Quality

by Jack Maher, *Managing Director, Head of Private Real Estate*
Mark Hopkins, CFA, *Vice President, Senior Research Analyst*

Commercial mortgage loans (CMLs) have emerged as a desirable option within a well-diversified fixed income portfolio for their ability to provide incremental yield while maintaining the portfolio's credit quality.

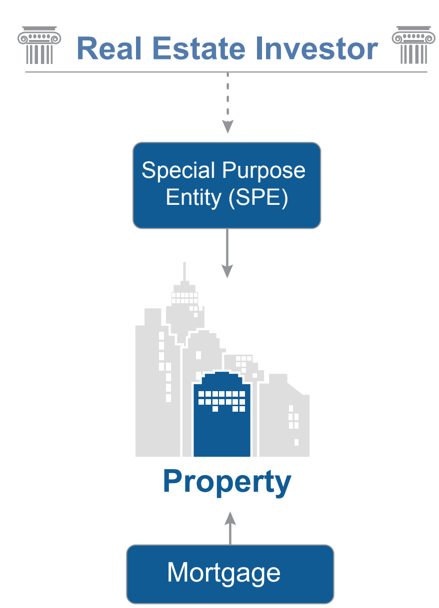
CMLs are privately negotiated debt instruments and do not carry risk ratings commonly associated with public bonds. However, our paper attempts to document that CMLs generally available to institutional investors have a credit profile similar to that of an A-rated corporate bond, while also historically providing an additional 100 bps in yield over A-rated industrials.

CMLs differ from public securities such as corporate bonds in the types of protections they offer investors, most notably the mortgage itself, a benefit that affords lenders significant leverage in the relationship with borrowers. The mortgage is backed by a hard, tangible asset – a property – that helps lenders see very clearly the collateral behind their investment. The mortgage, along with other protections, has helped generate historical recovery from defaulted CMLs that is significantly higher than recovery from defaulted corporate bonds. The private CML market also provides greater flexibility for lenders and borrowers to structure mortgages that meet specific needs such as maturity, loan amount, interest terms and amortization.

Real estate as an asset class has become more popular among institutional investors such as pension funds, insurance companies, open-end funds and foreign investors. These investors, along with public real estate investment trusts (REITs), generally invest in higher quality properties with lower leverage. They are all active borrowers in the CML market and provide an abundant supply of quality CMLs for life insurance companies and other institutional lenders.

Investors with an interest in CMLs are wise to seek managers/lenders with scale, experience, access to deal flow and, most importantly, underwriting strength. Within these parameters, evidence is strong that as an asset class CMLs deserve consideration among a portfolio's credit allocations. Credit rater Fitch, which studies life insurer investment portfolios, agrees and said it "generally believes the presence of a well underwritten portfolio of mortgages, diversified by property type and location, can add value to a life insurer's investment portfolio".[1]

Figure 1 – Typical Commercial Real Estate Ownership and Mortgage Structure

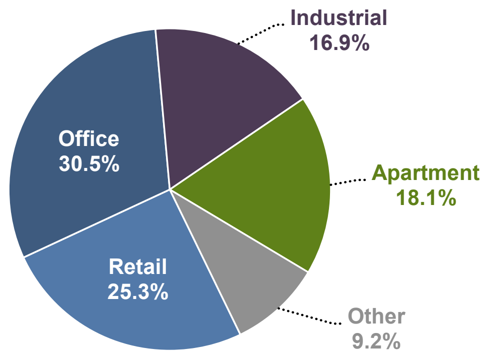


CMLs: A Brief Description

CMLs are loans secured by a first mortgage on commercial real estate such as office buildings, apartments and shopping centers. The mortgage entitles the lender to foreclosure on the property in the event of default, and its claim is ahead of all unsecured claims of the borrower. Generally, the borrower is a special purpose entity created exclusively to own the property, and recourse is usually limited to the property. The ultimate owner, often a major developer or institution such as a pension fund, is in most cases not directly responsible for payment **(see Figure 1)**. However, the financial strength of the ultimate owner, or sponsor, is an important consideration for CML lenders because the sponsor is the source of funds if the property requires external capital.

Figure 2 – Mortgage Loan Portfolio Profile

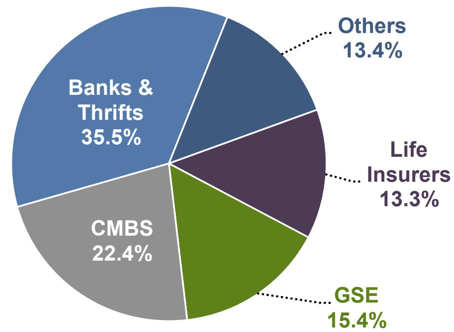
American Council of Life Insurers



Source: American Council of Life Insurers, as of December 31, 2013

Figure 3 – CML Debt Outstanding

By Investor Group



Source: Mortgage Bankers Association, as of December 31, 2013

CMLs are private transactions in that they are not registered with the Securities and Exchange Commission. The lender and borrower negotiate terms of the loans which, unlike public bonds, are not reviewed by rating agencies and therefore carry no public rating. Usually, one lender funds the whole loan with proceeds equal to a portion of the property's value at closing, a ratio referred to as "loan-to-value" or LTV. Life companies typically lend in a range of 60% to 70% LTV and are sought-after participants as lenders **(see "Life Companies: Lenders of Choice")**.

For institutional lenders, CML collateral consists mainly of four property types: retail, office, multi-family (apartments), and industrial (warehouse). These make up nearly 91% of life company mortgage portfolios as reported by the American Council of Life Insurers **(see Figure 2)**.

Today CMLs are an important component of the fixed income portfolios of many leading financial institutions including banks, government-sponsored enterprises (GSEs) such as the Federal National Mortgage Association (Fannie Mae), and life insurers. Wall Street has also packaged commercial mortgage loans into commercial mortgage-backed securities (CMBS) and sold the trust liabilities to fixed income investors **(see Figure 3)**.

Of the $2.53 trillion of CMLs outstanding as of December 31, 2013, life companies, with $336 billion, are the fourth largest participant, according to the Mortgage Bankers Association.

Benefits: An "A" Credit and Another 100 bps

While CMLs carry no credit rating, their performance within life company portfolios illustrates a credit risk profile that is similar to an A-rated corporate bond.

According to Fitch surveys of U.S. life insurers, which represent 90% of industry CML exposure, the cumulative loss rate on CMLs (realized losses and impairments) during the worst of the last credit cycle (2008-2012) was 1.28% **(see Figure 4)**.

To find a corporate rating equivalent to the CML loss rate, HIMCO consulted Moody's "Annual Default Survey" for corporate losses during the same period.[2] HIMCO concluded that the best fit was the "A" rating category which experienced a 2.437% cumulative default rate between 2008-2012. To convert the default rate into a loss,

Life Companies: Lenders of Choice

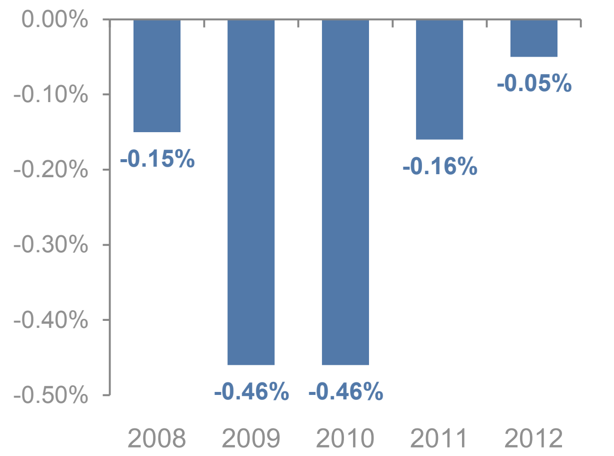
One key advantage for life companies,* which helps explain why they have access to CMLs backed by some of the more preferred properties, is that the industry provides borrowers with the type of capital they desire: floating or fixed rate financing at competitive rates, flexible terms and ease of execution.

Life companies often underwrite the whole loan, and usually have asset management services in-house. This can make it easier for borrowers with loan amendments and workouts, as they must deal with only one lender and no special servicer is involved.

Also, life companies can be flexible with respect to the property types they underwrite and the locations where they choose to lend. For borrowers with multiple property types in many locations, such as open-end funds, this is attractive because the number of lender relationships can be kept to a manageable level.

*HIMCO's parent company, The Hartford Financial Services Group, Inc., is mainly a P&C insurer yet invests in CMLs in a manner similar to life insurers.

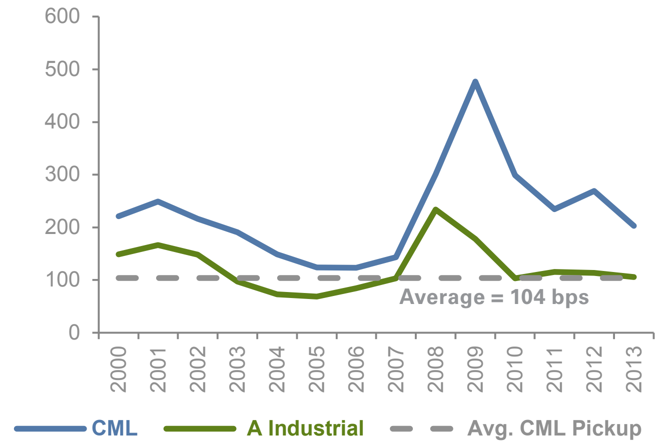
Figure 4 – Life Industry Commercial Mortgage Losses



Source: Fitch, as of December 31, 2012. Past performance is no guarantee of future results.

Figure 5 – Spread over U.S. Treasuries

A-Rated Industrials vs. Commercial Mortgage Loans



Source: ACLI and Point, as of December 31, 2013. Past performance is no guarantee of future results.

HIMCO subtracted the long-term recovery rate on unsecured corporate bonds from the default rate; the result was 1.53%.[3] This is close to the 1.28% cumulative CML loss rate discussed previously and supports HIMCO's contention that life company CML portfolios have a credit profile similar to A-rated corporate bonds.

HIMCO believes that the most recent credit cycle is the most relevant period for comparison because the recession severely impacted the real estate and corporate sectors, and life company CML portfolios fully reflected the industry's move to higher quality properties owned by well-capitalized institutional borrowers.

Figure 5 shows the historical spreads over U.S. Treasuries for CMLs originated by life companies and A-rated corporate bonds (7-10 year industrials). Over the period (2000-2013) the average spread advantage for CMLs was 104 bps. Currently, the spread pickup over industrials is approximately 65 to 120 bps, depending on quality, property type and maturity.[4]

Diversification

In addition to offering incremental yield, CMLs also help diversify institutional portfolios by adding another credit-based asset class whose performance dynamics differ substantially from corporate credit risk. CML portfolios themselves are also diversified by property type and location.

Type – The underlying fundamentals that drive performance for each property type rarely move in lockstep. Demand for office space is largely driven by corporate profitability, while warehouse demand moves with the market for tradeable goods. Demand for retail space is very location-specific and is often driven by the quality of anchor tenants. For apartments, the primary drivers include population and employment growth, and housing affordability.

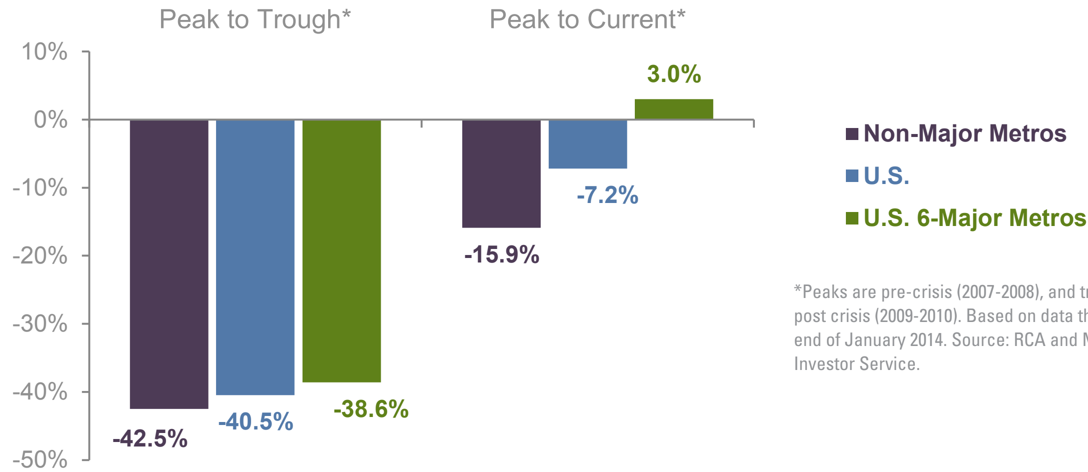
Supply (i.e., new construction) for each property type can also move independently. For example, a port city may be experiencing robust population and apartment growth, but little in the way of warehouse development because trade activity has been modest.

Tenant lease terms also vary by property type: office, retail and industrial leases typically run five years, while apartments run six months to a year. Longer leases can temper the decline in cash flows during downturns.

Location – Regions of the country have their unique economic foundations – Houston is oil country, Washington, D.C. is federal government, Silicon Valley is high tech, etc. – and correlation between the regions' real estate markets is often limited. Institutional investors, especially life insurers, typically favor the major U.S. metropolitan areas (MSAs). These MSAs have more diversity than smaller markets, are often supply-constrained, and are embraced by a wide range of real estate investors. In some cases a mortgage loan is secured by multiple properties located across several MSAs, a process called cross-collateralization. This is particularly advantageous for the lender because properties in weak areas, that otherwise could get into trouble, are supported by assets in the stronger markets.

Figure 6 – Major Market Price Recovery

2007 - 2014



*Peaks are pre-crisis (2007-2008), and trough are post crisis (2009-2010). Based on data through end of January 2014. Source: RCA and Moody's Investor Service.

As documented in **Figure 6**, prices in the major markets declined less and recovered sooner than secondary markets. Moreover, value coverage—even for mortgages originated at the peak—remained largely intact, especially for those who follow conservative underwriting lending practices like life companies.

Having a portfolio of high quality properties diversified with respect to property type and geography can mitigate idiosyncratic risk (i.e., property and location) from CML portfolios.

Systematic risk—risk associated with broad movements in the overall economy and financial markets—remains and affects properties through the primary determinants of property valuation: cash flow and the capitalization rate (cap rate) on cash flow. During periods of economic stress, property cash flows may decline while cap rates rise, resulting in a decline in property values and less asset protection for the mortgage loan (i.e., a higher LTV).

While no CML portfolio is immune to this risk, certain assets—quality properties in major metros—are generally more resilient for two main reasons:

Tenant trade-up – During downturns tenants often "trade up" to better quality properties, which may help keep occupancy high.

MSA strength – Properties located in metros with strong growth records (or supply constraints) will likely attract buyers —even at the bottom—because there is faith that, ultimately, recovery will come. Since the collateral backing life company CMLs is at the higher end of the quality spectrum (and largely located in the major MSAs), systematic risk for life portfolios is likely lower than that of the CML market as a whole.

The Mortgage Advantage: Higher Historical Recovery

Mortgages and the mortgage market operate differently than unsecured public bonds and offer additional reasons for institutional investors to consider including CMLs as a portion of their portfolios. The mortgage itself is a very powerful tool for serving the interests of the lender/investor and historically has helped lead to higher recovery rates on CMLs versus public corporate bonds.

Locked-in Debt – Once a mortgage loan is made, no additional debt can encumber the property without the lender's consent. That's a powerful level of control over an asset, and no equivalent level of control is available in corporate credit. Regardless of the bondholders' desires, a company can change a great deal after it issues bonds – it can take on more debt, acquire a new businesses, etc. CML borrowers have no such flexibility.

Simpler workout – In the case of whole loans which are provided by one lender, it's easier to conduct loan workouts that address the needs of the lender rather than those of a large group, which usually has multiple and often diverse interests.

Amortization – Under the terms of the loan agreement, a lender often requires the borrower to amortize a portion of the loan (pay down some of the principal) over its term. This reduces the loan balance over time, and assuming no change in the mortgaged property's value, will lead to a lower LTV ratio over the course of the loan and at maturity. The lower balance will be easier to refinance, thus reducing the risk for workout or default. For the borrower, however, amortization increases the monthly mortgage payment.

These protections for lenders have helped CMLs become extremely effective in reducing loss in the event of default. A long-term study of life industry CML defaults revealed losses in the order of 33% – an implied 67% recovery rate – for loans that went all the way to liquidation.[5] This is significantly higher than the 37% recovery rate experienced for unsecured public corporate bonds.[6]

Additional benefits of CMLs are:

No call – Typically, fixed-rate CMLs are not callable by the borrower for one to two years after origination. Subsequently, calls are permitted at the greater of par plus a fixed premium (typically 1%) or make-whole (typically at a discount rate of Treasuries plus 50 bps).

Monthly may mean more – CML payments are monthly as opposed to bonds' semi-annual schedule, which may provide lenders a slight increase in yield.

Negotiating the CML Terms

The CML market encourages creativity and choice as its parties negotiate their deals in competition (lenders' offers are often called "bids") and consider loan amounts, spread (interest) and amortization in the discussions. (**see "Working Examples: A Look at Two Loans"**)

For example, one lender may judge a property and its location better than others and allow the borrower to carry more debt. So the lender offers a loan with a higher LTV but charges a higher interest rate to compensate for the higher risk. Another lender may offer a loan at a lower LTV, but with a corresponding lower interest rate. Amortization also comes into play. A pair of lenders may bid the same loan amount, but one requires amortization and is willing to offer a lower interest rate as an inducement to make the loan. The borrower must weigh all of these options – loan amount, amortization and interest rate – and decide which is the best solution.

Working Examples: A Look at Two Loans

How do all of the factors come together when constructing a CML? Here are two examples, the details of which are outlined in the chart.

	Loan 1	Loan 2
Property Type:	Multi-family	Industrial
Loan Size:	$14.6M	$35.5M
Origination:	2011	2010
Maturity (years):	5	9
Spread vs Treasuries (bps):	160	222
LTV:	44%	68%
Maturity LTV:	44%	56%
Amortization:	None	Yes *25-yr schedule*
Reserves:	None	Yes *Re-tenanting*
Properties:	1	2: crossed

Source: HIMCO

While one CML is on a multi-family property and the second is for two industrial buildings, the differences between the two deals are more about leverage and mitigating the risk of higher debt.

Loan 1 has low leverage, as indicated by the 44% LTV ratio. The loan terms are fairly liberal: no amortization, no lender-controlled reserves (funds for debt service, re-tenanting and/or capital expenditures), and no cross collateralization.

Loan 2 has a higher LTV and a longer maturity (nine years versus five). The lender sought to mitigate these risks by adding amortization (note that at maturity, Loan 2 balance is reduced to 56% LTV), cross collateralization and reserves. The spread is higher – 222 bps over Treasuries vs. 160 - because the risk of loss is higher due to the higher LTV.

Another lender could bid for Loan 2 without the loan protections, but the spread would be much higher. So the borrower has a choice: accept more restrictive loan terms but lower spread, or more lenient terms and higher spread.

Once lender(s) and borrower(s) agree to terms, the mortgage loan is finalized, but there are still opportunities for other investors to gain access to these CMLs. **(see "Participation Interests: One Route of Investor Access")**

Underwriting: The Fundamental Skill

In a private market such as CMLs, originating lenders are relying on their experience, savvy and skill to reach an arrangement that best serves their needs. The lack of ratings found in the public markets might be a concern for some investors, but as the recent credit crisis illustrated, ratings may not always identify the full range of risks at hand.

Life company CML portfolios performed extremely well during the last financial crisis, one of the worst economic downturns in the postwar era. Why? Superior loan underwriting.[7] Underwriting is a capability that usually requires scale and experience to execute properly. And it's the main reason why working with a seasoned CML originator is of such value.

Underwriting usually can be viewed through four simple messages:

Own what you know – Life companies employ real estate professionals to scrutinize the properties backing the mortgage loans—in addition to using the debt metrics such as LTV and debt service coverage ratio (DSCR). Properties are not commodities: certain features (location, age, leasing, and amenities) support property values—particularly in weak periods—and recognizing these characteristics typically leads to better underwriting performance. Once a property is assessed, loan terms can be negotiated to address any concerns.

Know your market – In addition to property-specific features, loan underwriting includes a thorough analysis of the supply and demand drivers of a property's real estate market. Demand for real estate is often a function of a market's employment situation—employers, industries, hiring and incomes—and it must be fully understood to assess a market's vitality. The future pace of new construction must also be estimated. Lenders often use third-party vendors and contacts with local brokers to obtain market intelligence, in addition to their own market knowledge and experience.

Complete your due diligence – A substantial amount of due diligence is performed in the loan underwriting process. The property's financials, rent rolls and tenancy are reviewed and verified. Mortgage lenders engage consultants to provide expert opinions on the physical aspects of the property, including on-site inspections and assessments of environmental hazards. The property's title and survey are reviewed, and the lender receives title insurance confirming the priority of its lien.

Scale matters in maintaining relationships – The CML market is relationship-based and maintaining good relations with market participants is an important component of the underwriting process. Borrowers often engage mortgage brokers, or correspondents, to find a lender. It is paramount that a lender maintains a reputation for honesty, ease of execution and fairness. Otherwise, brokers—and borrowers—may be reluctant to transact with a particular lender and the better deals may go elsewhere.

Participation Interests: One Route of Investor Access

One way investors can gain exposure to CMLs is through a participation interest, a less well known but nonetheless efficient method for accessing the asset class.

Rather than maintaining a loan origination platform or purchasing commercial mortgage-backed securities, investors can purchase a "participation interest" in one or more CMLs originated by a lender. The "interest" is in a promissory note secured by a mortgage loan encumbering commercial property. The participant shares equally in all monies paid in connection with the note in proportion to its purchased interest; e.g., if an investor buys 50% participation in a note, the investor receives 50% of all interest and principal repayments.

Rather than having its own note, the participant receives a participation certificate from the originating lender, and the rights of all participants – including the originating lender (often called the "lead participant") – are governed by a participation agreement. The agreement documents the lead participant's obligation to transmit payments to the participant and its obligations in connection with monitoring the loan and the property. The participant pays the lead participant a fee for its origination and servicing functions.

The agreement enables the participant to invest side-by-side with a like-minded, institutional-quality investor. It also typically grants the participant approval rights in connection with certain material decisions, including changes to the loan economics and the pursuit of remedies if the loan goes into default. The agreement usually has a buy-sell mechanism that allows the participant to resolve a deadlock in connection with any of the material decisions. But the participant's relationship is all with the lead participant - it has no relationship with the borrower.

Monitoring

The work for lenders does not end once the loan is made. The loan's performance is constantly monitored to ensure that it continues to deliver along the terms agreed to in the loan documents.

The lender will regularly review information about the collateral such as occupancy, financials and valuations with an eye out for underperformance. If underperformance is identified, the lender wants to take action, in accordance with the terms of the loan documents, to manage a deteriorating situation with the idea of maximizing recovery in the event of default.

Lenders and borrowers have flexibility in the solutions they develop to address the issue of underperformance. For example, a borrower who is struggling to refinance a maturing mortgage loan may believe that the property's cash flow and valuation will improve with extra time. A lender can agree to a loan extension, but in turn ask that the borrower reduce the loan balance to improve the LTV ratio.

Conclusion

CMLs offer fixed income investors an asset class that provides competitive yield and an investment grade credit profile. They provide additional diversification for a portfolio's credit allocation, and through the mortgage offer investors unique protections that have historically generated recovery rates that are nearly twice that of corporate bonds. In addition, they provide lenders with a hard asset – a property – as collateral for their investment.

CMLs are less liquid than public bonds, but most institutions have plenty of sources of liquidity (public bonds and bank lines) and can afford to allocate a portion of their investable assets in CMLs. Some investors also may still have concerns based on the negative impact of CMLs on life insurance company portfolios in the early 1990s. Much has changed in the life industries' approach to investing in CMLs in the last two decades however, including an emphasis on strong, institutional sponsors, and a heightened focus on quality, which was evident in the life industry's strong relative CML performance during the recent financial crisis.

As with any sophisticated investment strategy, investors are wise to seek the most capable advisors when investing in CMLs. Those advisors are most likely to have scale and experience in commercial real estate, as they are the keys to sourcing, negotiating and monitoring the most valued opportunities.

About the Authors

Jack Maher

Managing Director
Head of Private Real Estate

Mark Hopkins, CFA

Vice President
Senior Research Analyst

HIMCO's Private Real Estate team manages about $6.7 billion in assets, including $5.6 billion in Commercial Mortgage Loans, $745 million in limited partnerships (funded and unfunded), and $408 million in other assets (includes JV equities) as of March 31, 2014.

Footnotes

1. "U.S. Life Insurers—Mortgage Loans Providing Yield", July 30, 2013
2. Moody's Annual Default Study: Corporate Default and Recover Rates, 1920-2012
3. HIMCO used Moody's Average Corporate Debt Recovery Rate by Post-Default Trading Prices as a measure for the unsecured corporate bond recovery rate. For the period 1982-2012 that figure was 37%
4. HIMCO, as of April 30, 2013
5. Howard Esaki and Masumi Goldman, "Commercial Mortgage Defaults: 30 Years of History", CMSA (Winter 2005)
6. See footnote 3
7. National Association of Insurance Commissioners and the Center of Insurance Policy and Research, "Capital Markets Special Report," December 20 2012

Disclosure

The forecasts, opinions and estimates expressed in this report constitute the Firm's judgment as of April 30, 2014 and are subject to change without notice based on market, economic and other conditions. Fixed income investments are subject to credit and interest rate risk. Bank loans are subject to liquidity risk, prepayment risk, credit and interest rate risk, recovery and call risk. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. All data contained in this is from sources deemed to be reliable, but cannot be guaranteed as to accuracy or completeness. Diversification cannot assure against market loss.

Investment Risks: All investments are subject to risk, including possible loss of principal. Real estate investments are subject to additional risks, including negative developments in the real estate market, such as vacancy rates and competition, volatile interest rates, defaults and economic recession.

Hartford Investment Management Company is a registered investment adviser subsidiary of The Hartford Financial Services Group, Inc. (SEC registration does not imply a certain level of skill or training).

HIMCO One Hartford Plaza | Hartford, CT 06155 | 866.403.4733 | www.himco.com

At *HIMCO* our sole business is asset management. We are focused on a clearly defined mission — understanding our clients' needs and providing long-term investment strategies. We are value-oriented investors, and we believe the best way to capture opportunities for our clients is a balanced top-down, bottom-up approach, supported by strong fundamental and quantitative research with an emphasis on risk management at every step of the process. Entrusted with $114.3 billion in assets under management as of March 31, 2014, we execute this approach on behalf of a wide range of clients.