Enhancing Risk-Adjusted Returns—A New Approach to Investing in the High-Yield Commercial Mortgage Market

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Introduction

The commercial mortgage market offers a number of products promising both high cash flow and high yields. While many of these products are attractive today, most investors are utilizing inferior investment strategies to access these sectors. Current investment strategies mirror an historical bias toward allocating real estate capital based on categories such as:

- Property Type
- Region
- Position in the Capital Structure
  - Mezzanine Debt
  - Below Investment Grade Commercial Mortgage Backed Securities (CMBS)
  - Leveraged Whole Loan Strategies
  - B-Note Funds
  - Collateralized Debt Obligation (CDO) Equity

For example, over the past few years a large amount of institutional capital has flowed to high-yield commercial mortgage strategies that target very narrow sectors such as commingled funds that invest in only high-yield CMBS or only mezzanine positions. The main disadvantage to this type of investment process is that the investment manager is motivated to continue to invest in the narrow strategy, even though the window of opportunity may have closed.

A more powerful and strategic approach would be to set investment goals in terms of more classic investment attributes, for example:

- Risk
- Return
- Cash Flow
- Duration/Time Horizon
- Control
- Call Protection

Once the program's goals are set in terms of these investment attributes, the investment program should allow for the widest range of product structures that individually meet these goals. Indeed, the parameters should be so broadly cast as to capture not-as-yet conceived structures that bear similar attributes. For example B-Notes, which today are one of the most attractive parts of the mid-tier portion of the capital structure, did not exist two years ago. This investment approach allows investors to pursue relative value across all investments that meet their desired attributes, and thereby create more efficient risk/return portfolios.

Background

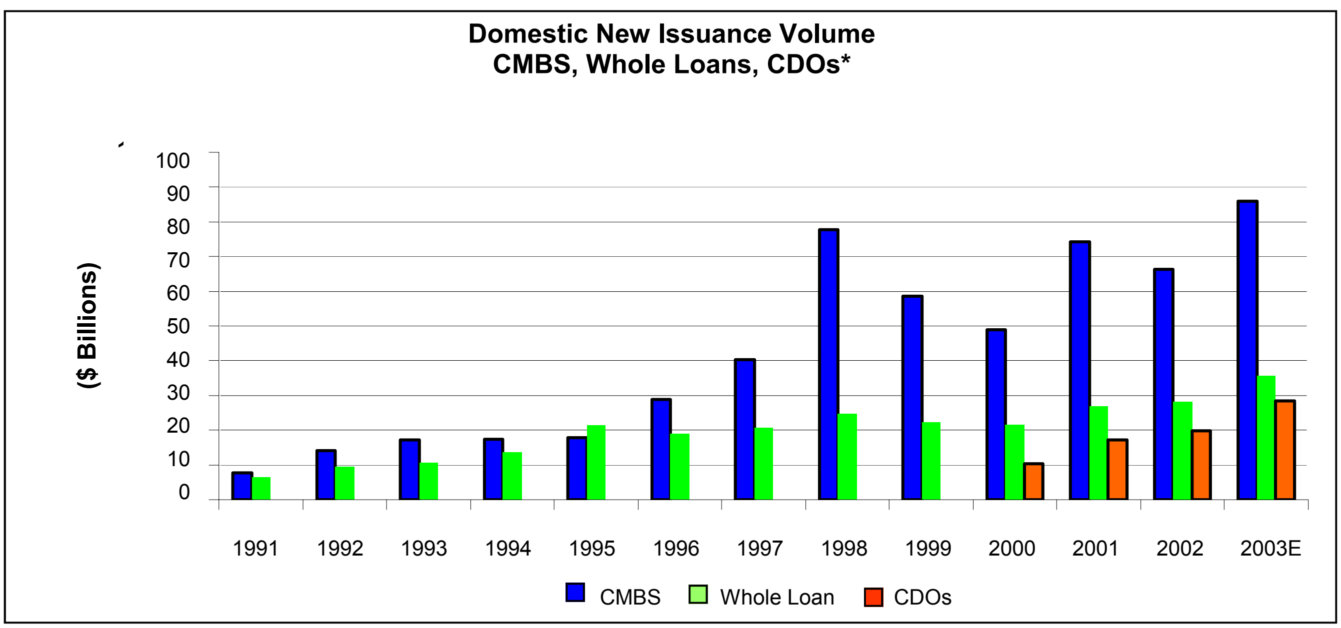
Numerous products are now available in the commercial real estate market that target similar risk/return, cash flow, and liquidity profiles. These products were largely created due to the extraordinary growth of the CMBS market over the past decade. See Exhibit 1, below.

The CMBS market participants, in particular the rating agencies, instilled much greater discipline in loan underwriting than was the case in the 1980s. Often this has resulted in individual property capital structures with less loan proceeds/leverage in the first mortgage position. Consequently, several new and old investment alternatives have stepped in to fill the void in the commercial real estate capital structure that property owners require. An example of a new alternative includes B-Notes, which represent the subordinate position in a first mortgage lien. On the other hand, mezzanine loans which are secured by the partnership interest in the equity of a property, have been around for years, but have been made more prevalent with the growth of the CMBS market.

Commercial Mortgage Investment Attributes

The capital structure of a single asset or a pool of assets has become increasingly sophisticated. Exhibit 2, on the next page, illustrates an example of a typical capital structure of a loan and/or pool of loans that is involved in a CMBS transaction. When viewed in totality, the mid-tier portion of the capital structure is substantial, and is growing

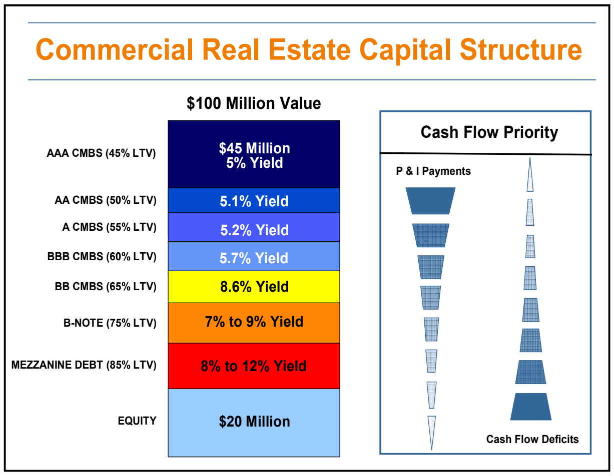
Exhibit 1



* CDO's backed by CMBS, ABS, and MBS

Source: ACLI, Morgan Stanley, Bear Stearns

Exhibit 2



Source: GMAC Institutional Advisors, LLC

rapidly. The precise size of the market is unknown. Assuming it is approximately 15%–20% of the CMBS market, which itself is a $400 billion market, would put the mid-tier portion of the market at approximately $60–$80 billion. One important point to note is that oftentimes the credit quality for these investment alternatives are comparable. For example, there are many B-notes that have leverage similar to a BBB rated CMBS bond, particularly for lower leveraged loans on large high-quality buildings.

In addition to risk and return, there are additional investment attributes that investors should consider when looking to invest in the commercial mortgage market. Some of these attributes are summarized in Exhibit 3, below.

Relative Value Example

A simplified, two asset example of the new investment paradigm is an opportunity set that includes BB rated CMBS and B-Notes. Both investments can offer similar investment attributes, such as yields, risk, and duration. However, the difference in the risk of the pool of assets securing a BB rated CMBS bond vs. the single asset risk profile of the B-Note collateral can create vastly different expected loss scenarios. Therefore, rather than view either of these alternatives in isolation, relative value opportunities should be pursued across both investments.

Today, B-Notes with comparable leverage and slightly lower promised yields offer greater

Exhibit 3

High-Yield Commercial Mortgage Market Investment Attributes

Investment/ Attribute	Yields	Risk	Liquidity	Call Protection	Diversification	Ongoing Control	WAL
Leveraged Whole Loans	7.0%–9.0%	Mod.	Low/Mod.	Mod./High	Low	High	5–10 years
CMBS							
Mezzanine BBB	5.2%–5.8%	Mod.	High	High	High	Low	10 years
High Yield (BB – NR)	7.6%–27.0%	High	Mod.	High	High	Mod./High	10–12 years
B-Note	7.0%–9.0%	Mod./High	Low	Mod./High	Low	Mod.	10 years
Mezzanine Debt	8.0%–12.0%	High	Low	Mod.	Low	Low/Mod.	1–10 years
CDO Bonds	6.0%–7.5%	Mod.	Low/Mod.	Mod./High	High	Low	5–10 years
CDO Equity	20.0%–25.0%	High	Low	Mod./High	High	Low	10 years

Source: GMAC Institutional Advisors, LLC relative value than BB rated CMBS. In the current market environment, where some market fundamentals are weak and many properties have existing rents that are above market, B-Notes offer several advantages over BB rated CMBS, such as:

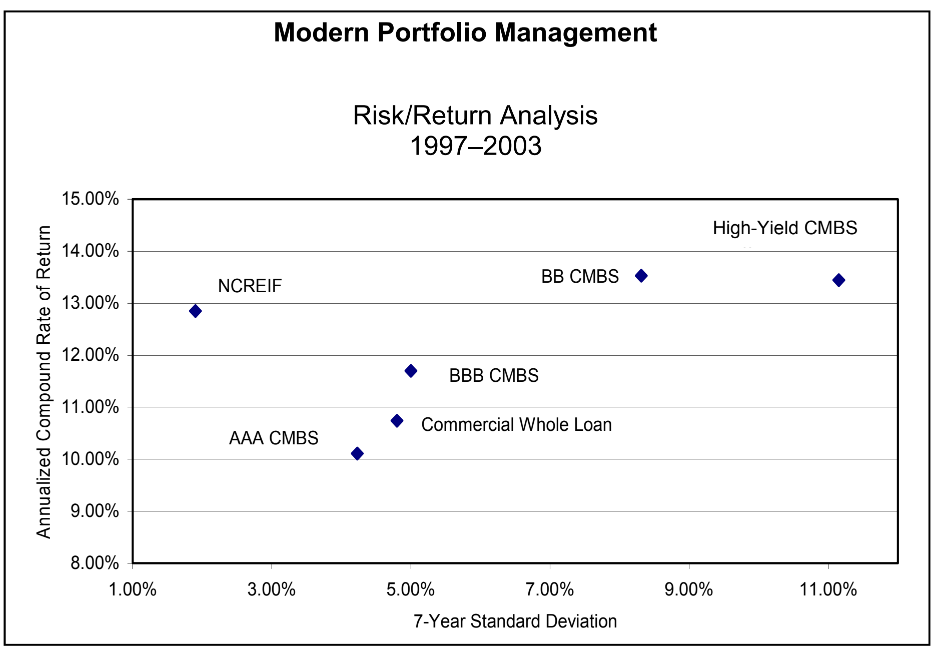
- Ability to completely underwrite a single asset vs. more cursory underwriting of a pool of assets,
- Greater control over the workout process,
- Limited capital chasing the growing B-Note market vs. a lot of capital chasing shrinking BB CMBS market (through lower subordination levels).

Over the past decade, institutions have allocated considerable capital to mandates which only invest in BB rated CMBS. Inasmuch as B-Notes share a similar position in the capital structure and today offer better relative value, a more robust strategy would be to include B-Notes in the opportunity set in order to arbitrage relative value opportunities and increase the pool of attractive opportunities.

With this simple example in mind one can extend the concept across the entire mid-tier range of the capital structure, allowing investors to access approximately $60–$80 billion of potential investments. This approach allows investors at any point in time have the ability to put large amounts of capital to work, take advantage of relative value opportunities, and create optimal risk/return efficient portfolios. See Exhibit 4, below.

Modern portfolio theory has been around for over 50 years, however until recently, investors in the commercial real estate and mortgage markets have had limited opportunities to apply the concept. One of the underpinnings of modern portfolio theory is that diversification provides investors the tools to maximize return for a given level of risk. Therefore, expanding the horizon of possible sectors not only allows investors to pursue relative value opportunities, but also to create risk/return efficient portfolios. Exhibit 5, on the next page, provides the data on commercial real estate correlations and highlights the opportunity to improve overall portfolio risk-adjusted returns through diversification.

Exhibit 4



Source: Lehman Bros., Giliberto/Levy, NCREIF, GMAC Institutional Advisors

Exhibit 5

Historical Correlation 1997–2003						
	AAA CMBS	BBB CMBS	BB CMBS	High Yield CMBS	Whole Loans	NCREIF
AAA CMBS	1.00					
BBB CMBS	0.86	1.00				
BB CMBS	0.66	0.71	1.00			
High-Yield CMBS	0.50	0.67	.082	1.00		
Whole Loans	0.90	0.87	0.82	0.64	1.00	
NCREIF	0.02	-0.14	-0.17	-0.15	0.02	1.00

Source: Lehman Bros., Giliberto/Levy, NCREIF, GMAC Institutional Advisors, LLC.

Conclusion

Many investment vehicles today offer real estate investors the opportunity to gain exposure to the commercial real estate market. Most of these vehicles pursue narrowly focused strategies such as including only certain structural sectors or property types. Conversely, the rapid increase in the sophistication of the market provides investors with more options today than at any other time in the past.

This creates the opportunity for investors to employ a new paradigm for investing in the commercial real estate market that first considers the desired investment attributes, and then identifies all investment products that meet those attribute constraints. With respect to high-yield commercial mortgage opportunities, this new paradigm allows investors to:

- Efficiently access the entire mid-tier portion of the capital structure,
- Create portfolios that are more finely tailored to meet investment objectives,
- Maximize the advisors' opportunity set, thereby creating more risk/return efficient portfolios,
- Better align the advisors' and investors' interests, (inasmuch as the advisor is investing using a relative value approach rather than chasing a narrowly defined sector of the market or property type).

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