Principal Real Estate Investors

CMBS — An essential quadrant of a real estate portfolio

Recently, **Jonathan A. Schein,** senior vice president and managing director of global business development for Institutional Real Estate, Inc., spoke with **Marc Peterson,** CIO of CMBS at Principal Real Estate Investors. Following is an excerpt of that conversation.

Principal Real Estate Investors has $78.6 billion of assets under management, including $9 billion of assets in commercial mortgage-backed securities (CMBS). Could you please describe the history of your platform and how you formed your investment approach?

We started investing in CMBS toward the end of the 1990s. The CMBS market as we know it today didn't really start until 1997, and that is when we started our investment platform. Our investments in CMBS grew out of the real estate group, and today they remain part of the real estate category, with CMBS considered one of the quadrants of real estate. Managing CMBS out of real estate versus out of fixed income makes Principal unique in our approach. Principal's general account was our first client for CMBS, and since then we have grown our business to managing investments not only for Principal, but also for dozens of other investors through separate accounts and funds.

Our investment process is really tied to getting feedback from Principal's commercial-mortgage underwriters, who are originating commercial mortgages for Principal's clients, along with having a proprietary CMBS model. We also have access to Principal's real estate ownership experience through our property asset managers, who manage a large portfolio of equity real estate. Through this connection with real estate, we are able to get a significant amount of market-specific feedback because we manage it all under "real estate." Even though CMBS is publicly traded, the longer-term performance of CMBS is going to be driven by the underlying mortgages, driven by the performance of real estate, and so our investment approach is focused on the real estate first, and then we translate that real estate view into our model.

How does CMBS fit into your clients' portfolios?

The majority of our clients are typically using CMBS as a complement to, or a more attractively valued substitute for, fixed income. We do have a handful of investors, however, for whom CMBS is a strategic part of their equity real estate portfolios. Especially during times of market dislocation, high-quality CMBS can provide relatively quick access to more opportunistic returns and enhance overall performance. Thirdly, we have clients who use CMBS as a complement to REITs, where Principal manages the allocation between REITs and CMBS for the benefit of the clients. Research shows that adding CMBS to a REIT portfolio results in lower overall volatility, while potentially providing equity-like returns.

What is different about CMBS today versus at the time of the GFC?

Significant changes have occurred structurally in the CMBS market in two areas, the first being underwriting. The quality of underwriting through the crisis really deteriorated in 2006 and 2007 — the leverage was elevated, the debt-service coverage had gotten as low as 1.2x, and the quality of the cashflow was poor. But if you compare where we are today in underwriting — average loan-to-value is 55 to 60 percent versus 70 to 75 percent back in 2007 — you have a much bigger equity cushion behind the debt. Debt-service coverages are greater than 2x, so income off the property is covering the debt more than two times, compared with 2007, where it was 1.2x. You have much more cushion against changes in the market, changes in rents and changes in occupancy.

What about the second area?

It is around how the bonds are structured in CMBS. Today, rating agencies are requiring much more credit enhancement, which we call subordination, in the various tranches. For example, for a bond to be rated AAA today, rating agencies are requiring 22 percent to 24 percent subordination. That means the bonds that are junior to the super senior AAA add up to 22 percent of the overall structure, which means that the AAA is protected from the first 22 percent of loss of the loan. Comparing that to 2007, the AAA rating required just 12 percent subordination, so you were only protected from the first 12 percent of loss. There is also almost twice as much credit enhancement protection from loss at the AAA level built into the yield today, and it can move down to AA, A, BBB. As a result, even in what is looking to be a quite severe recession due to the impacts of COVID-19, we expect to see many fewer downgrades in CMBS, especially investment-grade CMBS, than we saw back in 2007.

How does being part of a four-quadrant real estate organization influence the way you approach the market and assess relative values?

The real benefit we have being in all quadrants of real estate is we can more quickly, specifically, and accurately assess what the public market is implying for the performance of private real estate. We can go to our private real estate experts on the debt and equity sides and compare notes, and say, "The public market is now implying that defaults on private mortgages are going to go up 50 percent," for example. Or, on the equity side, we can say, "The market is implying that real estate values are going to drop 20 percent in the next 12 to 24 months." Then we can ask our private debt specialists if they are seeing this in their market. On the debt side, are mortgage spreads reflecting a higher default probability in private mortgages? On the equity side, is the outlook for real estate for value to be repriced materially? If our private debt experts come back to us and say, "No, we are not seeing that in our market," then we can take advantage of the dislocation in the public market if it is purely technical, because technical dislocations will correct themselves. This four-quadrant approach is especially helpful in a rapidly changing environment, such as the one we've been experiencing since mid-February. Real-time, experience-driven data provides a strong advantage.

Outside of the markets plummeting right now for exigent issues related to COVID-19, what risks are you watching today?

The risk in CMBS comes from the loans defaulting, so, depending on which bonds you own and the properties securing the loans, you always have that real risk of loss. The second risk is the perceived risk of loss, which affects market pricing. Today, the market is really trying to understand, with the virus and the current shutdown of the U.S. economy, what does that mean for the ultimate risk in commercial mortgages? The first property type to react is going to be the one with shorter leases, like hotels, and so a look at the risk in our portfolio would start with understanding our hotel exposure — where the hotels are located, and what is the outlook for recovery in income as the economy slowly opens up post COVID-19? Longer term, in a recession, hotels suffer due to lower demand from business travel and tourism demand, so that is always the most volatile asset class in the market sector. Consumer confidence and consumer spending during and post-COVID-19 are also issues that need to be understood as they relate to risk with retail, for example. It is really the same risk that investors have in their commercial-mortgage portfolios and in their private equity real estate portfolios. The difference being, as a CMBS investor, we need to be able to put that risk into perspective with the bond structure, to determine how to price that risk in an extremely uncertain and volatile real estate and fixed-income market.

We entered the year in a late-cycle environment, but all seems to have changed now. How are you approaching the CMBS market today?

Typically underwriting becomes much more aggressive and less conservative the later into a cycle you go, which sets up for a bad ending when the recession actually occurs and the market has to de-lever. Accordingly, we entered the year with a more conservative posture and tilt to our portfolios as a defensive measure, focusing on the real estate market from a supply-and-demand perspective — Are there markets that are overbuilt? How might tenant demand be affected by a recession? Where is future investor demand focused? There weren't a lot of markets where we had concern about overbuilding, and the economic backdrop remained constructive, so from a fundamental perspective, it felt like real estate was in a much better position late cycle this time than it had been prior to previous recessions. Similarly, we were encouraged by the risk profile of CMBS versus other asset classes. The corporate bond market had gone up materially since 2009, so corporate balance sheets had become much more levered than they were back in 2007–2008. Our view was and still is that CMBS should outperform because real estate had de-levered and continues to appear relatively healthy from a leverage perspective. Furthermore, compared with corporate debt, CMBS is at a cyclical low in maturity due to loans typically having 10-year terms, and since there were relatively few loans made between 2010 and 2012 that are maturing in the coming one to two years (when we anticipate the markets to recover from the COVID-19 crisis), we expect less re-fi pressure in real estate, which is different from other asset classes.

Finally, what are your clients looking for today? How does your strategy change depending on the market movement?

In a low-rate environment, investors are looking for the best sources of yield enhancement to help achieve investment goals, and CMBS has fit very well with that change in the market, given that CMBS has offered a yield premium to alternatives, such as corporate bonds and private mortgages. Managers are looking to diversify their portfolios from a risk perspective. CMBS currently trades with more attractive yields and offers a potential diversification benefit. On a risk-adjusted basis, CMBS is providing returns with relatively lower volatility compared with corporate bonds, and compared with REITs. So you get the benefits of yield and diversification with lower volatility, and that is why clients have benefited from their allocation to CMBS.

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COMPANY PROFILE

Principal Real Estate Investors is a top-10 global real estate manager with over 60 years of commercial real estate experience and expertise that spans the spectrum of public and private equity and debt. Our specialized market knowledge, dedicated and experienced teams, and extensive connections across all four real estate quadrants allow us to maximize opportunities and find the best relative value on behalf of our clients.

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