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Principal Asset Management℠

PRINCIPAL REAL ESTATE

Borrowing your cake and eating it too: Adverse selection in CRE debt prepayment options

Introduction

The Federal Reserve's (Fed) recent rate hikes have created significant headwinds for the commercial real estate (CRE) industry. Transaction activity has plummeted from the highs of 2021 and early 2022[1], office property loan defaults are on the rise[2], and there's a looming wall of mortgage and rate-cap maturities on the horizon[3].

Despite a backdrop of distress, there are still attractive opportunities for new CRE investments, particularly in private debt. Relative values for private debt remain strong, new loan underwriting standards appear robust, and hard assets underpin credit risk. Private CRE debt historically served as a defensive investment strategy relative to equity, which makes it appealing in times of dislocation and distress. However, private CRE debt investing has its own unique risks. This paper highlights an emergent trend within the private CRE debt marketplace: an increase in demand from borrowers for fixed-rate loans with softer prepayment provisions.

Borrower's betting on lower rates

In response to the current shape of the U.S. Treasury yield curve, many CRE borrowers shifted their focus from rate minimization towards maximizing prepayment flexibility – in hope of lower borrowing rates in the future. This runs counter to a longstanding strength of fixed-rate CRE debt: robust call protection. Traditional yield maintenance structures for CRE debt can provide investors call protection capable of generating gains upon prepayment. Beyond traditional structures, lenders may elect to provide alternative prepayment options. Year to date, we have observed a marked increase in requests for these alternative prepayment options. The frequency of these requests indicate borrowers are largely optimistic that rates will be lower in the future, and they're willing to bet on that optimism. Without the proper structures in place, this trend poses a specific risk to fixed-rate lenders engaged in asset-liability matching.

> "Many CRE borrowers shifted their focus from rate minimization towards maximizing prepayment flexibility."

If current implied forward rates prove mostly true, lenders with inadequate call protection may see an uptick in prepayment starting two years from today, along with declining nominal reinvestment rates. To better comprehend the current risk, it is useful to understand the existing market for call (i.e., prepayment) options in private real estate debt, and precisely how borrowers are using that to maximize prepayment flexibility.

[1] RCA U.S. Sales Volume, Q1 2023
[2] Wall Street Journal, Feb 2023 "Office landlord defaults are escalating as lenders brace for more distress"
[3] Wall Street Journal, Jan 20223 "Rising interest rates hit landlords who can't afford hedging costs"

Existing market for prepayment options

Traditionally, fixed rate Commercial Mortgage Loans (CMLs) provided by insurance companies, private funds, and CMBS conduits have only been prepayable subject to a yield maintenance formula or defeasance arrangement. Lenders sometimes choose to provide borrowers with bespoke call options as an alternative to yield maintenance or defeasance. These call options are written by the lender at origination and priced as either a spread add-on to the loan, a fixed premium payable at the exercise date, or a combination of both.

Common option structures include a declining premium schedule (e.g., prepayable at 103% of par in year x, 102% of par in year x+1, 101% of par in year x+2, etc.) or an extended par payoff window at the end of the loan (e.g., prepayable at par the last 12 months of term, rather than 3 months). The price of these options should reflect the unique call risk of an individual loan. Due to the on-going yield curve inversion and rise in prepayment option inquiries, we believe the current vintage of CRE debt investments carry elevated prepayment risk. We suspect in several instances that the marginal prepayment risk on new debt offerings is being mispriced or simply not priced at all.

Borrow today, refinance tomorrow

The in vogue fixed-rate loan request in the market targets a term just beyond the downslope in the treasury curve (currently the 5-year note) with prepayment available after year 2. This loan structure is designed to optimize interest expenses for borrowers by fixing their rate over a lower cost tenor on the curve, and then prepaying the loan when (if) treasury rates are even lower in the future. The implied forward curve for the 3-year treasury suggests that the bottom is approximately two years from today. For a borrower who believes forward rates are the best estimate of future rates, *this loan execution allows them to have their cake, and eat it too.*

EXHIBIT 1: Current U.S. Treasury (UST) yield curve vs. Forward 3-year UST note

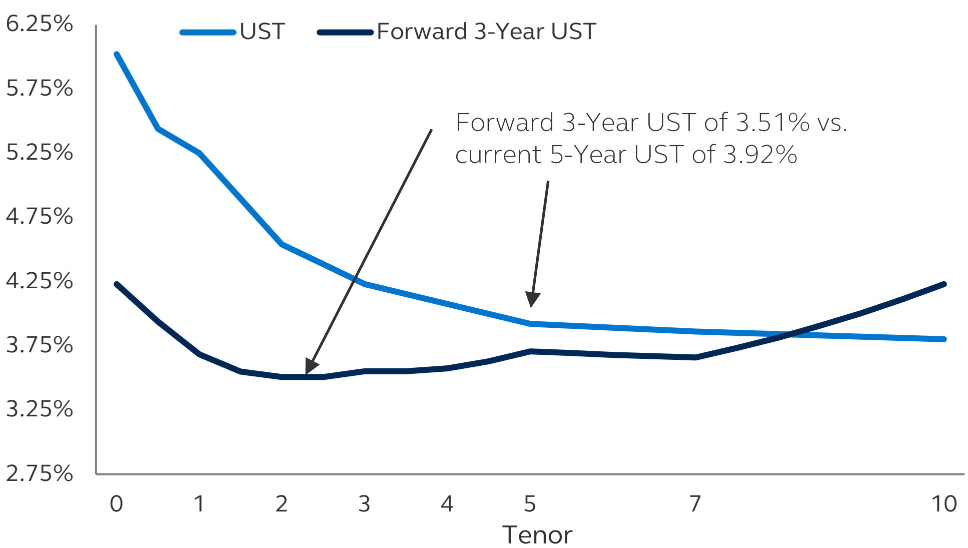


Exhibit 1 compares the current U.S. Treasury yield curve against the implied forward 3-Year U.S. Treasury note. The chart suggests that the 3-year note, two years from now will be 3.51%, 41 basis points *below* the current 5-year note of 3.92%.

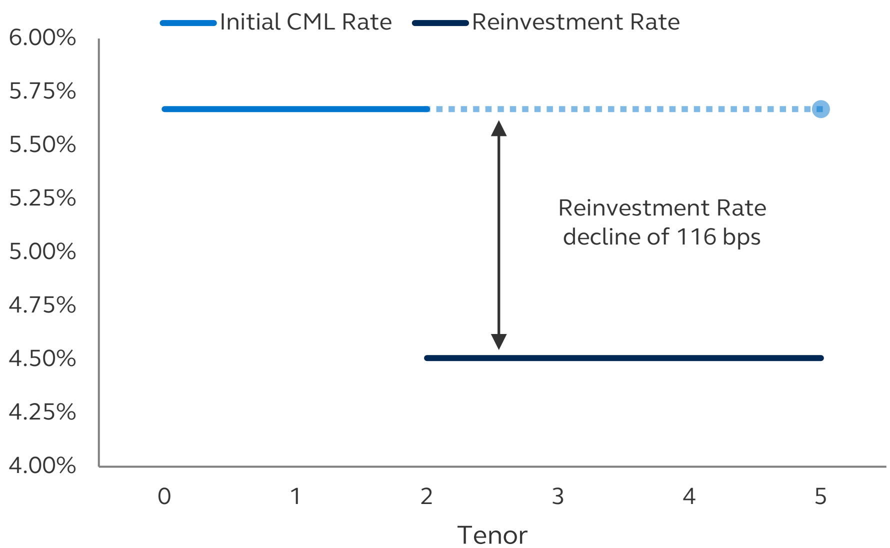
Source: U.S. Department of Treasury, 26 May 2023.

In practice, this structure is very similar to a 2-year loan with extension options out to five years. Under traditional "no arbitrage" principals, the 5-year callable loan *should* price at or near a 2-year loan with fixed extension options. As of this writing, the 5-year treasury is 3.92% while the 2-year note is 4.54%. In considering the yield curve's downward slope, a rational investor might believe a 5-year loan with prepayment open after year 2 should garner *at least* an additional 60 basis points in yield to account for the difference between the two reference rates. Accepting a premium below that amount may be suboptimal because it fails to fully account for prepayment and reinvestment rate risk. The preceding analysis does not consider spread risk, which may suggest further yield declines for investors seeking to preserve the initial term schedule[4].

[4] U.S. Department of the Treasury, 26 May 2023 - 5-year UST note is 3.92%

EXHIBIT 2: 5-Year CML callable after year 2

Assuming 175 bps original spread and 100 bps reinvestment spread



Source: U.S. Department of Treasury, 23 May 2023.

Exhibit 2 shows the hypothetical yield on a 5-Year, "A"-rated CML with a call option after Year 2. Assuming an initial rate of 5.67% (5-Year UST +175 basis points of spread), and a reinvestment rate of 4.51% (Forward 3-Year UST +100 basis points of spread) [5], the lender faces a potential yield decline of 116 basis points to maintain the initial term schedule for the investment. The reinvestment spread of 100 bps assumes the investor redeploys the loan proceeds into an "A" rated corporate bond with 3 years of term remaining.

Navigating potential adverse selection

At Principal Real Estate, we counsel our CRE debt clients regarding the dramatic uptick in prepayment flexibility requests. For clients with fixed-rate liabilities, we believe the prospect of reinvestment rate declines on new-issue, prepayable CML's are particularly high. As exhibits 1 and 2 illustrate, to maintain the term schedule after the option exercise, the lender may need to redeploy the loan balance into a 3-year asset with substantially lower yields—provided that the investor can find a suitable replacement investment. CRE debt prepayment options have the potential to increase duration, rate, and spread risk. Such risks do not need to be completely avoided, but they should be carefully considered and priced appropriately. We proactively work with our clients to monitor their prepayment option structures and seek to ensure adequate risk-based pricing.

Conclusion

While we believe the yield curve will eventually revert to an upward-sloping trajectory, the timing of that reshaping is highly uncertain. If the U.S. economy enters a "hard landing" scenario and the federal reserve is forced to cut interest rates, investors writing prepayment options today risk exposure to rate and spread declines tomorrow. Until the reshaping of the yield curve happens, lenders would be wise to thoroughly examine prepayment risk with their investment advisors. Non-traditional, highly flexible prepayment structures in the current market pose an aberrant risk to fixed-rate CRE debt investors.

With the right guidance and structure, this risk can be appropriately managed. Borrowers may want to have their cake and eat it, but it should be at the lender's well-informed discretion. As a CRE advisor with 35 years of experience, Principal Real Estate will continue to guide our clients through the evolving trends and opportunities in commercial real estate.

[5] Source: Principal Real Estate, Bloomberg Barclays Live U.S. Aggregate average spreads on 3-Year "A"-rated corporates over 15-year period.

Risk Considerations
Investing involves risk, including possible loss of Principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate. economic conditions. Investments in private debt, including leveraged loans, middle market loans, and mezzanine debt, second liens, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk.

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