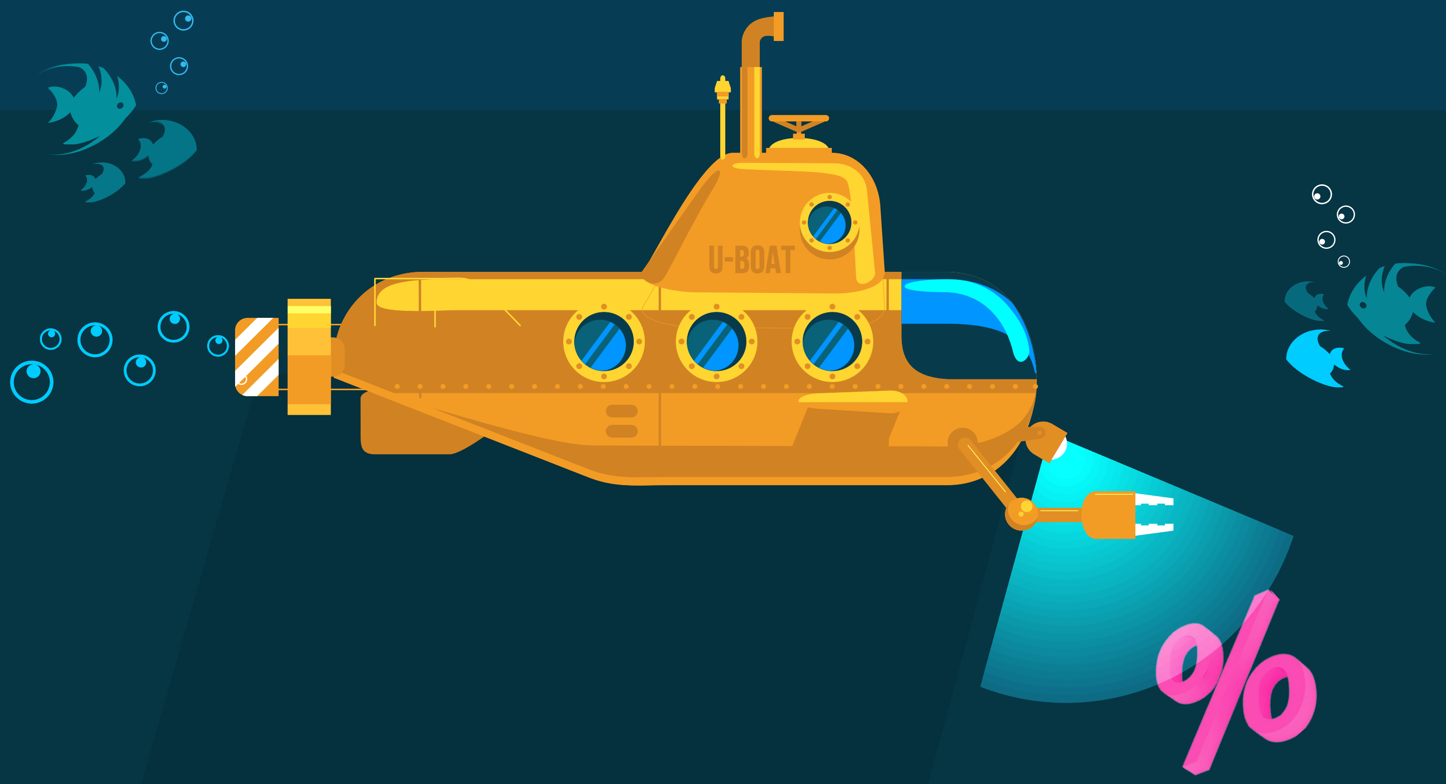
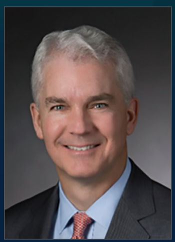
Insurance AUM Journal
Q4 2019
VOL 3 | ISS 4

How low can we go?





INTERVIEW

Anthony R. Malloy
Executive Vice President & Chief Investment Officer,
New York Life Insurance Company

Thought Leadership for the Insurance Investment Community

Commercial Mortgage Loans: The Middle Market Advantage

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Securian Asset Management

Sean O'Connell, CFA
Senior Vice President, Portfolio Manager

With concerns over interest rates and recession fears generating greater volatility in the bond market, investors may wish to add the unique benefits of commercial loans to their portfolios.

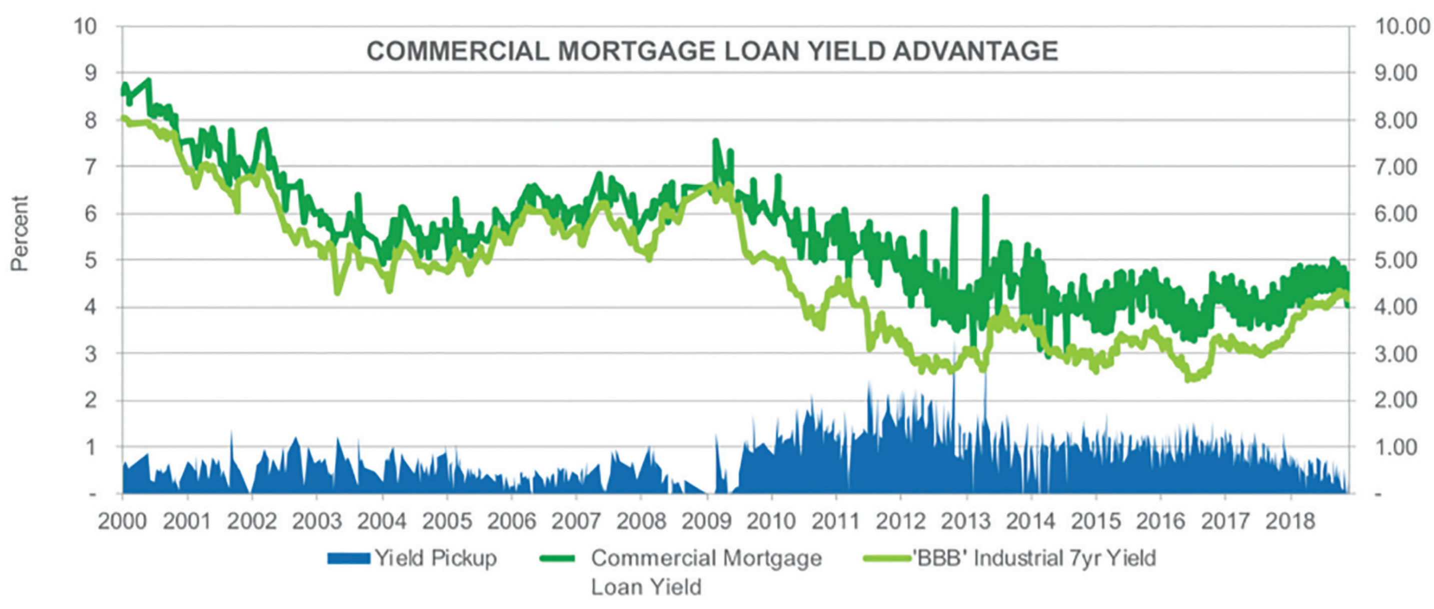
Commercial mortgage loans offer a number of advantages. Yield spreads relative to comparable corporate bonds are often higher. Lenders can negotiate lending terms to align with their own risk-return mandate, and they are in a senior-secured position in the event of a default.

HIGHER POTENTIAL YIELDS, LOWER VOLATILITY

Commercial mortgage loan portfolios can offer attractive yield premiums relative to investment grade corporates with long term loss experience similar to 'A' rated corporates.

In the chart below, the gross bond-equivalent equivalent yield of a portfolio of commercial loans managed by Securian Asset Management ranged from 100 to 350 basis points over a comparable index of A-rated industrial fixed income securities with 7-year durations from 2000 to 2018. Note that while yields for both categories remained relatively stable during the recession of 2008-2009, the yield spread widened significantly in the 10-year recovery that followed.

Figure 1: Commercial Mortgage Loan Advantage vs BBB-Rated Corporate Bonds



Securian AM Commercial Mortgage Loans as of 12/31/2018 (updated annually). Commercial Mortgage Loan Yield represents the gross current bond equivalent yield (BEY) of the Securian AM Commercial Mortgage Loans for this period. Commercial Mortgage Loan yield is net of fees, except Securian AM servicing fee. The BBB Industrial 7-year index includes industrial sector fixed income securities rated BBB with a 7-year duration, as defined on Bloomberg under the code C0097Y. Yield Advantage represents the difference between the Commercial Mortgage Loan Yield and the 'BBB' Industrial 7-year yield. The Index is unmanaged and is not subject to fees and expenses. Investments cannot be made directly into an index. See additional disclosures at the end of the materials. Past performance is no guarantee of future results. Lending involves many inherent risks. Loans can lose value, including the potential loss of the entire loan.

CATEGORIES OF COMMERCIAL MORTGAGE LOANS

Generally, commercial borrowers are categorized by the typical size of their loans.

- Large market borrowers are generally high-profile real estate firms that own and manage luxury residential, commercial and office properties in the six largest metropolitan areas.
- Middle market borrowers represent a highly diverse spectrum of established and experienced real estate firms in every region of the country.
- Small market borrowers are often individual investors or owner-occupied.

Each category has its potential benefits and drawbacks:

Figure 2: Characteristics, Benefits and Risks of the Three Commercial Loan Markets

Typical Loan Size *(in Millions)*	**Large** *($100M+)*	**Middle Market** *($3-$100M)*	**Small** *($3M or less)*
Borrower Locations	Limited to the six largest metropolitan areas	Every region of the country	Every region of the country
Advantages	• Highly sophisticated institutional or family ownership • Extensive third-party service providers and market related research available	• Deep loan market, both by size and property type • Experienced property owners • Diverse number of property management and leasing companies • Ability to build diversified portfolio by both property type/ geographic/borrower • More attractive lending terms than large markets provide	• Diversity of economic sectors served • Generally smaller loan amounts offer a lower-risk way for new lenders to enter the commercial loan • Lenders can generally negotiate more favorable terms, covenants and workout provisions than with borrowers in the large markets
Considerations/Risks	• Dominance of office towers in this space may increase vacancy/ default risk during recessions • Relatively few locations limits ability to build a diversified loan portfolio • Extensive competition from large investment banks and other large financial institutions makes it difficult to arrange attractive lending terms	• Third party information on companies and markets may be limited • Close local relationships between borrowers and existing lenders makes it difficult for new lenders to "break in" to an unfamiliar market • New-to-market lenders face difficulty in identifying and vetting targeted firms and opportunities	• Borrowers are often undercapitalized and inexperienced • Limited third-party company and market information • Relative few quality loan opportunities • Thin market of buyers in the event of lender foreclosure and liquidation

THE MIDDLE MARKET ADVANTAGE

While different kinds of investors may find suitable opportunities in each market segment, we believe that the middle market offers the best combination of diversification, risk management and returns.

Greater diversification. Unlike larger borrowers, which are concentrated in a limited number of markets, middle market borrowers are located in every region of the country. They range from retail property managers to lessors of warehouse, industrial, residential and office space. The breadth of lending options in the middle market space makes it relatively easy for a financer to build a diversified portfolio of commercial loans across different locations and industries that align with their specific return-risk profile.

Lower credit-risk. Direct lenders have greater control over managing credit risk than bondholders. They can negotiate favorable lending terms, including covenants and workout provisions. In the event the borrower becomes insolvent, direct lenders' claims for payment and collateral have a higher priority than those of bondholders and stock shareowners.

Extensive knowledge. Investment managers who focus on the middle market generally have more experience developing and managing properties and are more familiar with the structure and provisions of commercial loans than small-market borrowers. The most credit-worthy firms also have extensive knowledge of the demographics, zoning laws, land values and economic climate in the areas where they're developing and managing properties.

MIDDLE MARKET LENDING SWEET SPOTS

In our experience as a commercial lender, we've found that the most reliable middle market borrowers are well-established real estate companies that own affordable, moderately sized properties in stable suburban communities. These properties may include smaller shopping centers in prime locations leased primarily by local or regional retailers, multi-tenant warehouses and established residential communities catering to working families and retirees.

These firms are firmly entrenched in their locations and understand the demographics, zoning laws, land values and economic climate in the communities where they acquire and manage properties. They're usually less affected by cyclical economic factors than firms that focus on leasing office space or specialized manufacturing facilities.

We also favor real estate firms that lease to multiple residential or commercial tenants. While collecting rent from a single lessee may be easier to manage, it may be more difficult to find a replacement should the tenant terminate their lease. And while there may be more turnover in a multi-tenant unit, the temporary loss of rent from a single vacated space can be cushioned by the consistent stream of income from other long-term tenants.

ABOUT SECURIAN ASSET MANAGEMENT

Securian Asset Management, Inc. based in St. Paul, MN, is an institutional asset manager specializing in public and private fixed income, commercial real estate debt and equity, pension solutions and alternative investments strategies with more than $44 billion under management as of September, 2019. The asset manager was established in 1984 and traces its history to the founding of parent firm Securian Financial Group in 1880.

The author of this article, Sean O'Connell, CFA, Senior Vice President of Securian Asset Management, has more than 26 years of investment management experience.

For more information on commercial loan strategies available to institutional investors, please contact the Securian Asset Management team at 1-800-665-6005.

Thought Leadership for the Insurance Investment Community

Insurance AUM Journal

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