CRE FINANCE COUNCIL EDUCATION SERIES

CRE CLO E-PRIMER

A comprehensive overview of Commercial Real Estate Collateralized Loan Obligations

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CHAPTER 1

An Introduction to the CRE CLO Market

What are CRE CLOs?

Collateralized loan obligations (CLOs) are securitization vehicles that fund the purchase of loan portfolios. Rated debt securities and an equity component are typically issued. In particular, commercial real estate (CRE) CLOs purchase mortgage loans secured by commercial and multifamily properties that are typically undergoing some sort of transition.

CLOs are divided into multiple senior/investment-grade and subordinate/non-investment grade notes—which are sold to qualified investors, or, in the case of subordinate notes, retained by the issuer. The majority of CRE CLOs use the CLO securitization structure, which provides greater flexibility than traditional real estate mortgage investment conduit '(REMIC)' structures found in commercial mortgage-backed securities (CMBS).

Typical characteristics of underlying CRE CLO loans include:

- Loans are secured by assets that are not yet stabilized. The financing 'bridges' the redevelopment/renovation gap between acquisition and permanent financing
- Floating rate loans with two- to three-year initial terms and five-year fully-extended maturity
- Less call protection than conduit CMBS
- Loan proceeds are advanced in stages to address the capital needs of the sponsor's business plan, typically inclusive of performance hurdles
- Borrowers provide no or limited recourse

CRE CLO Evolution

Before the 2007 Financial Crisis, transitional commercial real estate properties were typically financed on bank balance sheets. Towards the peak of the cycle, meanwhile, they were securitized via large-loan CMBS transactions and collateralized debt obligations (CDOs). Post-crisis, CMBS issuance was significantly curtailed and CDO issuance ground to a halt. From 2012, non-bank lenders began to provide bridge financing and sought CRE CLO securitization as an alternative to balance sheet and warehouse financing. This was because CRE CLO securitization was the cheapest option, and because it avoided mark to market and recourse risks. The CRE CLO market therefore began to grow in earnest in 2016.

While pre-crisis CRE CDOs and current CRE CLOs share similarities, they have a few fundamental differences. One is the seniority and loss profile of the underlying debt. CDOs invested heavily in subordinated collateral such as B-Notes, mezzanine loans, subordinate CMBS, bonds of other CDOs, and real estate investment trust (REIT) debt. CRE CLO assets have been largely comprised of first lien mortgage debt with very few exceptions. CRE CLO subordination levels are also meaningfully higher than pre-crisis CDOs. Reinvestment periods are also more limited at two to three years, as opposed to five to six years in CRE CDOs.

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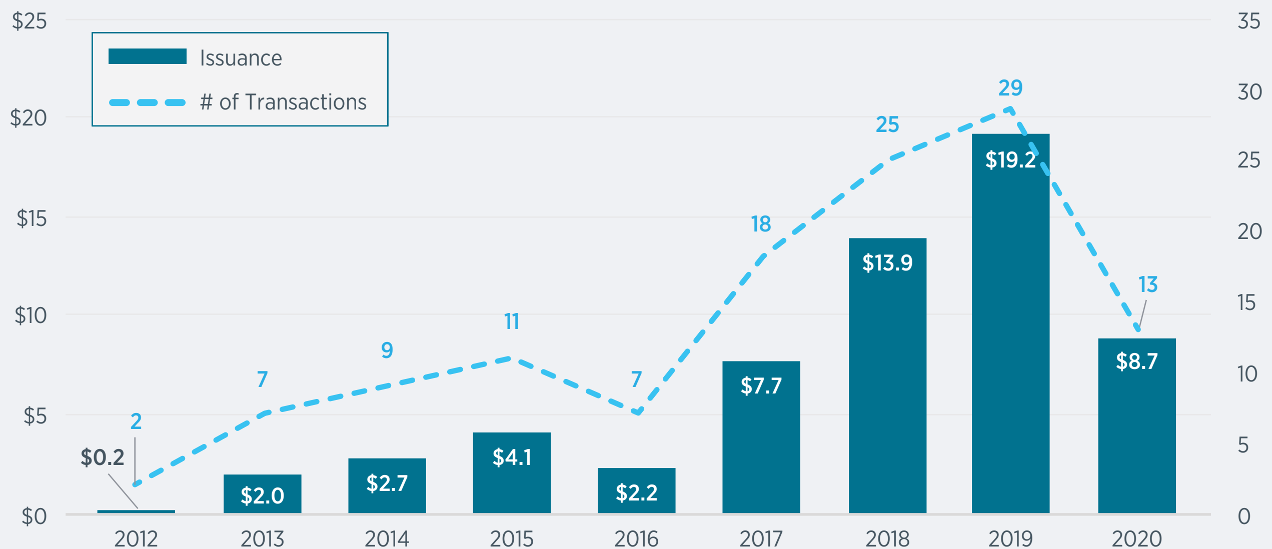
Beginning in 2018, CRE CLO issuance increased dramatically, with investor appetite driven by higher yield, floating rate exposure, and the appeal of a shorter duration product. Issuers and borrowers benefited from strong real estate and capital market fundamentals, lower interest rates, higher advance rates, and matched-term financing relative to warehouse lines. Compared to legacy CDOs, CRE CLO structures are simple, relatively conservative and provide significant alignment of interest. After all, issuers hold the non-investment grade, first loss positions and use the CRE CLO as a financing tool. While broader CRE securitization volumes increased, the share of all private-label CRE securitizations represented by CRE CLOs rose too.

Exhibit 1: CRE CLO Issuance (billions)



Source: Commercial Mortgage Alert

An Important Financing Tool for Lenders

Lenders have found CRE CLOs to be a competitive financing alternative to warehouse lines or repo funding, offering a more competitive advance rate, and cheaper cost of funds. CLOs can free up capacity under warehouse and repurchase facilities, adding diversity to lenders' funding sources. CRE CLOs also better match issuers' assets and liabilities, providing financing matched to the term of its loans. Conversely, warehouse line expirations may precede loan maturities. Because they're not subject to margin calls, CRE CLOs also provide non-mark-to-market financing, which can help issuers in economic downturns.

Managed CRE CLOs specifically provide more asset selection discretion to lenders relative to a warehouse facility. New assets must satisfy eligibility criteria in a CRE CLO. Repo warehouse lines are subject to lender approvals (with warehouse providers unique in having the authority to approve them).

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Lenders typically hold newly-originated loans on warehouse lines until they aggregate enough to issue a CRE CLO. They then acquire the loans from the warehouse line, freeing it up for the lender to originate new loans. Programmatic CRE CLO issuers repeat this process each time they issue a new CRE CLO.

Exhibit 2: CRE CLOs Provide an Alternative Financing Source

	CRE CLO	Repo Warehouse Line
Matched Funding	Yes	No
Recourse	No	Yes, often partial
Revolving Credit Facility	Limited	Yes
Asset Selection	Limited by Covenants	Sole Discretion Right
Collateral	A Notes/Whole Loans/Senior or Pari Passu Participations	A Notes/Whole Loans/ Senior or Pari Passu Participations
Mark-to-market	No	Yes, though may be limited to credit events at the property only.
Advance Rate	Typically 75-85%	Typically 65-80%

Source: Citi Research (adapted)

CHAPTER 2

CRE CLO Collateral: The Building Blocks

Loan, Collateral and Borrower Characteristics

The vast majority of CRE CLO assets are floating-rate whole loans—or senior or pari passu participations—featuring yield maintenance prepayment protection. Loans typically last five years (inclusive of extension options) but can sometimes vary from two to seven. Loans often provide for multiple one–year extensions if the property has not stabilized over the initial term. Borrowers typically obtain interest rate caps to protect against significant movements. Prepayment lockouts typically last from six to 12 months with spread maintenance or minimum interest. Penalty periods typically then last an additional six to 12 months.

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