INVESTMENT MEMO

MERGANSER
CAPITAL MANAGEMENT

Merganser Today

Merganser is an institutional asset manager with approximately $10 billion in assets under management. Our team has been analyzing structured securities since the mid 1980s.

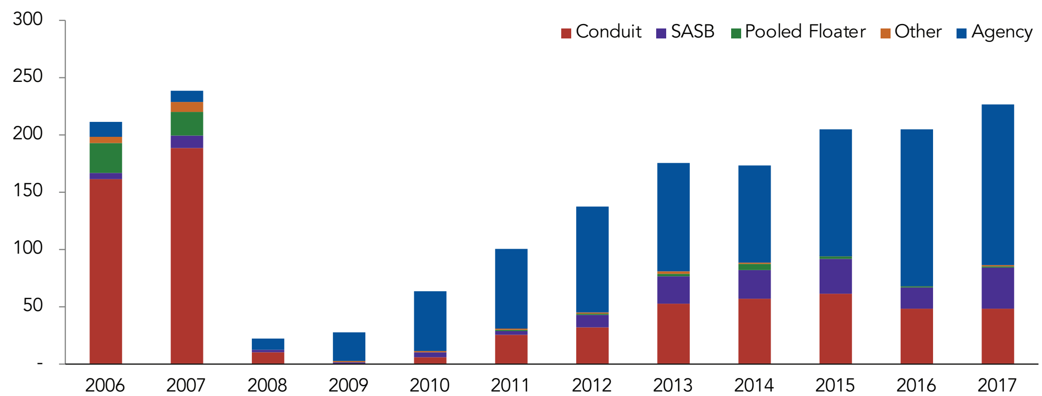
CMBS Update and a Few Thoughts on Retail

The CMBS market has changed materially in the years since the Global Financial Crisis (GFC). The most common, so-called 'conduit' deal with 50-100 loans no longer plays the same role it used to. Common reasons include the reduced number of originators given new regulations, and borrower and investor aversion to the product. Among other reasons, investor aversion to conduit deals can be blamed on its history of high losses affecting subordinated investment grade classes.

Background

In the two years leading up to the GFC, Wall Street created $160-$190 billion of conduit deals. Since then, issuance has struggled to break through $60 billion per year. Total CMBS issuance, however, has continued to recover rather consistently year over year post GFC. In fact, total 2017 CMBS issuance of $200 billion approaches the level from 2007 (Exhibit 1). Agency Multi-family CMBS (ACMBS) and Single Asset/Single Borrower (SASB) CMBS are two sub-sectors that have seen tremendous growth in issuance. This has implications for our clients' portfolios and strategy.

Exhibit 1: Annual Issuance ($Billions) - JPMorgan



Source: JPMorgan

Acronyms:

- ACMBS (Agency CMBS)
- SASB (Single Asset/ Single Borrower)

Agency and SASB CMBS address some of the reasons many investors have a poor view on conduit deals. Both sub-sectors have seen stellar credit performance as a result of better underwriting, higher quality collateral and increased institutional sponsorship. And both sub-sectors offer more targeted exposures to markets and/or asset types that meet investor preferences.

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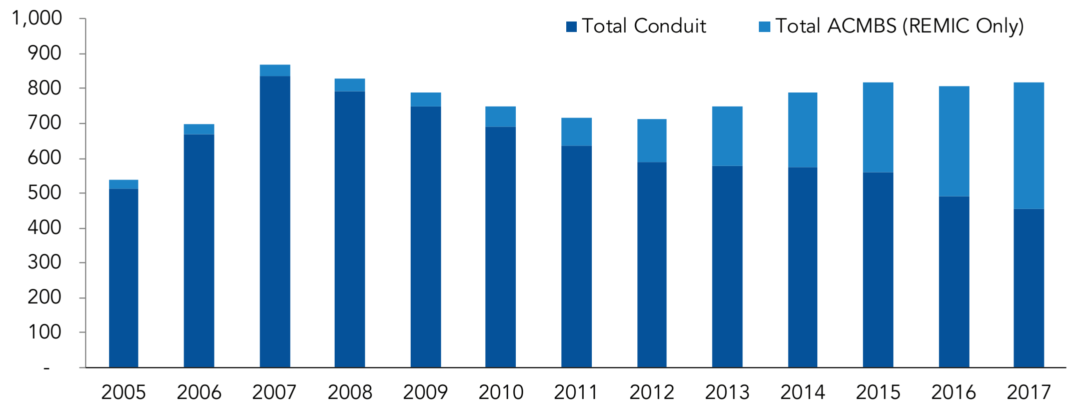
Conduit net issuance has been negative for many years, but is likely to change in 2018 (Exhibit 2).

Exhibit 2: CMBS Outstanding - JPMorgan

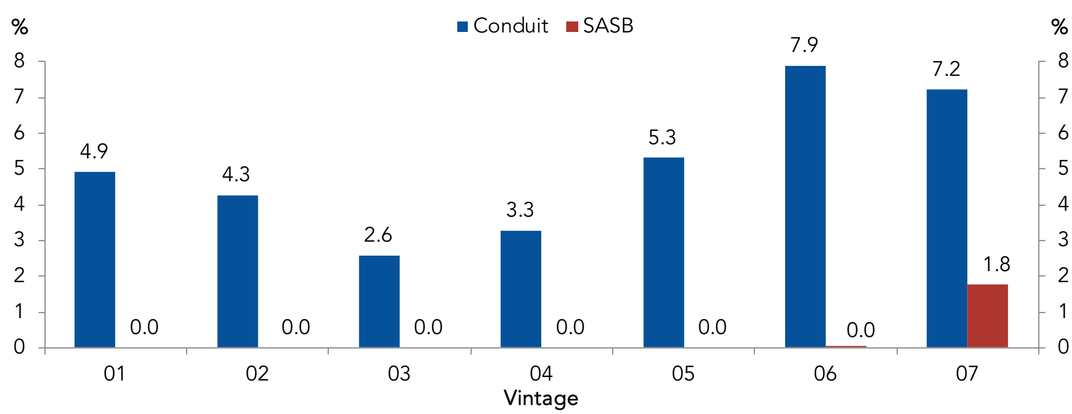


Source: JPMorgan

Relative to conduit losses of 6-7% from '06/'07 vintages, SASB deals had near 0% losses through the past two recessions. The 2007 loss is from one deal with a 6% loss (Exhibit 3). Government Sponsored Enterprise (GSE) multifamily (i.e., ACMBS) delinquencies peaked at just under 80 bps.

Most precrisis conduit vintages show 5%+ loss.

Exhibit 3: Cumulative loss by vintage, conduit vs. SASB CMBS



Source: Goldman Sachs

Given the increase in issuance and superior credit performance in the SASB and ACMBS sub-sectors, both are playing an increasing role in client portfolios at Merganser.

Another compelling reason for increasing exposure to SASB and Agency CMBS is attractive relative value amidst an on-going 'reach for yield' environment. At Merganser, we do not reach for yield in credit products; we remain selective and focused on preservation of capital. The yield loss going from a conduit 10 year 'last cash flow' AAA into a SASB AAA is often immaterial and, in-fact, SASB has been pricing with yield pick-up over conduit (Exhibit 4). SASB by nature are more concentrated. Rating agency models still punish for a lack of diversity, so AAA bonds in SASB deals have significantly higher credit enhancement, another attractive feature of SASB. Exhibit 5 shows how credit bonds in SASB price much tighter than credit bonds in conduit deals, a reflection of the superior credit. While we are not actively adding SASB credit in our high quality mandates given the absolute low level of spreads, we would like to do so at more attractive levels.

Likewise, the yield give-up illustrated in Exhibit 6 from a conduit AAA to a government guaranteed ACMBS AAA is rather attractive. In other words, the government guarantee is cheap at these levels.

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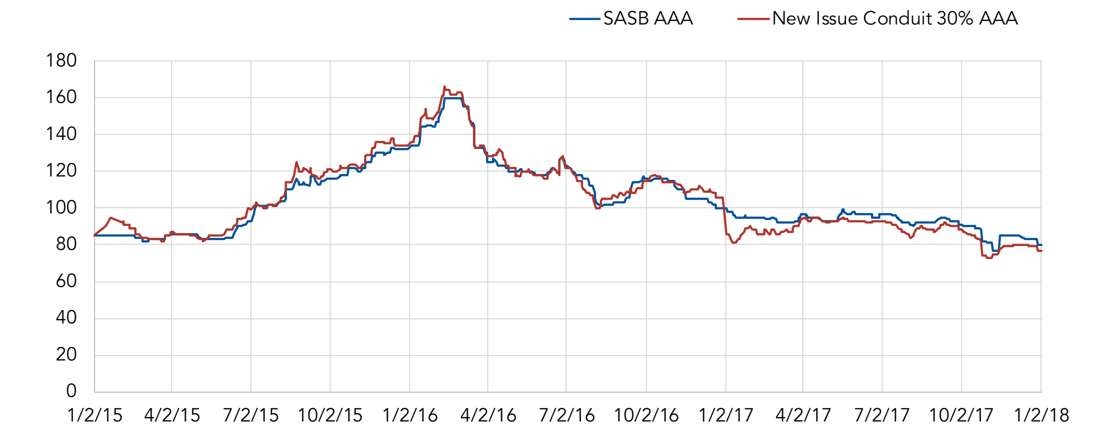
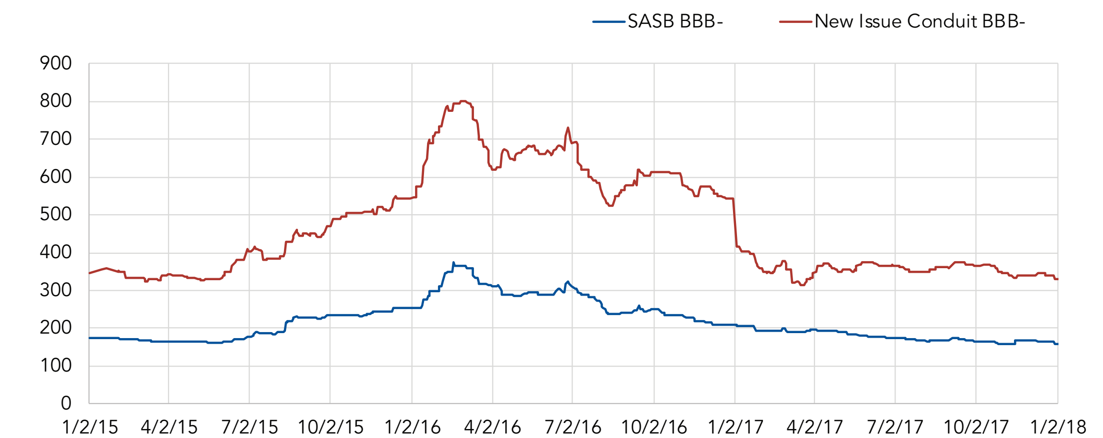
SASB credit bonds are tight, reflecting strong credit.

Exhibit 4: Generic CMBS AAA Spreads - from Wells Fargo



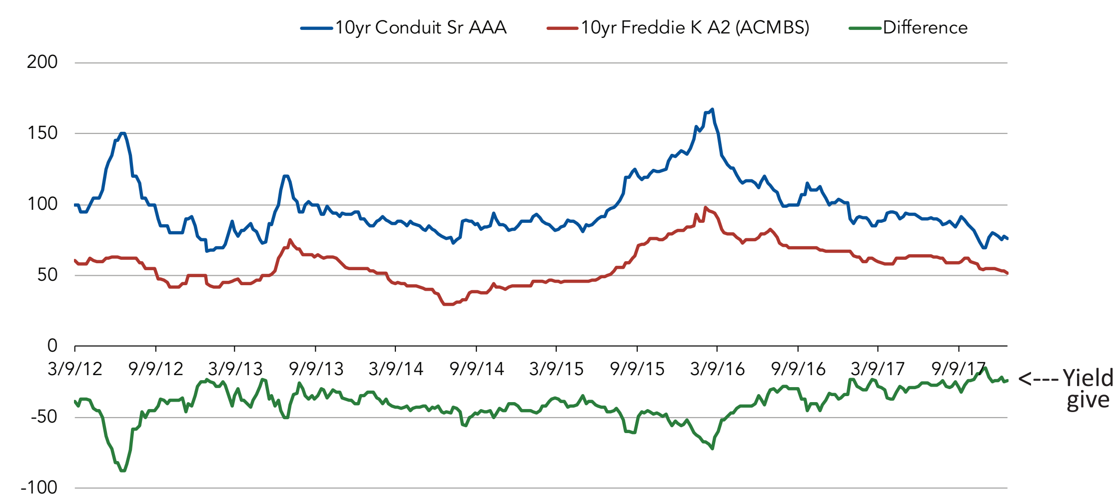
Source: Wells Fargo

Exhibit 5: Generic CMBS BBB Spreads - from Wells Fargo



Source: Wells Fargo

Exhibit 6: 10 year spreads; non-agency vs agency - from JPMorgan



Source: JPMorgan

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Thoughts on Retail

"The reports of my death are greatly exaggerated." — Mark Twain

Everyone it seems is concerned about the mall, and retail more broadly. Concerns over retail explain the significant underperformance of certain CMBS credit products over the course of 2017. Not a day goes by without another anecdote about the internet killing 'brick and mortar' retail. We wanted to take this opportunity to update clients on our views. While we share many of the market concerns, we believe the story is more nuanced than the headlines of doom and gloom. Retailers like Sears/Kmart and JCPenney will continue to rationalize their footprints and slim down. We expect store closings from these and other brands will continue over the coming years. As is typical, store closing announcements are weighted early in the year after the holiday season. To date, these announcements have not been as bad as the CMBS market expected, and pressure on rents and vacancy has been limited. Eventually, that will change.

CMBS will continue to have exposure to retail. This can be in the form of a mall, a grocery anchored neighborhood center, a single-tenant drug store, an outlet center, or a 'big box power center' to name a few of the many different retail formats. Obviously not all of these sub-sectors will be equally affected by changing consumer behaviors, and the old saying of 'location, location, location' matters more than ever.

The United States is over-retailed, but the story is more nuanced.

There is no doubt that the country is over-retailed and there will be fewer malls and retail over time; however, we believe it will take years for this adjustment. Many malls are still thriving, and those with strong sponsors that can re-invest in the asset with strong demographics and limited competition are poised to continue to thrive as retail continues to evolve. Retailers are improving their 'omni-channel' distribution, and utilizing space as fulfillment centers as they fight back.

The CMBS market has been concerned about malls for what feels like an eternity, but only recently has the market significantly cut back on mall financing. According to Wells Fargo, only six mall loans were securitized in 2017, down from 65 in 2012. Regional mall exposure has come down from 12% in 2012 to under 3% in 2017. Total retail exposure has fallen consistently year over year from a peak of 56% in 2010 to just 22% in 2017. For this reason, we are cautious on the 2010-2013 conduit vintages.

Our typical conduit CMBS holding has 30%+ credit support, and is often current pay. These structural features limit the impact that any asset can have on an individual security. With the benefit of structure, our typical A1/A2 securities would be repaid ahead of schedule from recoveries on liquidations. We believe the majority of retail credit risk is related to maturity risk, rather than term default risk. **We remain very selective in conduit deals and stress bonds using a variety of scenarios, including up to 90% loss severity on retail assets.**

Our SASB holdings in the retail sector are senior exposures in trophy assets (i.e., A+ assets in A+ locations with sales in excess of $1,000/ft representing some of the most productive malls in the country). Again, we remain very selective, avoiding problematic B- and C-quality SASB mall deals that were done earlier in this cycle.

Retail had a rather low 1.3% peak delinquency after the 2001 recession, and was the lowest of all sub-sectors at 7% after the Global Financial Crisis, according to Wells Fargo. However, it is a different world today. We expect that retail delinquencies will rise over the course of 2018, starting from a modest 6.1% as of December 2017 (down 24 bps from year-end 2016, according to Trepp Analytics). This will be driven by retailers rationalizing their footprint and the retail-heavy 2012 and 2013 conduit deals. These vintages are reaching the point of seasoning where credit issues would be expected to occur naturally—even in a healthy retail environment.

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Conclusion

- The CMBS market continues to evolve and provide opportunities for investors.
- We have been increasing our exposure to SASB and Agency CMBS, two growing sub-sectors with strong performance.
- These are sources of liquidity for us when credit spreads become more attractive.
- We are concerned about retail, but will take exposure in high-quality assets with strong sponsors and cash flows. At the same time, we are very sensitive to retail exposure in seasoned conduit deals.

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