MERGANSER
CAPITAL MANAGEMENT

MERGANSER Q & A
WITH DAVID FISHMAN, CFA
SUMMER 2020

DAVID FISHMAN, CFA
DEPUTY CIO,
STRUCTURED PRODUCTS

As the COVID-19 pandemic continues to change many aspects of our daily lives, Merganser's investment team is analyzing how changing behaviors might affect individual sectors. In the Q&A provided, David Fishman, CMBS Research Analyst and Deputy CIO, discusses the current and future state of the CMBS market and the lasting impacts the COVID-19 pandemic might have on the sector.

Q: What are the short-term and long-term impacts of rent deferrals on CMBS securities?

A: In the short term, we have seen a dramatic increase in borrowers seeking relief in the form of mortgage modifications and/or withholding their mortgage payments completely. We expect servicers to work with borrowers on a case-by-case basis to provide relief and avoid any near-term liquidation that would cement a loss. Furthermore, low property sales increases uncertainty around valuations. Transaction volume fell 71% year-over-year in April to the second lowest month since 2010, according to Citi/Real Capital Analytics.

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Given this environment, servicers see the benefit in giving borrowers some leeway and time, rather than take aggressive actions. The amount of leeway varies; however, it often includes 3-6 months forbearance (allowing reserve funds to cover the debt service) and a 12-month period to catch up. We continue to expect servicers to advance mortgage payments in the short-term so that CMBS investors experience no interruption in cash flows.

Servicers are in triage mode and are overwhelmed with how quickly a benign credit environment shifted to the most challenged environment in several market cycles. As we start to see an increase in losses driven by changing fundamentals, winners and losers will become clear and the range of possible outcomes (which is extraordinarily wide right now), will become narrower and more well defined.

Q: How could the potential increase in companies continuing to work from home after the COVID-19 pandemic subsides and the need for a reduction in workspace change the overall CMBS sector going forward?

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A: Within commercial real estate, the COVID-19 pandemic has most immediately affected the retail and hotel spaces as stores were forced to close and travel came to a standstill in April and May. However, with the current work from home (WFH) environment, office space will be the next most impacted. New York City (NYC) office space, for example, represents 6% of the entire conduit CMBS market, with certain deals over 30%. NYC and other office markets will be very challenged going forward. Even before COVID-19, the NYC population had been declining over the past three years, the COVID-19 pandemic could accelerate that trend.

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The good news is that outside of NYC, no other single office market is over 2% of the conduit universe, but we are cognizant of idiosyncratic deal exposures. We expect many firms will have more flexible WFH policies; this could be somewhat balanced by other firms requiring more office space per employee (although there will be less employees in the office for the time being). However, we ultimately expect that many tenants will go out of business. The recent increase in IG/HY defaults will certainly have knock-on effects throughout commercial real estate, so the overall demand for space will be softened. The current unknown is how prevalent each of these outcomes will be; however, on a net level, we expect less demand for office space going forward.

While larger cities might face the brunt of that impact, what happens to suburban office space will also be interesting to monitor. There are anecdotes of urban flight to the suburbs; however, we do not expect those leaving cities will move to suburban office parks but will be increasing their WFH presence. While all of this could negatively impact cash flows, it will take 2-3 years to have a better understanding of what these cash flows will look like given their long-term leases. With this uncertainty, we could see an increase in the discount rate, commonly referred to as the “cap rate.” The combination of lower cash flows and a higher discount rate should mean lower asset values over time.

As corporations continue to explore new working environments, other industries will not be able to have as much sustained flexibility. For example, healthcare real estate has been seriously impacted and while some doctors are using “tele-health” to meet with patients, it is not a sustainable solution as in-person checkups and surgeries will still be necessary. Furthermore, lab/research, rehabilitation centers, or senior housing cannot be transitioned to WFH. And given the aging population of the United States, healthcare operators should see growth over time.

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Since retail and lodging are out of favor, new conduit issuance has relied heavily on office collateral. Office and hotels were beneficiaries of the expansion of the Single Asset/ Single Borrower (SASB) market over the last cycle. During the prior cycle in 2007, a $300 million loan may have comprised only 10% of one conduit deal; however, in the most recent cycle, that $300 million loan would likely be split into a SASB deal plus one (or more) pari-passu pieces in various conduit deals. As it stands, the SASB market is not supported by the Fed’s TALF program and we have not seen a rebound in issuance. So, we expect large office mortgages will be more difficult to securitize.

Q: Based on your outlook for the sector, how is Merganser positioning client portfolios with respect to CMBS allocations? Has the COVID-19 pandemic and response to it created any opportunities? Do you prefer non-Agency over Agency?

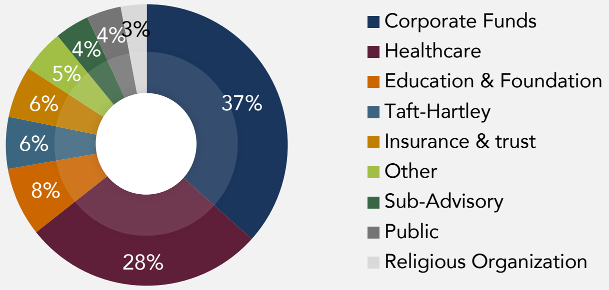
A: Currently, with Agency guaranteed spreads back to pre-COVID levels, we favor non-Agency CMBS; however, we are not adding aggressively. Within the Agency program, non-guaranteed bonds from Freddie Mac present interesting value to us, but Freddie has chosen not to issue at current levels. For Non-Agency, the initial risk-off move created attractive opportunities across sectors, most notably in high quality AAA securities that are well protected from losses. Unfortunately, that opportunity was very short lived as the Fed backstop of TALF led to a rapid compression in spreads that are now only 25bps away from pre-COVID levels.

The recovery in credit sensitive conduit bonds has been less meaningful. There are opportunities in mezzanine bonds trading in the $30-$60 range, but we expect these opportunities to last longer given the challenging fundamentals and uncertain economic outlook. These types of bonds are highly leveraged to the smallest assumption changes and we expect many will go lower as loss estimates become more certain. We also believe the credit curve could steepen as AAA's rally and mezzanine bonds continues to linger. For our higher risk seeking accounts, we would look to go down in credit in sectors like Single Family Rentals and other select SASB deals where we have better transparency to the underlying collateral.

FIRM OVERVIEW

About Merganser

- Formed in 1985, Merganser has been managing institutional fixed income portfolios for over 30 years
- Our strategies are long only, US dollar-denominated and do not utilize complex derivatives
- The investment team is highly collaborative and portfolios are managed on a team basis
- As a boutique manager, we embrace portfolio customization and solving unique issues for our clients
- As of March 31, 2020 our AUM totals $13.3 billion for 89 clients



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