TRAWLER CAPITAL MANAGEMENT

Understanding and Mitigating Risk in Commercial Real Estate Private Credit Investment

Frank Scavone - August 21, 2018

While investment in Commercial Real Estate (CRE) private credit has been steadily increasing since 2009, the cresting of CRE equity (property) prices in combination with continued low yields available in public credit, has recently driven increased demand from both CRE equity investors and fixed income investors into CRE private credit opportunities.

As a result, much has been written about CRE private credit investment including a) academic arguments as to why CRE private credit should be considered a separate asset class among allocators of CRE capital, b) why CRE private credit is a favorable risk adjusted investment relative to public credit, and c) the merits of open-ended vs. closed-ended investment structures for investing in CRE private credit.

All of these are noteworthy topics that we have been discussing in the marketplace for years, but noticeably absent is a granular discussion of CRE private credit risk definition, identification and techniques for mitigation.

Understanding Risk

Broadly stated, there are two types of risk associated with making a loan on a commercial real estate property: event risk and maturity risk.

Event Risk

Event risk, in the world of people who enjoy using complicated words, can also be referred to as idiosyncratic risk. Event or idiosyncratic risk can be thought of as the risk factors that uniquely affect a specific property and may be completely unrelated to the pressures of the macroeconomic environment. Obvious examples of event risk could include the loss of a major tenant or demand generator in the immediate submarket. Less obvious are situations where a combination of seemingly unrelated and peripheral events can lead to material erosion of collateral value. Other financial obligations of the sponsor may drive a shift in motivation during the term of the loan towards what, on the surface, would seem like illogical behavior. An example of this would be the upcoming maturity of a full recourse construction loan on a nearby property, where under pressure to perform, the sponsor begins “steering” existing tenants over to that nearby property, causing a significant decline in cashflow.

Maturity Risk

Maturity risk is the risk that refinancing, or sale of a property will not facilitate payoff of the loan at or prior to the loan’s maturity. Event risk immediately prior to, or following maturity can, of course, negatively impact the successful refinancing of a loan. However, the risk that market conditions or context at the time of maturity are such that payoff is not probable should generally be considered either **Systematic** or **Systemic** in nature. Systematic risk is the broader

"market" risk that generally cannot be mitigated through diversification. Obvious examples of systematic risk include interest rate risk, prevailing economic cycles and regulatory risk. Systemic risk is generally considered the collapse of a financial system as triggered by the failure of a major market participant. For our purposes, the impact of systematic and systemic disruptions will likely amplify maturity risk in a similar way, and therefore should be addressed similarly in the credit process.

In addition to event and maturity risk, when investing in CRE private credit, portfolio risks must also be considered. Portfolio level risks include liquidity, correlation and duration. Please note that while not covered in this discussion, to the extent leverage and hedging is employed as part of an investment strategy, different and significant risk is introduced and must also be considered.

Liquidity Risk

Liquidity provisions related to an investor's ability to monetize a CRE debt investment are considered in the discussion of mitigating systematic risk and is not what we are referring to when discussing liquidity risk. The liquidity risk that we focus on in this section is specific to the investor's ability to foreclose on its debt position in the capital stack, meet all of the capital requirements associated with owning the property (including operating expenses and any senior debt service obligations) and investing necessary capital to remedy any loss of value or income which caused the default of the loan (e.g. re-leasing a vacated space). Note that it is very difficult to conservatively reserve for maximum liquidity risk in a fund structure (in particular, closed-ended structures) and still achieve the objectives of maximizing deployment of investor capital and minimizing the negative effects of cash drag.

Correlation Risk

Correlation risk is the risk that a single event could materially and simultaneously distress numerous assets in the portfolio due to a common characteristic. The obvious example of this is a portfolio of loans collateralized by retail centers, at each of which Toys "R" Us is a significant tenant.

Duration Risk

Consistent with fixed income definition, duration risk is the sensitivity of an investment's price to a change in prevailing interest rates. The longer the weighted average maturity of a portfolio of loans, the more valuation volatility will be experienced as interest rates (underlying market rates and prevailing credit spreads) change. For investors that do not intend to hold to maturity or intend to employ leverage, this creates interim valuation or price risk.

Risk Mitigation Techniques

In contemplating how best to mitigate asset specific and portfolio risk, it is useful to understand the credit perspectives that defined the lending culture of earlier market participants. Historical credit practices generally employed prior to the Savings and Loan Crisis (1986-1995, but in my opinion we didn't really feel it until 1989) were value centric in nature, meaning the loan amounts advanced were generally constrained by loan to value ratio limitations. Up until this time, lenders, in particular life insurance companies, frequently underwrote to net operating income levels as the amount of free cash flow available to service debt. This approach thus implied the assumption that property repair and re-tenanting costs would be covered by the borrower who was motivated to protect its equity in the

property. When CMBS or Conduit lenders began to fill the lending void created by the dismantling of the S&Ls, the need to predictably meet debt service to bond holders forced a reorientation, away from value centric credit practices, and towards cash flow centric credit practices. This shift did not create an immediate challenge for homogenous loan pools comprised of loans on apartment buildings which at the time had been the focus of new loan originations and CMBS issuance. This is because multifamily properties with high granular rent rolls with many smaller tenants do not typically possess obvious event risk. A challenge was created, however, for heterogenous pools comprised of loans on different property types where event risk more commonly existed.

My first contributions toward standardizing cash flow underwriting methodologies for the mitigation of event risk across different property types began in December 1993 [(1)]. These efforts, admittedly, were born in the attempt to marry Fannie Mae underwriting practices across revenue and expense line items and with Project and Argus system approaches to probability-based tenant renewal cost assessments. Five basic credit elements were defined as:

1. Cash flow
2. Value
3. Borrower strength
4. Physical integrity
5. Environmental integrity

Despite a continued, and very necessary focus on borrower strength, net cash flows were underwritten to levels which reflected deduction of projected costs associated with property maintenance, tenant replacement, and in certain instances, seasonality, and specifically did not imply the assumption that borrowers would inject additional equity to remedy the occurrence of negative events. This pivot from a value centric to cash flow centric credit analysis (specifically the attention toward minimizing disruptions to cash flows resulting from property condition erosion or tenant loss) was an important step towards the goal of mitigating event risk.

Interestingly, the notion that event risks can be substantially mitigated by identifying and structuring around their possible occurrence, creates an opportunity for investor quality differentiation. Any event that can possibly disrupt the underwritten net cash flow of the property, beyond the reasonable absorption capacity facilitated by the debt service coverage ratio, should be considered for structural mitigation. Imposing reserve requirements either through pre-funding or cash flow sweeps are examples of event risk mitigation techniques. Further, potential risk events should be quantified individually at the investment level and assessed for appropriate liquidity risk reserves. From a portfolio management perspective, risk events should then be scheduled into risk event years and special attention should be paid to years in which multiple events, across different investments, are concentrated.

Systematic risk such as rising interest rates or general economic downturns should be mitigated via underwriting investments in both conservative and stressed scenarios. In a similar fashion to tenant rollover concentrations, maturities should be scheduled to determine concentrated portfolio vulnerability to certain future time frames. To emphasize the importance of this point, a portfolio of well underwritten loans in 1999, all maturing in 2009, all experienced materially heightened maturity risk, regardless of how well they were underwritten.

1. These underwriting practices were first employed by the author on the Nomura Asset Securities Corp., 1994-C3 securitization ($162.9 million at issuance) and were refined through use and generally applied across the CMBS market throughout the 1990s. With the help of McGraw Hill and due acknowledgement to Keith Harrison and Chris Tokarski, these credit practices were published in text book form in 2001 under the title *Precept: The Handbook of First Mortgage Underwriting*.

Higher LTV loans will obviously have more difficulty refinancing, thus are more vulnerable to rising interest rates, and therefore should have forced deleveraging structures to mitigate this risk. One example of this deleveraging structure is the implementation of a cash flow test during the loan term which, if not met, results in a "cash trap" or loan pay down from excess cash flow. Because the effects of systematic and systemic risk tend to endure beyond the course of a single year, reserve requirements should be defined on a cumulative and rolling three-year basis.

Lastly, portfolio diversification should obviously help to mitigate correlation risk. Property type, geographic, tenant, sponsorship, industry sector/employer, and natural disaster exposure concentrations should all be monitored and when possible, minimized. Natural disasters should also be insured against to the extent possible. With regard to systemic risk, while it is very difficult to mitigate the impact of a failing financial system, the investment strategy and structure should anticipate holding assets to maturity and protect against forced liquidations.

As a final thought, we should address the reality that prevailing risk evolves through the course of a market cycle. We cannot forget that, while a loan is an investment from the perspective of an investor, from the perspective of a borrower, it is a product. Because I believe in the merits of market-imposed discipline, I do not fully agree with the view that each risk mitigation measure imposed by the lender comes at an expense to, or limitation of, the borrower. It is also important to recognize that the borrowing community at large is represented by an entire industry of intermediaries whose "value add" is minimizing the expenses and limitations experienced by the borrowers they represent. Accordingly, as the market cycle progresses and becomes more competitive, mortgage banking intermediaries exploit their knowledge of the most aggressive lending practices then in the market to accelerate the rate at which risk mitigation practices are rendered "off market" and negotiated away. With this in mind, and beyond any risk mitigation practice that may be applied to a specific investment or portfolio in its entirety, perhaps one of the most important aspects of mitigating risk associated with CRE private credit investment, is evaluating the core values, culture and motivations of the lending/investment platform itself.