Adriano Taylor Escribano

Episode 246: Demystifying CMBS: Opportunities and Challenges in Today's Market

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com Podcast. My name is Stewart Foley, I'll be your host. Hey welcome back and thanks for joining us. We've got a great podcast for you today, and the topic is CMBS and Insurance Company Portfolios, and we're joined by Adriano Taylor Escribano, Principal Senior Quantitative analyst at Jennison. Adriano, thanks for joining us, thanks for being on, and thanks for taking the time.

Adriano: Thanks for having me, Stewart. This is great.

Stewart: Well, the first thing I'll point out is that in the conference room that you're in has an amazing view of Boston Harbor, so that's something that I'm going to paint that picture for our podcast audience so that they can see the same thing that I'm seeing here on this screen. But before we get going too deep into the topic, can you tell me where you grew up and what was your first job, not the fancy one? And also you mentioned that you studied math in college, how did you go from being a math major to the seat you're in today?

Adriano: Yeah, so I always struggled with that first question of, where do you consider your hometown? I was born in New York City. I moved to Spain when I was 13. And I never felt quite at home either in Spain or in the U.S. Right now I'm in Boston. Boston is where I'm raising my kids, so it's where I consider my hometown to be right now. As far as my background, so my math background, I ended up studying mathematics.

Stewart: Wait a minute, what was your first job? Don't skip that question. That's an important one.

Adriano: Yeah, of course. Well, I kind of wanted to skip it. My first job was in college. I was working in a kitchen in a dining hall, scrubbing pots and pans. I ended up doing that several days a week. I would scrub pots and pans, I would eat leftovers even though we weren't allowed to. It was a health code violation, but it helped save a dime here and there, so I would end up stuffing my face when they weren't looking.

Stewart: Perfect. That's great. I can relate to that. I really can. I taught for six or seven years, and have a lot of regard for the folks who worked in the dining hall. Not an easy job, but so let's go on with how your math background led you where you are today.

Adriano: It's funny, I went into university during the boom years of the GFC and graduated in the wake. And I studied university in the UK, and it's not a liberal arts education, so it's very much you go in to study math and that's all you do. And it's funny, because I would look down on the folks that were studying math and physics because they wanted to get into finance. I thought that was like, they were just sellouts, and here I am today. But the thing is, leaving the GFC or graduating post GFC I found myself really looking down on the finance industry. I thought those folks were the devil incarnate because all the mainstream media was very negative towards anything financial related; I'll remind you this is the CDO era. And so when I graduated, there were very few jobs out there. I had some part-time gigs in the Boston area that I was going through.

I had two failed startups that I tried doing. And a mentor of mine suggested that I join or that I apply to an internship at Luma Sales at the structured products group there. And I loved learning about how stuff works. It's how I got into math. I love the nitty-gritty of, how do you build things? How do you understand how the world works? I loved physics, I love chemistry. And I thought what a wonderful opportunity to jump into structured products, where it was ground zero for what was the financial crisis in '07 and '08. So I thought that was going to be a wonderful learning experience, and I have not left the industry since. That's how I ended up specializing in commercial mortgage backed securities and structured products in general. And I found that structured products really dovetailed nicely into a more quantitative background, like a math major does, because you end up dealing with large data sets, large numbers. And I eventually gravitated more towards just doing overall portfolio construction, optimization and how CMBS fits in, in an overall portfolio rather than just specific bond selection.

Stewart: That's a phenomenal story and also leads us nicely into our first question which is, how does CMBS fit into CRE lending? Bigger question is how it fits into insurance in general, but talk about how the CMBS fits into CRE lending.

Adriano: Yeah, so lending or CRE lending is a decent sliver of insurance assets in general. CMBS in particular, it's a smallish sliver of the CRE lending market, and I break those up into two big sections. There's agency CNBS, which is your GSE sponsored structures, and those are sponsored, when I say GSE mean Fannie Mae, Freddie Mac, and Ginnie Mae, so they're big lenders in the commercial real estate market. They tend to focus more on multifamily. When you get into Ginnie Mae project loans, they do a little bit more hospital lending and senior housing lending. And then there's the non-agency CMBS portion, which is more credit focused, that ranges from data centers, to hotels, to malls, and office buildings.

Stewart: So if I go remember right, I didn't realize that DUS Bonds still existed. So DUS Bonds, are those project finance? You've also gotten our notes, Freddie K, which is a term I'm not familiar with. So can you unpack some of that agency CMBS for those that might not be steeped in the tea?

Adriano: Great question. So the agency CMBS market is broken out into three segments. You have your Freddie K's, those are your Freddie Mac portion of GSE lending, and those are pooled loans of multifamily loans. So you have a structure that has say 30 to 50 loans on multifamily projects across the United States. And they typically have fairly rigorous or strict lockout periods or defeasance periods, meaning they let's just, everything in structured product, I'm going to caveat this, everything in structured products is all about subtlety. I'm going to paint very broad strokes because the moment you get into subtleties, we could be speaking here for 3 to 4 hours easily. So in the Freddie K market, I'm going to take the 10-year portion because that's probably a little bit more applicable to insurance money. Typically, you have 10-year loans and then they have a 9.5 year lockout or a nine and a half year defeasance period, meaning that loan is strict. It can't really, you're going to get interest for the nine and a half years to 10 years no matter what happens.

Stewart: So the question I guess I have is under that structure, does that structure offer positive convexity?

Adriano: Yeah.

Stewart: That's interesting. So they're essentially bullets, which is very different than agency resi collateral, for example, that would have prepayment risk and negative convexity.

Adriano: Bingo.

Stewart: Yeah. And is the same thing true for DUS Bonds? So if Freddie K is multifamily, is DUS just a Fanny version of Freddie K?

Adriano: To some extent, yeah. The underlying loans are also multifamily, but the structure is different. So as you go down the range of Freddie K to DUS to Ginnie Mae project loans, your negative convexity starts to increase. So DUS are typically, again, broad strokes here are single loans. So you invest in a single loan, and they have a little bit more prepay optionality to them. So they might not have a lockout period, they might have a penalty associated with it or a yield maintenance associated with it. And you introduce the negative convexity because they're single loans. With a Freddie K, you have the benefit of having a diversified pool of loans, where one or two prepaying or defeasing or defaulting, that doesn't happen much in the agency CMBS space, won't really affect your cash flow as much.

In the DUS space, that's very different because of the single loan nature of it. And then you enter the Ginnie Mae project loan space, which is a pooled version of DUS, to some extent, it's again different because it's Ginnie Mae and it's multifamily. You can also have construction loans in there, senior housing facilities, and hospital lending. But those structures typically are very convoluted and complicated, but also the prepayment structure is also a little bit more diverse and more forgiving for the borrower.

Stewart: So if we ranked those top to bottom in terms of convexity, Freddie K has the most convexity, DUS has the second most, and Ginnie Mae project loans has the least, is that how to think about it?

Adriano: Yeah.

Stewart: Okay. And then given that it's all agency credit, does the yield profile follow that convexity as well or are there other factors? I realize we want to do broad brushstrokes here, but just generally speaking, do you get paid more for accepting negative convexity?

Adriano: I would hope so.

Stewart: Yeah, me too. Me too.

Adriano: It's not always the case. And the question of how much is really where some people can make money. I find these days that the transfer from K's to DUS, you're picking 5 to 10 basis points. And these days it's not super compelling, just given the volatility and rates, and that convexity issue is meaningful.

Stewart: Is there a similar breakdown in non-agency CMBS? Is there a similar category, or what are the differences there?

Adriano: The other thing that I'll mention too before we jump into non-agency is, in the agency CMBS space we spoke about convexity, but then there's also a liquidity element to it. And Freddie K's are, because they're so fungible and they're bullets, that the space is extremely liquid and very easy to either add or reduce exposure. Whereas in DUS, because you're dealing with single loans, it becomes a little bit more tricky and difficult to move in and out.

So jumping into non-agency CMBS, the big two categories are conduit and single assets, single borrowers, which I'll short to SASB for folks in the industry. Everything in structure products tends to, turns into alphabet soup eventually. And then the smaller category is CRE CLOs. So this is all credit-focused, there's no wrap from an agency or a government-sponsored entity.

Conduits tend to be pooled loans, again of anything from the hotel you might see behind me, to the office tower you might see behind me as well, to storage facilities in Florida, data centers, you name it, it's in there. Single asset, single borrowers tend to be one specific loan either to an individual property or to a pool of properties. And these are typically, the folks that borrow in this market are typically large institutional, private, CRE-focused entities, or REITs. Blackstone is the largest borrower in the SASB market.

Stewart: What about CRE CLOs? You mentioned that it's the smallest group, but do you want to touch on that or are we good?

Adriano: Yeah, we can touch on that a little bit. It's more focused on floating rate nature, floating rate bonds. There are also floating rate notes, or loans underneath, but they tend to be more focused on transitional properties. It's a part of the market we haven't been active in. Just in the nature of over the last two years, we've seen rising rates, although granted that changed with the Fed decision recently, but because of the transitional nature of the underlying properties, economic uncertainty, and the cost of the debt has gone up considerably over the last two years. It's just a market that I'm not very comfortable with these days or we're not comfortable with these days.

Stewart: So interestingly, you talked about convexity and rate volatility, and the Fed just announced its first 50 basis point cut in quite some time. That's big news. Can you talk a little bit about how you think that this is going to impact the CMBS market? I'm kind of combining a couple of questions here. But I think you know where I'm headed, it looks like we're going to get into an easing cycle. What do you think happens there?

Adriano: Yeah, long story short, commercial real estate really needs lower funding, or lower cost of capital. So taking a step back, since 2022 we've had a very dramatic Fed hiking cycle. Cost of funding has gone up and the amount of CRE debt has dropped about 50%, from an issuance perspective.

Stewart: 50 as in 5-0?

Adriano: As in 5-0, yeah.

Stewart: Yeah. Okay.

Adriano: And that's twofold, right? One is cost of capital has gone up, and that plays hand in hand with valuations. And valuations are a little bit of this, in this limbo state right here. Where only the most pristine, best types of properties are transacting, and so hence the drop in transaction volumes and the drop in the lending environment. The other thing that I'll mention too is we talked about conduit before and the agency CMBS market, the really fascinating thing, and I was blown away when I saw these stats, is the conduit market was governed by 10-year fixed rate structures.

And in Freddie K's also, I mean there's a little bit more flavors of it, but the bulk of the issuance was in the 10-year space. What you've seen over the last year and a half, is in the CMBS market conduit went from a 100% 10-year to about 25% 10-year fixed rate issuance. And now 75% of that is in the 5-year conduit space. It's a sector that didn't exist 2 years ago, which I find just mind-blowing. And that kind of partially answers your question, because I'm trying to skirt your question really because I don't know what's going to happen at this easing cycle.

Stewart: But I mean that's a massive, I mean, when I ran money, I mean CMBS new issue was 10-year, period. There's an entirely different maturity structure that's popped up that I wasn't aware of that, honestly, until you just said it. So that's really interesting. I mean, what does that do to the CMBS market generally? I mean, banks used to be steady buyers of agency CMBS, what's changed there, if anything, maybe nothing's changed, but it sounds like there's been some structural changes there.

Adriano: So banks used to be a large part of the agency CMBS market, and by and large, they've disappeared. Now you hear of piecemeal banks buying here and there, but by and large, they've mostly vacated the space. So it's been an interesting environment over the last 18 months, since March of 2023. I can't even do math. I'm a quant, but I can't do math. I don't know how many years ago that was now. So yeah, it's been a very unique environment. Banks pay are a lesser part of the non-agency CMBS market, where most of the players in that space are either insurance money managers, or some REITs, and some private CRE folks.

Stewart: So when you think about CMBS, how does it fit into your portfolios?

Adriano: So we kind of view CMBS at Jennison similarly to the way we do corporates where it's a positive, or we try and focus on high liquidity, highly diversified pool, so we use it a little bit like a corporate, like we do corporates. So when fundamentals are strong, and the underlying securities make sense, relative value makes sense, we're not afraid to go overweight. And you mentioned, your question before from, where do we think we're heading? That question I'm trying to avoid - I don't know. And so in this environment where spreads from a corporate perspective are very close to all time tight still. CMBS has lagged really since the hiking cycle because there was this large question mark of where are the valuations on the underlying?

And so from a fundamentals perspective, it's very difficult to wrap your head around what's going to happen. Now the fundamentals, the Fed would have to, or rates would have to come down significantly and the economic environment would have to remain strong, in order for valuations to stay where they were from three years ago or four years ago. And so you have headlines these days of even AAA single asset, single borrowers taking 26% haircuts. It's very difficult to get very comfortable with CMBS. Now that's why we stick to up in quality. We tend to focus on diversification, liquidity, and well-structured deals.

Stewart: Yeah, it's music to the ears of most insurance companies, that tends to be their focus as well. Where have you found, as you look out today at the market, where do you think there's opportunity and what are you cautious about?

Adriano: Yeah, it's interesting because when the Fed hiking cycle started, we weren't shy of getting overweight and we did that. Over the last 12 months I would say, we've migrated to an underweight in the sector, so opportunities are far in between. I found that the underwriting quality of the deals that we're seeing has deteriorated over the last 12 months. And that's kind of in line with some of the pundits out there saying that the credit box is still fairly loose. And I think that's the case in commercial real estate by and large. Granted, you've got to remove office from that because office is this thing that nobody wants to talk about or touch these days. But again, we focus on diversification, so actually we're not afraid of having some office in a conduit deal, so long as it's underwritten properly. Now, what I don't want, and that's some of the stuff that we've seen more recently, is more concentrated conduit deals.

Now that's great for a subordinate buyer who wants exposure to a particular asset, but at the AAA level, what's in vogue today might not be in vogue tomorrow. And I can talk to you about how in the conduit deals of 2013, 2014, you had a heavy exposure to retail. What happened three years later? Nobody wanted retail anymore. And those AAA bonds that were priced on top of everything else all of a sudden widened. I could say the same thing about office in 2019 and 2020, AAA bonds that were pricing, either maybe even through generic on the runs started, when nobody wanted to touch office anymore, started to price significantly wider than the rest of the market.

So again, this focus on diversification and loan quality is really paramount to what we do. Again, I don't care that there's office in there, as long as it's diversified, and well underwritten, and it makes sense. What I don't want is heavy concentrations in multifamily and industrial that are really in vogue today, that might not make sense four years from now when you have either a glut of oversupply in multifamily or a glut of oversupply in industrial.

Stewart: And so you mentioned that some SASB floaters are taking some losses, anything else concerning you right now?

Adriano: Yeah, we did a really deep dive into bank exposure to commercial real estate a couple years ago, and part of that, I was really kind of worried about some of the SASB floater part of the sector. Not that the banks have much exposure in there, but it was just part of this overall rethinking of the market that we did last year. And Fed funds, or SOFR rate for floating rate, went from close to zero to five and a quarter percent, now we're just shy of 5% with the Fed cut from yesterday. But even with the Fed cut from yesterday, I have 20%, or almost 20% of the SASB floating rate market, not meeting debt service coverage ratios if those loans were allowed to float with SOFR.

And I realize after saying that, I kind of have to take a step back. One of the really interesting things from the SASB floating rate market is that a borrower usually writes an interest rate cap on the underlying loan. Now what that means is, when they write or when they borrow, they say, I'm going to borrow, but I'm going to write an option into the loan that says, if SOFR goes above 4%, I'm only going to pay that 4%, somebody else is going to pay that difference. Usually the person that's writing that swap agreement. And so what you find is 20% of the market, of the SASB market right now, can't meet that debt service coverage ratio if SOFR were allowed to move to that 4.8% that it is today.

Stewart: Wow, that's interesting. I've gotten a tremendous education today about CMBS. I really appreciate that. What would be a couple of takeaways, key takeaways for our audience, and then I've got a couple of fun ones for you out the door.

Adriano: So key takeaways, don't be afraid of the CMBS market, but be very cautious.

Stewart: Wow, there you go. Those are good takeaways. Let's talk about this. I want to take you back to when you were at, and it's interesting that you studied, not only did you study math, but you studied at the University of St. Andrews in Scotland, which had to be an interesting experience. So go back to that, and if you could talk to your 21-year-old self today or people who are early in their career that are studying mathematics, what advice would you give them given what you know now about the opportunity set in the asset management space and other opportunities they might want to consider?

Adriano: The second question is a lot harder to give advice to other people. Can I answer the question of going back in time…

Stewart: Yeah.

Adriano: To talk to myself?

Stewart: Of course.

Adriano: So this is 2009 or 2010, I had downloaded an application on my computer to mine Bitcoin.

Stewart: There you go.

Adriano: And I would go back in time to tell myself, don't lose that password and keep doing it.

Stewart: That's great. All right, so the last question I have is kind of an interesting one, and it goes something like this, a lunch for four people, you being one, you can invite up to three guests, alive or dead, who would they be?

Adriano: That's also a great question. Admittedly, on one of my first dates with my now wife, we asked each other the same question. And my question right now, or my answer right now would be very different to what it was, I don't know how many years ago, 10 years ago now.

Stewart: What was your answer then? Do you remember?

Adriano: I can't say for certain, but it was something along the lines of Richard Feynman, some historical figure. Yeah, I don't remember exactly, but it was important figures in either history or math and physics. My answer today would be remarkably different, in that I'm a bad cook, so if I had these people over for dinner, they'd probably spit my food out and walk out on me. So what I would do is I would have my father over who passed away eight years ago and my two kids.

Stewart: Wow, there you go.

Adriano: I'm choking up here, but my two kids never got to meet my father. And the benefit of having these people over is they wouldn't be able to complain about my cooking.

Stewart: That's a really heartfelt answer. I appreciate that one. Man, that's very nice, really nice sentiment. I've really enjoyed having you on. I've gotten a great education on CMBS and CRE lending. It's been great to get to know you as well. So thanks very much for taking the time and being on today. We really appreciate it.

Adriano: Thank you, Stewart. Pleasure's all mine.

Stewart: We've been joined today by Adriano Taylor Escribano, Principal Senior Quantitative Analyst at Jennison. Thanks for listening. If you have ideas for our podcast, please shoot me a note at Stewart@InsuranceAUM.com. Please rate us, like us, and review us on Apple Podcasts, Spotify, or wherever you listen to your favorite shows. My name's Stewart Foley. We'll see you again next time on the InsuranceAUM.com Podcast.