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NAIC 1 bonds with 6%+ yields ... fear the risk or embrace the opportunity?

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SASBs in the industrial, multi-family and life sciences spaces are compelling. Higher-yielding office and retail CMBS aren't worth the reach ... yet.

Risk is not homogeneous across CMBS

Like other fixed income sectors, commercial mortgage-backed securities (CMBS) widened as markets repriced throughout 2022. While we believe the space offers value, selectivity is key. 6%+ yields for investment grade CMBS may seem tempting, but buyer beware. As always (but especially now), risk is not homogeneous across CMBS.

The headwinds for retail and office property types are severe. Retail properties continue to feel the effect of cyclical and structural economic changes, as consumer spending would likely moderate into a potential growth slowdown and online retail battles to take share away from brick-and-mortar stores. Meanwhile, hybrid working arrangements continue to plague the office subsector, as the still evolving work-from-home environment has prolonged uncertainty. In our view, higher spreads available in these spaces are not yet worth the risk.

We prefer property types in the industrial, multi-family and life sciences subsector. Industrial collateral has benefited from retailers catching up to Amazon, as well as the need for facilities to support "last-mile" distribution as consumer preferences dictate. Multi-family has benefited from demographics in the US, as well as structural under-investment in housing stock and the resulting growth in rents.

Life sciences collateral is essential, purpose-built laboratory/office space supporting a segment of the economy that cannot work from home. Select properties in the hospitality space are also attractive at current levels. We prefer irreplaceable "trophy" hotels that are benefiting from currently insatiable consumer demand for vacation travel, as well as extended stay–oriented and suite-style hotels that cater to the price-sensitive business traveler. These properties have proven very resilient post Covid.

CMBS: Where to invest and what to avoid

Single-asset single-borrower (SASB) CMBS offer spreads (C/D tranche)

Rating	✓ Industrial	✓ Multi-Fam	✓ Life-Sci	! Hospitality	X Office	X Retail
A	220	215	210	275	425	400
BBB	250	245	240	310	650	500

As of 02/14/23. Source: Voya Investment Management.

Spotlight on industrial CMBS

Industrial CMBS are particularly attractive, in our view. The space offers investors the opportunity to purchase single-A rated bonds with the capital consumption of AAA rated securities and spreads in line with BB-rated corporate bonds. Not only do these bonds offer attractive yields relative to their capital requirements, but seasoned secondaries are also offered at discount prices, which provides a total return opportunity for more active investors. Below, we highlight a recent purchase that illustrates the attractive characteristics of the industrial CMBS space.

EQUS 2021-EQAZ C

In late January, we purchased EQUS 2021-EQAZ C at 97-08 / 6.9% yield (226 bp discount margin to maximum extension):

- The C tranche is bond rated A+/A+ (upgraded from A-) by S&P/Kroll and has 54% CE.
- Loan to purchase price through the C tranche is 32%, and underwritten debt yield is 13.7%.
- The modeled NAIC rating is 1A.
- Collateral is a 74-asset industrial portfolio in Phoenix and Tucson, AZ, that is performing well (98% average occupancy).
- All properties except one are multi-tenant. While the largest tenant leases 1.4% of the net rentable area, all other leases are less than 1% (1,900 tenants across the portfolio).
- The sponsor has $360mm cash equity in the deal based on a $1.15B purchase price, resulting in a loan-to-purchase-price ratio of 70%.
- The underlying interest-only mortgage loan has a two-year term subject to three successive twelve-month extension options.

Other tailwinds for CMBS SASBs

CMBS SASBs are mostly floating-rate instruments, which have been afforded deeper investor sponsorship in this rising-rate environment. The associated increases in income (as the Fed has pressed forward) have rewarded risk takers.

The technical backdrop also favors risk-takers, as demand has clearly outweighed supply into 2023, not only in SASB but across conduit, CRE CLO and agency CMBS issuance channels. Supply expectations against the volatile rate backdrop remain muted, which supports tighter spreads in the medium term.

The structures of SASB bonds are durable, with significant credit enhancement, low loan-to-value, and high debt yields. Modeling by the National Association of Insurance Commissioners' Securities Valuation Office (NAIC SVO) confirms this view, and most of these bonds are modeled with higher ratings than their nationally recognized statistical ratings organization (NRSRO) ratings. In 2022 year-end modeling, the NAIC SVO scenarios punished certain office and retail transactions, particularly for subordinate bonds, which in some instances saw multiple notch downgrades. Other property types — appropriately, in our view — saw continued stability in ratings and very efficient regulatory capital.

While the sector has pockets of risk to avoid, we are constructive on CMBS, favoring SASBs in the industrial, multi-family and life sciences areas.

Past performance does not guarantee future results.

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