REAL ESTATE

Opportunities and Avenues

January 25, 2021

Our views on U.S. commercial mortgage relative value, accessing the sector, and boosting returns using Federal Home Loan Bank membership.

We believe the commercial mortgage sector has provided investors attractive risk-adjusted returns in recent decades, and recent changes with the Federal Home Loan Bank (FHLB) offer investors a new method to potentially increase returns. Later in this report we will discuss that method, but first we believe it is worth briefly discussing the sector, and why we feel it can fit into many institutional portfolios.

At approximately $4.7 trillion, just under half the size of the U.S. corporate bond market, the U.S. commercial mortgage market is home to a diverse array of attractive opportunities.[1] For a number of reasons, commercial banks and insurance companies typically hold the majority of U.S. private commercial mortgages. However, with additional commercial mortgage investment vehicles emerging, and with the increasingly transparent attractive yield potential the asset class offers, the sector is also gaining interest from a broader range of investors.

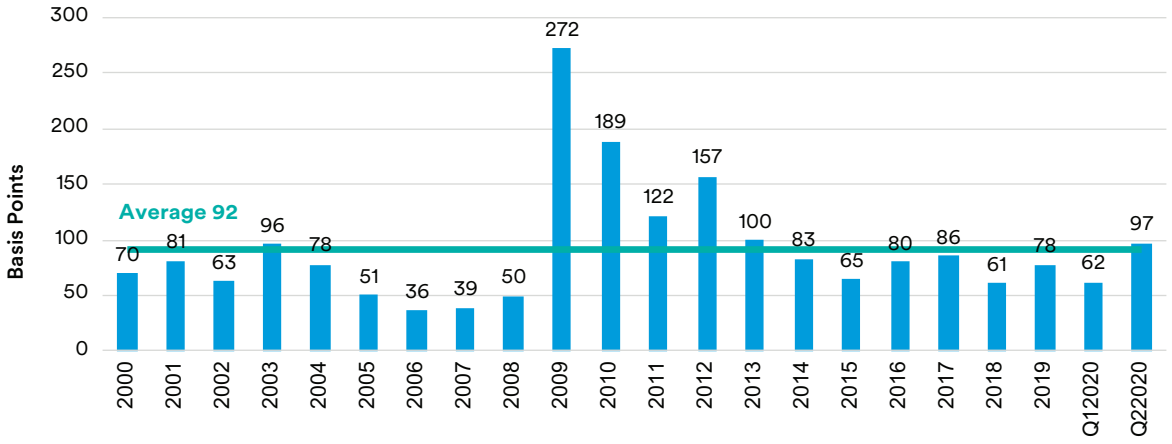
MetLife Investment Management

Commercial Mortgages Provide Attractive Yields

Commercial mortgages have historically delivered a spread premium relative to public corporate bonds with similar risk profiles (Figure 1). Since 2000, fixed rate U.S. commercial mortgages originated by U.S. life insurance companies provided, on average, a 92-basis point spread premium over single-A public corporate bonds.[2] There are several reasons for this phenomenon. Higher costs associated with originating and servicing loans can partially explain the spread premium commercial mortgages provide relative to similar term and risk public corporate bonds. Investors may also demand a spread premium to compensate for a lack of liquidity. This liquidity premium can vary materially by investor.

We believe the premium the asset class generally offers today compensates for illiquidity and servicing costs and represents an attractive relative value opportunity.

Figure 1 | ACLI Commercial Mortgage Spread Premium Over Comparable Public Corporate Bonds (Non-Financial Index)



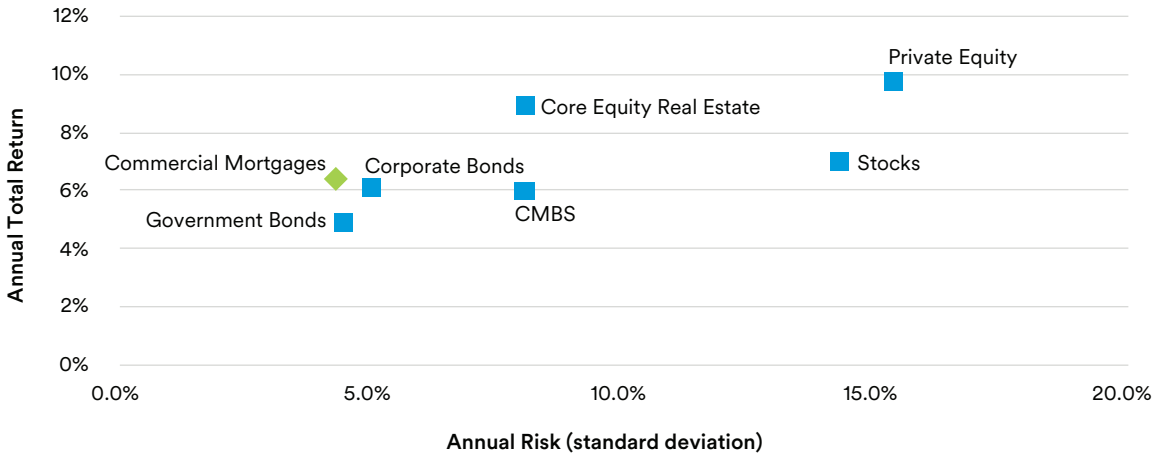
Source: ACLI Commercial Mortgage Commitments Historical Database (Fixed Rate Mortgages), Barclay's Point US Credit Corp ex Financials A1-A3 Index.

Commercial Mortgages Offer Attractive Risk Adjusted Returns and Diversification[3]

Commercial mortgages have also provided one of the highest risk-adjusted returns among the major asset classes (Figure 2). A major contributor to this is the lower historical volatility of commercial mortgages. Like other fixed income products, commercial mortgages derive their total returns primarily from income. That income is usually generated from multi-tenanted properties with staggered lease terms.

Leasing to multiple tenants helps ensure that in many cases the vacancy of a single floor or suite is unlikely to decrease a property's income below the required level of debt service. Further, staggered lease terms can allow landlords to gradually increase rents, and improve debt service coverage ratios, over time. This can result in a less volatile and more reliable income stream that can help meet debt service requirements.

Figure 2 | Historical Average Returns and Risk by Asset Class



Calculations are made from 2Q2000-2Q2020 data.
PE runs from 2001-1Q2020 due to data availability.

We also believe that commercial mortgages can act as an attractive diversifier in investment portfolios due to their low historical correlation to other major asset classes (Figure 3). It can be difficult to make like-for-like comparisons across asset classes. However, we believe that the correlation and return analysis shown in Figure 3 reflects the general relationships between the total returns of the major asset classes.

Figure 3 | Correlation of Total returns for U.S. Commercial Mortgages Versus Major Asset Classes: 2Q2000-2Q2020[4]

	Commercial Mortgages	Core Equity Real Estate	CMBS	Stocks	Corp. Bonds	Gov't Bonds	Private Equity
Commercial Mortgages	1.00	0.09	0.73	-0.08	0.48	0.34	-0.01
Core Equity Real Estate		1.00	0.08	0.14	-0.20	-0.06	0.44
Investment Grade CMBS			1.00	0.29	0.64	0.08	0.26
Stocks				1.00	0.25	-0.61	0.75
Investment Grade Corporate Bonds					1.00	0.35	0.06
Government Bonds						1.00	-0.48
Private Equity							1.00

Private equity returns conclude in 1Q2020.

As the table illustrates, with the exception of Commercial Mortgage Backed Securities (CMBS), private commercial mortgages exhibit relatively low correlations with other major asset classes.

How to Invest in Commercial Mortgage Loans

There are numerous ways for investors to access commercial mortgages, and many of these assets are eligible to be pledged to the Federal Home Loan Bank (FHLB), which can help enhance yields. The FHLB is a federally chartered network of banks created to support housing finance and community investment. These banks offer low interest rate advances on eligible collateral to member banks, insurance companies, and other financial institutions. FHLB eligible collateral related to commercial mortgages includes commercial mortgage backed securities (CMBS), whole loans, and participation loans.

The CMBS market allows investors to buy into liquid pools of mortgages with a wide selection of risk levels, which can be attractive to investors who need precise asset/liability matching. Private debt funds also offer access to a diversified pool of mortgage assets and may also allow for a more granular form of management during the life of the investment.

Whole loan investing is another way to access to commercial mortgages. Whole loan investing may be worth considering for investors who are unable to find the scale, or types of loans they want, through other investment options.

Participation interests in commercial mortgages are another avenue, and one that allows investors to screen and choose allocations on individual loans. It could take time for an investor to build a diversified portfolio with participation interests. However, it is usually easier to achieve diversification and precisely manage what a portfolio is comprised of using participations, relative to whole loans and CMBS.

In 2020, FHLB of Boston expanded the eligibility criteria for commercial mortgage participation interests. Members of the FHLB of Boston can now pledge participations where the lead lender, or one of its affiliates, is a member of any of the 11 FHLBs.

Figure 4 depicts a mathematical example of how leverage could affect the return profile of a hypothetical $5 million commercial mortgage participation. As the table shows, if an investor were to fund their $5 million participation interest that earns a 3.00% coupon, and then received a $3.25M advance from FHLB at a 0.85% rate. The investor's return on their $1.75M net investment could then be expected to yield 6.99%, in the first year of the investment term. This new avenue of investment can provide medium or small sized institutions access to small investments in large commercial mortgages, while also offering what we believe are attractive absolute and risk-adjusted return potential. Actual achieved yield may vary.*

Figure 4 | Example of a Leveraged CML Investment ($M) Mathematical Illustration of How Leverage Could Impact a Hypothetical Loan Participation*

	Unlevered CML	Levered CML
Property Value	$150.0	$150.0
Loan to Value	60%	60%
CML Principal	$90.0	$90.0
Participation Level	5.56%	5.56%
CML Participation Value	$5.0	$5.0
CML Interest Rate	3%	3%
FHLB "Haircut"		35%
FHLB Advance		$3.25
FHLB Interest Rate		0.85%
CML Investment Income	$0.15	$0.15
FHLB Interest Payment		($0.03)
Net CML Income	$0.15	$0.12
CML Cash Investment	$5.00	$1.75
Net CML Yield on Cash	3.00%	6.99%

***Important Disclosure:** The foregoing hypothetical, including income and yield statistics, represents an example of a mathematical calculation and does not reflect actual historical results or yield for any actual investment or investment strategy. Terms may not be representative of today's market conditions Hypothetical examples do not include the impact of manger or transaction fees and have other limitations including: they do not reflect actual investments made and therefore do not reflect the impact that actual market conditions may have had on the investment manager's decision-making process. There is no guarantee that any actual CML strategy, levered or not, would achieve the target return exemplified above. Actual achieved yield may vary from the yield shown above for a variety of reasons including, 1. If the spread between average CML interest rates and FHLB interest rates was smaller. 2. If the "FHLB Haircut" is higher. 3. If there was a significant interest rate movement during the time between purchase and recapitalization of the participation interest. 4. If there were credit losses in the underlying loan, which could exceed 100% of the net investment. Analysis also excludes FHLB membership and activity-based stock purchases and corresponding dividends. Analysis also does not consider returns resulting from differences between FHLB interest rate benchmark floors and that of the participation interest being leveraged. A decision to allocate money to the CML strategy should not be based on hypothetical examples of target returns or simulated performance. All figures are illustrative and may not represent currently available terms. The FHLB "Haircut" and Interest rate shown are within the ranges of available terms published by the FHLB of Boston, as of 9/2020. Additionally, the Loan to Value (LTV) and CML interest rate assumptions are similar to the 59.5% average LTV and 3.4% contract interest rate reported for 2Q2020 originations, in the American Council of Life Insurers Investment Bulletin on 8/13/2020. It should also be understood that leverage can magnify potential losses. The $5M participation value used is purely illustrative.

Conclusion

We believe commercial mortgages, and especially those funded with FHLB advances, can fit well in a multi-asset portfolio due to their historically favored risk-adjusted returns vis-à-vis other asset classes, as well as their attractive income return potential and lower historical loss rates versus public corporate bonds with similar risk profiles.

Endnotes

1 Federal Reserve Flow of Funds, 2Q2020

2 ACLI Commercial Mortgage Commitments Historical Database (Fixed Rate Mortgages), Barclay's Point U.S. Credit Corp ex Financials A1 – A3 Index. Spread premiums are gross, not net of fees.

3 The commercial mortgage data shown in Figures 2, and 3 come from the Giliberto-Levy Commercial Mortgage Performance Index which models senior commercial mortgage performance based on the American Council of Life Insurers (ACLI) commitments data and is most comparable to the investment grade corporate and CMBS universe. The commercial mortgage loss data is collected from publicly available SEC filings from life insurance companies. While the commercial mortgages held by these publicly traded life insurance companies have a single A corporate credit risk profile, on average, they also hold below investment grade mortgages as well as subordinated commercial mortgages which are below investment grade.

4 The indices used for each asset class are: Commercial Mortgages, Giliberto-Levy Commercial Mortgage Performance Index; Government Bonds, Barclays U.S. Treasury Index; Corporate Bonds, Barclays U.S. Investment Grade Corporate Credit Index; Core Equity Real Estate, NCREIF Property Index (NPI); Stocks, S&P 500 Total Return Index; Commercial Mortgage-Backed Securities, Barclays Capital U.S. Investment-Grade CMBS Index, Private Equity, Cambridge Associates LLC U.S. Private Equity Index; Hedge Funds, HFRI Hedge Fund Index; International Stocks, MSCI EAFE Index. Data is from 2Q2000-2Q2020.

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For more information, visit: **investments.metlife.com**

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[2] At estimated fair value. Includes MetLife general account and separate account assets and unaffiliated/third party assets.

MetLife Investment Management Real Estate Research and Strategy

WILLIAM PATTISON
Head of Real Estate Research

William Pattison is the head of the real estate research & strategy team within the risk, research & analytics group of MIM. He is responsible for research and strategy development in support of MIM's real estate equity and debt platforms, working closely with MIM's regional offices and portfolio managers to craft the strategic house view, drive thought leadership initiatives, and project domestic and international capital markets. Will has over 15 years of experience in institutional real estate research, valuation, and portfolio management. He is a graduate of Iowa State University, where he earned his Bachelor of Science degree in economics.

REGINALD ROSS
Associate Director

Reginald Ross is an Associate Director in the Risk, Research, and Analytics Division of MetLife Investment Management (MIM). He is responsible for market forecasts, client engagement, investment committee participation. Reginald has over 16 years of experience in CRE financial and econometric modeling. He joined MetLife in 2019. Prior to joining MetLife, Reginald was a Director at JLL focusing on redevelopment finance and advisory. He began his career in investment banking at Wolfensohn & Co and UBS. Reginald earned a Bachelor's degree in Economics from Morehouse College and an MBA from the Wharton School of Business at the University of Pennsylvania.

MICHAEL STEINBERG
Associate Director

Michael Steinberg is a member of the real estate research & strategy team within the risk, research & analytics group of MetLife Investment Management (MIM). He is responsible for development and maintenance of the team's quantitative research models, market forecasting, and communicating the team's investment strategies and economic outlook. Prior to MetLife, Michael worked in both research and portfolio management capacities at UDR, a national multifamily REIT, and Reis, a leading real estate market research firm. Michael received a Bachelor's degree in economics from the College of the Holy Cross and an M.B.A. from Columbia Business School.

AUSTIN IGLEHART
Senior Analyst

Austin Iglehart is an analyst on the real estate research & strategy team within the risk, research & analytics group of MetLife Investment Management (MIM). He is responsible for research & strategy development in support of MIM's real estate equity and debt platforms. In this role, Austin develops and maintains analytical tools for the research team, conducts market analyses in preparing team members for investment committee, contributes to the authoring of strategy whitepapers, assists team members in client service, and supports senior members of the research team in the development of long-term investment strategies. Austin earned his Bachelor of Science degree in finance at Wake Forest University before joining the real estate research & strategy team in 2018.

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One MetLife Way | Whippany, New Jersey 07981
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