Aegon Asset Management

CMBS UPDATE: A HEALTHY OUTLOOK

By Kayla Kremer, CFA, Structured Finance Research Analyst &
Glen Kneeland, Structured Finance Portfolio Manager

What we like

- Single-asset/single-borrower deals with low leverage on trophy properties in primary markets
- Industrial properties with high barriers to entry or last mile locations
- Biotech lab space in life science corridor

What we're watching

- The pace of CRE property price growth is decelerating and is subject to risks from slowing NOI growth and increased supply; however, lower rates are supportive for cap rates and prices
- Rising natural disaster occurrence and the impact to CMBS exposure and rising insurance costs
- Impact of policy and regulation such as rent regulation in multifamily or local tax incentives that stimulate growth

What concerns us

- Markets exposed to industry concentration, e.g. Houston and North Dakota oil impact
- Single tenant office, particularly in suburban market locations
- Tired retail properties in areas with weak demographics (class B/C quality malls)

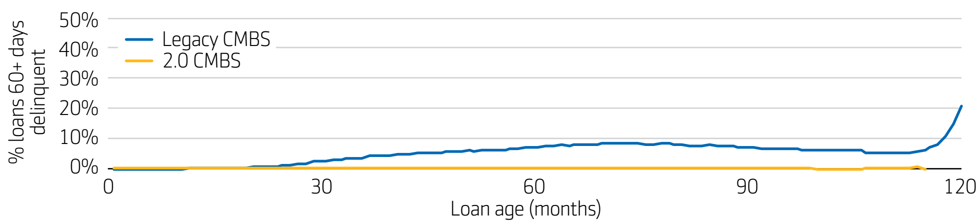
Market participants are largely optimistic on commercial real estate fundamentals; however, macro uncertainty and political tensions are weighing on investor sentiment. Despite uncertainty and volatility in the market, we believe commercial mortgage-backed securities (CMBS) remain an attractive investment opportunity as the key themes are generally positive.

Stable fundamentals outweigh slow growth fears

The current US expansion is now the longest on record and we are experiencing late-cycle symptoms in several areas of the credit market. Today, commercial property prices, as measured by Real Capital Analytics' Commercial Property Price Index (CPPI), are 30% above their August 2007 peak. However, we believe commercial real estate remains an attractive opportunity for investors in a slow growth environment.

Commercial real estate (CRE) fundamentals remain strong with robust demand amidst limited construction. Net operating income growth is expected to remain above inflation and continued low interest rates make low cap rates look attractive on a relative basis. CMBS 2.0 performance, vintages issued post-financial crisis, is stable with delinquencies relatively muted at 0.84% overall, according to Trepp Research as of June 2019. The stable fundamental trends are expected to continue and will offer support against the developing narrative around slower growth.

Exhibit 1: CMBS conduit 2.0 loans are reporting delinquencies significantly lower than legacy



Source: J.P. Morgan, Trepp as of 7/31/2019.

Disciplined underwriting has led to a healthy outlook

Since the global financial crisis, commercial real estate fundamentals have improved and underwriting practices have become more disciplined. Loan debt service coverage ratios are over 2x. We believe this will result in low term default risk. The pro-forma cash flow underwriting seen pre-crisis has been largely absent. An increase in interest-only loans has been offset by lower loan leverage. Finally, credit enhancements are almost two times higher than legacy conduit issuance. Lower leverage, coupled with higher credit enhancements means the leverage at each tranche is also significantly lower than pre-crisis. Exhibit 2 depicts some of these trends.

Exhibit 2: CMBS conduit underwriting

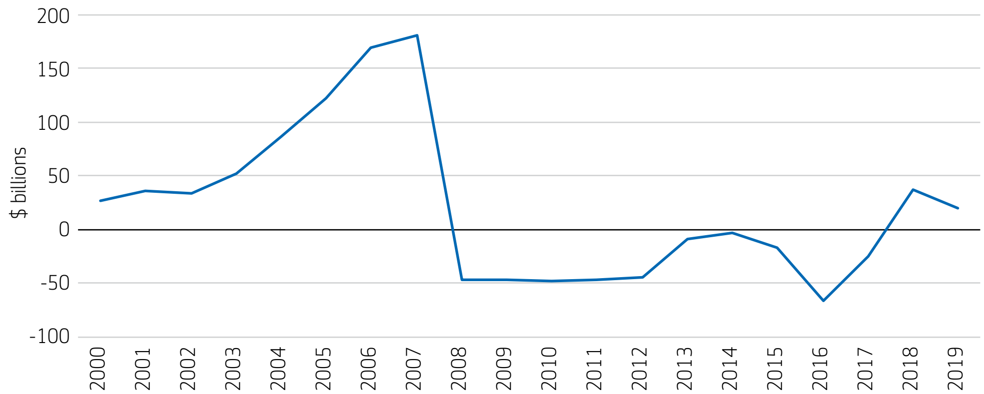
	2018	2017	2016	2007	2006
Loan-to-value	58.4%	57.2%	60.0%	69.1%	68.0%
Net cash flow debt-service coverage ratio	2.05	2.16	2.00	1.38	1.47
Net operating income debt yield	11.4%	12.5%	11.0%	10.0%	10.6%
% of interest only (full or partial)	77.6%	73.9%	66.3%	85.5%	74.4%
Avg. AAA (junior) credit support*	21.3%	21.1%	23.4%	12.1%	12.0%
Avg. BBB- credit support	7.6%	7.3%	8.5%	3.3%	3.1%

Source: Aegon AM US, deal documents. *Note: AAA (Super Senior) was consistently 30% over the time periods noted above.

Low net supply is supportive for the CMBS market

Net issuance of private label CMBS remains fairly light and is expected to remain constrained this year given the limited refinance volume and increased competition for loans from other commercial real estate lenders. At the same time, demand has been robust. The CMBS maturity pipeline is light because fewer 10-year loans were originated from 2009 to 2011. Given the lending landscape for commercial real estate loans is very competitive, this has been a challenge. CMBS market share is down to roughly 16% of CRE origination compared to 54% in 2007. From a technical perspective, these supply constraining factors are supportive for the CMBS market.

Exhibit 3: Private label net issuance has turned slightly positive after years of negative net supply

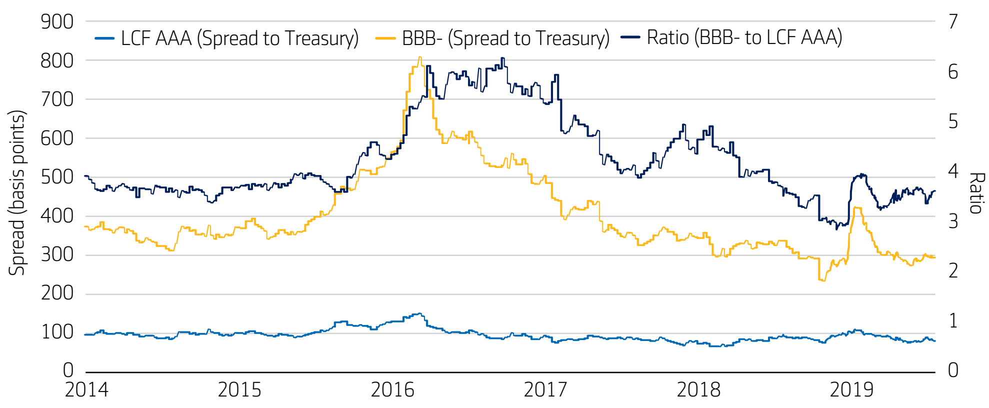


Source: Morgan Stanley as of 6/30/2019.

Constructive outlook

Commercial real estate fundamentals remain stable with CRE construction easily absorbed by demand, slow but positive NOI growth, and a current low interest rate environment. Since the 2008 financial crisis, CMBS underwriting has remained disciplined exemplified through higher debt service coverage, lower leverage, and increased subordination at all rating levels compared to transactions issued prior to the global financial crisis. Despite these broad positive trends, idiosyncratic risk remains a concern. It is important to remain diligent in underwriting credit risk. The credit curve is flat and investors are not being compensated to go down in credit. In conduit, we prefer super-senior AAA bonds which offer the potential for less volatility and significant enhancement against both macro and idiosyncratic events.

Exhibit 4: BBB- spreads are near four-year tights with high volatility during periods of weakness



Source: J.P. Morgan Data as of 6/27/2019.

Property type at a glance

Office

The future of office is changing and employees are showing an increasing preference for collaboration, amenities, and convenience. Location remains important and suburban office continues to experience weakness. Watch out for small markets, concentration risk, and single-tenant properties.

Retail

The bifurcation between the haves and have-nots in retail continues. Look for retail properties with strong, well-capitalized sponsors who are willing and able to invest in the properties. We believe the top-performing property in a given market will outperform over the long term as tenants look to locate in the highest traffic centers.

Hotel

The hotel industry is highly cyclical. Certain markets are beginning to feel the effects of oversupply, particularly in the limited service sector. Remain cautious of markets with heavy supply and slowing RevPAR (revenue per available room) growth.

Industrial

The industrial sector has the most positive outlook; however, not all properties are created equal. Location factors such as high barriers to entry and last mile properties, age, and clear height are important to consider for industrial investments.

Multifamily

There is large demand for affordable housing; however, most new supply is targeting luxury/class A properties. We remain concerned about luxury supply and are watching rent stabilization controls and the (dis)incentives it may create.

Disclosure

Past performance is not indicative of future results. This material is to be used for institutional investors and not for any other purpose. This communication is being provided for informational purposes in connection with the marketing and advertising of products and services. This material contains current opinions of the manager and such opinions are subject to change without notice. Aegon AM US is under no obligation, expressed or implied, to update the material contained herein. This material contains general information only on investment matters; it should not be considered a comprehensive statement on any matter and should not be relied upon as such. If there is any conflict between the enclosed information and Aegon AM US' ADV, the Form ADV controls. The information contained does not take into account any investor's investment objectives, particular needs, or financial situation. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to you. The value of any investment may fluctuate. Investors should consult their investment professional prior to making an investment decision. Aegon AM US is not undertaking to provide impartial investment advice or give advice in a fiduciary capacity for purposes of any applicable federal or state law or regulation. By receiving this communication, you agree with the intended purpose described above.

All investments contain risk and may lose value. Structured Finance assets (such as ABS, RMBS, CMBS and CLOs) are complex instruments and may not be suitable for all investors. The assets may involve a high degree of risk and are exposed to risks such as interest rate, credit, liquidity, issuer, servicer, underlying collateral, prepayment, extension, market, and default risk. Certain classes or series may have more or less volatility depending on the predictability of cash flows. Investors may lose some or all of the investment and there may be periods where no cash flow distributions are received.

Results for certain charts and graphs are included for illustrative purposes only and should not be relied upon to assist or inform the making of any investment decisions.

Specific sectors mentioned do not represent all sectors in which Aegon AM US seeks investments. It should not be assumed that investments of securities in these sectors were or will be profitable.

This document contains "forward-looking statements" which are based on to the firm's beliefs, as well as on a number of assumptions concerning future events based on information currently available. These statements involve certain risks, uncertainties and assumptions which are difficult to predict. Consequently, such statements cannot be guarantees of future performance and actual outcomes and returns may differ materially from statements set forth herein. In addition, this material contains information regarding market outlook, rates of return, market indicators and other statistical information that is not intended and should not be considered an indication of the results of any Aegon AM US-managed portfolio.

Aegon Asset Management US is a US-based SEC registered investment adviser and is also registered as a Commodity Trading Advisor (CTA) with the Commodity Futures Trading Commission (CFTC) and is a member of the National Futures Association (NFA). Aegon Asset Management US is part of Aegon Asset Management, the global investment management brand of the Aegon Group.

The enclosed information has been developed internally and/or obtained from sources believed to be reliable. Aegon AM US is under no obligation, expressed or implied, to update the material contained herein. Recipient shall not distribute, publish, sell, license or otherwise create derivative works using any of the content of this report without the prior written consent of Aegon USA Investment Management, LLC, 6300 C Street SW, Cedar Rapids, IA 52499.