



Perspectives

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Retail Exposure in CMBS

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The media has, in recent months, flourished with news that the growth of e-commerce is leading to the demise of retailers and retail commercial real estate. News of major retailers closing stores, like Sears, J.C. Penney, Macy's, and others filing for bankruptcy, e.g. PayLess, has brought renewed attention to the changing landscape of retailing, a phenomena that has been around for decades in one fashion or another. With published photos of dying or dead malls capturing the headlines, the dire state of the retail sector of commercial real estate is portrayed for all to see. Many readers might be left to think that brick-and-mortar retail is dying. Investors in the retail sector of commercial real estate, whether via direct ownership, REIT (Real Estate Investment Trust) stock or debt might be left wondering what kind of nightmare they currently find themselves experiencing.

The retail sector, particularly in the United States, has been in a state of change for decades. Many of us have been a part of the rise of popularity of malls from about the mid-1950s until about 2007, a year in which no new malls were built in America. We have also witnessed the effect of marketing giants, like Walmart, on communities, mom-and-pop businesses and commerce, in general. Not long ago, big box retailers, for example Best Buy, Toys R Us, Bed Bath & Beyond, Staples and Sports Authority, were the rage. Today, Amazon is among the most talked-about success story among retailers. And, while there has been a strong trend of growing sales, e-commerce accounted for only 8.3% of total sales (4Q2016 U.S. Dept. of Commerce).

Opus Investment Management has long been aware of the ever-changing landscape within the retail sector of commercial real estate. Opus and its predecessor companies have been investing in direct commercial mortgages since before 1960. The commercial mortgage-backed securities ("CMBS") issued by the Resolution Trust Company (RTC; N Series) in the early 1990s, were some of the earliest CMBS investments in which Opus had been an active participant. Today, Opus continues to invest

in both direct commercial mortgages and CMBS. As a result of its years of experience in commercial real estate, Opus has an approach to investing in both CMBS and REIT debt that is designed to capture the benefits of both diversification and yield while mitigating the most significant risks of the sector.

By various measures, CMBS comprises ten to twenty percent of all commercial real estate debt. According to an industry-related analytical tool, TREPP, the retail component of all conduit CMBS deals totals 34.8% (by principal balance) as of April, 2017. The underlying loans that collateralize CMBS deals typically represent 75% or less of the market value of the corresponding properties. This implies that a loan will not suffer one dollar of realized loss until: (1) the loan has defaulted; (2) the property has been foreclosed or sold; and, (3) the value of the property has declined to or below the then outstanding principal balance of the loan.

Commercial mortgage-backed securities have various levels of investment available for purchase by investors. The structure of CMBS provides for various bonds, also known as tranches, to have varied degrees of risk and return. In addition, there are different ratings assigned to the bonds by agencies, such as Moody's and Fitch. At the time of bond issuance, there are typically bonds that have no protection from loss (non-rated) and others that have as much as 30% of additional protection (AAA rated) and many other bonds in between. A more vibrant market exists for the AAA rated securities than those of lower rating, offering liquidity to investors who choose to invest in these more plentiful bonds.

The Opus strategy for investing in CMBS is to select the bonds offering the best combination of quality, price, liquidity and other characteristics relative to the universe of CMBS, whether newly-issued bonds or secondary market transactions. Since each conduit CMBS deal consists of multiple loans, risks are further mitigated by diversifying an

investor portfolio across multiple deals, spreading the risks of any particular loan default or loss and minimizing its impact on an investor's portfolio.

The overwhelming majority, often more than 90%, of Opus' CMBS investments are in AAA rated tranches. Industry studies show that very few bonds, originally rated AAA, have migrated to below-investment grade status and even fewer have suffered any realized loss. Among the universe of CMBS conduit bonds initially rated AAA and originated during the peak of aggressive underwriting, i.e. 2005, 2006 and 2007, the loss rates were 0.02%, 0.09% and 0.14%, respectively. For AAA rated bonds originated between 1998 and 2004, there were no losses.

While it is true that commercial real estate loans in CMBS transactions have incurred defaults and some have had losses, even significant losses, it does not mean that all CMBS bonds have suffered losses. Opus continues to follow its strategy outlined above and regularly assesses and monitors its CMBS exposures as markets and sectors change through time. We will continue to seek to add quality investments, including CMBS bonds with retail exposure, in a very deliberate and analytical fashion with the goal of creating a well-diversified portfolio while mitigating risks through careful selection of individual securities.

CMBS Losses by Original Rating (includes all property types)

Original Rating	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
AAA	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.02%	0.09%	0.14%	1.26%
AA+	0.00%	-	-	-	0.00%	0.00%	0.00%	0.00%	4.35%	8.08%	39.41%
AA	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	2.23%	11.06%	15.44%	42.64%
AA-	-	-	-	0.00%	0.00%	0.00%	0.70%	5.78%	17.06%	25.02%	40.35%
A+	-	-	0.00%	0.00%	0.00%	0.00%	0.00%	6.51%	16.44%	30.03%	52.36%
A	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	1.75%	7.53%	31.14%	46.13%	43.03%
A-	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	2.04%	15.01%	48.04%	52.24%	68.13%
BBB+	-	-	0.00%	0.30%	2.58%	0.00%	6.41%	20.73%	65.77%	59.65%	72.96%
BBB	0.00%	0.00%	0.00%	2.26%	7.99%	3.28%	12.42%	37.97%	77.78%	64.69%	78.43%
BBB-	0.00%	0.00%	0.68%	12.71%	12.45%	10.81%	21.38%	55.72%	86.02%	78.76%	81.79%
BB+	2.26%	0.77%	7.96%	26.24%	22.18%	15.82%	27.42%	63.36%	92.46%	78.38%	86.31%
BB	2.63%	6.60%	30.97%	38.88%	29.37%	24.56%	38.11%	78.60%	91.74%	84.85%	90.33%
BB-	7.60%	15.07%	64.17%	67.16%	39.61%	39.07%	54.06%	83.50%	96.16%	89.21%	99.18%
B+	5.16%	30.44%	76.09%	84.35%	56.68%	57.89%	60.05%	88.40%	96.92%	93.85%	100.00%
B	18.09%	41.38%	85.01%	81.44%	61.21%	58.61%	67.79%	90.02%	97.31%	99.10%	100.00%
B-	59.64%	68.11%	94.09%	90.54%	69.03%	64.94%	85.43%	94.38%	99.53%	100.00%	100.00%

*Excludes rake bonds and interest-only tranches. Not all transactions include every rating level, which can result in higher-rated classes having higher loss rates than lower-rated classes for some vintages.

Source: Trepp, LLC, and Wells Fargo Securities.

NOTE: Only eight CMBS deals were originated in 2008. The low volume of 2008 issuance can result in outlier results

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