CapitalStructure
A Fitch Solutions Service

Published: 09/10/2020 13:32

Source: CapitalStructure

STRUCTURED FINANCE INSIGHT: Bright spots emerge for CMBS issuance as more traditional collateral hit hard by COVID-19.

Almost all corners of the real estate market that underlies European CMBS have been hit by the COVID-19 pandemic, curtailing what had looked like a promising year for new issuance and putting existing deals under pressure. The good news for the market is that CMBS 2.0 structures have so far held up well - with some help from the deals' sponsors - and a CMBS exit still appears to be possible for select collateral.

"For any potential CMBS issuance in the current market, the underlying asset class and form of issuance will be key," said Georghios Anker Parson, partner at Brookland. "Banks are hesitant to take on the underwriting risk of a conduit CMBS in the current climate, as it is difficult to get a view on what the exit price would be. The only realistic avenue is the agency route, where the sponsor takes on the risk."

A small number of public deals have come to market since the pandemic's outbreak. A UK logistics deal, **Taurus UK 2020-2**, priced in July, while details of a social-housing-backed transaction, **Sage AR Funding No.1**, emerged this week. More transactions are expected to be brought to market in the coming months.

"The recently priced Taurus deal proved that conditions are still right to finance certain parts of the real estate market," said Euan Gatfield, managing director and EMEA head of CMBS at Fitch. "The logistics/light industrial sector continues to be viewed favourably – even benefiting from changes in market sentiment. But it is harder to see what other parts of the traditional commercial property market could be financed by CMBS at present."

Yee Cent Wong, the lead analytical manager at KBRA Europe, thinks that securitising real estate assets with predictable cash flows – cash flows that are unlikely to be interrupted by the pandemic – remains feasible in the current market and is likely to happen in the coming months.

Pools of logistics assets, preferably with multiple properties and a diverse tenant base, would be good candidates for a CMBS, she said. Residential transactions such as social housing also look feasible due to the strong demand for this type of accommodation. She also thinks that offices cannot be ruled out as long as tenants are locked into long-term leases. "Tenants will eventually go back - it may be in one or two years' time, but office workers will eventually return to their offices," she said.

Student accommodation would be more problematic because cash flows may be disrupted – students can defer or move out due to shutdowns and/or rising COVID-19 cases, and sponsors may need to return some of the payments, for example. Even retail CMBS are not entirely ruled out, Ms. Wong thinks, but such deals would have to be carefully structured, with essential tenants (such as grocery stores and pharmacies) and other tenants relatively immune from online shopping competition.

"Having a strong sponsor and a liquidity reserve are helpful to overcome short-term liquidity problems, but in the long term, what matters is to have strong properties, which are not affected by a long-term shift in terms of competition or the way they are used," she said.

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Mirco Iacobucci, head of European CMBS, DBRS Morningstar, thinks that capital markets remain open for logistics CMBS, transactions secured by residential assets, and potentially some offices or retail warehouses outside city centres. “Smaller cities have benefited from the fact that more people are now working from home. This seems to be the only bright spot in a generally bleak retail sector; it is expected to be much more difficult for deals backed by shopping centres to access capital markets right now, unless they are backed by super prime assets,” he said.

Sturdy social housing

Social housing appears to be a potentially safe sub-asset class. Deals are being structured and offered to investors. Sage AR Funding No. 1, a social housing rental secured note transaction of up to £220m, was in the market this week via Deutsche Bank. Sage Housing, the sponsor, is owned by Blackstone and Regis, a registered provider of social housing.

Last month social housing association **Notting Hill Genesis** priced a single-tranche securitisation backed by 1,523 private rental units in the south of England.

Social housing is attractive in the current market, because this market has been historically safe and stable. “The sector has not been directly affected by the pandemic crisis, and, in a transaction like Sage, there is a strong sponsor as well as the expectation of a stable cash flow, as partially funded by the government,” said DBRS’ Mirco Iacobucci.

In most cases the rents are paid (or a large contribution of the tenant’s rent is paid) through Universal Credit, which is effectively granted by the government to low-income earners to assist with their daily expenditure, DBRS wrote in its presale report for Sage AR Funding No. 1.

Although the COVID-19 outbreak has negatively affected all commercial real estate sectors, the portfolio of affordable rented housing has experienced a relatively limited impact compared with other asset types, DBRS noted in the report. DBRS Morningstar thinks that Sage AR Funding No. 1’s occupancy rate of 91% is likely to increase to full occupancy as there is strong demand for affordable housing across England.

In a distressed scenario, the portfolio would be in the first instance offered to another social housing provider and based on previous evidence this is expected to be the more likely outcome, Mr. Iacobucci noted.

Retail hit hardest

The retail sector, by contrast, is going through a rough patch. A growing list of deal downgrades in the CMBS sector gives some indication as to the pressure on transactions since the pandemic’s outbreak – the majority of the downgrades are in retail-backed transactions.

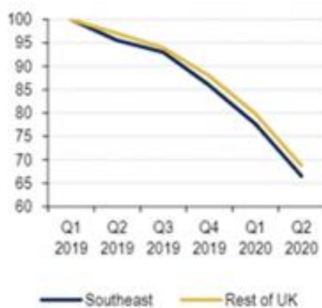
Link to CapitalStructure's Structured Finance downgrades tracker: SF downgrade tracker 9 October.xlsx

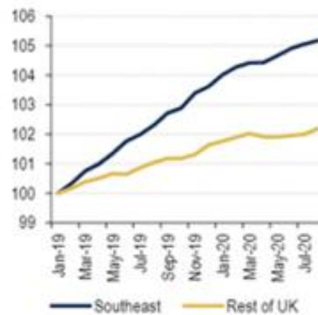
However to date, in the UK, just one deal has undergone intensive restructuring negotiations (**Intu**) - and that process was under way prior to COVID-19 - and just one UK deal has so far

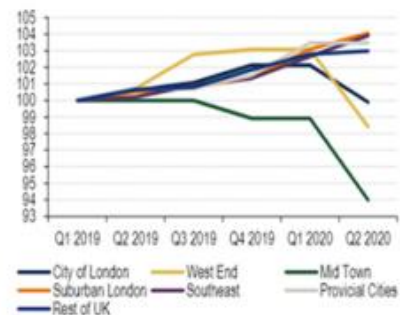
had to draw on its liquidity facility (**Meadowhall Finance**). In Italy, one deal, **Emerald Italy 2019**, has seen a loan default and bond shortfalls.

According to Iain Balkwill, partner at Reed Smith, COVID-19 has provided a good stress test for CMBS. “All signs so far show that structural reforms made since CMBS 1.0 are fit for purpose and the asset class is holding up well,” he said. “If loans are distressed, the CMBS 2.0 structure also gives a much longer timeframe for restructurings.”

Fitch’s Euan Gatfield agrees that European CMBS has seen a big impact from the pandemic but that deals have held up pretty well so far. “We expect the situation will play out for a while longer, though, and expect to see deterioration at the loan level on some deals, particularly in retail.”







Source: BofA Global Research

Of the 31 European 2.0 CMBS deals reviewed by Barclays Credit Research, nine of them are currently in breach of cash trap covenants, while four of them have obtained covenant waivers without which the deals would be in default. One more deal, **EMERA 2019-IT**, is in the process of obtaining a covenant waiver following a covenant breach to default. The deals with waivers are backed by retail or hotel properties, apart from **TAURS 2018-UK2** which is backed by an office in London largely let to WeWork, Barclays noted. Deals that have breached cash traps are also mainly retail and hotel, but **FROSN 2018** is mainly office space, as is **Italy Office 2017**, while **TAURS 2018-IT1** and **BAMS CMBS 2018-1** are backed by logistics deals.

Some sponsors step in, some don’t

For many deals, servicers are granting covenant waivers to borrowers, and there have been many instances of sponsors stepping in to shore up transactions with extra equity, particularly when viewed as a short-term bridge.

“With a few exceptions, the vast majority of CMBS transactions have still been able to meet their debt obligations during the first months of the pandemic,” DBRS’ Mirco Iacobucci said. “What this crisis has confirmed is how important it is for CMBS transactions to have a strong and collaborative sponsor”.

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The sponsor of Unite (**USAF II**) for example, a transaction backed by purpose-built student accommodation assets, added 17 extra properties to the securitisation vehicle to negate the impact of a drop in collections brought about by the pandemic. This enhanced the portfolio's market value and projected net operating cash flow by £588.5m and £26.7m, respectively.

"Deals such as this should see no real scarring from the pandemic," said Fitch's Euan Gatfield. "Once the virus is under control, university life should return to normality. The same cannot necessarily be said for office, retail or hotel assets."

In the case of Emerald Italy 2019, a deal secured on three northern Italian shopping centres, the sponsor, Kildare Partners, did not intervene when the loan defaulted as a result of very low rental collections during the Q2 2020 repayment period. The loan has now been transferred to special servicing.

Analysts at Bank of America Securities expect servicers and special servicers to continue to grant forbearance for the foreseeable future until market conditions improve, to make property disposals a viable option for maximising recoveries. "As we have seen already, forbearance actions can include waiving covenants, delaying new property valuations, or extending loan maturity dates," they said in a recent research report.

As there are no loans in CMBS 2.0 transactions scheduled to mature in 2021, it may still be too soon to tell which deals are under water. BofA analysts pointed out that the senior loans backing **TAURS 2018-UK2**, **TAURS 2019-UK2** and **Libra/EURO 31** all have first repayment dates in 2021 but are subject to multiple extension options, which they think are likely to be exercised. Their ultimate loan maturity dates are in 2023 and 2024.

It remains to be seen if further stresses/restructurings are to take place further down the line. "Servicers have on the whole been accommodating to borrowers for six months, but it is not clear for how long this can continue," said Brookland's Anker Parson.

Despite the acuteness of the pandemic crisis, CMBS professionals remain comfortable with the asset class. Structures have so far coped well and arrangers are working on new transactions. But there is one big caveat: current optimism is based on the expectations that a vaccine will be found by early next year, that offices will start refilling in the following months, and that the long-term value of most assets is preserved.

The European CMBS market is small relative to the US and bonds can be quite illiquid in the secondary market, making CMBS bonds offputting for many investors. However, some bonds look cheap, notably in the Italian CMBS retail sector. If a vaccine is found, this may become one of the best trades of 2020, a trader commented.

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