Securitized Products Special Topics

Future Funding: Potential Key Performance Driver as CRE CLO Pipeline Builds Up

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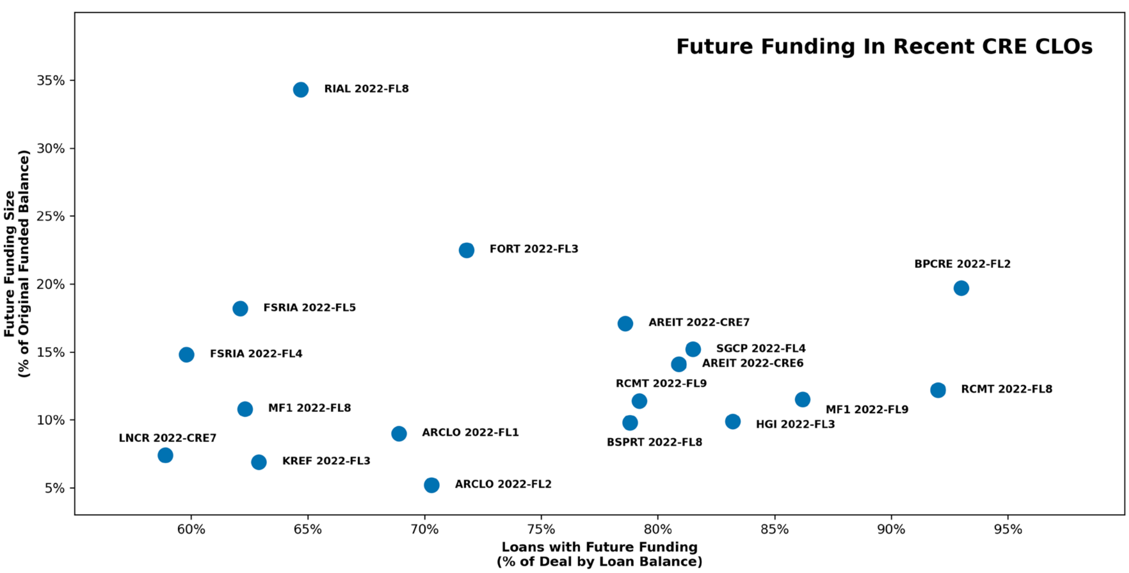
Track CRE CLO Future Funding Levels to Assess Depth of Property Transitions

We expect to see greater focus on CRE CLO loans' future funding levels as the sector scaled back a bit in recent months amid market volatility, and property transition plans face more uncertainty. Notable future funding ("FF") differences across loans in recent CRE CLO deals may drive performance differences down the road. Some loans feature significantly high FF needs, suggesting deep renovation plans, or full property conversions. For example, the $25 million The 600 loan in the recently issued MF1 2022-FL10, has $62.5 million FF, or 71.4% of the total committed balance. The sponsor of the 30-story, ~700K sf office tower in Birmingham, AL, plans to convert the vacant property to luxury multifamily. In turn, the $47.6 million Spectrum Center loan in FSRIA 2022-FL5, had $38.5 million FF. The 613K sf two-tower office complex in Addison, TX, is going through a repositioning effort.

On the other end of the spectrum, many CRE CLO loans do not feature any FF commitments. This may also pose some constraints on sponsors' ability to complete their business plan as new capital expenditures arise. We observe a wide variation in deal-level FF amounts across recently issued CRE CLO deals. FF levels range from 5.2% to 34.3% of the initial funded balance (Figure 1). FF levels also vary significantly across individual loans. Anecdotally, we find low FF loans in deals with high deal-level FF, and vice versa for low FF deals.

Figure 1. Future Funding Levels in Recent CRE CLO Deals

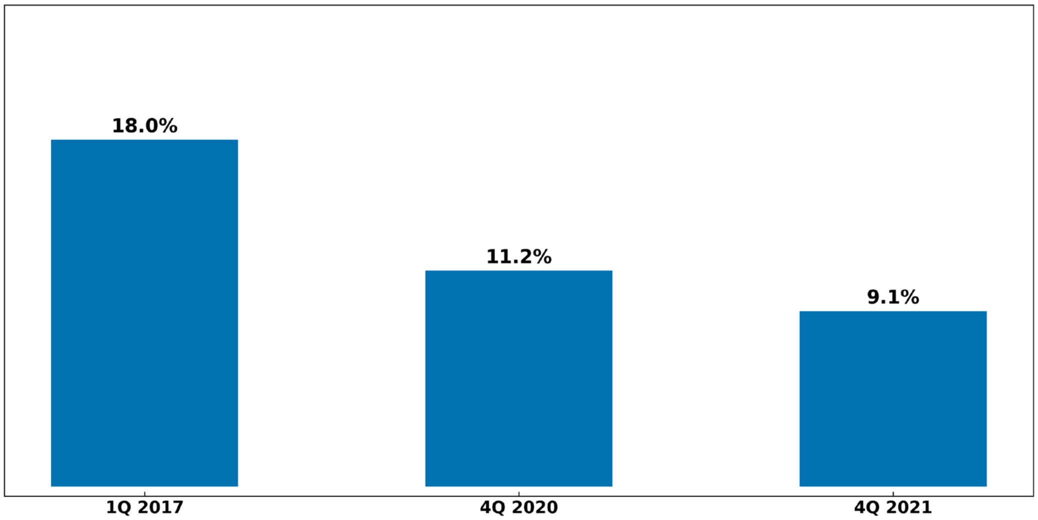


Source: Deal documents and Academy Securities

Several CRE CLO issuers noted that the pandemic may have impacted the pace of future fundings. The progress of lease-related or capital improvement expenditures may have slowed, which in turn reduced the expected pace of future fundings, according to recent filings of Lument Finance Trust and Granite Point Mortgage. Some of the issuers also note that FF might face additional pandemic-driven challenges if financing counterparties choose not to provide ongoing funding, including for future funding obligations for existing loans.

We also see variation in future funding trends at the corporate level across CRE CLO issuers. For example, unfunded commitments increased in 2021 at KKR Real Estate Finance Trust according to a recent earnings call. The firm tied the increase to greater focus construction lending in the industrial space. In contrast, TPG Real Estate Finance Trust reported a sharp drop in its future funding as a percentage of total loan commitments between 2017 and 2021 (Figure 2).

Figure 2. Future Funding as a Percentage of Total Loan Commitments

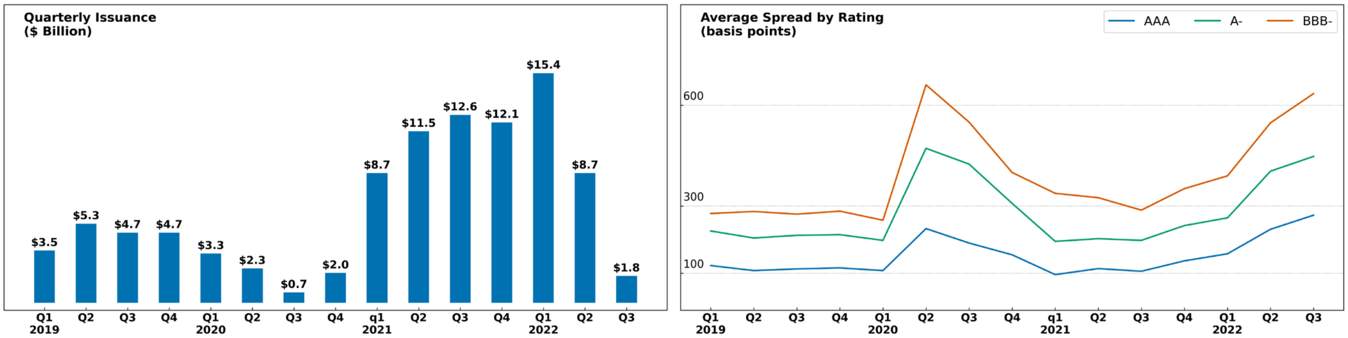


Source: TPG Real Estate Trust and Academy Securities

CRE CLO Issuance Slowed Down in 2Q, But Pipeline is Building Up Again

CRE CLO issuance slowed down in the 2Q 2022, after a strong start of the year. The first quarter saw $15.4 billion issuance, followed by $8.7 billion new deals in the second quarter (Figure 3). The issuance slowdown was accompanied by widening spreads across the capital structure. The CRE CLO pipeline is now building up again. At least nine CRE CLOs topping $7.5 billion are slated for September or October, according to CMA.

Figure 3. CRE CLO Issuance and Spreads



Source: CMA and Academy Securities

Elevated Future Funding Levels Suggest Deep Conversion Plans

Exceptionally high loan-level future funding may raise a concern that a property transition plan the CRE CLO finances in fact masks a construction project, with a much higher risk profile. CRE CLO presale reports usually provide data fields listing the FF uses. But we often find the information in such fields very generic, usually mentioning "capital expenditures" or "leasing costs" as the FF uses. For example, The 600, which is a full conversion project, mentions only "capital expenditures" as the FF uses. Investors can find more context for the FF needs only deeper in the deal documents.

Rating agencies pointed out in the past that loans with FF typically pay off slower versus loans which are fully funded at securitization. Moreover, larger future funding commitments, as a percent of total committed balance, correlate with longer outstanding periods.

Still, loans with exceptionally high FF components and extensive conversion plans appear to be relatively uncommon, based on scanning of FF levels across 2021- and 2022-vintage CRE CLO deals. One notable example of such loan is 345 Park Avenue South, which had $75 million and $65 million pool exposures in LNCR 2021-CRE6 and LNCR 2021-CRE5, respectively. The CRE6 deal had FF of $66.6 million associated with the trust loan amount. The sponsors planned to convert the class-B office building in the Midtown South submarket in Manhattan into a Class A mixed-use life science complex. The loan fully paid off in May 2022.

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