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What Can We Learn From High-Yield Debt Study?

Are high-yield commercial mortgages priced in a manner commensurate with the risk to investors?

The question has long been a puzzle, largely due to the paucity of data. Originators and holders of subordinated debt tend to be private operators that keep a tight lid on information for fear of giving away trade secrets.

Now, however, a new study of high-yield loan performance has an answer. The paper by Michael Giliberto, a co-founder of the Giliberto-Levy mortgage indexes, found that high-yield debt originated between 2010 and 2020 produced returns in line with its position in the commercial real estate capital stack.

The Giliberto study, first published in the October issue of the *Journal of Portfolio Management*, reported that high-yield debt produced a return of 8.5% during the 2010s decade, more than senior instruments such as senior fixed-rate debt (5.5%) and CMBS (5.9%) and less than equity indexes produced by the National Council of Real Estate Fiduciaries: the ODCE fund index (10.5%) and NCREIF Property Index (9.4%).

Since mezzanine mortgage debt falls between equity and senior debt in the capital stack, those results make intuitive sense and indicate that the industry is pricing risk efficiently. However, the study won't be the last word on the topic. For one thing, the study was based on a relatively small sample, $20.9 billion of loans in the Giliberto-Levy 2 index, which is the first index to track the performance of high-yield debt.

A much bigger caveat is that there was no property market downturn during the time period in which the study took place. That means the study doesn't cover the impact on mezzanine debt during down markets—such as the early 1990s or 1998, or after the global financial crisis of 2008-10—when high-yield loans experienced a wave of defaults.

G-L index co-founder John Levy said there was no attempt to avoid downturns. The study was made possible by the formation of the G-L 2 high-yield debt index in 2017, which helped the firm to obtain data on loans dated back to 2010. Whatever its limitations, the study provides valuable information on the high-yield commercial mortgage market.

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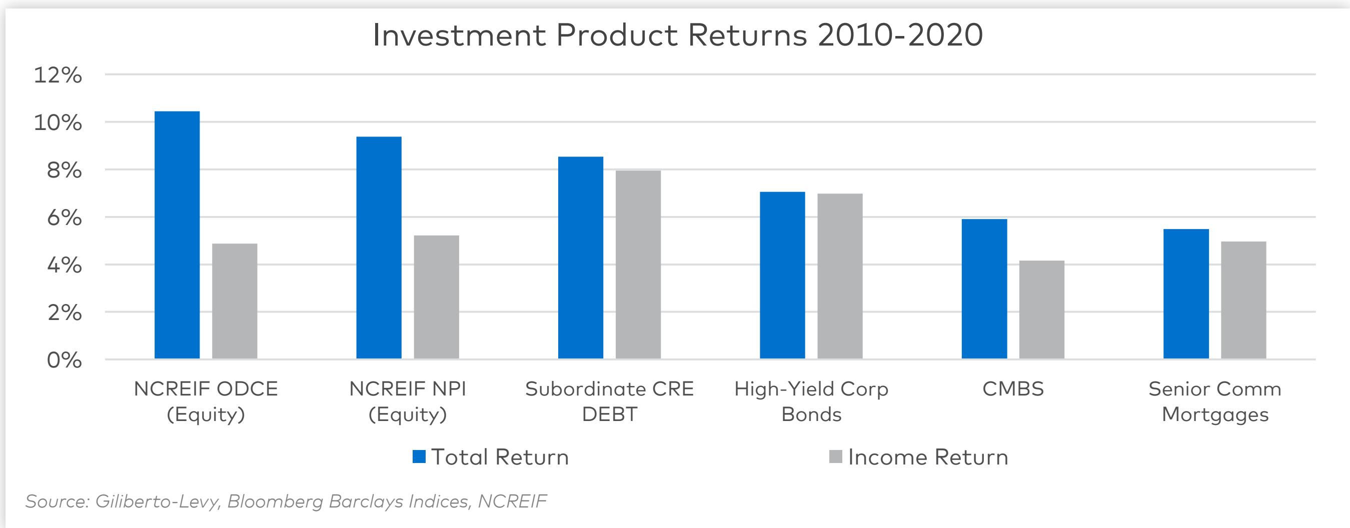

Source: Giliberto-Levy, Bloomberg Barclays Indices, NCREIF

"Now we have data that allows chief investment officers to compare real numbers with other asset classes such as corporate bonds and the ODCE (NCREIF's Open-End Diversified Core Fund)," Levy said. "Before G-L 2, investors couldn't compare returns (of high-yield debt) with the market. It was all subjective."

Index Tracks Mezz Returns

Giliberto and Levy's first groundbreaking commercial mortgage index, the Giliberto-Levy Commercial Mortgage Performance Index (G-L 1), was first released in 1993 and included loan data going back to 1972. G-L 2 was developed to track the performance of mezzanine debt, which has almost no publicly available market-level data available.

High-yield debt encompasses different forms of debt that are junior in the capital stack to a senior mortgage. A simple and common form of high-yield debt is a second mortgage/mezzanine loan. Another form of high-yield debt is a B-note, in which a lender originates one high-leverage loan and splits it into senior and junior classes. The originator can then sell or retain either tranche, depending on its strategy.

Subordinate debt is common with floating-rate loans on transitional properties—i.e., those in which the property owner plans to increase cash flow and refinance with more dollars—but it also can be deployed with stable properties and fixed-rate debt. Of the universe of loans from which the study was derived, about two-thirds was floating-rate and there was a roughly even mix between stable and non-stable assets.

The mezzanine loan market is so opaque that even measuring its size is guesswork. The Giliberto paper examines various estimates that put the size of the commercial mortgage mezzanine loan market at anywhere between $65 billion and $190 billion, although it concludes that the actual number is probably closer to the larger end of the scale.

Data used in the survey came from 408 loans in the G-L 2 index totaling $209 billion that were originated between 2010 and 2020. Only two loans that were part of the survey defaulted, both at maturity. The defaults produced a total loss, although the amount of principal lost by investors was only 20-25%, due to interest payments and origination fees.

The study found that high-yield debt produced a total 8.5% return, which was higher than other forms of commercial property debt and high-yield corporate bonds but less than equity returns produced by the NCREIF indexes, which are generally stable properties owned by large institutional

managers. At 7.95%, high-yield commercial mortgages generated the highest income returns of all the asset classes studied.

"Time-weighted returns indicate that over the January 2010 through December 2020 period, CRE subordinate debt returns have been commensurate with risk and compare well with various alternative real estate investments," the paper concludes.

Mezz Funds Proliferate

Subordinate debt has long been used in commercial real estate, although before the securitization era, high-yield debt was mostly in the form of a second mortgage. An explosion of high-yield debt was produced in the early 2000s, when new structures were employed and it became common to finance properties with debt totaling upwards of 90% of property value. In some large deals, lenders created layers of high-yield debt—sometimes dozens in large deals—that were sold to debt funds.

The 2000s saw growth of new structures of high-yield debt such as B-notes and resecuritizations of junior CMBS. The financial crisis led to defaults on a large amount of high-yield debt, particularly deals with numerous tranches of highly leveraged loans. After the financial crisis, the high-yield debt market shrank considerably, as many of the investors suffered losses and exited the business, and financing for high-yield debt became scarce.

As the financial crisis gets further into the rearview mirror, however, the high-yield debt market is once again growing. The number of investors in the high-yield debt market has grown dramatically since before the financial crisis, when there were about 50. Commercial Mortgage Alert's annual list of high-yield debt originators totaled 164 funds this year, and the full market probably exceeds 200 lenders. One driver is the overall success of commercial real estate. Property income and values in most segments continue to reach new highs, leading to a huge inflow of capital into the sector. The strong fundamental performance means that defaults in post-GFC loans have been extremely low.

Another driver of capital into high-yield debt is the search for yield. Yields of senior fixed-income bonds and sovereign debt have reached all-time lows in recent years and seem unlikely to increase much. Many senior commercial mortgages have coupons in the 3% range. Investors searching for more return are turning to high-yield commercial property debt, which has less risk than an equity position and can include an option to take over the collateral in the event of a default.

"Subordinate debt can be attractive in such times because: (1) borrower equity provides a cushion against moderate declines in asset values and (2) income yields on subordinate debt tend to be above distributable cash flow yields produced by properties," the Giliberto paper said.

Lessons About Leverage

It is difficult to say what the study of high-yield debt would have found if the time period had included the global financial crisis, but clearly it would have been less favorable given the losses suffered by investors at the time. The Giliberto study itself noted that caution is warranted.

"(T)he sample period does not include one, let alone multiple, complete economic or real estate cycles," the paper said. "Of course, CRE debt's investment performance is asymmetric with respect to cycles: A debt investor generally does not directly participate in increases in property income or value but can experience losses when income and value decline. In addition, changes in sample composition over time may affect measured correlations."

If there is a lesson in the study, it might be that high-risk strategies pay off during times of favorable capital market forces, when the market is performing well, as long as originators exercise proper judgment in underwriting the loans. Aggressive lending has doomed high-yield debt funds during market downturns. Highly leveraged loans leave less room for error in the event property income declines or collateral assets—for example, poorly located malls—become obsolete.

What does this say about today's market? Although the market is extremely competitive given the amount of capital chasing deals, a decade into the current bullish cycle, most lenders have learned basic lessons from the past. One lesson involves incentives. In the run-up to the financial crisis, some high-yield debt was structured in ways that disincentivized poor underwriting practices. Junior debt and CMBS tranches were originated and sold in complicated structures so that the originators made money whether the debt performed well or not. What's more, the long-term holders of the debt often did not understand the risks they were taking on because of the way the debt was structured and packaged.

Another lesson is about leverage. Standards have loosened in recent years but leverage generally remains restrained. Levy said that the average ceiling for loan-to-value ratios in the G-L 2 universe is about 70%, which leaves a buffer for most high-yield debt investors in the event of a downturn. When the market turns—and it will eventually—that could mitigate the severity of losses on high-yield debt.

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