December 2017

At Long Last, The CRE Market Has a Mezzanine-Loan Index

Contacts

Jeff Adler
Vice President & General Manager of Yardi Matrix
Jeff.Adler@Yardi.com
(800) 866-1124 x2403

Jack Kern
Director of Research and Publications
Jack.Kern@Yardi.com
(800) 866-1124 x2444

Paul Fiorilla
Director of Research Yardi Matrix
Paul.Fiorilla@Yardi.com
(800) 866-1124 x5764

Chris Nebenzahl
Real Estate Market Analyst
Chris.Nebenzahl@Yardi.com
(800) 866-1124 x2200

There are multiple indexes that measure the performance of public and private commercial real estate, property types, different geographies and investor strategy. Examples include the NCREIF Property Index, which is the standard for assessing "core" real estate assets, or RCA's Commercial Property Price Index, which measures property values.

One key exception, however, has been mezzanine debt, an investment type that grew substantially during the last cycle. Mezzanine loans and other high-yield assets such as B-notes are difficult to measure, in large part because each is relatively unique and most investors are private entities that are loathe to share performance information.

Now, however, the market has its first third-party measure of high-yield commercial mortgage debt performance, created by John B. Levy & Company and S. Michael Giliberto & Company, which have been publishing a quarterly performance index for senior debt–the Gilberto-Levy Index–since 1993. Both indices were co-created by John Levy, president of Levy & Co., and Michael Giliberto, a Columbia University professor and former investment manager. The two companies worked with a group of investment managers to create the new Giliberto-Levy High-Yield Real Estate Debt Index.

The first GL index (GL-1) focuses on senior loans originated by portfolio lenders. The high-yield index–known as GL-2–tracks the performance of $8.5 billion of loans held by private entities dating back to January 2010. Mezzanine debt represents 53% of the GL-2 index collateral, with the rest a mix of senior loans and B-notes (32%), preferred equity, second mortgages and blended investments. About 60% of the loans carry a floating rate, while the rest are fixed.

High-yield debt racked up a 7.6% average annual return from 2010 through December of 2016, dramatically eclipsing the 5.3% return achieved by the firm's senior-loan index over that same timeframe. For 2016, investments tracked in the GL-2 produced a 9.4% return. Returns on mezzanine loans in 2016 were 10.4%. The high-yield index is available on a subscription basis, and the results will be published quarterly, starting with 2017 returns.

Giliberto-Levy 2 Index Historical Returns*

	All Loans	Mezz Loans	Floaring Rate	Fixed Rate
1-year	9.4%	10.4%	10.1%	9.8%
3 years	8.1%	8.0%	8.8%	7.7%
5 years	7.9%	9.5%	7.6%	8.6%
Full period (2010 through 2016)	7.6%	8.9%	6.5%	9.7%

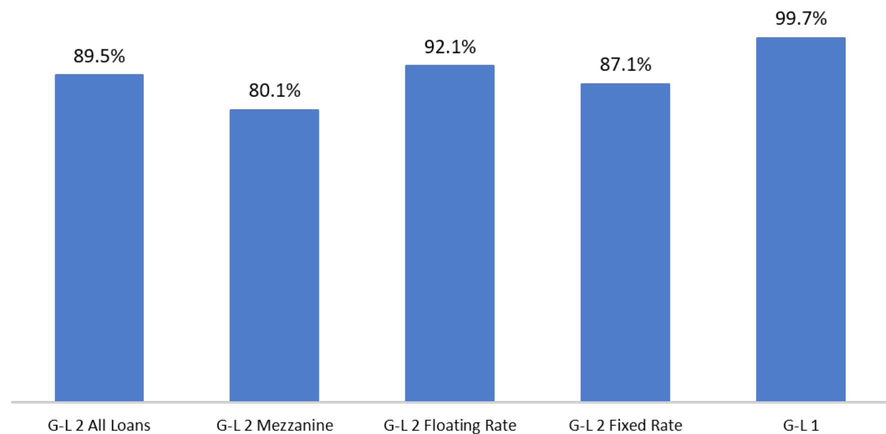
Source: S. Michael Giliberto & Co., Inc. and John B. Levy & Co., Inc. * Through 12/31/16

To Subscribe
Hollie Zepke
Audience Development Specialist
Hollie.Zepke@Yardi.com
(800) 866-1124 x5389

© Yardi Systems, Inc., 2017. All rights reserved. All other trademarks are the property of their respective owners.

Investors Long Sought Benchmark

Mezzanine debt investors have long craved a high-yield debt index to create a barometer of performance and guidance for price quotes for deals. Having an index generally improves liquidity in a market, because it helps the perception that the market is established and provides confidence that investors have a target against which to measure performance.



Source: S. Michael Giliberto & Co., Inc. and John B. Levy & Co., Inc.

Unlike senior debt, information about high-yield debt is not nearly as readily available. High-volume lenders such as banks, pension funds, insurance companies and CMBS not only must publicly disclose some information about senior loans, but they are generally willing to share with index creators or trade groups (example: American Council of Life Insurers) that aggregate the data. Mezzanine lenders, on the other hand, tend to be private equity firms that want to keep information closely held, in part because the selling point for many touts their ability to exploit mispricing in the market.

"Investors in high-yield real estate have long wanted to compare their returns and performance against an industry standard benchmark," said Levy. "Our GL-2 carefully crunches the numbers and variables within financing packages, giving high-yield investors the deep insight that was previously only available to holders of senior loans."

High-Yield Debt Hard to Measure

Mezzanine loan investments proliferated in the run-up to the last financial crisis. Many lenders originated loans of up to 95% of asset value and either held or securitized the senior portion (generally ranging from the 50-75% layer of the capital stack), and sold the junior portions to high-yield investors. In large deals, the mezzanine classes were "tranched" and each class was sold to a different investor.

That turned into disaster when the financial crisis hit in 2008. Property values slipped and many mezzanine investors lost huge amounts of capital as their investments turned underwater. In deals with multiple junior classes, mezzanine investors were forced to fight over control of properties.

The experience not only helped fuel demand for a performance index, but also illustrates the difficulty in creating and maintaining an index. Mezzanine loans represent different portions of the capital stack, they are subordinate to senior loans and have different terms regarding how to handle issues such as reserves, servicing, recourse and cross-collateralization.

The reaction among mezzanine investors has been mixed, with some happy that a benchmark is finally available, while others were less enthused. "All mezzanine loans are not created equal. Senior loans are more homogenous," said one veteran debt investor. Said another: "Since mezzanine debt is typically heavily tranched, a 'one size fits all' index probably does not fit all."

Levy and Giliberto, however, say that doubts expressed by some investors are unfounded. The index is broken down by leverage levels to provide an apples-to-apples comparison of

the portion of the capital stack. If a high-yield lender originates a 60%-LTV loan and sells the first 40%, the remaining mezzanine portion of 40-60% will be grouped differently than a junior loan in the 60-80% portion of the capital stack. What's more, subscribers will be able to customize report components to align with their given investment profiles.

In addition to returns, the index will enable market players to measure over time a host of questions surrounding mezzanine debt, including:

- Appropriate pricing for loans given their position in the capital stack.
- How much managers' returns come from extension and exit fees.
- Tracking strategies, such as the difference in performance between loans backed by stable properties and those on construction or transitional assets.
- The magnitude of losses and how terms such as reserves and recourse impact that.
- Defaults, although since the data starts after the last financial crisis during an up cycle for commercial markets, no GL-2 index loans are in default.

Lenders Maintaining Discipline?

Since the recovery began eight years ago, property values have increased steadily and the total volume of commercial mortgages outstanding has risen to record levels. That sounds a lot like the situation preceding the last market crash, but Levy and Giliberto say that lenders are not nearly as aggressive as they were in the run-up to 2007. Senior lenders are not writing loans with as much leverage as they did in 2006-07. Lenders are "exercising a reasonable amount of discipline," Levy said. However, loan spreads have come down over the last couple of years. For example, debt that may have yielded 11%-12% in the years just after the financial crisis would yield 200 basis points less in today's market.

Whether lenders have learned the lessons of the last cycle or will gradually write more aggressive loans is to be determined. Whatever happens, though, for the first time there will be a way to measure what happened and why, and the impact in the high-yield debt market.

—**Paul Fiorilla**, *Director of Research Yardi Matrix*

Disclaimer

ALTHOUGH EVERY EFFORT IS MADE TO ENSURE THE ACCURACY, TIMELINESS AND COMPLETENESS OF THE INFORMATION PROVIDED IN THIS PUBLICATION, THE INFORMATION IS PROVIDED "AS IS" AND YARDI MATRIX DOES NOT GUARANTEE, WARRANT, REPRESENT OR UNDERTAKE THAT THE INFORMATION PROVIDED IS CORRECT, ACCURATE, CURRENT OR COMPLETE. YARDI MATRIX IS NOT LIABLE FOR ANY LOSS, CLAIM, OR DEMAND ARISING DIRECTLY OR INDIRECTLY FROM ANY USE OR RELIANCE UPON THE INFORMATION CONTAINED HEREIN.

Copyright Notice

This document, publication and/or presentation (collectively, "document") is protected by copyright, trademark and other intellectual property laws. Use of this document is subject to the terms and conditions of Yardi Systems, Inc. dba Yardi Matrix's Terms of Use (http://www.yardimatrix.com/Terms) or other agreement including, but not limited to, restrictions on its use, copying, disclosure, distribution and decompilation. No part of this document may be disclosed or reproduced in any form by any means without the prior written authorization of Yardi Systems, Inc. This document may contain proprietary information about software and service processes, algorithms, and data models which is confidential and constitutes trade secrets. This document is intended for utilization solely in connection with Yardi Matrix publications and for no other purpose.

Yardi®, Yardi Systems, Inc., the Yardi Logo, Yardi Matrix, and the names of Yardi products and services are trademarks or registered trademarks of Yardi Systems, Inc. in the United States and may be protected as trademarks in other countries. All other product, service, or company names mentioned in this document are claimed as trademarks and trade names by their respective companies.

© 2017 Yardi Systems, Inc. All Rights Reserved.