Navigating the CMBX Market

JULY 2020

Why does Putnam maintain conviction in its CMBX Series 6 position?

The macroeconomic environment has clearly changed due to the outbreak of COVID-19. Putnam remains confident in its original investment analysis behind the CMBX trade, even under extreme stress scenarios. We have outlined below a number of points supporting why we continue to have conviction in the trade and that the investment merits still stand.

Fundamentals

We project future cash flows on each underlying property of each CMBS deal under various scenarios. The pandemic has created new uncertainties for commercial real estate but, after accounting for seasoned loans with built up property price appreciation, we believe the downside outcomes look to be appropriately accounted for in the price of the index.

- By property type and geographical location, we are estimating a forecast of the shock of business interruption in light of the COVID-19 pandemic. We believe this is essential given the unique nature of each property type's specific leases and stability of their cash flows.
- Our scenario analysis considers a continued severe disruption in economic activity over the intermediate term, including vast unemployment and significantly subdued cashflows for commercial properties, and incorporate some of the worst submarket corrections that the CRE market has experienced since the 1990's.
- Meaningful price appreciation has built up within the commercial real estate (CRE) market since 2012 when the underlying loans were originated, meaning that the majority of the underlying properties have significant equity cushion to help protect bond holders from losses. Even given the most severe scenarios, the index still has significant credit enhancement in the BBB- tranche.
- Stabilization efforts for the properties that were performing well before the virus impacted their revenue stream have been and, we believe, will continue to be made by the borrowers with access to capital in order to maintain their investment. Early evidence is that servicers are inclined to offer forbearance solutions rather than modifications to borrowers to avoid significant fees prior to true distress.

Valuation

Even with the additional loss estimate we are predicting due to COVID-19, we believe current valuations fairly compensate investors for the risk of taking additional losses and include an attractive risk premium.

- The CMBX Series 6 BBB- Index now trades in the range of 67-70 cents on the dollar in recent weeks.

- This is more than 20 cents below where it traded in early March, when we believed the valuation already priced in bearish retail scenarios and some malls that very likely will create losses.

- The short sellers continue to pay 3% to the holders of the long position.

Why do we believe investors who are shorting the index may be disappointed?

We agree with the general market consensus that the retail landscape faces long-term challenges from evolving retail shopper preferences and behaviors. However, we believe shorting commercial real estate via the CMBX Series 6 Index is an inefficient way to express a bearish view on the retail sector for three important reasons.

Timing

- Investors who are short the index generally believe that mall defaults will happen quickly, and that the malls will be liquidated at steep discounts.

- While liquidation is a possibility for some malls, mall owners typically try to stabilize the properties and cash flows by repurposing the space and improving it when the geographic area is supportive. This stabilization strategy ultimately decreases the chances of the loan defaulting with steep losses on the property and allows for the continuation of the coupon.

- Even after defaulting and potentially a long foreclosure process, properties are controlled by a special servicer that also works to stabilize and maximize the value of a property, if at all possible. In light of the pandemic and isolation challenges, special servicers will often seek to avoid rapid or below market sales.

- This benefits investors with a long position in the index because the short position continues to pay the fixed interest rate during this stabilization period, making the short position relatively expensive over time if defaults do not happen quickly enough.

Property type exposure

- The CMBX Series 6 Index provides exposure to a large and diverse portfolio of commercial properties, most of which are *not* retail malls.

- There are approximately 1,300 properties that underly the CMBX Series 6 Index.
    - Each CMBX vintage (i.e., Series 6) references a basket 25 CMBS deals issued during a specific year. Those deals are equally weighted, with each representing 4% of the index.
    - Each CMBS deal typically comprises 50-150 underlying loans on various property types.

- The CMBX Series 6 Index is well diversified by property type. Despite short sellers' focus on the index's retail mall exposure, only 19% of the properties underlying the index are malls, with the remainder of the index's exposure consisting of a diverse mix of property types.

Office CBD	Office non-CBD	Retail Mall	Retail non-Mall	Industrial	Hotel	Apartment	Self-storage	Other
15.5%	13.4%	19.1%	23.8%	3.8%	10.8%	8.1%	3.7%	1.7%

As of 6/30/2020
Note: CBD = Central Business District

Evolution of malls

- Many short sellers' premise that as mall anchor tenants, such as JC Penney's and Sears, close their doors, in-line tenants will follow, leaving mall owners with empty unrented space.

- We believe the trend to re-tenant mall space to reflect evolving consumer tastes helps to counteract the struggles endured by malls with traditional department stores. The practice of re-tenanting by the mall operators delays resolution of the loans themselves.

- Unlike residential homes, commercial properties can be refashioned to accommodate more in-demand businesses, such as grocery stores and other service oriented properties. These, in turn, add a new revenue stream for the mall and can even lead to increased foot traffic. We have seen success at various malls when these properties re-tenant or repurpose space.

What is Putnam's team and expertise in the securitized markets?

Putnam has built an experienced team of specialists covering the securitized markets. The team is led by three portfolio managers — Michael V. Salm, Brett S. Kozlowski, CFA, and Jatin Misra, Ph.D., CFA — who have worked together at Putnam for over 12 years.

Our platform is organized into three sub-teams of specialists based on risk: residential mortgage credit, commercial mortgage credit, and prepayment to identify the most attractive opportunity in each space. Focusing on risk as opposed to sector allows our specialists to identify the drivers of return and determine relative value/alpha potential. Specialists divided by expertise in risk rather than by sector is a differentiator — and dovetails with our overall fixed income investment philosophy at Putnam.

The team roles are divided as follows:

- Portfolio Managers oversee the investment team and process, make relative value decisions, and ensure resources are allocated efficiently.
- Sector Specialists are responsible for buying and selling securities based on their allocated risk budgets. They generate best ideas within their specific sector/risk coverage areas.
- Research Analysts are tasked with surveillance of underlying loans. They use granular data-driven models calibrated on historical and projected data across multiple scenarios to understand the factors that impact cash flows.

The model-driven nature of our process is what makes our research efforts unique. Our internal modeling technique and technology allows us to enhance our models in a consistent way across all structures and deals to quickly adapt to changing markets. Although results cannot be guaranteed, this technique measures timing and magnitude of events, which we believe may lead to better assumptions and higher confidence in the securities we choose for our portfolios.

Background information

How did the opportunity in the CMBX BBB- Series 6 (2012 vintage) emerge?

In early 2017, the spread on the BBB- rated tranche of the CMBX Series 6 Index began to widen and diverge significantly from the spreads of the CMBS deals that underly the index.

- The catalyst for this divergence can be attributed to a research report published by a New York-based hedge fund promoting an outright short to the CMBX Series 6 BB and BBB- indices. It claimed there was significant downside to the price of these indices given the exposure to retail properties, especially regional enclosed malls, whose traditional department store tenants have been under financial stress given struggling business models and rising penetration of online sales.

- The report was impactful as investors subsequently built short positions betting against the index, which pushed the index's spread significantly wider than the spreads on the underlying bonds.

- As the spread on the BBB- rated tranche of the CMBX Series 6 Index widened sharply over the following months, the spread on the CMBS deals that underly the index remained fairly steady. This divergence created the opportunity for CMBS investors to earn a premium by holding the index rather than the underlying CMBS deals.

Are the cash flows from a CMBX contract the same as the underlying CMBS deals?

A long position in a CMBX Index is different than owning the CMBS deals because the investor doesn't actually own the underlying securities. Here's how it works.

- An investor takes a long position by entering a derivative contract with an investor taking the short position.

- At the onset of the trade, the short position pays the long position a lump sum equal to the discount the contract is trading at (i.e., $10 discount if the price is $90, and par is $100), or vice-versa if the contract is trading at a premium.

- On an ongoing basis, the short position pays a fixed rate of interest to the long position. In the case of the CMBX Series 6 BBB- Index, the interest rate is 3%.

- In exchange for the interest payment, the long position offers protection to the short position if there is a "credit event" such as a principal write-down or a shortfall in principal or interest payments from one of the underlying CMBS deals.

- If no credit event occurs, the long party simply receives the interest payment.

- If a credit event does occur, then the long/short parties exchange the net value of the interest payment minus the shortfall resulting from the credit event. If the interest payment exceeds any shortfall, the long party receives the payment, and vice versa.

Mortgage- and asset-backed securities are subject to prepayment risk, which means that they may increase in value less than other bonds when interest rates decline and decline in value more than other bonds when interest rates rise. Investments in mortgage-backed securities and asset-backed securities, and in certain other securities and derivatives, may be or become illiquid. Exposure to privately issued mortgage-backed securities and mortgage-backed securities issued or guaranteed by the U.S. government or its agencies or instrumentalities may be more susceptible to economic, market, political and other developments affecting the housing or real estate markets. Mortgage-backed securities may be subject to the risk that underlying borrowers will be unable to meet their obligations.

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