AEGON Asset Management

Commentary
July 2024

US COMMERCIAL MORTGAGE LOANS

Market Commentary

The stabilization of interest rates over the past two months has led to increased activity in the CML universe. Market participants seem more willing to transact than at any time over the past 12 months. While price discovery remains slow as equity investors continue to adjust financial models and return expectations based on current rates, it continues to gain traction week after week. As of July 8, 2024, CML spreads have declined by approximately 30 basis points (bps) since the beginning of 2024, currently ranging from 140 to 170 bps over corresponding average life Treasuries, with competition for strong CML opportunities remaining fierce.

Focus on Industrial

Industrial real estate has become a favored asset class in commercial real estate over the past 10 years. The expansion in e-commerce during the last decade has led to consistent and material growth in rents, net operating income (NOI) , and valuations.[1] For example, nominal e-commerce growth accelerated to 8.6% in 1Q 2024, up from 7.5% in 2023, an encouraging dynamic for industrial landlords given e-commerce requires approximately three times the warehouse footprint versus brick and mortar per dollar of sales.[2] Along these same lines, industrial real estate, unsurprisingly, was one of the clear “winners” during the Covid slowdown as increased online ordering and delivery needs led to significant growth in demand for logistics real estate.[1,3]

Fundamentals have been muted somewhat during 2023 and through 2Q 2024 as an increase in new construction deliveries coupled with diminished transaction volume (driven by concerns around a potential recession, higher interest rates, and inflation) caused upticks in vacancy and a decline in rent growth.[1,4] However, most of this effect was felt in the Class A property sector, as this cohort has seen the bulk of the supply growth over the medium term.[1]

Class B industrial properties are typically older properties that serve middle market tenants. Properties in this subgroup offer standardized space without special features and often benefit from established, infill locations that serve as a very high barrier to entry. While properties of this type do serve the e-commerce market (especially by offering “last mile” functionality), the sector also provides necessary space to the logistics, food and beverage, cold storage, and biotech/pharmaceutical industries. Additionally, these properties are often located in proximity to densely populated areas and a readily available workforce.

Deal spotlight	
Sector	CML
Name	Midwest Industrial Portfolio
Funded	July 2018
Maturity	August 2028
Aegon AM risk rating[5]	AA
Loan size at funding	$78,000,000
Current balance	$57,216,805

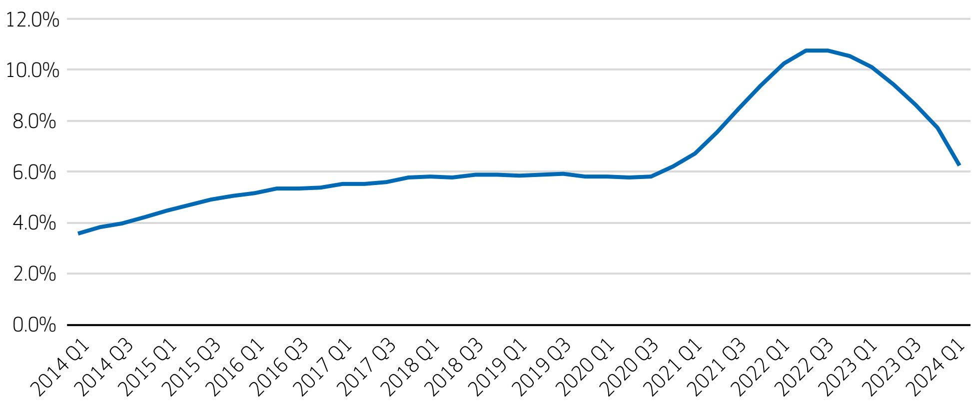
The portfolio loan offers a potential opportunity to provide additional financing to the existing loan. The initial 10-year loan was collateralized by 18 properties located in five Midwestern submarkets. The tenant mix operates in the distribution logistics, food supply, manufacturing, and custom packaging industries.

Since the loan was initially funded, three properties were sold and the loan balance on a fourth property was paid off, leaving the remaining collateral at 2,882,116 square feet. Since loan origination in 2018, the properties have consistently maintained an occupancy rate above 95%. The net operating income has grown by 31%, and the debt service coverage ratio has improved from 1.9x to 2.6x, after factoring in the changes to the portfolio composition. The debt yield has increased from 12% to 17%, and the loan to value ratio has improved from 65% to 45%.[3]

LTV comparisons are based on value at the time of loan origination compared to current values. For illustrative purposes only, subject to change. This information should not be relied upon for investment decisions. Information sourced from deal documents.

From a financial perspective, based on the age of construction and the quality of the locations, it's common that the value of a majority of Class B properties is well below replacement cost, providing potential downside protection to an investor. Current rents, in many cases, can be 20 to 40% below market depending on the vintage of the lease, providing an investor with compelling "mark-to-market" opportunities.[3] These aspects of Class B industrial have kept this cohort in demand for investors and potential tenants. It is also worth noting that despite a slowdown in rent growth at the start of 2024 from the historic highs of 2021-2023 (see chart below), even a rent growth figure of 3-4% is considered attractive, and a 5% growth figure is strong by historical standards.[1]

US cumulative Class-B industrial year-over-year rent growth (Q1 2014 – Q1 2024)



Source: CoStar Realty Information, Inc. June 30, 2024

Conclusion

By focusing on the less-glamorous Class B industrial market, we see an opportunity to take advantage of compelling supply-demand imbalance. While rent growth has tempered somewhat in 2024, we expect that the robust fundamentals for industrial should continue, providing a tailwind to this asset class for the near-term future.

[1]CoStar Realty Information, Inc. June 30, 2024
[2]Green Street. May 22, 2024
[3]Aegon Asset Management. June 30, 2024
[4]MSCI Real Capital Analytics. June 30, 2024
[5]Risk Rating categories are based on Aegon Real Assets US' internal proprietary CML rating system, and do not necessarily reflect ratings criteria, systems or methodologies used by third party rating agencies or other commercial mortgage lenders. Due to limitations on available information, not all categories in the CML rating system, and not all corresponding CML spreads, are listed above. The information set forth above, and the underlying data from which it is derived, have not been validated or tested against the actual risk rating criteria utilized in Aegon Real Assets US' CML rating system, but rather only reflect, based on limited data, Aegon Real Assets US' estimation of where the indicated spreads (and the underlying data upon which they are derived) would fall within the rating system.

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