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Schroder Securitized Credit

Commercial Real Estate Update

As of Q4 2020 (unless otherwise noted)

Should I stay or should I go?

US Commercial Real Estate Outlook

- US commercial real estate is one of the sectors caught in a COVID-19 induced acceleration of trends
- Commercial real estate is both benefitting and suffering from the impacts of COVID-19: shelter in place and the associated impact on consumption, work and travel
- Industrial properties and hotels evidence the extremes of positive and negative impact
- But the commercial real estate market is far from being understood, and far from being resolved
- More limited lending, very limited property transactions and policy leaning into a “kick the can” approach will likely continue to create opacity and opportunity over the next 2-3 years
- Opportunity in smaller loans, where regional banks have been a major lender, are one of the likely trends we expect to see as loans reach maturities
- We view the opportunity set as likely more focused on lending than on CMBS
- In a “clash” of distress and policy support, if you go there may be trouble, but if you stay then it may double…

Source: Schroders. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change.

Real estate varies, property, leverage and sponsor are key

Major property types range in their volatility and transparency

Industrial/Warehouse

- Best demand drivers
- Benefit from continued increase in ecommerce
- Preferred property type for lenders
- Most competitive sector of the permanent loan space
- Blackstone buys 60% of LBA industrial portfolio for $1.6bln
- Seeing transaction activity

Multifamily Housing

- Multifamily, other than downtown luxury properties, benefit from a general lack of affordable housing
- Rent collections been stronger than expected except for lower quality affordable apartments
- Tenant demographics/location matter more than ever
- Freddie Mac) expects ‘21 originations to increase to $340bln from $287bln
- Transaction activity picking up

Office

- Work from home and economic strength are factors in the temporary versus permanent impact on office values/rents.
- Downtown, Class A office could be negatively impacted as companies will need more space per employee and rents are higher
- High amounts of lease expirations over the next two years is a risk
- United Airlines giving back 150k sf of its 850k sf in Willis Tower, Chicago
- Little transaction transparency

Retail

- What is “retail”, it’s a diverse segment. It’s not all shopping centers/malls.
- One of the most negatively impacted with tenants forced to close
- Local tenants might not survive, and many national tenants refused to pay rent
- Too much retail space per capita in the US is also affected by online retailing
- Opportunity to finance new owners at lower basis and redevelop/tenant existing centers in strong locations.

Hotel

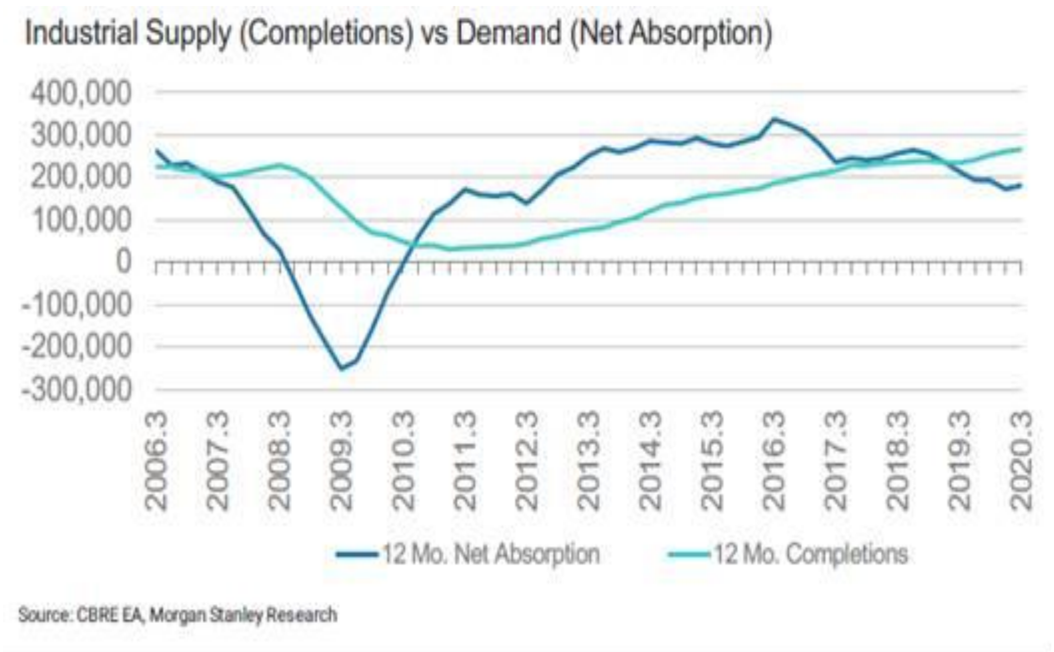
- Most hotels completely closed operations after the virus
- Many hotels may never open again which will reduce supply
- Business models will be impacted.
- Financing will be needed for new buyers of distressed properties at much lower basis
- Financing will also be needed to help fund flag required property improvements
- Transactions and basis reset required

Source: Schroders. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change.

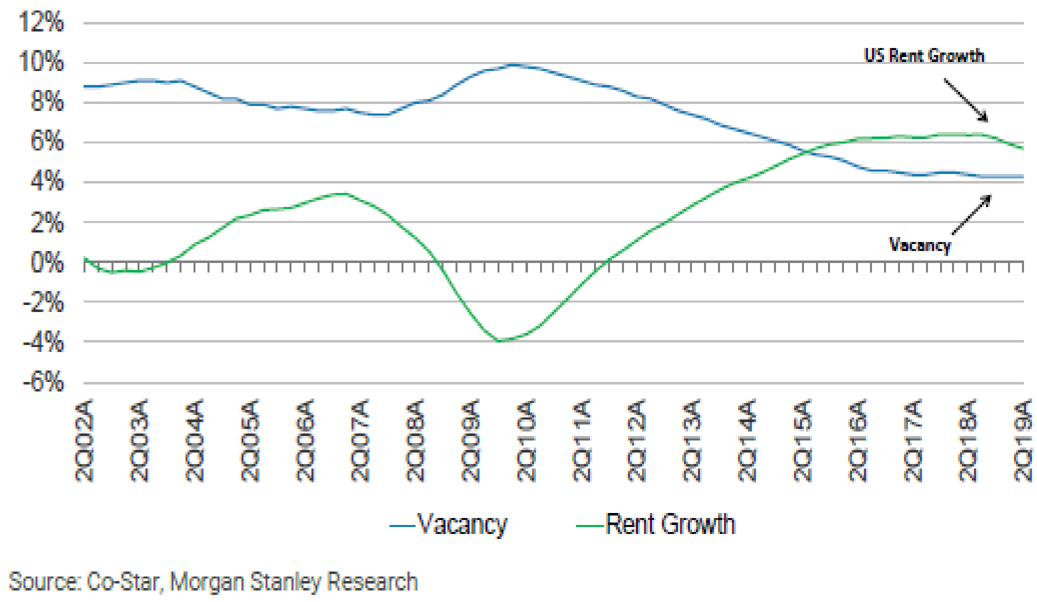
CRE Debt Market Update

Property Sector Thoughts – Industrial

Industrial Property Supply Demand Fundamentals



Industrial Property Vacancy and Rent Growth



- The industrial sector has been the most sought-after property type for lenders and owners due to the favorable demand dynamics fueled in part by the continued growth in ecommerce
- However, there are beginning signs that supply may be starting to catch up with demand as rent growth starts to slow

Source: Morgan Stanley Research, CBRE. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change.

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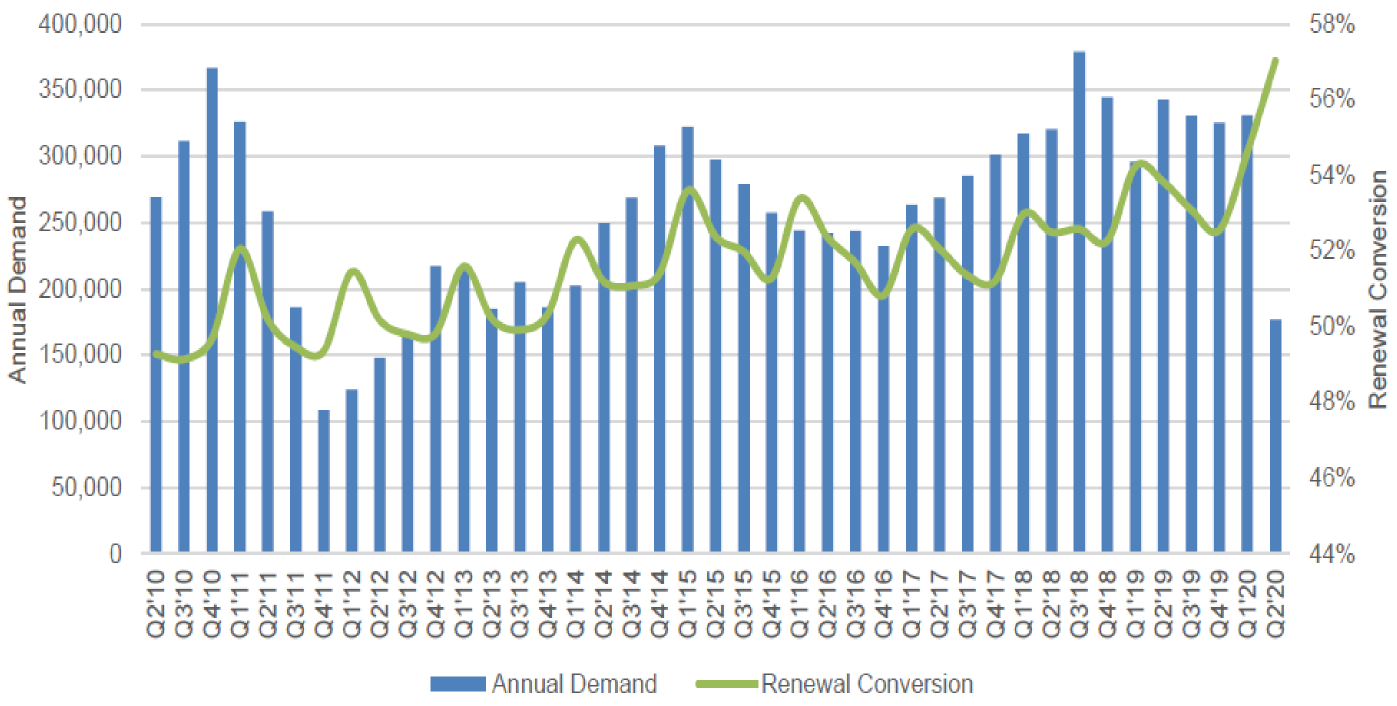
CRE Debt Market Update

Property Sector Thoughts – Multifamily

Annual Multifamily Absorptions



- Fannie Mae and Freddie Mac remain active lenders, which should help soften potential declines in values
- The demand growth for apartments declined in the second quarter but was somewhat offset by a spike in tenants choosing not to move out when their lease expires. We view this as a temporary phenomenon due to "shelter in place"

Source: RealPage, Freddie Mac. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change.

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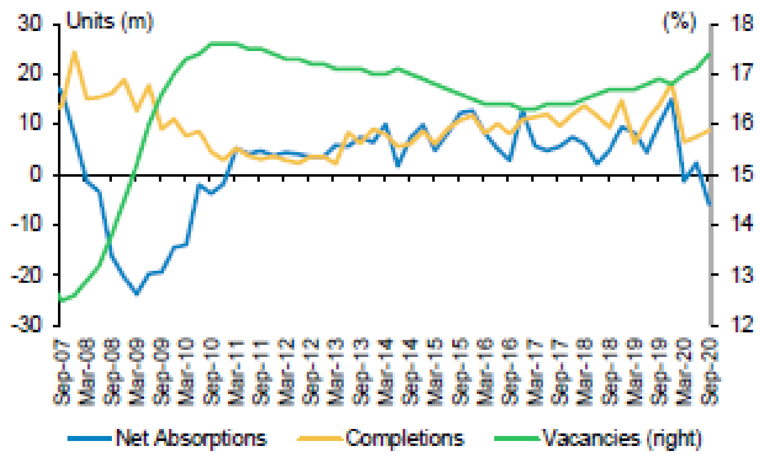
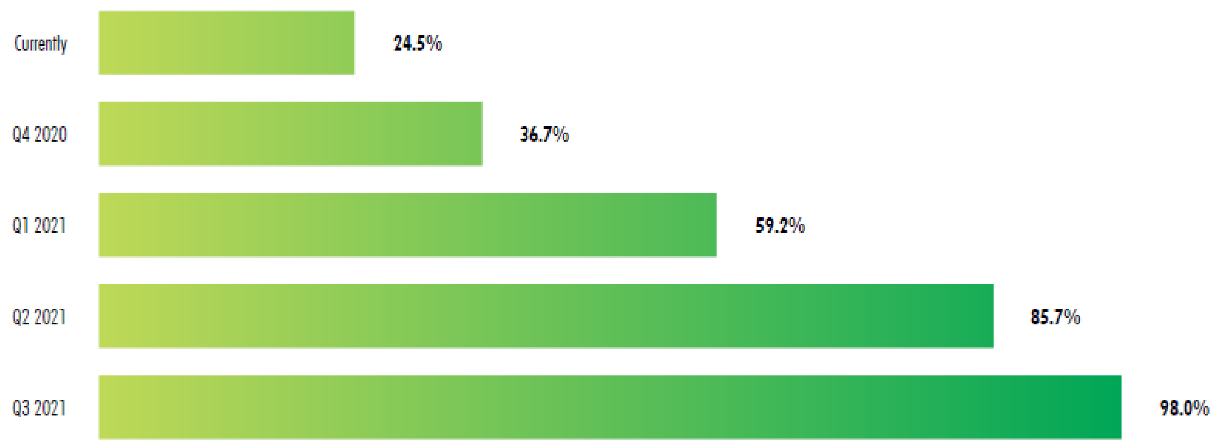
CRE Debt Market Update

Property Sector Thoughts – Office

Office Supply and Demand



Office Re-entry Plans



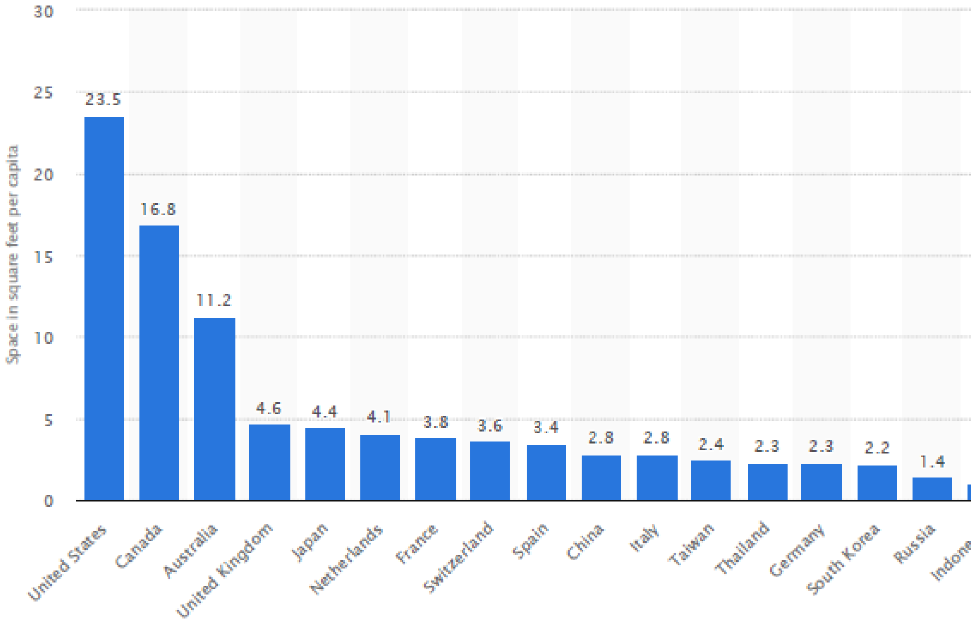
- Suburban office is likely to recover quicker than urban office
- Many tenants continue to delay their decision to physically return to the office
- Current physical occupancy estimated at around 20%
- Tenants have the upper hand in negotiating new (and lower) lease rates with landlords

Source: CBRE Survey. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change. Estimates may not be accurate.

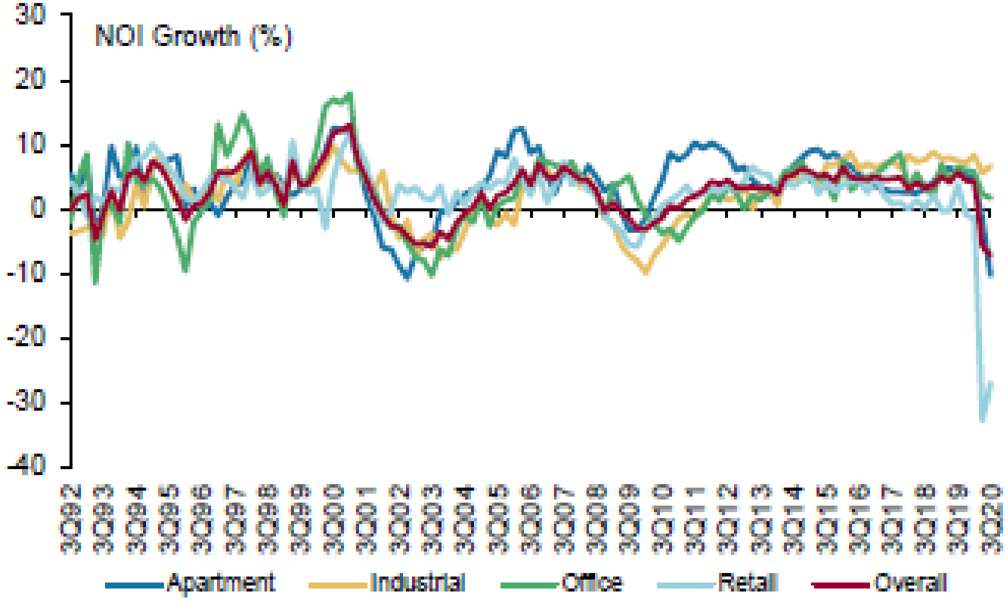
CRE Debt Market Update

Property Sector Thoughts – Retail

Retail Space per capital in Select Countries



Net Operating Income Growth



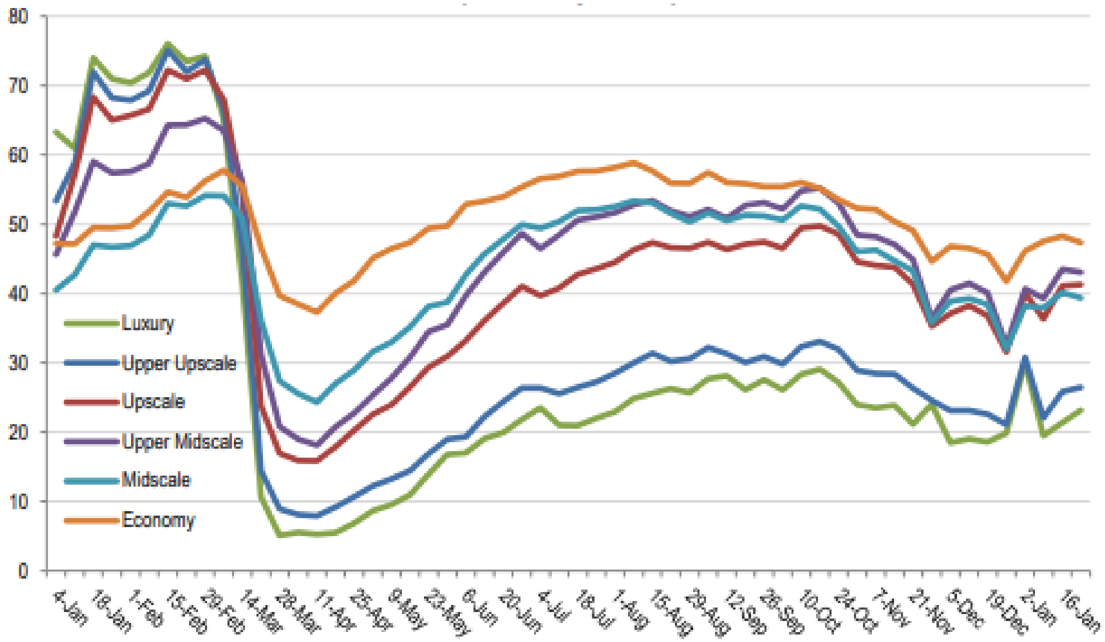
- The COVID crisis has accelerated trends already in place before crisis
- In the US, there is an excess supply of existing retail space
- Excess supply in conjunction with forced closures and limited business for many typical retail tenants has resulted in a substantial decline in property income for some properties

Source: NCREIF, Morgan Stanley Research, Statista. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change. Performance shown is past performance. Current results are poor predictors of future market conditions.

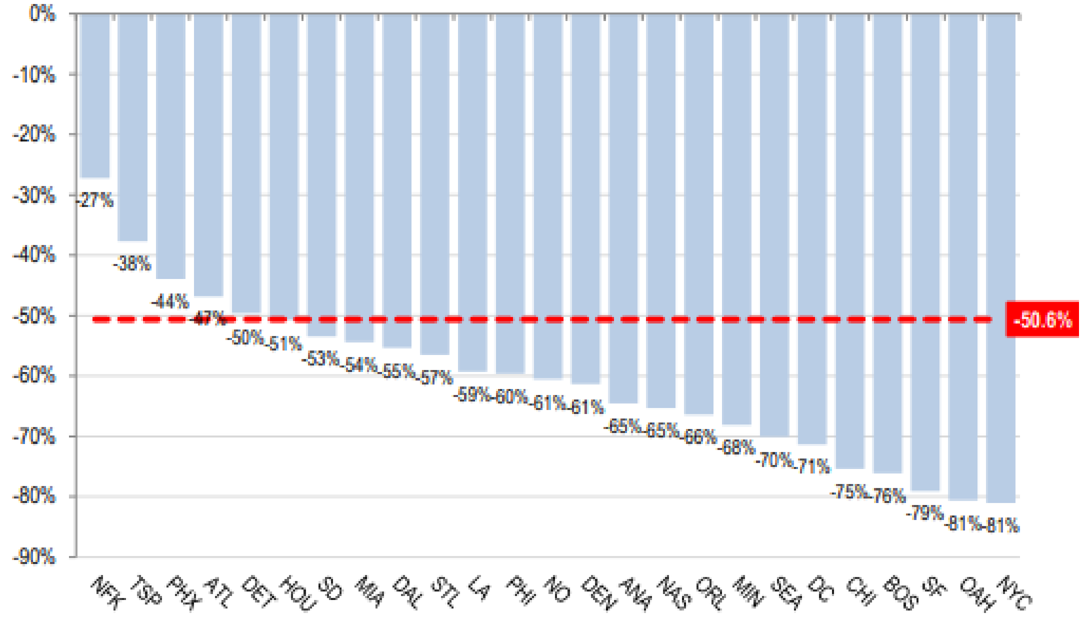
CRE Debt Market Update

Property Sector Thoughts – Hotel

Hotel Occupancy by Type



Hotel Revenue by Location

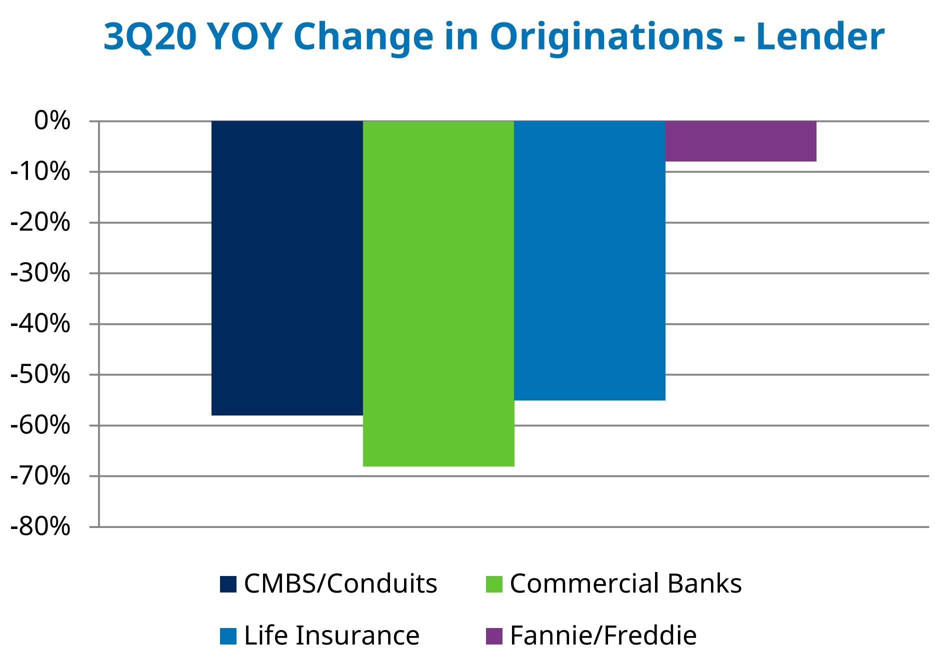


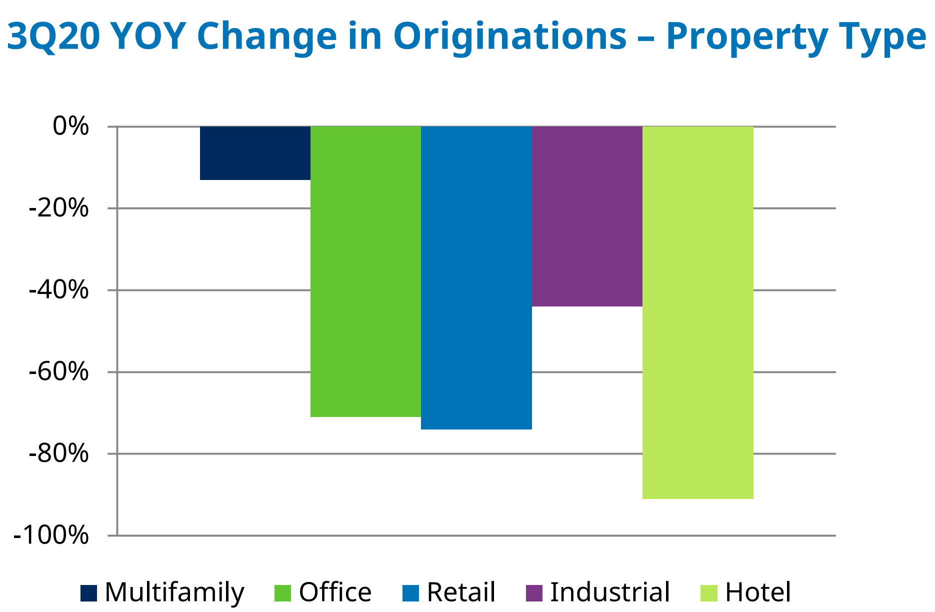
- Urban hotels that cater to business travel and conferences are the hardest hit segment and will be the slowest to recover
- Resort hotels had a similar initial revenue impact, but are expected to bounce back more quickly as there is pent up demand to “get out of the house”

Source: STR, Evercore ISI. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change.

Limited lending creates an opportunity

Lending declined massively, multi-family via Fannie/Freddie support was the exception

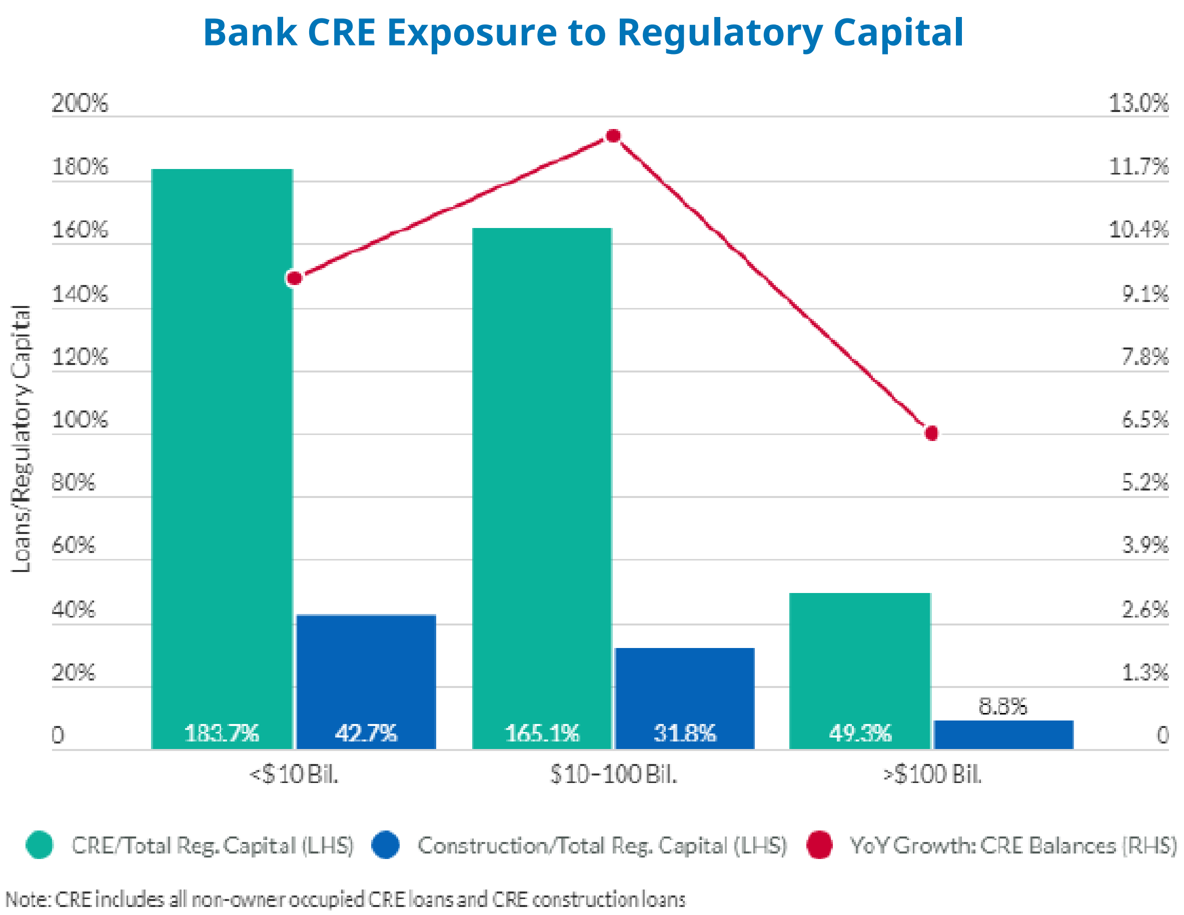




- CMBS lending shutdown in the second quarter as the stalled capital markets made new loans impossible to price
- Other sources of liquidity were pulled back as well, except for Agency guaranteed CMBS (multi-family), where the Fed has been using its balance sheet

Source: Mortgage Bankers Association, Schroders. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change. Not a recommendation to buy or sell any security.

Real estate lending is capital intensive for smaller banks

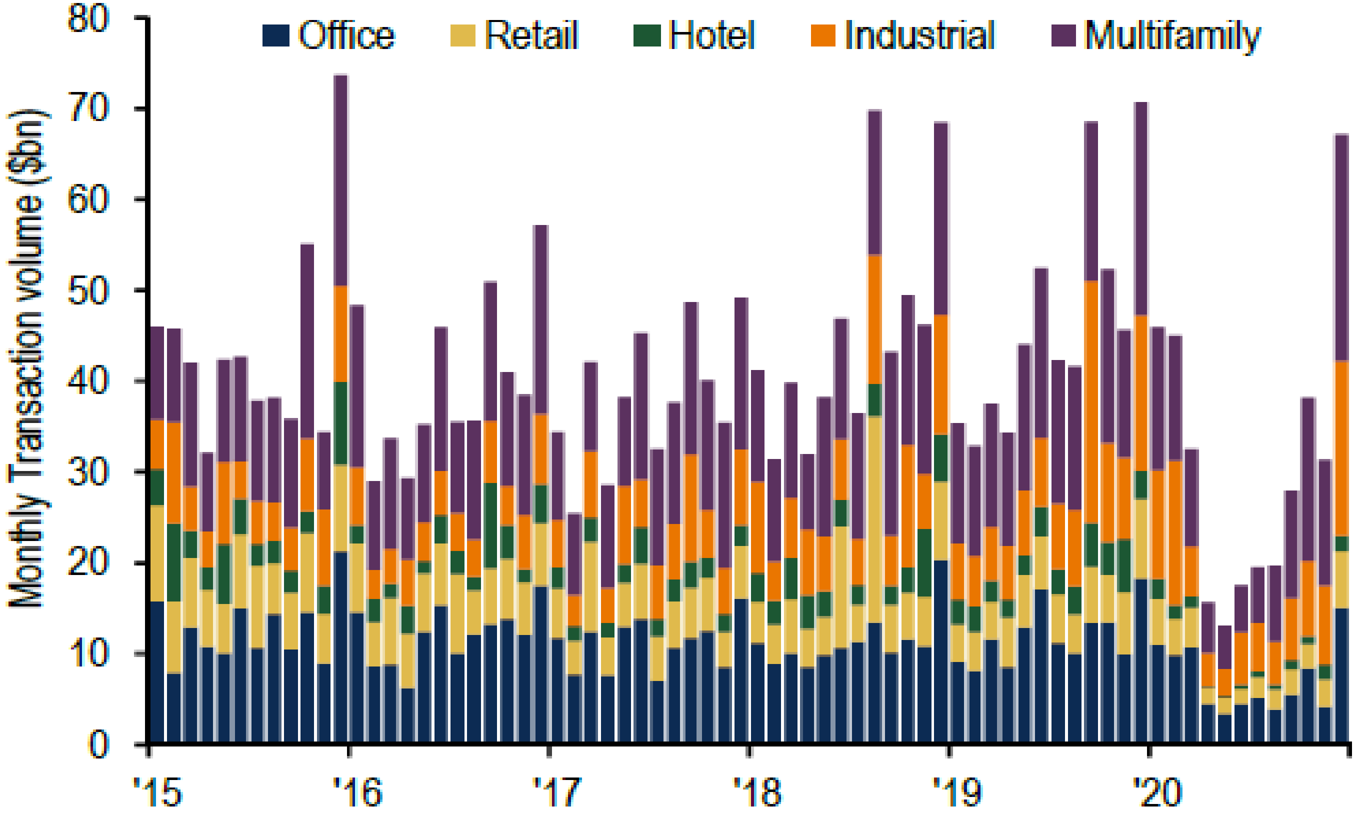


- Smaller banks have much higher exposure to CRE than larger banks
- Regulatory pressure on the smaller banks could
  - Reduce loan origination volumes for small/middle market CRE loans or;
  - Create the need for some loan sales

Source: Fitch Ratings, FedFIS, Schroders. As of December 31, 2019. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change. Not a recommendation to buy or sell any security.

Potential opportunity found, CRE property transaction volume is increasing

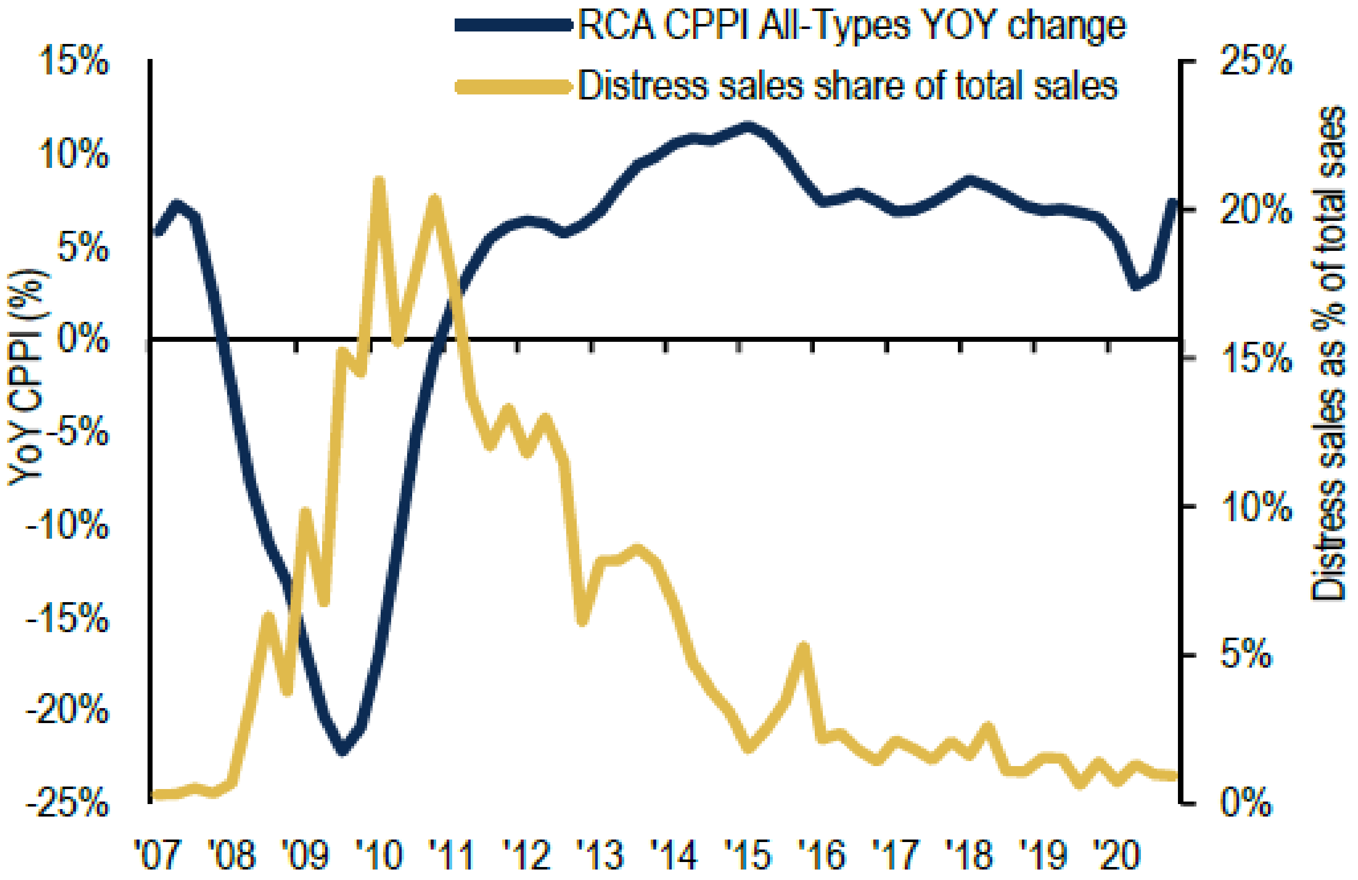
Transaction volume



- Multifamily and Industrial properties dominated the recent acceleration in transaction activity
- Office properties also managed a strong increase in activity
- The composition of sales impacts the valuation indices

Source: BAML RCA. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change. Not a recommendation to buy or sell any security. There is no guarantee that current market activity will lead to favorable investment opportunities.

No impact from distressed sales in the CPPI index



- CRE property value indices haven't seen any impact yet from any distressed transactions.
- The limited transaction volume, is normal earlier in a cycle and sales currently reflect mainly multifamily and industrial transactions, that are the healthier markets
- Distressed sales may pick up later in the year as forbearance periods end and reserves that were being used to keep loans current are depleted
- There is heavy debate related to the impact of "kicking the can" and "dry powder" potentially mitigating distressed sales

Source: Morgan Stanley Research, Prequin, RCA. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change. Not a recommendation to buy or sell any security.

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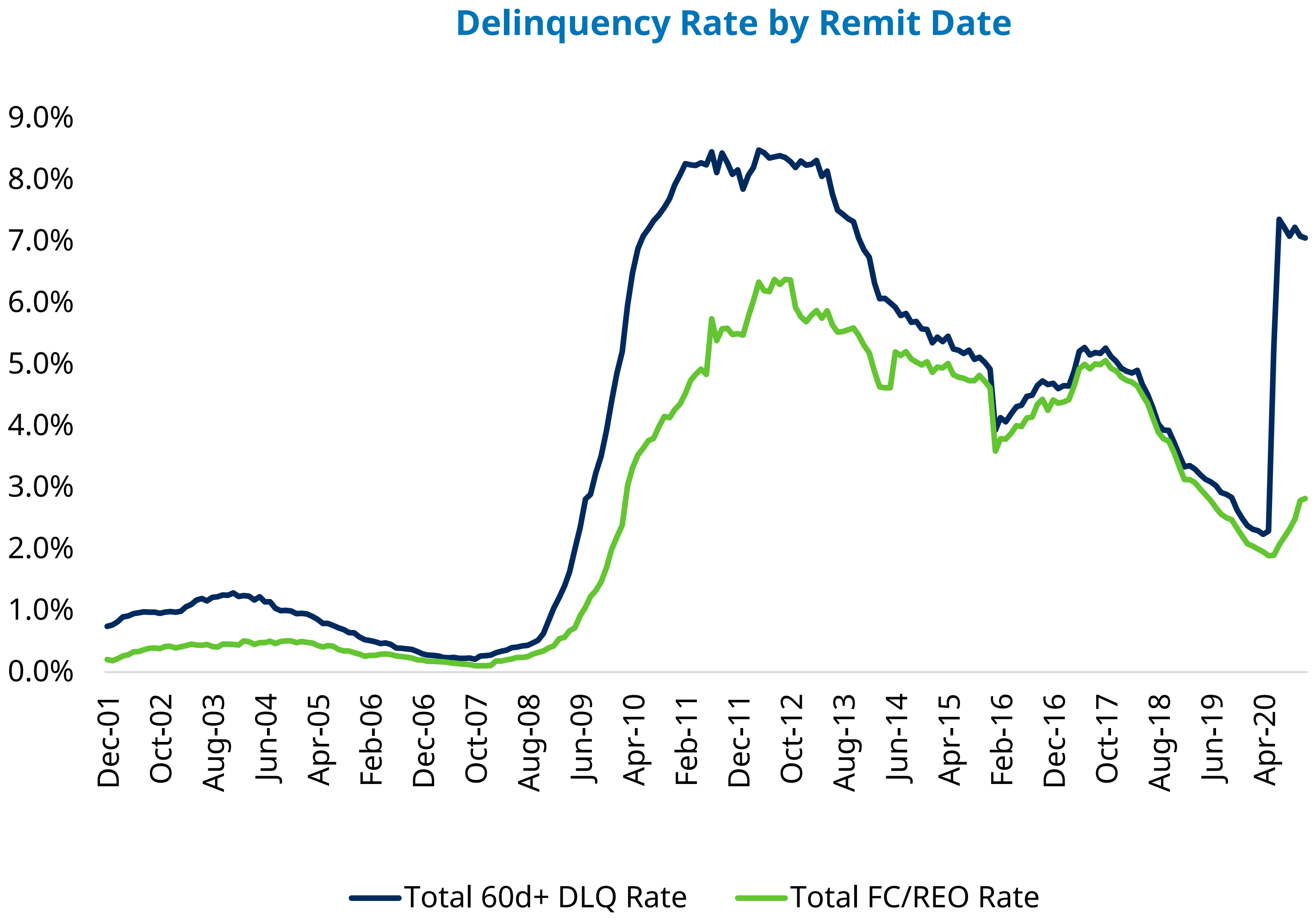
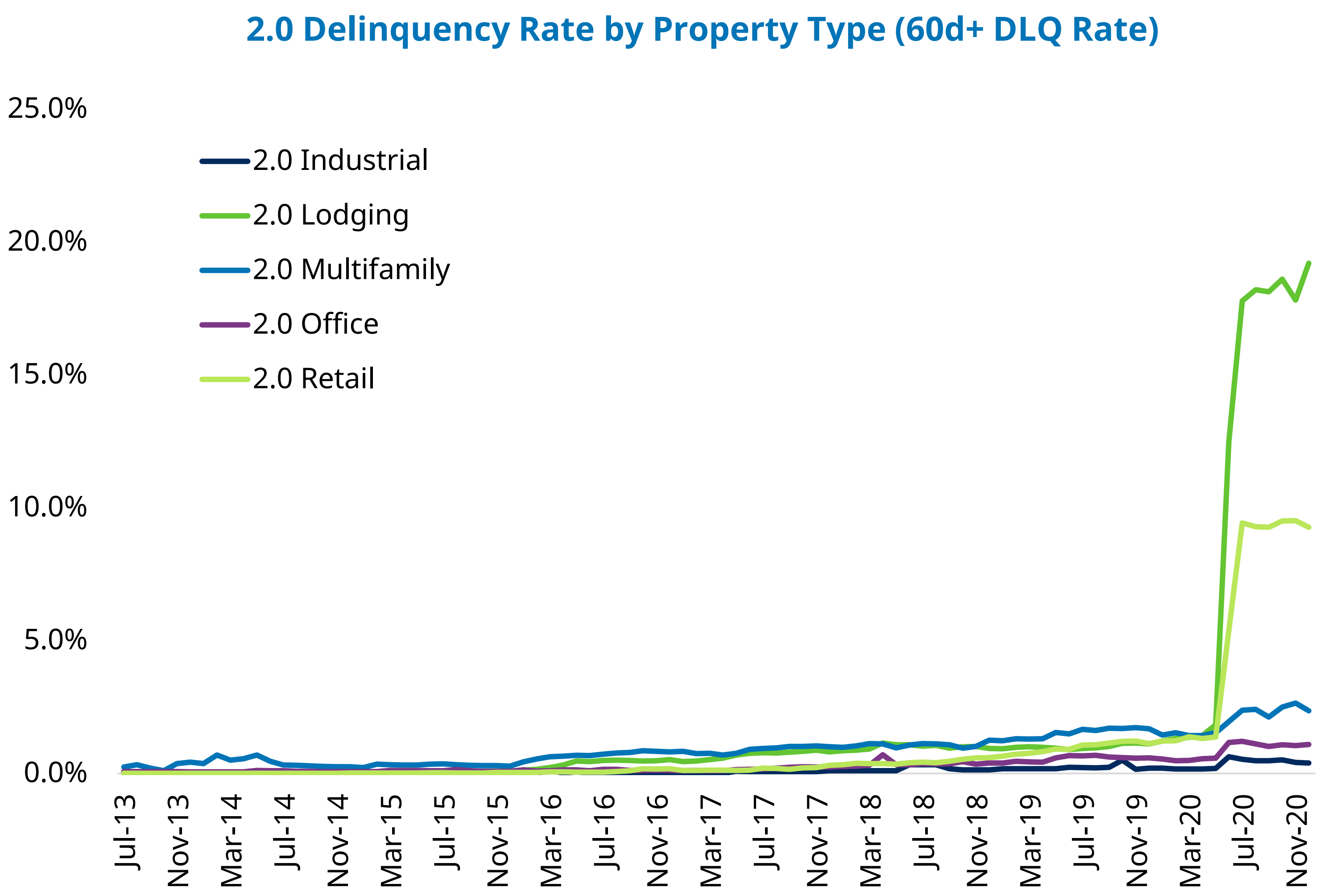
CMBS, the devil's in the delinquency details



- While the delinquency rate has shown signs of declining, that's not the whole picture
- There are another 4% of loans that are in forbearance and/or using reserves to keep loan payments current, which theoretically could push the "real" delinquency rate closer to 11%

Source: J.P. Morgan, Trepp, Bloomberg. As of December 2020. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change.

CMBS, the devil's in the delinquency details

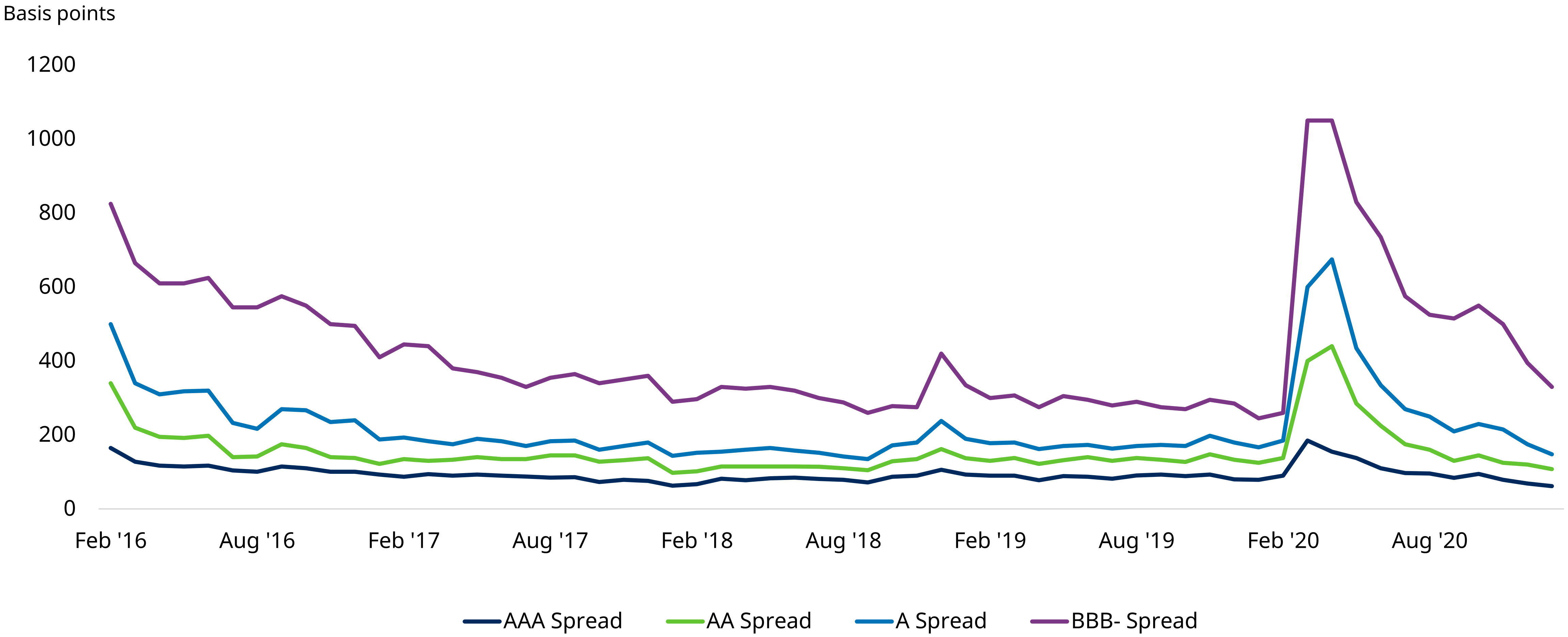


- Office and Multi-family have yet to show the impact of lease roll-over
- Hotel and retail clearly evidence the impact of the COVID shelter-in-place as well as persistent change in retail

Source: J.P. Morgan, Trepp, Bloomberg. As of December 2020. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change.

CMBS spreads maybe ahead of the fundamentals

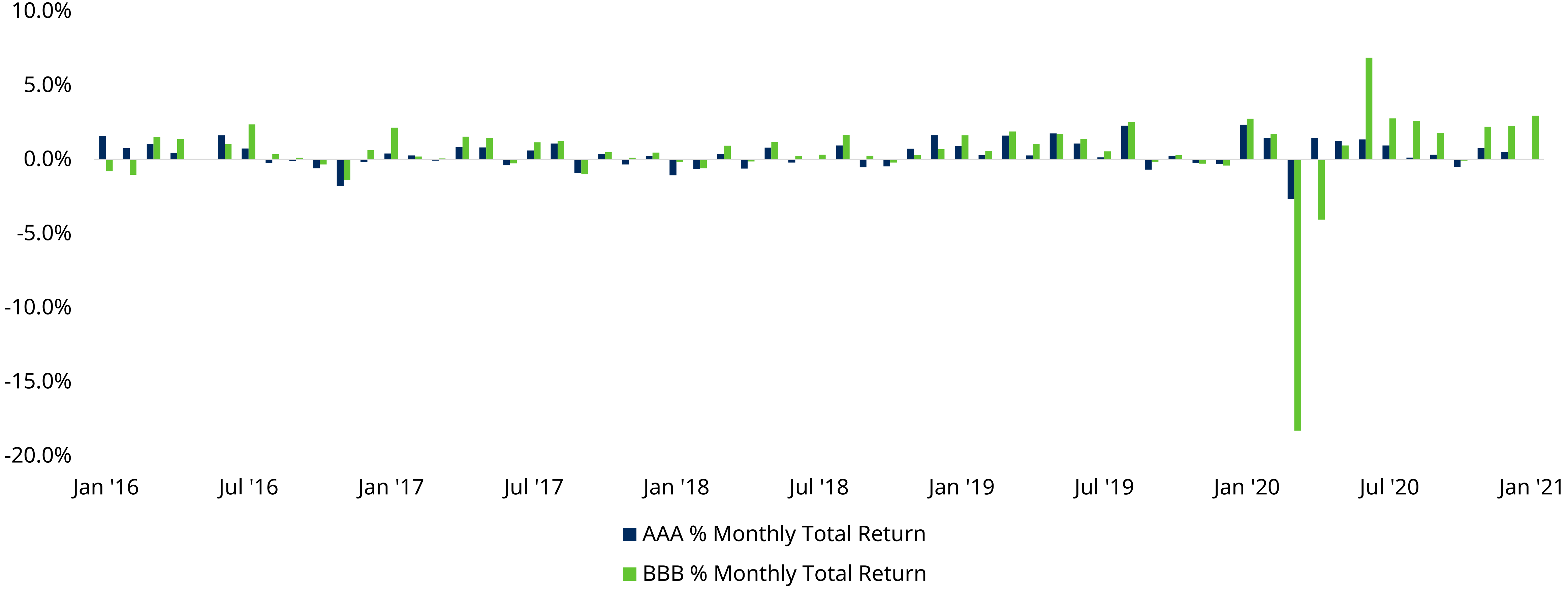
Spreads across AAA, AA, A and BBB-



Source: JPM, Bloomberg, Schroders. As of January 31, 2020. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change.

CMBS BBB returns are VVVolatile

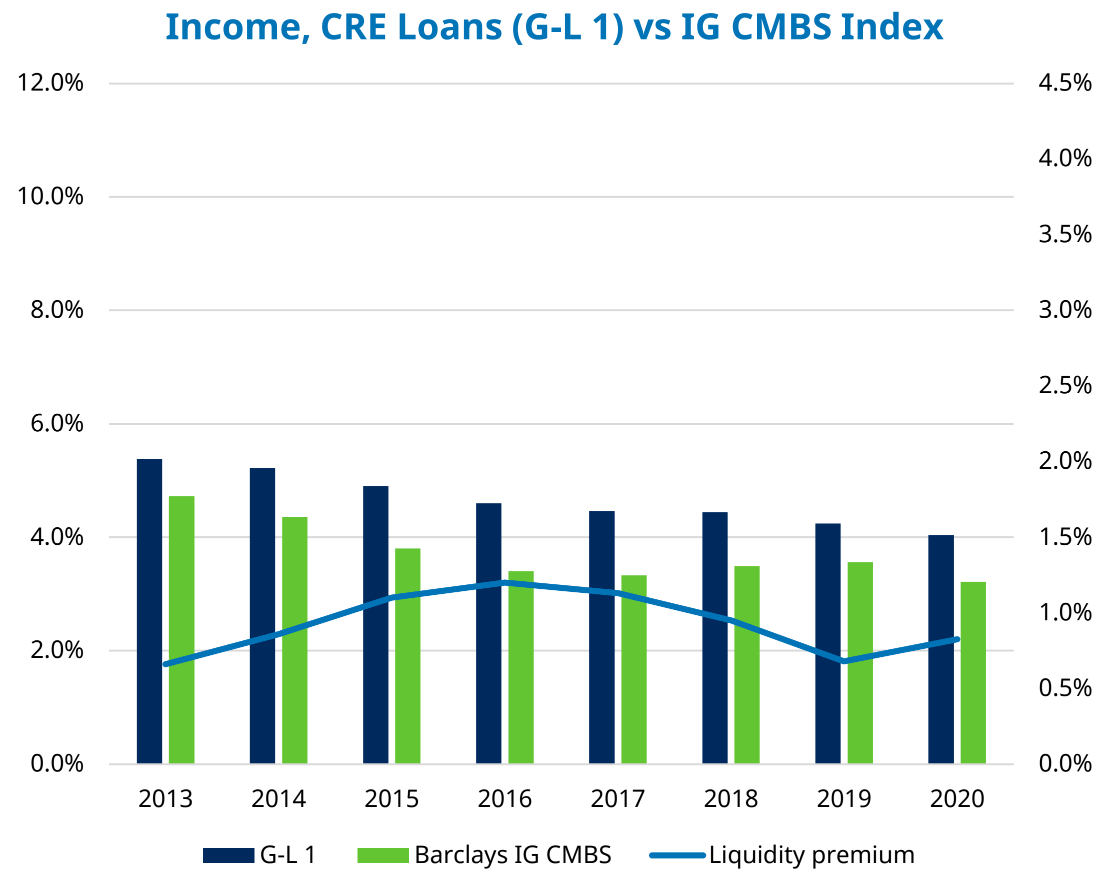
AAA and BBB monthly returns

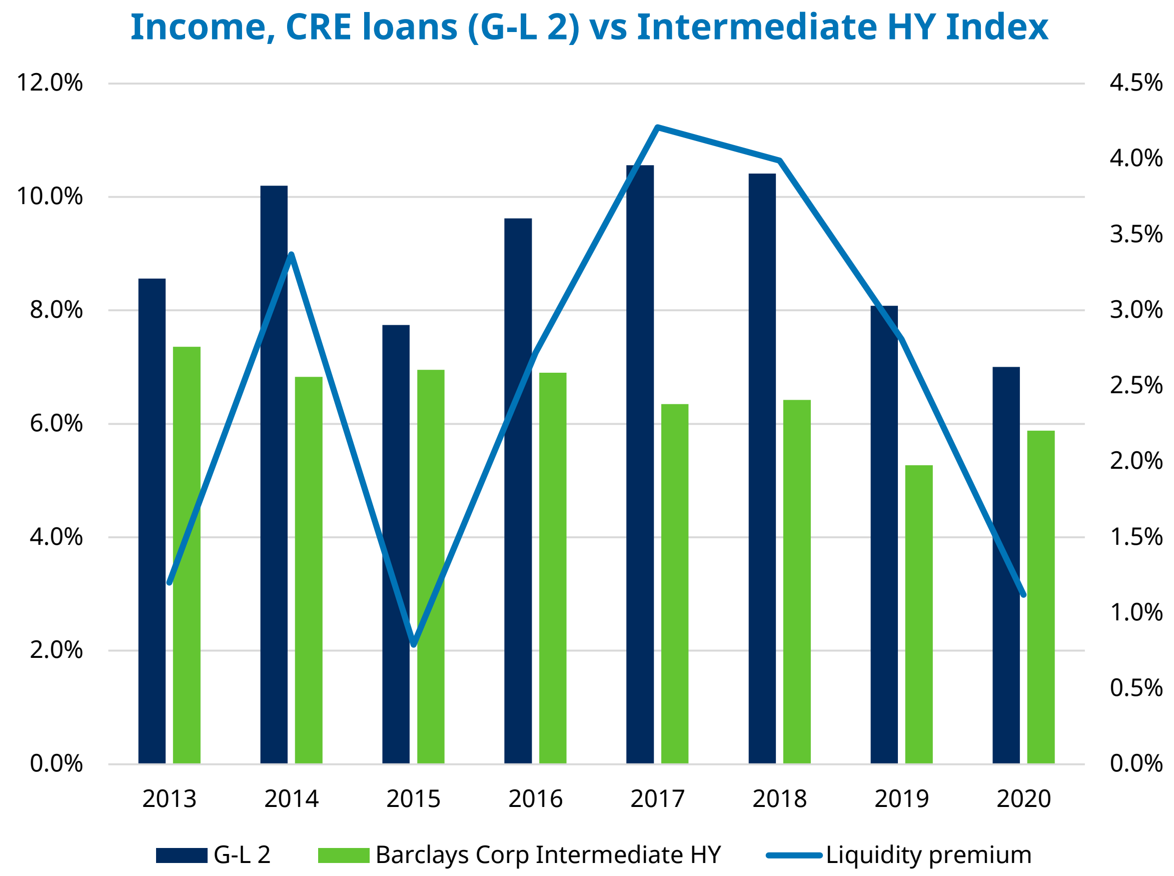


Source: Bloomberg, Schroders. As of January 31, 2020. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change. Past performance is no guarantee of future results.

Private CRE loan income versus securities income

Comparing higher yielding CRE loans and investment grade CRE loans to HY corporate and IG CMBS indices shows a persistent liquidity premium





Source: Giliberto-Levy, Schroders. As of December 31, 2020. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change. Past performance is no guarantee of future results.

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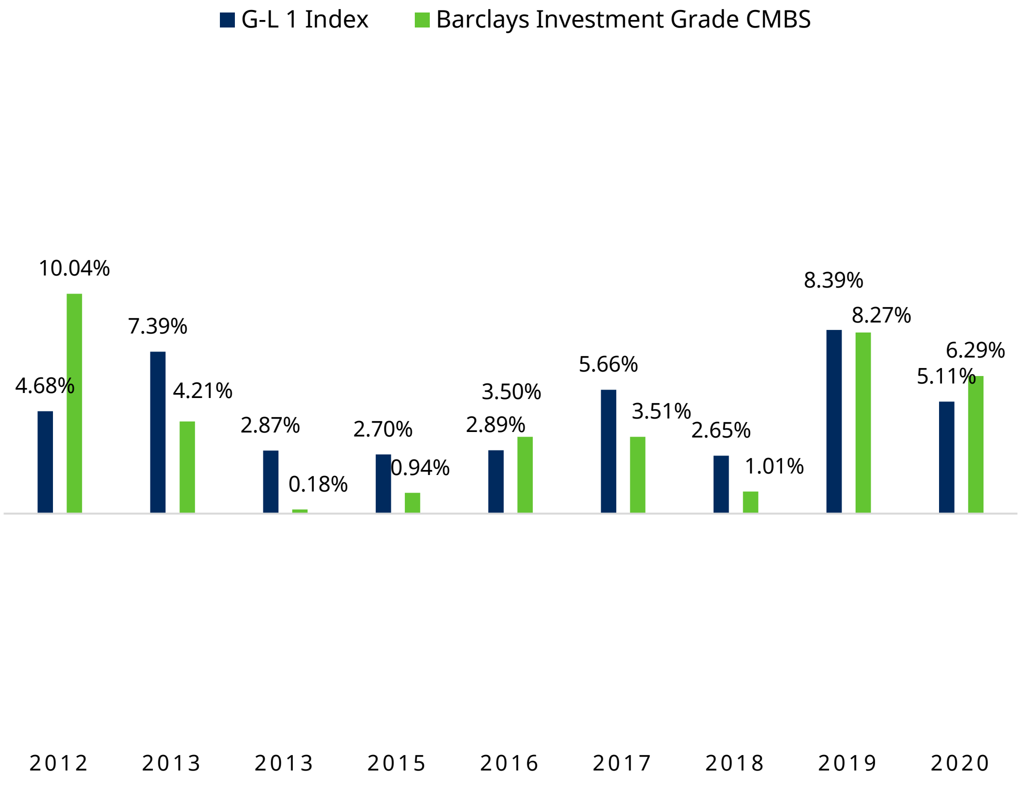
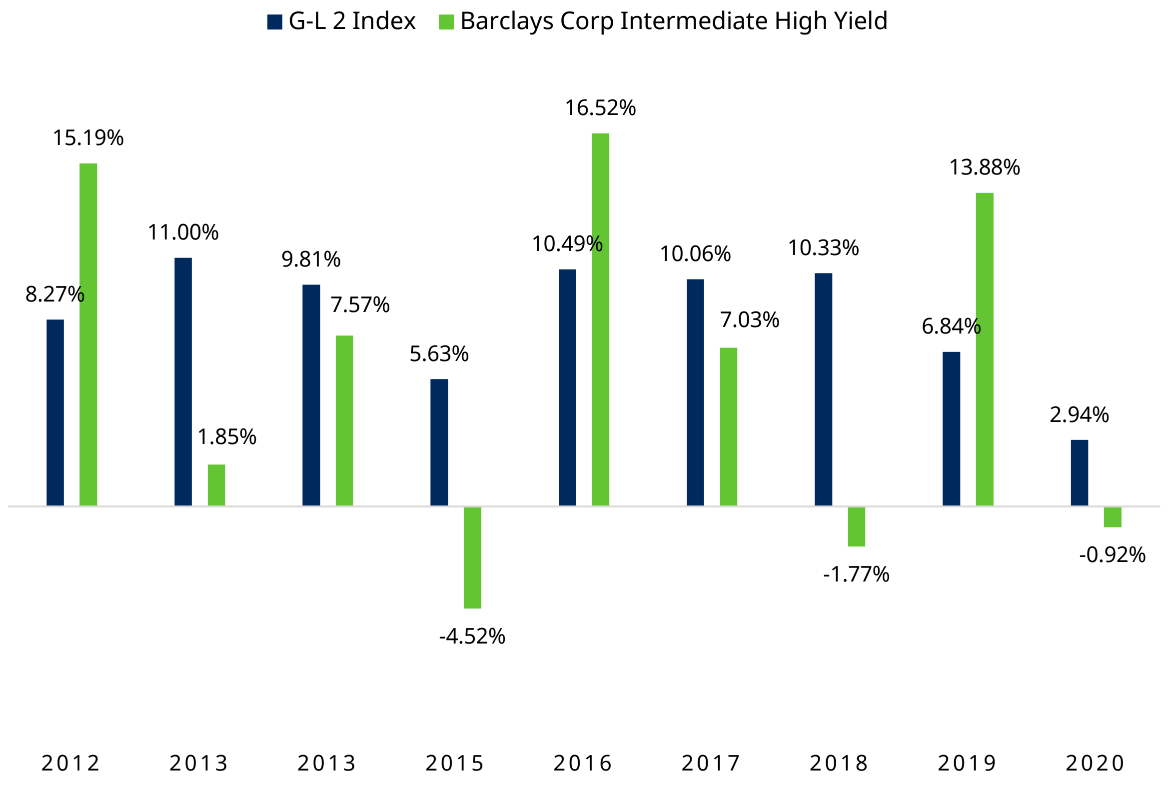
Private CRE loan returns versus their liquid surrogates

Commercial mortgage loans have more consistent total returns as higher income helps to cushion the impact of interest rate increases or credit spread widening



Volatility: G-L 1 3.1%; IG CMBS 3.7%



Volatility: G-L 2 2.1%; Int HY 6.9%

Source: Giliberto-Levy, Schroders. As of December 31, 2020. The views and forecasts shared are those of Schroders Securitized Credit team and are subject to change. Past performance is no guarantee of future results.

Definitions

- The **Giliberto-Levy indices** track the performance of the commercial mortgage private lending market.
- "**G-L 1**" tracks the performance of low leverage, senior fixed-rate commercial mortgage loans held on institutional balance sheets. Index returns are a market-value weighted blend of office, apartment, retail, industrial, lodging, mixed-use and other miscellaneous property types.
- "**G-L 2**" is a high yield commercial real estate debt index used as a performance benchmark for fixed and floating rate mezzanine loans, second mortgages, preferred equity and other high yielding subordinate commercial real estate notes as well as high-leverage senior mortgages.

Source: Giliberto-Levy, Schroders.

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Schroder Investment Management North America Inc.
7 Bryant Park, New York, NY 10018-3706
(212) 641-3800
www.schroders.com/us