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BRAMSHILL INSIGHTS

A Closer Look at U.S. Real Estate & Investment Opportunities in Securitized Products

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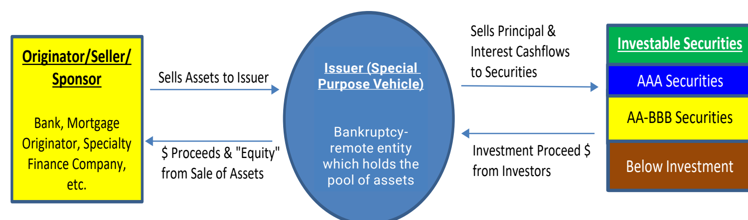
Portions of U.S. Real Estate Markets May be Stressed, but Not All Investments Secured by Them will be Impaired

A Closer Look at U.S. Real Estate & Investment Opportunities in Securitized Products

Overview of Investments Secured by U.S. Real Estate Market and their Underlying Assets

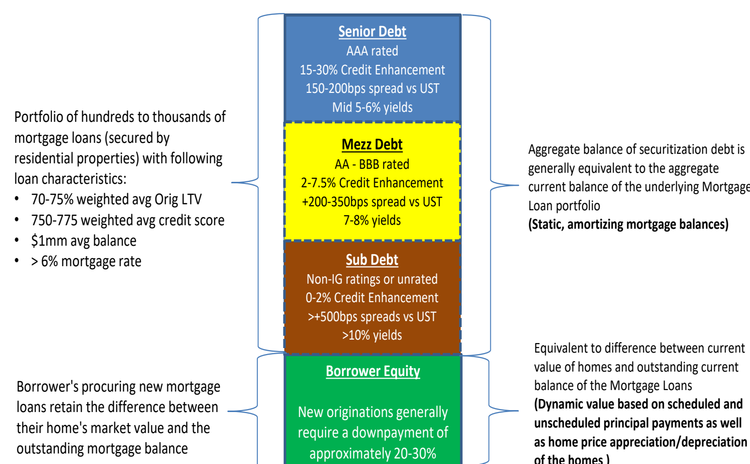
In our Bramshill Insights article from October 2023, we generally discussed the underlying assets that secure some of the Securitized Products in which we invest. Specifically, such investments that are secured by U.S. residential and commercial real estate. In this piece, we will focus on the structure of the Securitized Products and spend more time on the characteristics of some of the securities in which we invest, in relation to the underlying assets by which they are secured. Firstly, we will revisit the definition of a securitization. According to Investopedia, "Securitization pools assets and repackages them into interest-bearing securities. An issuer designs a marketable financial instrument by merging financial assets, commonly mortgage loans or consumer or commercial debt. Investors that purchase these securities receive the principal and interest payments of the underlying assets." The simple illustration below shows how an originator/seller/sponsor can transfer a pool of assets into a Special Purpose Vehicle ("SPV"). SPV's are legally formed trusts that are bankruptcy remote and used to create a securitization. Once the assets have been deposited in the SPV, the SPV can simultaneously issue investable securities and then pass through the proceeds received from selling the securities back to the originator/seller/sponsor via the SPV.

Illustrative Example of a Securitization



Many of the assets used in securitization, for example, residential mortgage loans, are assets that can be traded and invested in directly. However, there are many barriers of entry to invest in and own a pool of residential mortgage loans. Some examples include, but are not limited to, the fact that they are not rated by Nationally Recognized Statistical Rating Organizations ("NRSRO"), have various federal and state regulations and licensing requirements in regards to ownership of said mortgage loans, servicing licenses may be required depending on the type of mortgage loan owned, real estate related tax consequences, custodial requirements of documents to prove ownership, interest related risks and default risks. Banks have historically been the natural owners of mortgage loans as they are already required to manage most of these risks as originators. However, money managers, insurance companies, hedge funds and other investment entities would generally have to set-up various vehicles in most cases to own such mortgage assets. There are numerous costs and expenses that would be incurred upon setting up such vehicles as well as ending up holding much less "liquid" investments. However, by converting a pool of mortgage loans into NRSRO rated securities that follow a strict set of payment rules, the pool of mortgages typically will have a higher overall value. In the example above, a money manager may invest in a shorter duration "AAA" rated security, whereas insurance companies may invest in longer duration "AAA" rated securities or even a lower rated, investment grade security. On the other hand, a REIT or a hedge fund, for example, may choose to invest in the non-investment grade rated securities from the same securitization. By creating a wider range of investable securities, the securitization effectively creates "more" demand for the underlying loans at the same time it fills demand for investable securities.

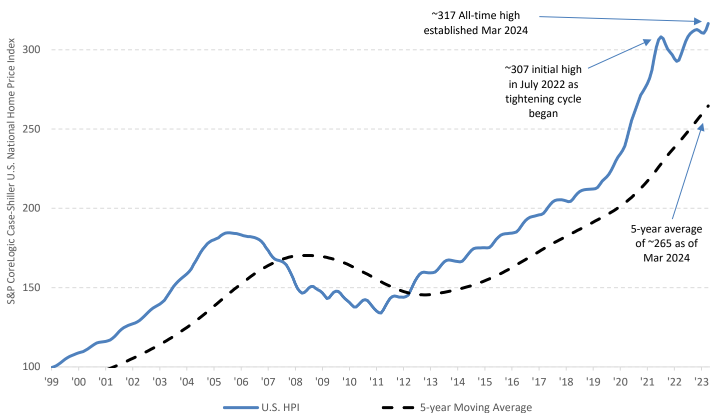
Illustrative Example of Securities in a Securitized Products Transaction Composed of Mortgage Loans Secured by Residential Properties



A major benefit of creating investable securities via securitization, to note from the diagram above, is the credit enhancement created by tranching (securitization technology that reprioritizes cash flow and allocation of losses to the investable securities in a securitization) the securities (shown as a percentage of the mortgage loan balance) includes the benefit of the equity the borrower has in each underlying mortgage loan. For example, if a borrower was to purchase a $1 million home, they would theoretically obtain a mortgage loan for $800 thousand and would be required to fund the difference between the purchase price of their home and the mortgage loan balance ($200 thousand in this example) with cash out of pocket. If such borrower's mortgage loan originator chooses to securitize that loan, it does not change the fact that the borrower still maintains $200 thousand of equity in their home. Further, if the value of their home increases to $1.2 million, then the borrower's implied equity would now increase to $400 thousand (assuming they haven't paid down any principal in their mortgage loan). In the example above, generally all holders of the investable securities should also benefit from this increase in borrowers' equity as they will have more implied credit enhancement as well. Such mortgage loan's Loan-to-Value ("LTV") would have decreased from its original LTV of 80% down to 66.7% ($800 thousand mortgage loan secured by the current home value of $1.2 million). Being invested in a security with 30% credit enhancement secured by a 66.7% LTV loan is considered to be a better credit than a security with 30% of credit enhancement secured by a loan with an 80% LTV.

Next, we want to highlight how much borrower equity has built up in the broader residential real estate market in recent years. Below is a chart of the S&P CoreLogic Case-Shiller U.S. National Home Price Index ("HPI") showing residential home values since the turn of the century.

S&P CoreLogic Case-Shiller U.S. National Home Price Index



Source: Bloomberg (S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index)

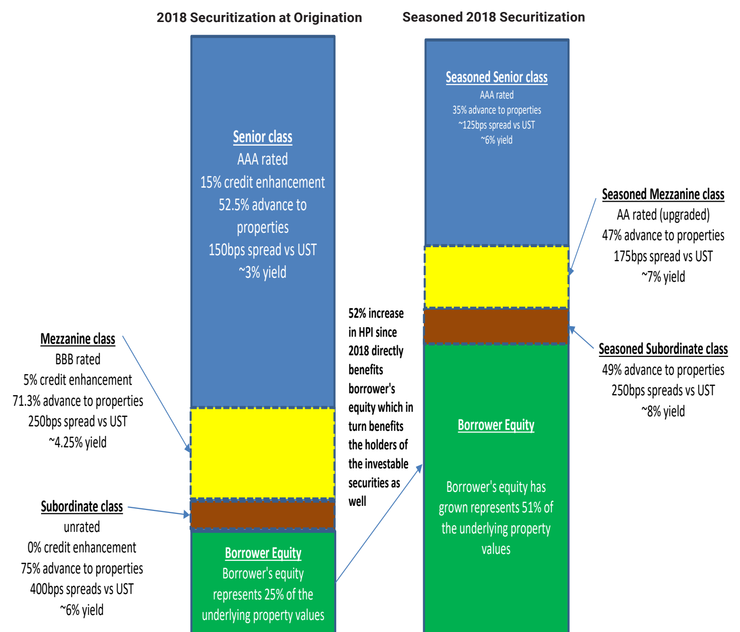
The sharp increase in HPI since 2020 has resulted in an unprecedented increase in the equity homeowners have in their homes across the U.S. Further, as home equity increases for the borrowers, the protection for a bondholder that invested in a related mortgage loan securitization commensurately increases as well, thereby reducing the probability of default. Below is an illustration of how a pool of mortgage loans originated with a 75% LTV in 2018 would benefit by measuring the advance rate compared to the value of the underlying homes each year. As can be seen in the chart below, a AAA-rated Residential Mortgage-Backed Security ("RMBS") secured by 75% LTV loans originated in 2018 with 30% credit enhancement had an advance rate to the senior-most security of 52.5% of the pool's underlying market value, would only be advancing the senior-most security 34.6% of the pool's underlying market value today. Similarly, the first loss piece of the unrated RMBS security, initially only had the original 25% of borrowers' equity as support when the portfolio was originated in 2018, whereas now it has grown to 50.6% of implied equity the borrowers have in their underlying homes. Additionally, if borrowers paid down the principal balance of their mortgage loans according to their scheduled payments, that would result in a larger amount of borrower equity incremental to the figures shown below.

Illustrative Credit Enhancement of Various Tranches of RMBS Securitizations

	U.S. HPI	205	212	234	279	294	311
		Advance to Value of Underlying Asset (as of Year End)					
Security Rating	**Initial CE**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
AAA	30%	52.5%	50.6%	45.9%	38.6%	36.5%	34.6%
BBB	5%	71.3%	68.7%	62.2%	52.4%	49.5%	46.9%
BB	1%	74.3%	71.6%	64.8%	54.6%	51.6%	48.9%
Unrated	0%	75.0%	72.3%	65.5%	55.1%	52.2%	49.4%
Borrower's Equity	NA	25.0%	27.7%	34.5%	44.9%	47.8%	50.6%

Source: Bloomberg (S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index)

Below is an illustration of how the table above would benefit the investable securities that were issued back in 2018.



Note: Figures above are not drawn to scale
Source: Bloomberg (S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index)

Although the illustration above is not to scale, directionally it clearly shows how much the borrower equity increase in the underlying home values benefits the investable securities. As mentioned above, this benefit is even higher if the borrowers are paying down their mortgage balances. On the other hand, despite this benefit from positive HPI, it doesn't completely remove the probability of defaults from the underlying mortgage loans. At the end of the day, borrowers will continue to have life events no matter how much borrower equity they possess. Layoffs, deaths, divorces, health events, accidents, natural disasters, other financial related events, etc., could cause a borrower to be incapable of paying their mortgage which could ultimately cause the lender to foreclose on and liquidate the property to recover the amount lent to the borrower. Further, the process of foreclosing on a property may be judicious and incur many expenses/fees such as legal, taxes, insurance, real estate broker/agent, etc. Given such expenses/fees, there is still a potential that a default on a mortgage loan of a borrower, who is perceived to have positive equity, could still lead to a potential loss on their mortgage loan, which in turn could cause a loss to the securitization trust and the most junior security which is scheduled to absorb losses. Further, since some expenses like legal fees are fixed, that could cause higher potential losses on lower balance mortgage loans more so than higher balance mortgage loans. However, despite this possibility of potential future losses, we envision borrowers with a vast amount of equity in their homes will be extremely proactive in protecting as much of their personal wealth as possible, especially if they experience a life event as well as the fact that there is typically enough equity in the home to pay for all the liquidation expenses which would result to no loss to any of the investable securities. Even if they have an extremely low mortgage rate, borrowers that run into financial hardship should be willing to sell their house themselves and payoff their outstanding mortgage loan to retain as much of their remaining home equity as possible, especially since much of it was gained since 2020. On the other hand, as can be seen in the chart below, we don't foresee the same result from recently originated vintages as borrowers who may experience life events may be more inclined to let the foreclosure process occur as they won't have as much, if any, equity in which they would be incentivized to protect. The supply of residential homes has been constrained in recent years, which has been integral in keeping home values relatively strong despite generationally high mortgage rates over the past couple of years. However, we do envision a potential future scenario of a weaker economy and of higher unemployment, which could result in HPI declines going forward. Whether such decline of HPI in this scenario is de minimus and reverts back to levels seen recently in 2022, or if the decline is more extreme reverting back to HPI levels seen 4 to 6 years ago, our view is that focusing on more seasoned mortgage loans should have more protection than more recent vintages from potential losses. Note that these figures do not factor in amortized mortgage balances from scheduled payments of principal by borrowers, which benefits the more seasoned vintages more than the more recent vintages as well.

Projected Borrower Equity if HPI declines back to previous year-end levels

Projected Borrower Equity	HPI Change from 2023	2018	2019	2020	2021	2022	2023
Original LTV	NA	75.0%	75.0%	75.0%	75.0%	75.0%	75.0%
HPI LTV	0%	49.4%	51.2%	56.6%	67.2%	71.0%	75.0%
Borrower's Original Equity	NA	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%
Borrower Equity @ 2023YE HPI	0%	50.6%	48.8%	43.4%	32.8%	29.0%	25.0%
Borrower Equity @ 2022YE HPI	-5%	47.8%	45.9%	40.3%	29.0%	25.0%	20.8%
Borrower Equity @ 2020YE HPI	-25%	34.5%	32.1%	25.0%	10.8%	5.8%	0.6%
Borrower Equity @ 2018YE HPI	-34%	25.0%	22.2%	14.1%	-2.1%	-7.8%	-13.9%

Source: Bloomberg (S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index)

By taking these factors into account and focusing on loss/default-adjusted total returns, we expect the following in regards to investments related to U.S. real estate investments for the remainder of 2024:

1. Given the universe of over tens of trillions of dollars of real estate related Securitized Products we can invest in, we will continue to remain selective and focus on investments that are secured by underlying assets with stronger fundamentals and larger balances, such as residential properties with prime borrowers and multifamily commercial properties. More specifically, we can be very tactical, not constrained or forced to buy "the market," don't rely on one channel to source assets and have the capabilities to invest in a large swath of investments within the Securitized Products space. In the current environment of all-time high property values, being able to be selective and skip new issue deals that are not secured by seasoned collateral is a huge advantage. Instead, we can focus on investments in pools of mortgage loans that were originated in 2021 and prior as they have experienced a great deal of positive HPI since they were securitized into the given deal. This results in the underlying borrowers having more equity cushion in the assets they own, which should result in lower defaults and severities (losses) if they experience any life events or extraordinary circumstances. Depending on the risk profile of the varied mandates we manage, we will continue to focus on more senior investments in this real estate targeting returns in the mid-to-high single digits and more junior investments targeting returns in the high single to mid-teens that should outperform the total universe of real estate related Securitized Products.

2. After the fundamentals flow through and "bottom out" (i.e. U.S. HPI indices stop decreasing after they fall considerably from their current all-time highs), defaults, recoveries and to potentially credit spreads should reach more distressed levels than they are currently trading at, which could potentially lead

to sales of securities at very attractive valuations. We will look to make opportunistic investments in a wider array of investments secured by U.S. real estate that offer good risk-adjusted total returns that show promise of high single digit to mid-teens types of returns.

We believe that all-in-all the backdrop of continued deleveraging from historically high debt levels, a decreasing money supply and a patient U.S. Federal Reserve Bank cautious about re-inflationary pressures, should result in a good foundation for most fixed income, especially in select Securitized Products such as seasoned non-agency RMBS securities. In this environment, good asset selection resulting from a repeatable process with a long track record should allow Bramshill Investments to outperform its peers.

About Bramshill Investments

Bramshill Investments is an alternative fixed income asset manager with over $5.72 billion in assets under management as of May 31, 2024.

Founded in 2012 and headquartered in Florida, with offices in California and New York, the firm offers alternatives to traditional fixed income investment management featuring a variety of strategies across various debt and fixed income markets and specializing in preferred securities.

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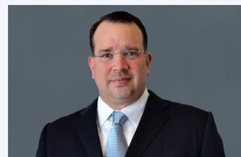

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