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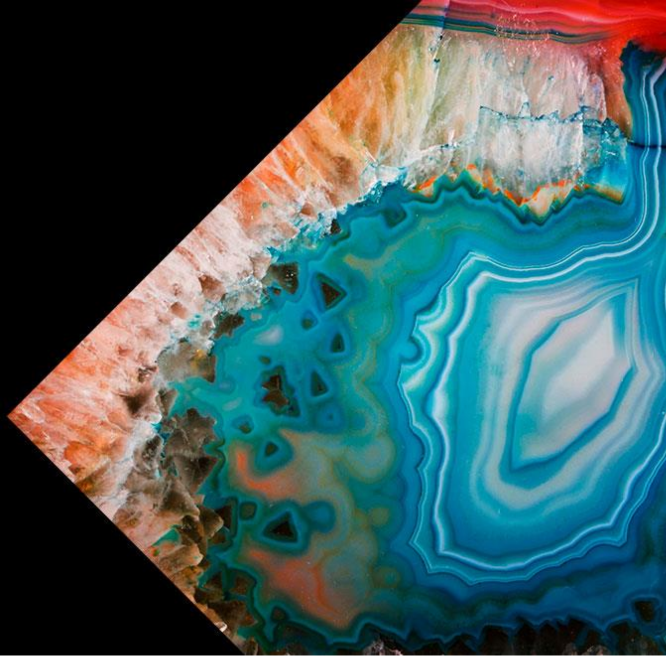

Commercial Mortgage-Backed Securities: Phoenix from the flames?

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Synopsis

Commercial Mortgage-Backed Securities (CMBS) is a sector in Securitised Credit that has come under pressure recently. However, we believe that each sub-sector is being painted with the same brush as the more problematic areas.

- To navigate these challenges and extract real value from this bifurcated asset class, comprehensive due diligence is required

There are three key reasons driving the weakness at a sector level:

- Persistently high interest rates have led to increased borrowing costs for new borrowers significantly raising the expense of refinancing existing loans upon maturity
- Property valuations, which are inversely related to interest rates, have decreased compared to pre-2022 levels due to rising property yields. Consequently, lenders are offering reduced refinancing amounts and existing loan-to-value ratios may increase unless, borrowers inject additional equity
- Changing property trends – over the past decade, shifts in property usage, intensified by the COVID-19 pandemic, have altered market demands. The transition to hybrid working models and the growth of e-commerce have reshaped the need for office spaces, distribution centres, and retail properties

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The factors above highlight the importance of selecting:

1. Securitisations on fit-for-purpose properties, that is, properties that do not require significant costs to maintain, are in a good location and are not inhibited by their age or type of use
2. High quality tenants in sectors more likely to outperform in the current economic cycle
3. Securitisations that have well-structured lease structures, the right blend of tenants and high occupancy rates

As a result of the sector coming under pressure, spreads are at historical wides.

Due to the sector's pressures, spreads are wider. Therefore, selecting high-quality CMBS securities could enable investors to earn attractive risk-adjusted returns and secure compelling yields. As we move into the next cycle, with anticipated lower interest rates, the asset class could benefit from spread tightening and capital appreciation as transaction volumes increase, property values rise, and the cost of financing falls.

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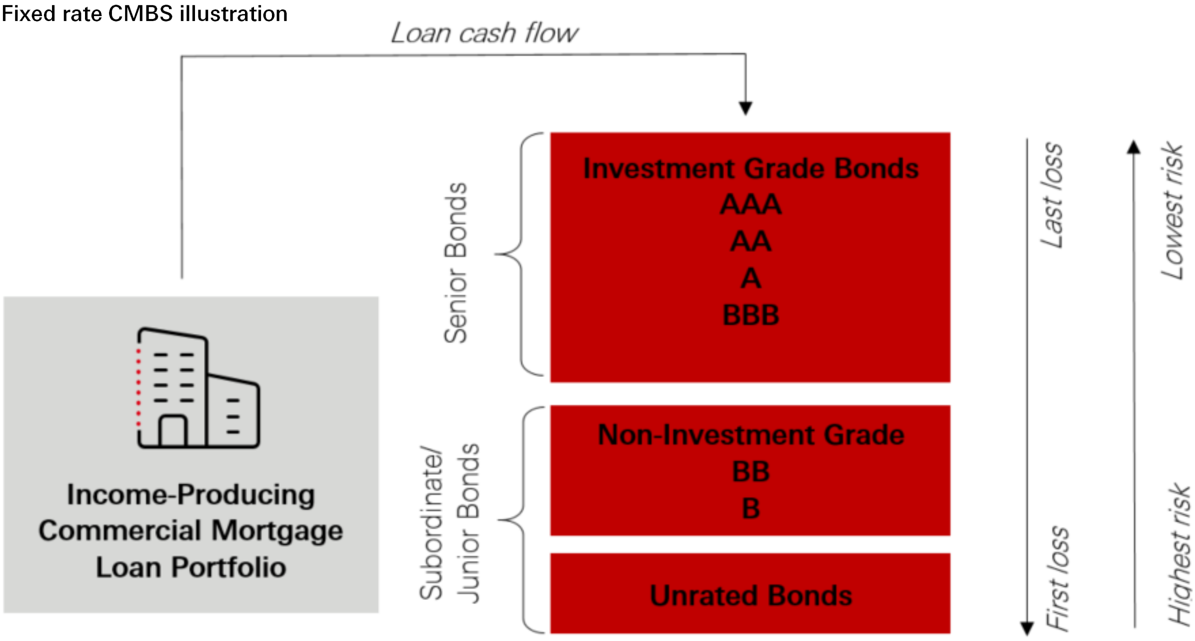
What is a CMBS?

A CMBS is a fixed-income investment product that is backed by mortgages on commercial properties. A typical CMBS structure is illustrated below consisting of different types of bonds at different risk tranches. This allows investors to pick their desired risk level.

Fixed rate CMBS illustration



Source: HSBC Asset Management. The information provided is for illustrative purpose only.

The importance of due diligence

Selecting the right type of property is key. The change in demographics has meant that there are winners as well as losers across the different sub-sectors of CMBS.

Conduit CMBS: One area that has come under scrutiny, and where a lot of the stress in CMBS lies, is conduit CMBS. These are securitisations where the underlying properties are a pool of loans which has diverse asset types such as offices, retail, hotels, apartments, self-storage etc. The asset quality is usually not prime for these asset types. It is thus no surprise that we do not invest in this area.

Instead, we take a rifle shot approach, focusing on “Single Asset, Single Borrower (SASB)” CMBS.

A SASB CMBS is where the securitisation is secured on a single property or a portfolio of similar properties with one institutional sponsor/borrower.

Sub-sectors

Office: All secondary real estate is underperforming, but secondary offices are currently in the spotlight.

The hybrid working environment we now find ourselves in has resulted in a significant reduction in the demand for secondary office space.

Investors in Conduit CMBS specifically could be inadvertently exposed to:

1. Outdated office properties which are not fit for purpose and require significant investment
2. Vacant office floors, due to fewer tenants
3. Buildings located in areas which have become obsolete

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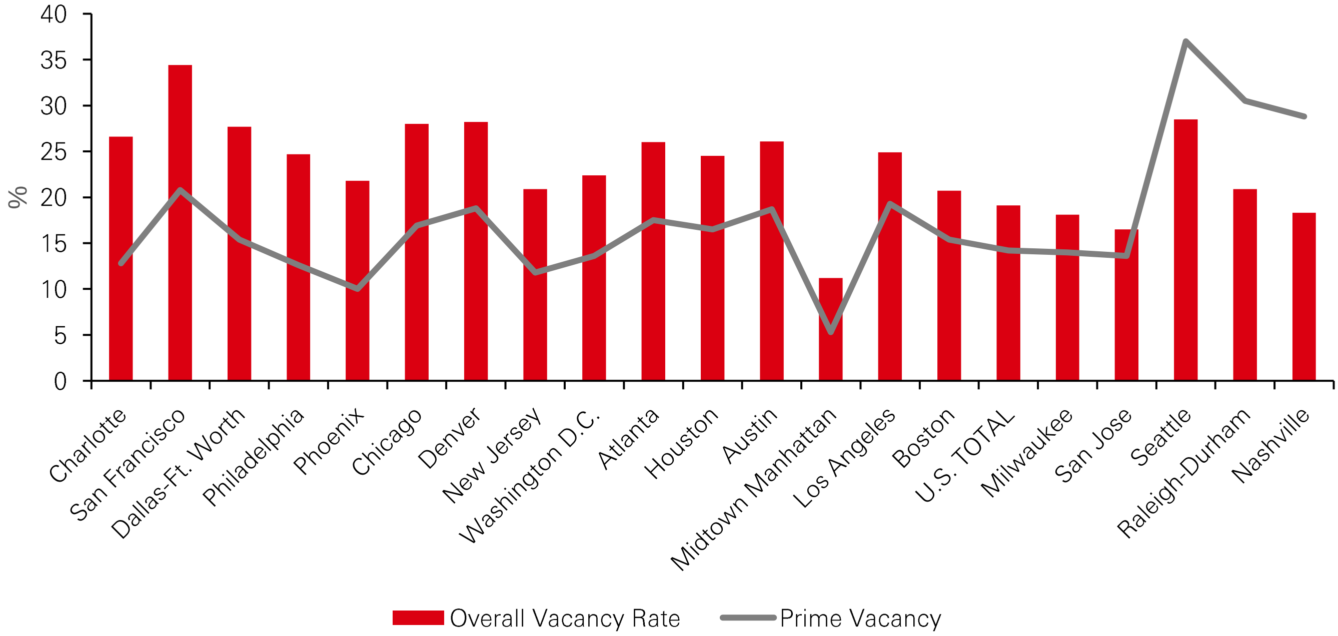
Our SASB focus, as it relates to Office, allows for two things:

1. Sourcing of deals backed with "trophy buildings": We focus on acquiring high-quality properties that are well-suited to the current economic climate, adhere to advanced energy standards, and are in prime areas.

2. Transparent evaluation of borrowers: Our approach involves evaluating individual borrowers or sponsors rather than pools. We engage in transactions with top-tier sponsors who are both experienced and financially robust.

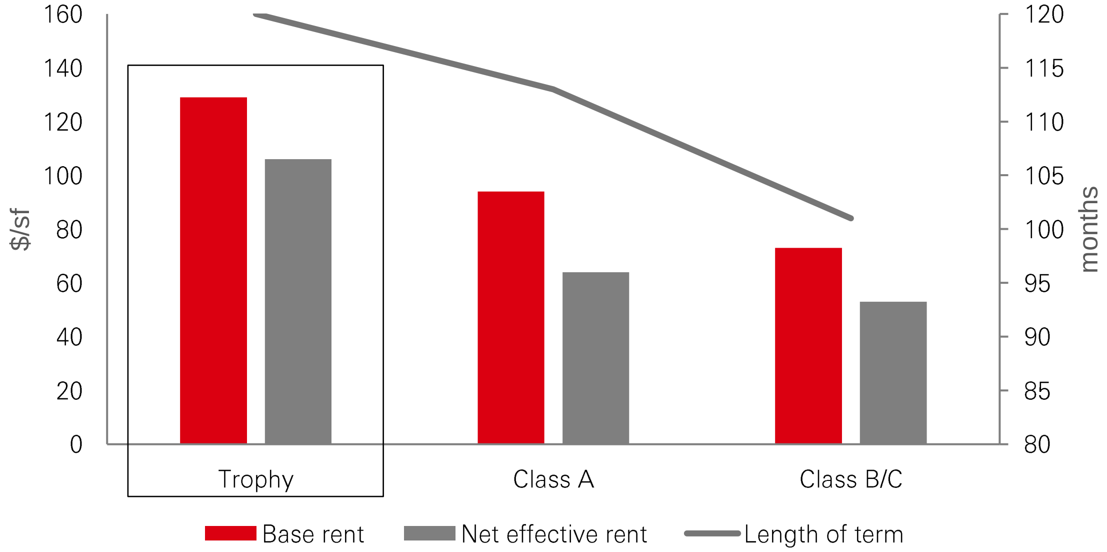
Vacancy rates can very dramatically from region to region. By selecting prime and "Trophy" office buildings, we benefit from reduced vacancy rates—approximately 5% lower (as can be seen in the chart from CBRE below), and the ability to command higher rental prices (as evidenced by the second chart below from Avison Young). So selecting the right type of property in the right area is key.

Prime vs Non-Prime office vacancy rates in Top 20 US markets



Source: CBRE Econometric Advisors, CBRE Research, Q3 2025

Trophy vs Class A vs Class B/C office asking rent

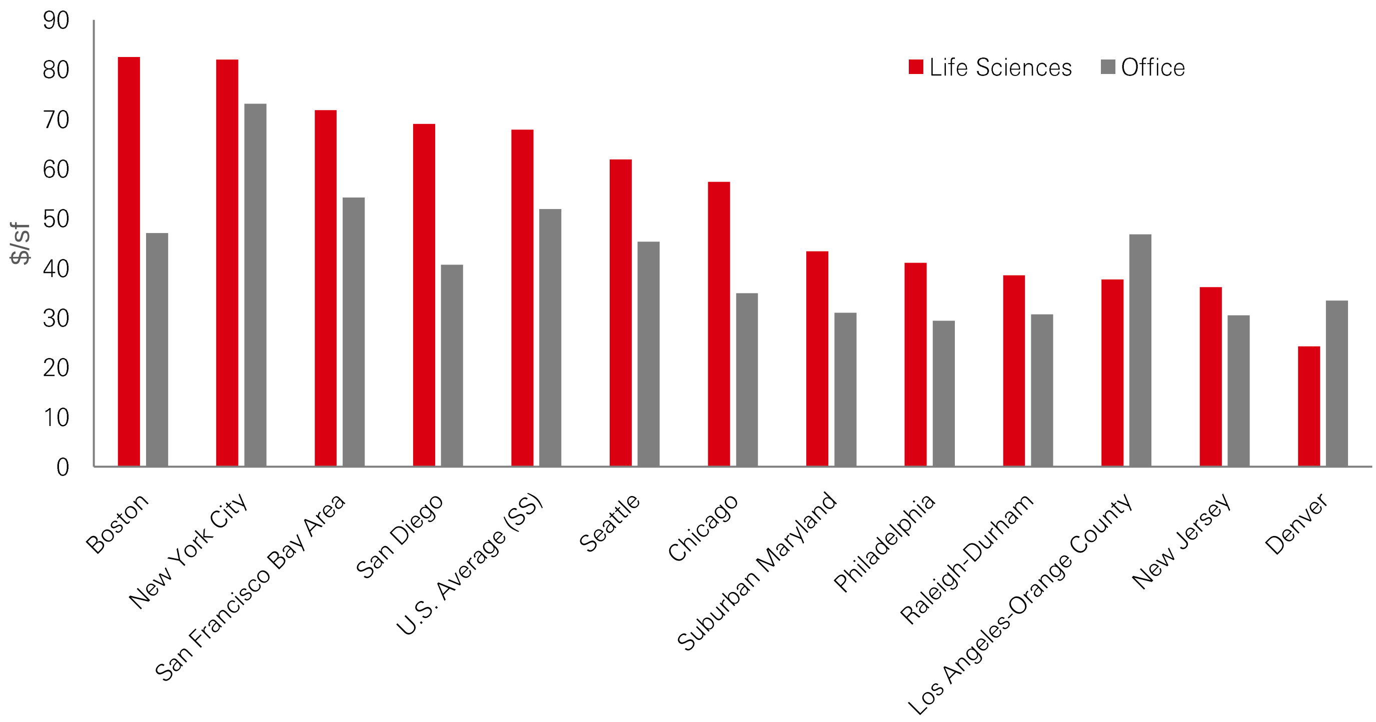


Source: Avison Young Market Intelligence, Q2 2025

As a result of this focused investment process, there are three SASB office CMBS areas that have interesting features:

- **Life Sciences:** While many employees can work from home, Life Sciences requires the use of laboratory spaces and experimentation and testing for vaccines cannot be done remotely. As a result, these properties have generally performed well and rents are at a premium to offices in the same markets, as can be seen below:
- **Industrial:** Whilst the retail market is increasingly going online, goods to be delivered to the end consumer must be stored and distributed to their homes. Unsurprisingly, warehouses which store these goods and last mile distribution/logistics is an area that has directly benefitted.

Overall Asking Rents, Q2 2025



Source: Cushman and Wakefield, HSBC Asset Management

- **Data centres – the future:** In the ever-increasing digital world we are in; data is a fundamental requirement. However, data needs to be stored and utilised. As a result, data centres have a very important role to play, and demand is showing no signs of slowing.

  New construction has only partially met demand and thus rents for wholesale data centres are likely to continue to rise. In fact, a report by Jefferies estimates that data centre growth will grow at a compound annualised growth rate between 10–20% globally to 2030.

Retail: The death of the shopping mall has been a longtime coming. There is no doubt that retail has changed over the past two decades. As technology continues to advance, it has become easier and easier to order and consume goods and services remotely. Consequently, secondary retail shopping malls and high street properties have arguably gone out of vogue. COVID-19 undoubtedly accelerated this trend.

However, some areas of retail remain popular. For instance, grocery-led out of town supermarket complexes (next to retail stores) and super regional malls continue to see strong demand.

Multifamily CMBS: In this area of CMBS, size and scale matters. We tend to prefer large rented units, that is, purpose-built apartment buildings specifically designed to be let out to tenants.

Hotel: The seasonality and demand elasticity of hotels has also resulted in us avoiding this sector.

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Structural features

Once investors have picked the correct sub-sectors within the asset class backed by top tier sponsors, the structural features of the securitisation are just as important. It is crucial to consider four elements.

1. Tenants and the mix of tenants:

The tenants are the income stream of the securitisation. It is therefore of paramount importance that the tenants comprising the loan are suitable. Not only do we typically invest in the higher rated tranches of securitisations, but the underlying tenants are also predominantly high-quality tenants.

2. Lease terms:

In some CMBS deals, there can be instances where the leases for the tenants runs out before the end of deal term. In these cases, and especially where a tenant comprises a significant portion of the property, there are risks that the tenant doesn't renew their lease, a new tenant is not sourced or there is a period of time where the property remains untenanted whilst a new tenant is found.

Selecting securities where the lease terms are longer than the maturity of the deal or there is only a small proportion of leases that expire before the deal term is therefore necessary.

3. Occupancy rates:

An ongoing concern is the occupancy rate of the properties. While it is unlikely that every CMBS deal is always fully occupied by its tenants, should the occupancy rate fall to an unsustainable level (that is, impacting the rents received by the sponsor/borrower), this could be a cause for concern.

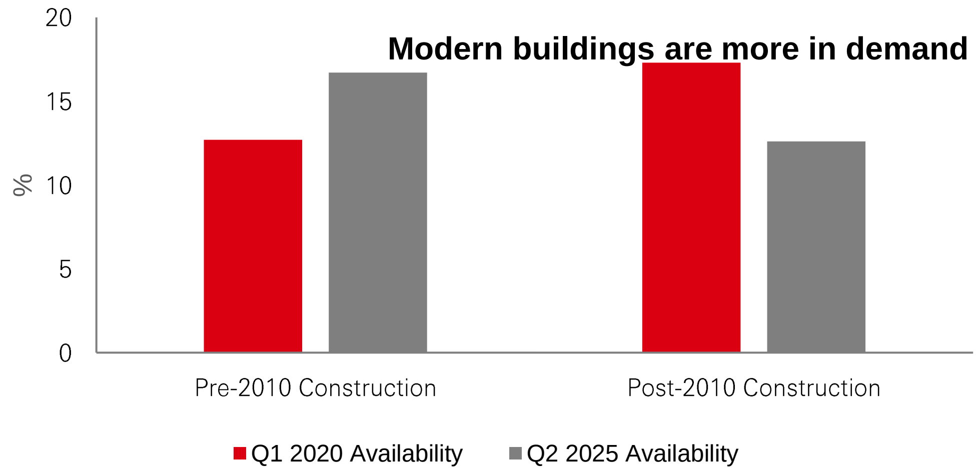
We evaluate deals based on their occupancy rates at the time of investing as well as applying stress tests to ensure that should occupancy fall noticeably; the tranches we invest in are adequately protected.

4. Properties:

There is a direct correlation between vacancies and when a property has been built/last been renovated. Generally, properties that have been renovated or built more recently have significantly lower vacancy rates.

This makes sense given these properties would be most likely to have been built with the demands of today's world front and centre.

Vacancy rate by vintage (Year built/ Last renovation)



Source: Avison Young, HSBC Asset Management

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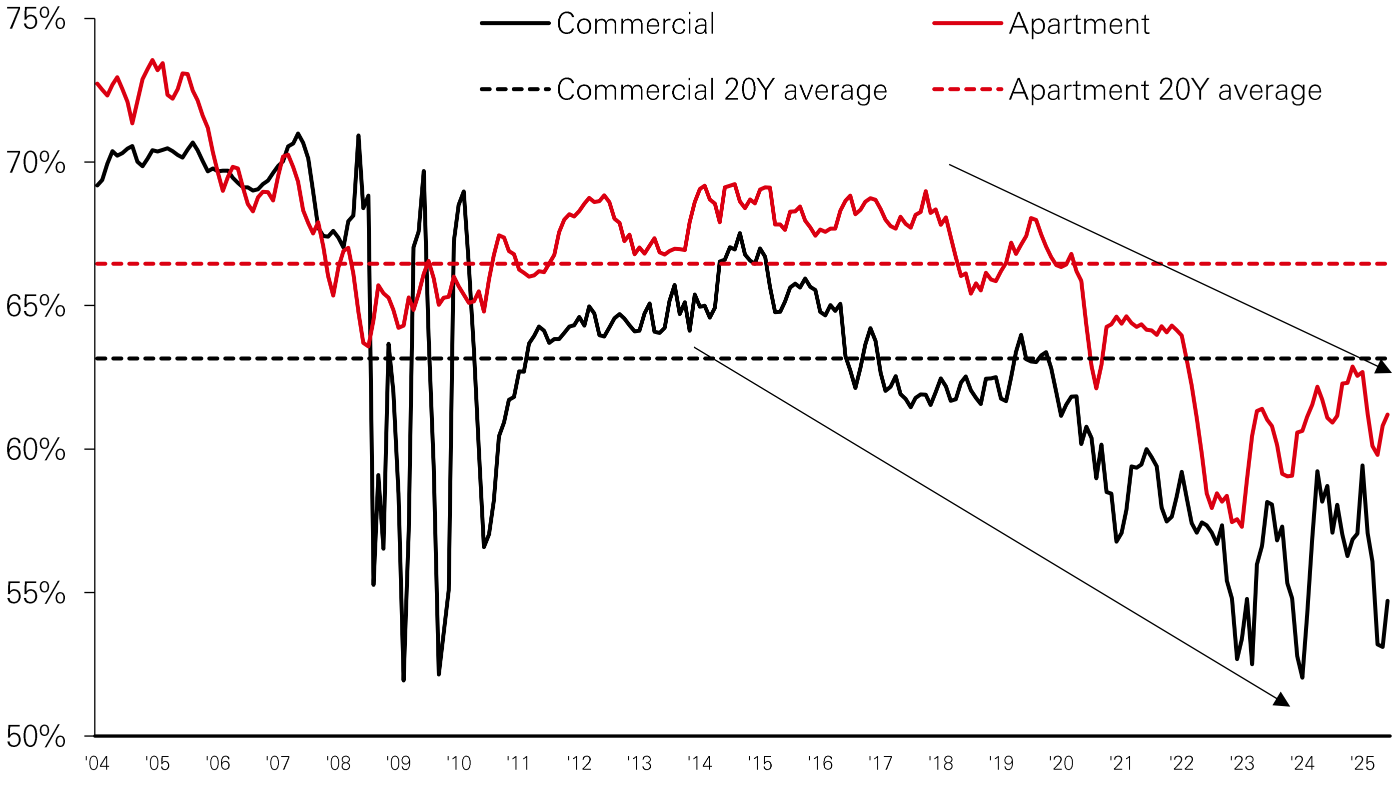
Is now the time for CMBS to realign to the fundamentals?

When we look at CMBS spreads, not only do they remain wide of historic tights, but they are one of the widest sub-asset class within the Securitised Credit universe. This has been the result of the changing use of property which was fuelled further by COVID-19, the unprecedented speed and magnitude of interest rate hikes over 2022 and 2023 and President Trump's trade policy implementations in 2025.

One can argue that the whole CMBS sector has been unfairly punished because of specific areas of CMBS that have come under pressure, as mentioned previously. From an asset allocation perspective, the right high quality CMBS securities with the same credit rating as high-quality corporate bonds are much more attractive at this point in the cycle because of the higher spread compensation on offer to investors.

Interestingly, since the GFC, commercial real estate debt has had better credit metrics such as lower loan to values (LTV), suggesting the sector is better able to survive stress in the market.

LTVs have fallen significantly below 20Y averages



Source: Real Capital Analytics, Morgan Stanley, HSBC Asset Management. Data as at 30 June 2025.

What's more, interest rates returning to more neutral levels has and will continue to ease pressure on the sector. When compared to equivalent rated corporate bonds and fixed rate ABS, CMBS provides a noticeably higher spread. As the chart below shows, as of 30 November 2025, the sector at an index level offers an asset swap spread of 113bps vs 96bps for fixed rate ABS and 84bps for AAA-A US corporates.

In fact, as can be seen below, the potential for spread compression to more normal trading levels is highest in CMBS when compared against fixed rate ABS as well as US investment grade corporates.

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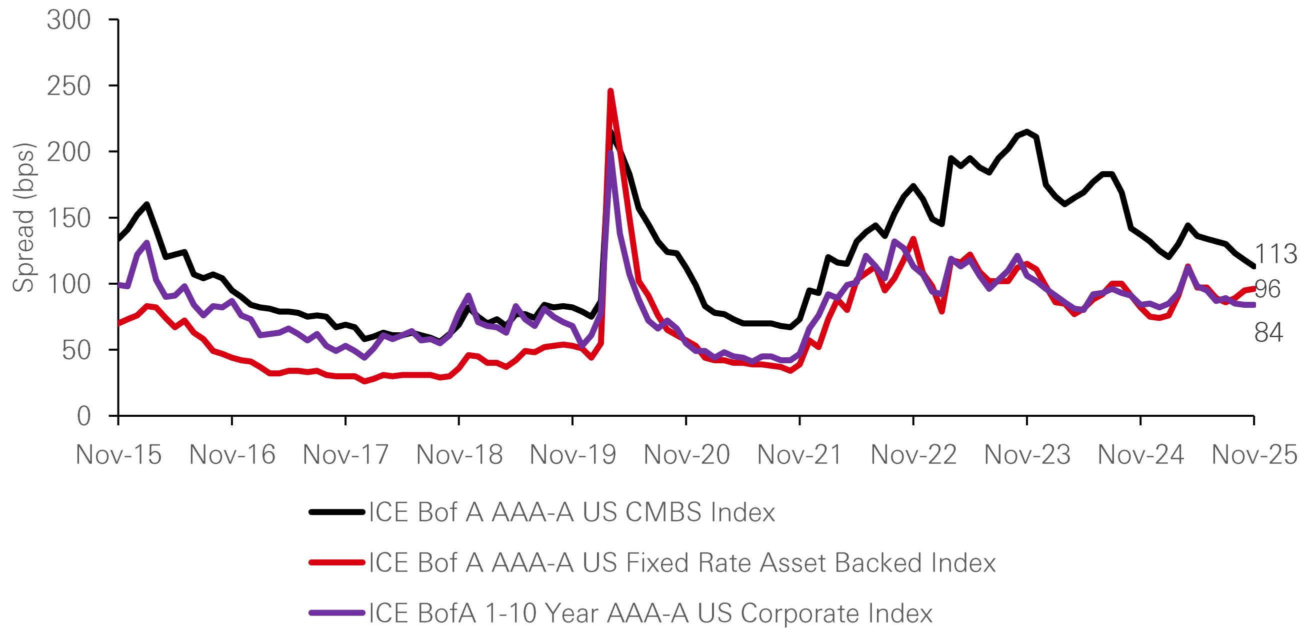
CMBS spreads are compelling versus similarly rated ABS and US corporates



Source: Bloomberg, HSBC Asset Management, as at 30 November 2025.

Conclusion

It is fair to say that investing in CMBS requires significant understanding, experience and research. However, if done correctly, investors stand to earn a significant complexity premium, participate in potential spread tightening and lock in the higher yields on offer compared to Investment Grade corporate bond securities. As we shift towards a neutral interest rate paradigm, the tide appears to be turning for an arguably undervalued sector.

Source: HSBC Asset Management

The level of yield is not guaranteed and may rise or fall in the future.

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