

Voya Financial Inc. (VOYA) | Citi | August 18, 2023

Michael Ward:

Good afternoon, everyone. Thank you for joining us today. Pleased to have Voya with us. Today we have Matt Toms, Global Chief Investment Officer of Voya Investment Management, as well as Mike Katz, Executive Vice President of Finance.

So really happy to have Voya on the line with us today. We're just going to be discussing investment portfolios, primarily commercial real estate, and trying to get a handle on the latest in that sub-sector. And yeah, so thank you guys for joining us again.

So Matt, maybe just to kick it off here today, would be sort of curious if you had sort of a brief recap, maybe an update on your investments in commercial real estate, specifically office, which is getting a lot of attention and maybe any actions that you've taken or have taken, given the challenges there.

Matthew Toms:

Yeah, no. Michael, thanks for the time. Appreciate the opportunity to talk through our views and our balance sheet and the outlook for the future. So bottom line, it is and going to remain a difficult environment for commercial real estate. It is one of those asset classes that are exposed to higher interest rates. And so as we look forward, it's right to be very diligent, but it's also important how you're set up heading into an era like this.

So certainly there's going to be noise to continue, it's not going to be short-lived. But when we look, just to level set, we step back and look at our exposure to start with, we feel extremely strong as far as how Voya is positioned. And that informs where we can go, starting from a position of strength and being really a debt investor. We're not an equity investor. 99% plus of our portfolio is debt. That's differentiated from many of our peers who have a broader array, and equity gets it first. And in debt you have a high level of insulation, so really what we're looking for is downside risk, meaningful downside risk. It's not a symmetric game in debt.

So that's what we're looking for. And we feel really good about our starting position. We have a high-quality portfolio. As I mentioned, nearly all debt, CM1s, commercial mortgage ratings to get a little bit wonky, CM1, 2 and 3. CM1 that equivalent to a NAIC 1 or Single-A bond. 75% of our portfolio is CM1 rated, 17% 2. So we start at the very high-quality end the spectrum. And only 8% is 3, so not only do we feel really good about being in debt, we're in higher-quality end of debt. And where you're seeing most of the exposure right now is finding the valuations in the equity underlying. And you see some really big headlines in the newspaper about trophy property selling at big discounts and what was the equity value loss, but you have to eat through all that equity value before you get to the debt, so we're at a really strong starting position.

Now to get into office in a little bit more granularity, it's a small percent of our portfolio. It's 2% of the overall portfolio. That's 15% of our commercial mortgage loan portfolio. And Michael, you're right to call it out as an area of specific concern. So broadly speaking, commercial real estate is impacted by the rate

environment. And specifically speaking, you've got the rate environment and the usage environment in office that we're all aware of. But we start out at a position where we're meaningfully [inaudible] our peers. We think 10 plus percent, if you look at ACLI numbers, 15% of our CML portfolio, notably different than our peers and an average loan size across our holdings of 11 million dollars. So it's also very diversified, our CML book.

So I think the key is yes, there's stresses. You can either start a position of strength or weakness. We feel undeniably we're starting at a position of strength and really have... While we're going to be diligent about how we underwrite the space, we think there'll be opportunities that come with this pain that is being felt in other balance sheets much more largely away from ourself. One other call out, no current delinquencies. Will it stay difficult? It will. But a high-quality diversified portfolio with no delinquencies, we're feeling pretty good about the opportunity set ahead.

Michael Ward:

Great. Thanks Matt. That's really helpful. Maybe sort of bouncing off that topic around delinquencies or individual loans... Curious if you have seen any office property maturities year to date or in the last 12 months, I guess, with the higher rate environment, have you made resolutions on office loans or elsewhere? I would imagine so, even if it's a smaller number, but curious if you can discuss how any of those have ended up.

Matthew Toms:

Yeah, so I mentioned the no delinquency stat or that's a strong starting spot. And we have had three maturities this year in the office space, specifically small amounts. We have a very... I mentioned that granular portfolio, diversification matters. So our average loan size is 11 million dollars and there's no loan over a 100 million dollars. And so when we get into the granular details, just be aware that what we're looking for is, is there a systemic risk? Is there's something that's aggregating? Because the idiosyncratic individual investments in our portfolio tend to be quite manageable and small because we're very diversified, over 3000 unique holdings. So I just want to highlight that. But we have seen maturities year to date. We've had payoffs as scheduled first half of the year.

We put some detail in our report this quarter as well that shows the forward maturity schedule. I think we have a 100 round number, 159, 160 million dollars of maturities in office over the next five years. And that's a pretty modest number. So we start with high-quality, start with relatively low office. And I would state, just going back to that equity versus debt profile, you've seen a move lower in overall commercial real estate value indices, but don't take the front page of the New York Times and what trophy property is traded down 60% as a barometer for all commercial real estate. Our portfolio very diversified, not heavily exposed in Tier One massive buildings. Our balance sheet is not big enough to need to do 200, 300, 400 million dollar loans. That means we have a much broader array of primary and secondary markets. Average loan size of 11 million dollars lets us be very diversified. That's different than some of our peers. So we really look at it on a case-by-case basis.

The narrative, just to extend that for a second, and we've seen our maturities, we think our maturities that are coming down the pike are very manageable. Our entire portfolio has about 530 million of maturities over this year to next year. And we gave that next five years of office is 159. So diversified office isn't a big component of it. The one opinion I'd share is that there's been a big narrative around really it's not going to be a large market or a Tier One property issue. I think that's wrong. I think what you're seeing is some of the bigger properties, Tier One markets, that were most aggressively valued in recent increases is where you're seeing some of the pain. Voya's portfolio is much more diversified in

the primary and secondary markets and we don't sense that gap risk that you'll have in some of those bigger loans, bigger properties and major metros.

Michael Ward:

That is a fascinating point actually. So I guess when we talk about those bigger properties, and I know that you guys aren't as big there, but some across insurance might be bigger there, when you think of that conceptually or when you discuss that internally, those Tier Ones you mentioned maybe more aggressively valued, is the bulk of that... Should we think about that maybe underwritten from in recent years, 2019 through 21 or something like that? Or is it earlier than that? I'm just wondering if the pandemic, if we should be maybe putting a little bit more focus on pandemic era loans than elsewhere.

Matthew Toms:

So I think it's rational to look at... If you look at the national or commercial real estate index, you did have a ramp higher into the low rate environment of 2020 and 2021. That took you up, say 10, 15%. And if you had a highly leveraged loan with an origination timeframe in that 21 areas where you will have more potential risk if you have high leverage in large properties. And one of the issues with large properties is there's fewer balance sheets that can refi that size loan and you're typically not paid a premium because those big balance sheets, during most times, are seeking those big tickets to get a lot of money put to work. So concentration doesn't pay in debt investing generally, because you have all downside risks. You want diversification. But yes, there's a window where you sell 21 valuations really increase meaningfully.

Now it's important to also note that while valuations have come down, they haven't come down meaningfully say 10, 15% nationally off the top, but if you go back five years, you're still 30 to 35% nationally up on the basket of commercial real estate value. So you're right to highlight that spike. Late 2020, 21 is an era of vintage that would be a natural look for. But by and large, if you think of a portfolio having something like a five-year average vintage, a 10-year asset that's five-year vintage, you're still well above your value from a 2018 to today. So it's idiosyncratic in that unique vintage, it's not broad based for the industry, just to highlight that.

Michael Ward:

Right. Okay. And so that's really interesting. Thank you. Maybe somewhat specifically, there have been newer buildings in urban areas like New York. I think the West coast is somewhat unique, but there's new buildings that have gone up in recent years. So just maybe, in terms of geography and just thinking across the life or the insurance balance sheet spectrum, we've had some companies sort of tout that they have focused, whether it's direct loans or CMBS exposures, but they highlight the fact that they have to focused in maybe smaller office buildings or in more rural areas, maybe away from cities whereas others have touted, "Look, we are bigger in the urban transportation hub areas, so there's more demand there." Curious if you have a view on, not if one's better than the other, but I've personally been trying to reconcile that dynamic, not just from a pure credit risk perspective, but I've got to imagine that maybe the relationships with the borrowers are stronger in different components of the size. But before rambling, just curious, geographically, if you have any sense for office specifically where there is incremental challenges or maybe not.

Matthew Toms:

Right. So I just start by reiterating that the Voya portfolio were generally very diversified and we tend to skew heavily away from the primary major metros, large market, you can call it fly over, you can call it

Tier Two, Tier Three, much more diversified. We think you get better value there and you get less volatility. So that volatility, if you say growth trends and demographics, volatility in valuations on the coast has been higher. Volatility can be very good for equity investors. Volatility is generally not something you're seeking from a debt investor standpoint. You don't get the up, you only get the down. And so generally speaking, if given the option to diversify across a broad array of markets or be exposed to higher volatility, larger markets on the coast, all else equal equity should push to the coast and debt should push to the middle.

And then the economic game of the market starts there end. So our exposure is very diversified. We think that provides more stability. We actually think it provides better recoveries and better income over time because you're not fighting to put out really big tickets that perversely as you get larger in size, sometimes you get lower in yield. Now, large markets also if you're in them, can tend to correlate, so not all property in New York or Washington DC is going to correlate, but it's going to correlate more than a diversified array of things across a broader array of cities in the US that have different drivers from the medical industry or the defense industry. And you think about some of the industrial bases that are doing incredibly well right now and the industrial properties types and real estate types across hotels and beyond. So correlations don't help debt balance sheets because things start to act, not like a diversified portfolio, they act like a systemic portfolio. So we like diversification. As you're in big cities, you tend to lose some of that.

And if I would just throw out a place, we don't have a whole lot of exposure either, DC, there's been an auto correlation of the government saying, generally "Work from home and can you get you back?" And so DC has had one correlating decision of the government, in office or out of office, that's driven a lot of property values. And so when we step back, that's something we're not heavily exposed to... And as a debt investor, we'd always rather be more diversified so that your risks don't end up aggregating against you. We feel extremely comfortable in where we're positioned. So our opinion is diversification in quality is the way to win in the debt markets, and that's why we're up in quality and more diverse than most of our peers in our opinion.

Michael Ward:

That is super fascinating, especially with the equity versus debt coast versus rural. Hadn't heard that before, so thank you. It really makes sense too, I think. So it sounds like solid diversification, solid resolutions so far. And you guys are of course monitoring it heavily. But if we were to, and this is not a Voya specific question, but if an investor were maybe skeptical of life insurers overall, in terms of, if we look at the maturity schedule for the bulk of, or just across office, it looks like we have seen... There is a pretty solid chunk of office maturities coming due in 23, 24, 25, whereas maybe 26, 27, 28, it has looked a little bit lower. So I'm just curious, I've got to imagine that there has been some or there has been amend and extend across the sector, right? But are you able to sort of qualify, maybe, to any extent that you guys

Michael Ward:

... guys have been working with borrowers, which is a competitive advantage when you're lending directly to a borrower on an office property or any commercial real estate transaction. You have that relationship and you can work with them. And so that can help stave off fear or more negative outcomes if you didn't have a relationship. But if we look at the bar charts, and again, not just for Voya, there is a good amount of maturities it feels like in the next 1, 2, 3 years. So is there a chunk in there that you have worked to extend or is it just a function of when you had underwritten them more so?

Matthew Toms:

Yeah. So it's a good question. It is a bit of an industry question and Voya question. So I'll start with the Voya question. We had put on page 28 of our quarterly that maturity schedule for office specifically pretty light over five years and it's about a hundred million dollars this year and next. And you'll note that our schedule A, which is REO, doesn't have anything other than our offices that we own and work in. So we have not been... You're always ready as a real estate lender and we have a 50 plus person team. We've been doing this for decades. You are always ready, including during the pandemic where we were very proactive and ended up with a fantastic credit track record that is well proven out to where when you work with your borrowers and you find the best mutual path forward, it's typically not give the keys back and we just haven't seen that.

Does it happen in this business? It does. But again, we have a team that's been doing this for decades. We don't think our maturity schedule looks particularly intimidating. I would say that maturity is typically in the debt market you like because you're shorter, less things can go wrong in a shorter period of time. In this environment, it's right to focus on what comes too is then exposed to the financing market of that time. And the one area of the market where you're seeing the most acute concern is in office. So you can have good things happen to bad property... Bad things happen to good properties. It can happen, just like good companies can be underfunded at a time of rolling debt. So the maturity schedules matter. I think ours, it's very nicely spread vintage and our quality is very high.

But even then within commercial real estate, I think there's enough. What you're seeing is differentiation to where the equity is having a hard time finding the home, but if there's equity value, the debt will be there. It's generally not the debt pulling the rug out for refinancing. If there's equity value, the debt will work with the equity to get around the corner. I think that is only beginning though, Michael. I think it's a really good question, but why some of the turnover has been so low and where new financing opportunities has been low is that equity is sitting still waiting to figure out what their value is. And that's likely, we think, that's starting right now. It's likely to build over the next six to 12 months. Only as the equity decides to move or refinance, do you really have the new debt issuance opportunity? So right now you're not seeing in the debt side, it's more the downside for those who have equity portfolios. Our portfolio is debt as we mentioned.

As that occurs should provide opportunities for lenders over the next 12 to 18 months. But the equity side is slowing it down. But you're right to look at maturities typically viewed as a good thing in the bond market, not currently a good thing. And where you have the biggest concerns are trophy properties, big floating rate debt stacks that can't be refinanced or can't carry what used to be a 3%, 4% rate up to an 8, 9% rate, lenders who didn't put caps in place. We put caps in place to protect our borrowers. So there is a subsegment, but today it feels idiosyncratic, not systemic within the CRE market.

Michael Ward:

Got it. Super interesting. And yes, totally. So if we look at the bar chart on page 28 of the presentation, it is a nice diversification across maturities, six and a half percent in 2023. Yes. And the bar chart, sure, maybe it's higher than 26, 27, but it's still mid-single digits. It's not a huge chunk. So I definitely hear you on that and didn't mean to imply that it did feel front loaded. It does feel like for some out there there is a little bit more of a front-loading aspect. So I think it'll be super interesting. But maybe like you said, it'll present some opportunities. So super fascinating.

So maybe just on the watch list for you guys, I would imagine that you have one internally, whether it's on your office portfolio or overall CRE or just overall general account. Curious how that looks if you've added loans to the list, and maybe not just on your own balance sheet, but is there a broader list

industry wide where that can maybe feed inputs into your watch list, but curious how that's trended year to date?

Matthew Toms:

So I'll start with commercial real estate and then maybe expand more broadly, because I think there are two different stories there. So generally, as I mentioned, no delinquencies. The portfolio is performing well. We do view the watch list as benign. It has grown modestly. Our CRE, our commercial real estate watch list has grown modestly. And that's just the nature of seeing what rents are and what current day valuations are. But again, we're starting at a very high quality portfolio. The average holding size, $11 million on a loan means we're no loan over a hundred, unlikely to have that idiosyncratic hit, which is really what you worry about is big hits or correlating hits. So we're really happy with where we're starting.

You did see... Actually call it out. Our CMM1 and 2, I mentioned before, just the vast majority of our CMM 1 and CMM 2 exposure that's tied to LTV systematically by the NAIC and that service coverage ratios. You saw a slight, a modest tick up in our CMM3 exposure. And that's really tied to interest rate moves to where we have floating rate loans to where the mechanism doesn't take into account that we have our issuer, our borrowers buy an interest rate cap. So they're insulated from the move higher, but their debt service coverage ratio will actually be reported lower because their interest cost goes up, but they own a cap. The value of that cap insulating them from the interest rate risk going higher because they're receiving that cap doesn't get calculated in the score.

So we're clearly on the outlook for issues. We know there's a headwind in the CML industry, but even on a CMM1, CMM2 score, the increase is really modest and we're starting at the higher end skew of the marketplace. So nothing that I really call out. We're in active dialogue with borrowers and we're ready to do what's necessary. But when you're starting from an average LTV and debt service coverage ratio where we're starting from 2.1 times debt service coverage ratio and 42% LTV on our broad portfolio, you're starting from a position of strength and that's key.

So not yet, but we expect the cold winds to continue in commercial real estate for a couple of years and that'll bring the opportunities. More broadly in credit... And this is important because credit markets overall, as you have more areas of pain, the debt markets have trouble sustaining all those different areas. You're not seeing anything like this level of pain in the broader corporate bond markets. So insurance company balance sheets and broader investors aren't experiencing pain in the investment grade corporate market where the spreads are currently 122 basis points, which is about a below a long-term average. 150 for triple Bs is not sensational in any way, shape, or form. It's actually kind of tight.

Default rates in high yield and senior bank loan are expected to increase, but from 2 to 3% levels. High yield spreads are 376. Arguably, that's through the long-term average. And even the triple C component is below a thousand where it had been 1100 recently. So you're not seeing broader signs of stress and nor are we seeing that in our credit migration broadly. And so what that means is corporate credits behaving well. And when you have a pocket of commercial mortgage related debt that does have some headwinds, it's not doubling up on your capital consumption. Now for us, neither is hitting our capital consumption in a meaningful way. And so we feel very strong. We're going to remain diligent. We're starting at a fantastic starting point. But really, you're not seeing it yet. You're not seeing a meaningful credit cycle on the corporate side.

Michael Ward:

Okay. Super, super interesting. Maybe just on the rating agency topic and migration, curious from your perspective over cycles that definitely go back further than my career, I would imagine. As we move

through these periods of higher rates and bouts of credit fears, we've tried to anticipate credit rating migration occurring at a greater frequency. It seems like credit rating agencies these days are a lot more sophisticated than maybe they once were. And at the same time, post-financial crisis, I've heard the phrase, "A triple B is the new triple A," or something like that or vice versa, just given how post financial crisis credit rating agencies have evolved.

Curious, should we be expecting credit rating agencies... In your view, should we expect if things get worse across the sub-sector, across the CRE landscape, should we expect maybe quicker action on behalf of rating agencies? Should we be looking at downgrades and whether it's not direct originated loans or maybe it's CMBS or REITs or something like that, but are you more comfortable with using rating agencies and migration as maybe not a leading indicator, but is it a better view at the state of things beyond what we see in headlines these days?

Matthew Toms:

So it's an important question. I'd start by saying that in general, spreads... And I just quoted IG credit 122, high yield 376... Spreads tend to be a leading indicator. Ratings tend to be a lagging indicator. So I'd maybe frame the question as are they lagging less than they used to? And I'd say that that's fair. And with all due respect to the rating agencies, their job is to give more of a state in time opinion as opposed to, "I think the world is going to turn into something," because we don't want an opinion on top of opinion. So they should never be quite as forward looking as the market. And I do think the gap is closed. Where the agencies are more prominent is in the CMBS market. But I would say that in the securitized market in general, the agencies still are much less proactive as they are in the corporate credit space where they are highly attuned to earnings trends, leveraged trends, belief in management trends. And it aligns a lot more with the equity markets, which give a lot of daily input and influence.

And the securitized markets, in my opinion, there's still a lag. We're re-underwriting individual collateral. And again, we have 50 people looking at our loans that we make. Agencies struggle to keep up with the collateral analysis at an in-depth level when there's idiosyncratic risk to it. You can look at a pool of high FICO mortgage or high FICO car loans and you can pretty quickly discern what's going on. You look at a pool of commercial real estate in a CMBS or in a CMO, it's harder analysis. It's this building is different than that building. What's the rent role? I don't think the agencies have caught up materially in that space, but I think the markets are showing you in the CMBS market, there is a huge increase in spread in triple B CMBS relative to triple A.

And recently you've actually seen a meaningful rally in triple A and double A CMBS spreads. So the highest quality form of the securitization, which has 20 or 30% of subordination of other tranches below it, those are rallying aggressively as debt investors are saying, "Yeah, there's some pain but not enough to impact the single A and triple As," where the triple Bs are trading as if they're more double B or single B rated and the agencies have not caught up there yet. So I do think that lag still persists in more specialized markets. I would agree with you that it's closed meaningfully in corporate credit markets.

Also, just to be clear, our credit portfolio is 54% NAIC1 and 44% NAIC2. So it's heavily investment grade. We're at our lowest level of below investment grade as a public company, 4%. And so we're entering what can become a bit more of a choppy credit cycle at a really good position. But I also want to make clear, because your question's really important about triple B, credit risk is not linear. In credit, you get your coupon back or you get a default and you got to assume a 40 to 60% loss. So as you move below investment grade, the risk increases exponentially. So single light at triple B, fair. It's almost linear increase in risk. As you get below investment grade, it's an exponential increase in risk. And I wouldn't confuse those two topics. I think that's very different as you go below investment grade and we're the lightest positioning we have been in NAIC3 in our public market existence.

Michael Ward:

Got it. Thank you. Yeah, no. That's great to see. And I would imagine a function of the business simplification that Voya has been doing over the last several years, which is definitely positive, I think. So that's tremendously helpful, Matt. Maybe while we're on this topic, combining two questions into one, are there any asset classes that you are staying away from, whether it's this year or last couple of years where you see maybe incremental risk and then maybe multifamily that has gotten some attention, not nearly as much as office? But curious

Michael Ward:

... what from your perspective, if you are seeing stress emerge in multifamily as well.

Matthew Toms:

So I'll start with your first, are we staying away from anything intentionally? We're not. You're always looking to build a portfolio through the cycle. You're looking at risk return and opportunities and we start with a diversified portfolio. And when you have that and it's high in quality, it can provide you opportunities when others can't. And so if you preclude yourself, you actually take away the opportunity that you presented yourself by being up in quality and more diversified.

So we're not leaning away from anything. The natural question is, where are you leaning into? The investment grade corporate market, actually the yields available there from a regulated balance sheet standpoint, 5.5% to 6% levels are very attractive over a long period of time. So we like that space. Private credit is an area where we are preeminent, again, multi-decade, a leader in the space and attractive yields with more downside protection. So we like that. And as I mentioned in the stressed environment, very selective, but the commercial real estate market, we think over the next 12 to 18 months, again preeminent franchise, 50 plus person team, that will be an opportunity for us to the extent that there's others that have to leave the market or a constraint that provide opportunity for us.

So let's get into multifamily. So generally that's a no, we're not avoiding anything and because the quality of our portfolio doesn't force us to in any way, shape or form. Multifamily, I would frame as really the abatement of strength versus the prominence of weakness. And so again, when you lose upside, that's an equity holder's problem. It has to be the creation of downside to create a debt holder's problem and you're not there yet in the multifamily space. And so we're really not. While you can take the top off a bit, that's not what bond investing is about.

So I think it's too early to say there's a big issue there. There is, however, a lot of supply coming through in class A large market properties, which rhymes with our earlier conversation about don't worry, the big shiny markets will be fine. Well that's where the most supply is coming through. So you will see some degradation in values, but we think that's mostly an equity influence.

If we think about vacancy rates, they are going to rise modestly but likely into say a 7% range. With rent growths moderating, we look at this closely because of inflation likely into the mid-single digits, low single digits, low single is probably fair. Those aren't bad numbers for the debt investor in commercial and resi real estate multifamily. They might not be exciting for equity holders. That's a different game and I wouldn't extrapolate that lack of an upside in equity to the downside in debt. The last thing I mentioned from a debt investor standpoint, the federal agencies are always present in the multifamily market and that provides another avenue of capital in a stressed market that provides financing. And so there's extra downside support from a government financing through the agencies if it were to get destabilized, which is nowhere near. But if it were to get destabilized, the government financing does provide the ability to roll loans better than markets where the government agencies are not active.

Michael Ward:

Okay, wow. Yeah, that makes a total sense because it's housing, right? It's arguably more systemic or it's more important for the federal government optically to do that. I hadn't thought of that.

Matthew Toms:

They do. And Freddie and Fannie can be viewed as crowding out private capital during good times. They can also be viewed as lenders. If the store and clouds develop, they can provide a floor. And so that's an area, it's the biggest individual sector of our commercial real estate portfolio. We laid that out, I believe on page 27 of our filing. Some of that, so you can stay up in quality and you have more resilience through a cycle.

Michael Ward:

Got it. Thank you. I was going to ask about private credit later on in the discussion, but maybe bringing that up a little bit earlier, since you touched on it. Seems like a key strength of Voya Investment Management, we have been hearing a number of life insurers specifically speak about this area as a growth spot, but you guys seem well positioned to partake in that growth. Just curious, maybe if you can characterize that a bit more granularly for us. And then how do you see this asset class evolving over time? At least in my career, I've seen interest, whether it's on general account balance sheets for insurance companies, it's just grown as an allocation throughout the entirety of my career it seems. And I think it makes total sense to capture liquidity risk without taking on incremental credit risk.

So just curious how you see this asset class developing over time. Also, it seems like it might get a little bit more competitive, so could that yield alpha maybe come down a little bit over time, but still it seems like a strong asset class. Anything on private credit?

Matthew Toms:

Yeah, no thanks Michael. So it's 20% of our balance sheet laid out in our financial statements. It is an area that we view ourselves as preeminent within both on our own balance sheet investments as well as a very strong array of external institutional clients that hire us. We have a large business with 60 plus institutional clients that we invest money in the private credit markets for as well as in our commercial real estate franchise. So it's something that it both benefits our balance sheet, but our size and scope. Also benefits our market access for our balance sheet, which is key because what's happening in in the private credit investor grade market, it used to be a little clubby, a little insurance heavy, made a lot of sense to pick an extra 70 to 100 basis points of income and lose downside risk.

That was viewed as kind of boring, honestly to the broad external marketplace. In the era of low interest rates that became a lot less boring. Picking 100 or 70 plus less downside mattered to a lot of people and it opened up a lot of doors. And what I'd say is happening is the access to the deal flow there is going to become more and more something that is resigned to those bigger players in the marketplace that are fully formed, large teams, multiple decades, large legal teams workout capabilities. It will become clubier again for those who control the access points and the distribution points. That's what's happening now. The market has grown actually as all private markets have grown and it provides a nice offset to some of the volatility and the rating agency's nuances in the public markets. You can have a diversified array of components, but I think the bar to be an active player in that market is increasing.

We are the largest provider of external client management for private credit that benefits the entirety of our investment management business. What I see is happening is the access to that market is probably going to get harder as you have, it won't be a handful but say 20, 30 large institutions continue to invest there. It's harder for the very smaller institutions to participate. So I think you're going to see a crowding

out effect and we provide a service of access for many of the mid to smaller size balance sheets that want to access. It's an attractive business that we have.

The one thing I would mention though, with rates rising, you're seeing some issuance slow down a bit, and so the deal flow is slowing, but at the same time some of the demand from insurers who want to increase their liquidity has slowed. So you've seen a nicely balanced market, but per your question, will the value go away there? Is there going to be too much demand? Some of that demand is still auto correlated from insurance companies and generally speaking, there's a skew towards stained liquid right now. So we're seeing actually more opportunities in the micro cycle, more opportunities for spread in the private credit markets, which we think will continue to be a little bit clubier going forward.

Michael Ward:

Got it. Super interesting. So maybe just quickly, when you're talking about small midsize business, private credit, origination, what types of lending vehicles are we talking about in general, can you help me sort of think about how that portfolio is spread out a little bit better?

Matthew Toms:

Yes. So if you think private credit and what issuers are in the private credit market or the nature of the debt, I think is where you're getting to.

Michael Ward:

Yeah.

Matthew Toms:

The markets are deep, they're liquid, they're actually harder to buy than they are to sell. So the liquidity is, it's a buy liquidity, which is challenging. It's an under sourced market. So generally there's plenty of people who would like to buy the paper in the secondary market if you'd want to. But think of companies that want to issue even a billion dollars of debt. And if you're only going to have a billion dollars of debt in the investment grade corporate bond market, that's not enough for the IG credit market to care or to trade. IG credit market has become increasingly liquid and tradable. And what that does is it creates a focus on the liquid traded component, some of which are an ETF form. That smaller end of billion or 2 billion issuer can often be better off going directly to a private market that's going to focus on it, structure the right deal and have long-term lenders that will be in place.

So it could be any mid to large size company that just doesn't have a big enough debt stack and still have very strong single A or triple B credit metrics. Or it could be an international company that doesn't want to register with the SEC to have to issue financials in the US. It can be very large multi-billion dollar debt stack companies, 10 plus billion who are international and find the private markets the more convenient way to access what is a big buyer base. And then you can also have more structures, infrastructure or private asset financing. So you'll get an array of what is different, but a lot of it is actually corporates that just choose to issue in that space or infrastructure or asset back lending.

Michael Ward:

Okay. All right, thank you for that. And then just for those on the line or tuning in, I believe it says on the screen, but if you do have any questions, please email me at michael.ward@citi.com. Matt, I have a few in here now. Some we've touched on, but one was specifically on consumer credit and how you're assessing that risk across your portfolio, maybe between sectors, at least in my, over the last several

months, my take is that consumer credit has hung in there pretty well historically even, so curious if anything in that regard?

Matthew Toms:

So I'd start with, it's a bit of a macro statement, but what's unique about this credit cycle or the turn in the credit cycle that really hasn't happened yet is that there is a fiscal transfer of a couple trillion dollars into the US economy. And so typically late in the cycle you've got consumers and businesses that are stretched. That's not happened. Actually consumers were topped up and you're only now depleting the middle income consumers component of that excess savings. And so you didn't have stress in the consumer or the corporate end of the economy into this rate rise cycle. So people are wondering how high do you need to take rates before people stop taking that vacation or stop buying X, Y, Z? And what you're seeing is there is a sub component, but it's only a sub component. It's idiosyncratic at the lower income consumer that is depleted their excess savings.

And the worst scenario is in October your student loan will kick back in and the car loan for the overpriced car because it was pandemic, there was low supply, you got a check, you bought a car, you took out a subprime auto loan, that car has gone down by 20% in value. That's a problem. But there's only so many of those in the system. So again, you're getting to an idiosyncratic problem. I think by and large the consumer has a mortgage, those who own a home, about a third of homes don't have a mortgage. Those who have a mortgage, you're talking about a 3, 4, 5% mortgage, which is a family asset at this point. Increased interest rates have not hurt them. It's actually helped the older generation who has excess savings that were sitting at 0% or low returns that are high return.

So I think you're looking at a consumer base even where you have areas of stress, you can still get a job. We think incomes are still likely to rise by 3 to 4% and you're at a 3.5% unemployment rate. So it's very hard to forecast something that is about to top on the consumer side. So credit card looks fine, watch out for your subprime and auto. Housing valuations look strong, look like they should start to wane here, but from a very strong position and there's not a lot of supply, so I would second, just to build on, it's hard to see too many signs of weakness in the consumer currently.

Michael Ward:

Got it.

Matthew Toms:

We can project weakness, but it's hard to actually demonstrate weakness in a meaningful way. But all that said, you are starting to see delinquencies get back to a more normal level after being incredibly low during the period of massive fiscal transfers, which really topped the whole economy off. Typically you don't see fiscal restraint into an election either, and so we're entering 2024 election year, seems unlikely that either side is going to want to look too stingy, typically doesn't happen. So it doesn't feel like there's an anvil hanging above the consumer's head either.

Michael Ward:

Got it. That's fascinating. All right. Okay. And so maybe just quickly, you may have this offhand, any exposure that you know of to Hawaiian utilities credit?

Matthew Toms:

We do. Hawaii is different components that are issued in the markets, either through real estate and hotels and beyond. No exposure that we're at all concerned about in that regard. We do, and there are dead instruments out by Hawaiian Electric. We own some of those as well. We have not announced anything and don't anticipate it to be material. Again, we have a very diversified portfolio and we are always planning for idiosyncratic components. That's the key is to make sure you don't have correlated systemic components. So that is an issuer in the market. We're aware of it and we think it's completely manageable within our normal credit process.

Michael Ward:

Got it. Okay. Thank you, Matt. I do know we only have about 10 minutes left, so again, anyone on the line, feel free to email me questions. I do have one, and this kind of actually ties into a question that I had for you, Matt, on CMBS, which is one of several varieties of structured you guys do. I know you do have a heavy skew to agency, which I think is really good, but within the non-agency it did seem like there's decent chunk of, I guess, office par. I'm curious if you could maybe speak to that and how you see CMBS and even maybe drilling down further between SASBs and conduits. But that's a lot. So maybe-

Matthew Toms:

Right.

Michael Ward:

Yeah.

Matthew Toms:

The acronyms of the debt market never disappoint, as you mentioned upfront. So CMBS, commercial mortgage-backed securities. Typically speaking, the value of CMBS is that you have diversification. So you'll have one of two sorts, conduit, which you have many loans, 30, 40, 50, 70, and you have tranching, where you can be in single A and above or further down the cap struck. Versus SASB, single asset, single borrower, where you're taking a loan to an individual property. In general, the view is that with SASB, single asset, single borrower, you can identify the property, a hotel, a series of properties owned by one company and that it's much more straightforward to identify if there's any risks.

Conduit is great because you have diversification unless you have an issue. And that issue because it's diversified matters most if you're in the triple B or below rated tranches all the way back to my prior comment to where you're seeing the spreads of triple B rated and below CMBS stay very high while the diversification benefit of all those different pools of loans in a conduit, if you're in the single layer or triple A actually benefits you. And we've seen those spreads narrow to where high quality is narrow. So key talking point is CMBS provides us the opportunity to have more liquidity and to have a higher quality skew because you can buy at the single A and above attachment points. And so, 97% of our portfolio is rated NAIC one or two. So you're in the investment grade realm and if you just step back a little further, 85% of that is single A, of that 64 is NAIC one A, which is AAA.

So we're very high in quality as you mentioned. The third is agency, which is tied to the US government and that's an issue of when the repayment happens, not if that's a timing issue. So we like the CMBS market because you can attach to more liquid securities, you get more diversification 'cause it's loans that were not just in the commercial real estate direct lending market. So you get diversification, you get liquidity, and you get quality. The issue is lending standards in the CMBS market can admittedly be lower

at times than what our underwriting standards would be in our direct commercial whole loan lending. I think most market participants would agree, CMBS loans tend to have a longer maturity, tend to have a higher loan to value. So that's the offset, but we've stayed at the higher quality end of it.

We expect more chop. The CMBS market will have some chop within it, but within our conduit portfolio, again, we're 97% investment grade rated, and we have a credit enhancement of over 20% beneath us in those structures beyond the LTV benefit and SASB, that's a 30% benefit of the structure. That's structural enhancement when you stay up in quality matters, I would go out of my way to highlight as you go triple B and below in CMBS is where the market is experiencing and is projecting you'll have more credit volatility. So to date, we haven't had to disclose any notable write-offs 'cause the portfolio's performing as expected. Will there be chopped? 100% there will be in the CMBS world. We feel really well-positioned to start.

Michael Ward:

Great. All right. So maybe trying to manage some of the inbound questions with some of that I had personally, which are aligning here. But there's been some changes in terms of NAIC insurance capital and risk weighting. Has that influenced your allocations, maybe it's between asset class over the last couple of years? Or are you expecting further changes to come from the NAIC that might make you rethink some allocations here or there, but maybe that dynamic could be a good discussion?

Matthew Toms:

Yeah, so I'll try to stay high-level. This gets really granular really quickly. So in a regulated balance sheet, the NAIC always wants to judge the quality of the assets, which is important. It's an important part of the industry. There's also importance to have inputs from other recognized components like the eight rating agencies and our SROs. And the feedback around the current proposals to let the SVO, Securities Valuation Office of the NAIC override a rating agency rating if they want to, has been pushed back on pretty aggressively by the industry and we think rightly so because you kind of get a judged jury and prosecutor element of what if the regulator's wrong.

So from our standpoint, you're always attuned to the regulatory efficiency of your assets and we feel very good about where we start. I think the intention of the regulator is to go where they think there's been more abuse and the creation of structures that would create debt from equity, for example, or really push the boundaries of regulatory capital arbitrage. That's not how our balance sheet is positioned. As I mentioned, it's generally higher quality, very diversified portfolio. I think what they're trying to go at is perhaps more aggressive manipulation of ratings that happens around the fringes perhaps in the industry. I don't think that's something that we're particularly concerned about, but there's always going to be a tension about what structure can be created by Wall Street that provides the right capital relief.

The reality is how we look at it, we're investing through a cycle, there's capital, but there's also risk and we're balancing those at all times. If you love the capital, it doesn't mean the risk went away. The capital charges are different than risk charges. And so, we feel very good about our high-quality portfolio. We have not had to change our investment strives because the SVOs approach, but I think there are securities in the industry that probably fly closer to that wind or that edge that might be impacted.

Michael Ward:

Okay. Just a couple minutes left here, maybe just the last one. So on commercial real estate overall, I'm trying to think of have been a couple months, a lot of us trying to think of the levers that you guys have that you can pull in order to stave off the worst case scenario for a direct loan or maybe not so much for

CMBS. So my understanding is that you guys are charged with keeping the valuations and the debt service coverage and those metrics up to date and accurate and tracking those. And then those metrics inform the capital charge or the CM1, CM2 rating. Maybe can you confirm that? And then, does that give you a level of control over that aspect of it? I would imagine you're incentivized to keep those accurate for a number of reasons, but maybe if you can. I think that's a question that's come up here and there.

Matthew Toms:

Yeah, so super detailed but important question. So the CM scores, commercial real estate scores are driven mechanically. So we don't get to set them, we have to follow the rules as prescribed by the SVO. It is based upon a debt service coverage ratio, which is... It's a reporting. What is the coverage over the last three years or since the time of the loan. So that is a straight calculation as the regulator prescribes and that's what we do to follow that. The other component is the LTV, the loan-to-value and it's also prescribed that we use the loan-to-value at the time we underwrote the loan and then those float, that value of the property floats with the national index of that property type. So again, it's prescribed to us how we calculate that and so that calculation comes out and that generates our CM1 and CM2 scores. So we don't think we have a lot of flexibility. We're complying with that methodology.

Now, I just want to be super clear. When we report our LTVs, the LTVs that I've mentioned, 2.1 times average coverage and debt-service coverage ratio and a 43% LTV, 42% across the portfolio. Our LTV, that's a starting LTV of when we underwrote our loans on average. The CM score LTV is slightly different for that calculation in that it floats with that National Association of Real Estate Index. And by using the LTV at underwriting, our LTV actually are pretty conservative because you still have... If you go back five years, that index for all property types is up 35% versus 2018 number, which if on average your portfolio is season five years. A beginning LTV is a much more conservative measure than an LTV on a property that went up 35% over the last five years, somewhat on the back of low interest rates during COVID. So I just want to create a differentiation between those CM scores.

Mechanically, we follow the rule. What we report is an LTV we think is a very conservative way to report that and we track that through a re-underwriting process in our watch list. You asked about the watch list. That's a process that goes on with our 50 plus member team that every loan gets touched at least once a year.

Michael Ward:

Okay.

Mike Katz:

Michael, I know, we're near time here, but just maybe a step back on all of this for you and the listeners too. I think that, when you think about just the environment we're in, and I think Matt painted the picture perfectly, we're going to continue to be prudent. We're going to continue to be disciplined with our use of capital. However, when you step back and think about how much cash we generate each quarter, 90% plus free cashflow generation and the storyline that matches presented with your good questions around where we are positioned going into where we are today with the general account. It's why we were comfortable putting roughly 200 million to work last quarter and we've signaled that we're going to do at least that amount in the third quarter. So I think just as a step back and as we're thinking about capital, of course, we're going to continue to be prudent, but that generation of cash and Matt and basically his team managing this general account is what gives us a lot of comfort.

Michael Ward:

Thanks, Mike. Super helpful. And, Matt, thank you so much for your time as well. This was a tremendous discussion and if there's anyone out there with any follow-up questions, we can work through those. But thank you again, Voya team, great talking with you. And thanks for everyone on the line for your time. Hope everyone has a great weekend.

Mike Katz:

Thank you, Michael.

Matthew Toms:

Have a good weekend.