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CMBS 3.0: An Undated Overview

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CMBS 3.0: An Updated Overview[1]

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Capital Markets Overview

Commercial real estate has been financed efficiently through the packaging of commercial mortgages into commercial mortgage backed securities (CMBS) sold into the capital markets for over 20 years. Issuance exploded in 2007 to $230 billion, then plummeted: $12 billion in 2008, a paltry $2.9 billion in 2009. In 2010, lenders returned to the market with issuance of a still anemic $12 billion. Yet investors made it clear they wanted more transparency, better underwriting, and stronger alignment of risk. Thus began an effort to bring about changes that would encourage a return to the sector by investors as well as loan originators and issuers, led in part by the Commercial Real Estate Finance Council (CREFC), a key industry group composed of participants in all aspects of CMBS. That return began anew in 2011 with $34 billion of issuance, lower than projected due to macroeconomic volatility in the summer, but still a positive direction move. A lingering malaise for the market is the uncertainty of the impending regulatory framework under the Dodd Frank Act calling for significant financial market regulations. The new and evolving changes in the market for CMBS, which include self imposed industry standards and implementation of legislative and regulatory mandates, are referred to as CMBS 2.0, and with a few capital market structure tweaks in 2011, the hopeful were encouraged to promote the "CMBS 3.0" nomenclature.

Unfortunately, the third quarter of 2012 finds recessionary conditions unabated, unemployment still painfully high, the U.S. economy barely growing, and dire European markets negatively impacting recovery in U.S. markets. Commercial real estate remains overleveraged, with over $1 trillion in loans maturing during the next 3 years. A huge equity gap remains and fundamentals do not give encouragement for a quick rebound even though primary markets are experiencing some price recovery. Consequently, owners and buyers continue to struggle to salvage fledgling properties, or refinance performing properties even though new capital sources have entered the market and traditional sources have considerable lending allocations. We do not have a lack of capital, we suffer from substantial valuation losses and market volatility.

Even with this negative backdrop, CMBS has continued the positive trajectory in issuance begun in 2011 from severe downward to upward, albeit bumpy and low. Most participants expect around $40 billion in issuance for 2012. Recent volatility in the capital markets, the European economic crisis and the instability of the Middle East temper that outlook somewhat. Congress and the Administration, rather than forging a recovery, have demonstrated an intractable partisanship offering the country little confidence they can bring about a restoration of the economy, reduction of the excessive national debt or, more importantly, a reversal of the severe unemployment problem.

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1 See, Sargent, CMBS 2.0: An Overview of Changes and Challenges, Vol. 28 Real Estate Finance (December 2011). This article follows the same format with updated information.

Meanwhile, all of Washington is now in election mode. Most pundits agree: the impending "fiscal cliff" is real and the economy is the single most important election issue. Thus, the tepid recovery for CMBS still faces many challenges.

What Has Changed for Lenders?

Lenders, chastened by investor reaction to pro forma underwriting, lack of escrows and reserves, and overleveraging, for the most part have imposed a greater discipline on new loan origination. Underwriting is more conservative, tax and insurance escrows and tenant finish reserves are more common, and cash management and lockbox structures appear with greater frequency. Moreover, lease rollover, purchase options and tenant credit risk have taken on increasing scrutiny, as investors have demanded more information about these risks. On the retail side, co-tenancy rights and "go-dark" provisions also receive more attention, particularly since retail has been a prominent property type in recent deals.

Metrics. In the past, the debt service coverage ratio (DSCR) and loan to value ratio (LTV) were key metrics for assessing a potential loan's credit risk. In legacy CMBS a typical loan would have a minimum 1.25 DSCR and up to 80% LTV. As will be shown later, those have changed to roughly 1.5-1.7 DSCR and 55-70% LTV, reflecting the more conservative underwriting. A few rating agencies and market analysts have remarked that 2012 issuance reflects a slight relaxing of this discipline, although still far better than pre-recession numbers.[2] Significantly, lenders are now using another metric that better assesses the property's ability to handle loan payment terms: "Debt Yield", which is calculated by dividing net operating income (NOI) by the loan amount and multiplying by 100%. This measure gives a more clear and consistent picture, for example, than applying DSCR measures to a loan that has a low interest rate, is interest only or has amortization variances. In today's market a minimum 10% debt yield is common.

Sponsors. Sponsor background, which has always been important even in a market that boasts non-recourse lending, has received increased focus as well. Lenders perform more extensive background searches and probe further into sponsor histories to get a better idea of what to expect when times turn bad. Usually, that includes control parties as well as any owner of at least 10% of the borrower equity.

Funding. Lenders have also been whipsawed by an increasingly unpredictable cost of funds and pricing for securitization. Even though the Federal Reserve has kept interest rates at historic lows, market volatility has made loan pricing and hedging virtually impossible. For example, spreads on 10 year triple A CMBS recently averaged 125-140 basis points (bp). If a lender originated loans at rates of 250+ over swaps, it could expect to make two points or more of profit on the securitization. However, in several recent weeks the triple A spreads widened to over 200 bp, and that profit quickly turned into a loss. In fact, a rule of thumb is that an increase of 15 bp in triple A spreads

[2] See, Standard & Poor's Financial Services, "CMBS Leading Indicators Update: Higher Leverage and Interest-Only Loans Signal Rising Risk in 2012 Transactions," (May 8, 2012).

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