CMBS Is Back

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By Richard Gatto

Although the CMBS market is no where close to the $230 billion in sales it registered in 2007, it has staged a valiant recovery with $7 billion available in the fourth quarter of 2012. Wall Street banks report selling $1.25 billion of CMBS during the week of September 10 alone. Issuance could hit $45 billion this year, partly because many loans written in 2007 are rolling over and are refinancing with new conduits. That total could rise to $58 billion in 2013 and $75 billion in 2014.

All of this is good news for the industry because the simple truth is that we can't function without CMBS. At its peak in 2007, CMBS backed 40 percent of all commercial real estate lending. The bond market remains the principal way that developers and owners convert temporary financing (often three-year construction loans) into permanent financing. Typically, this is accomplished with conduit loans, which are converted into securities and sold to investors.

In early 2012, some commercial real estate industry authorities feared that when existing commercial loans matured, they would not be able to refinance and the properties would revert to REO status for portfolio loans and special servicing for securitized debt. However, the Fed's recent announcement of low interest rates till 2015 means that returns on T-bills narrowed to as little as 150 basis points, forcing the global investment community to look for yield elsewhere. Real estate securities are a strong alternative and lenders see the opportunities in pushing out conduit loans to meet Wall Street's appetite for new CMBS issuances. Doug Mazer of Wells Fargo's CMBS lending group notes that investors are turning to CMBS because, according to Mazer, "There are just not a lot of places for investors to put their money to get relatively high yields with relatively safe investments." B-piece CMBS investors are achieving 20 percent and higher yields.

For example, Minnesota-based NorthMarq Capital arranged 46 CMBS loans totaling $525 million in the first half of 2012, more than twice the amount for 2011 when the firm organized 30 CMBS loans totaling $214 million. William Ross, president, forecasts that NorthMarq will assemble between $750 million and $800 million of CMBS in 2012. "That would be a pretty amazing comeback," Ross said. Why is NorthMarq seeing this significant uptick in volume? According to Ross, nearly three-quarters result from maturing securitized loans as borrowers arrange alternate financing.

Five-Year Low for CMBS Delinquencies but Risks Remain

CMBS delinquencies – at just 8.96 percent – have hit their lowest levels since beginning of the recession. Ninety-two percent of loans originated in 2007 that are rolling over will be refinanced at a value upwards of $362 billion. Despite the upbeat numbers, problematic loans exist. Morningstar Credit Ratings, LLC, reports that of the $4.4 billion in CMBS loans that will roll over before July 31, 2013, 8.64 percent are in special servicing. More than one third of these loans are on Morningstar's watch list. Half of 2012 delinquencies are for office properties. So what about the new loans? One source of concern, according to buy-side sources, is that CMBS transactions with riskier collateral are becoming common. For example, a UBS/Barclays conduit included loans for regional malls in secondary markets, a challenging investment. "All it takes is for one mall to go bad, and the B piece buyer is wiped out," according to the head of CMBS investing at an asset-management firm. A

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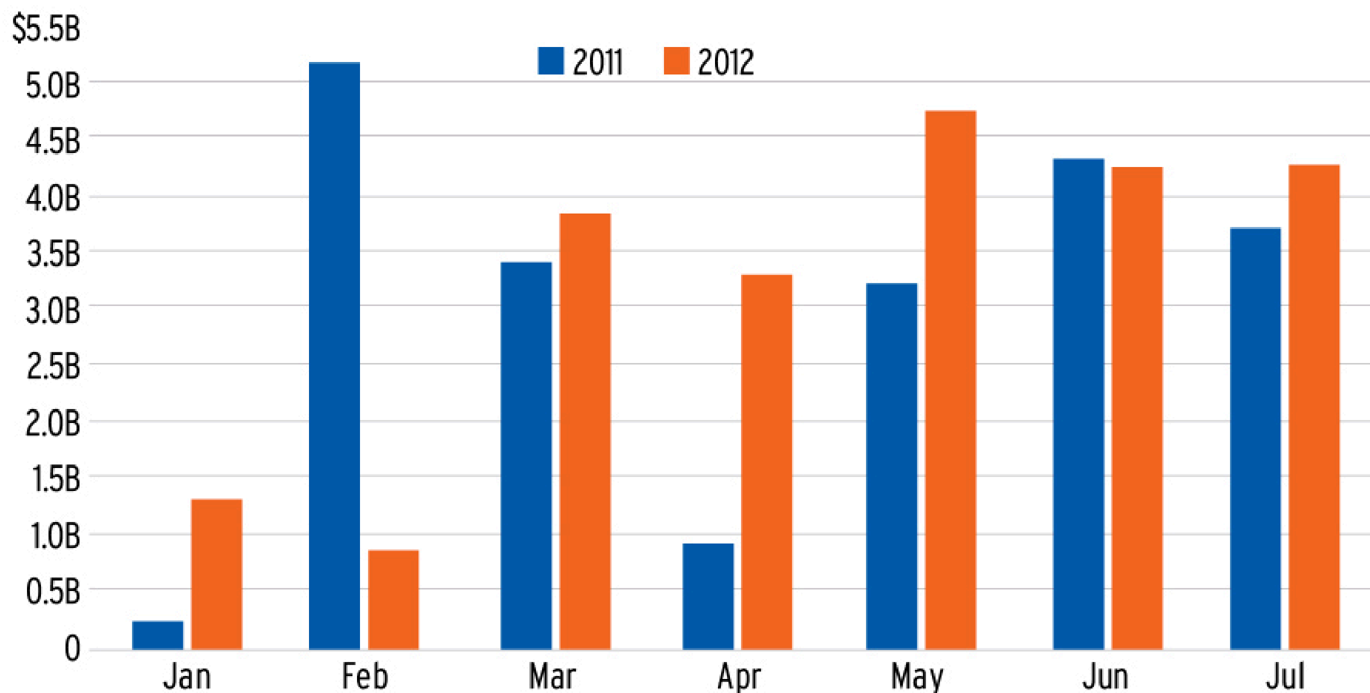


Citigroup/Goldman Sachs conduit included a loan for a Florida mall which hypothesized that the tenants would be able to pay rent increases in five to 10 years. Another deal included a half-empty Manhattan office building that had no guarantee that any attempt would be made to lease the space.

Even with rising risk, CMBS investors know that it is far below the levels seen before the financial meltdown. Because investors have limited options for where to put their money, they are opting for CMBS.

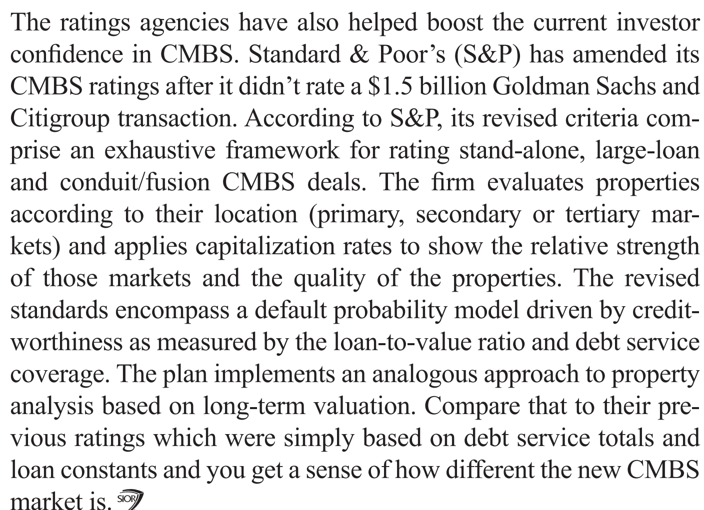
Constantine Scurtis, CEO of SL Capital, a correspondent lender of Cantor Fitzgerald Commercial Real Estate (CCRE), informs B-piece buyers of the risk early. "It's almost like they're part of our credit committee," he said. "We're showing them everything before closing—almost like getting pre-approval from them because we don't want to risk any kick-outs."

These B-piece buyers "Don't want any fat in the underwriting — the loans aren't based on future cash flows, but on existing rents. We're even writing down rents if we think they're higher than market, and we're including rent rollovers. They're not interested unless the loans are for stable, quality assets.

The New Conduit

At present, the securitization market is in a good place: Borrowers considering CMBS loans will find available money at attractive rates, primarily because investors have achieved a comfort level despite the risk. Much of CMBS' current status is because lenders have moderated leverage and increased transparency. As a point of comparison, while portfolio lenders will make non-recourse, loan-to-value (LTV) loans of up to 65 percent; CMBS lenders will go as high as 75 percent. Although the LTV is not at the 90 to 95 percent level that prevailed before the financial crisis, it is loosening the credit market and creating liquidity. Fixed-rate CMBS loans are now around four percent, only slightly above what insurance companies are quoting. There had been concerns that the LIBOR scandal might affect CMBS but in truth its impact is minimal: if the conduit loans behind the CMBS were floating rate loans, they would have been pegged to LIBOR; however, considering that interest rates were kept artificially low by the LIBOR banks, borrowers benefited from even cheaper money while investors saw lower returns.

S&P Issues New CMBS Guidelines



The ratings agencies have also helped boost the current investor confidence in CMBS. Standard & Poor's (S&P) has amended its CMBS ratings after it didn't rate a $1.5 billion Goldman Sachs and Citigroup transaction. According to S&P, its revised criteria comprise an exhaustive framework for rating stand-alone, large-loan and conduit/fusion CMBS deals. The firm evaluates properties according to their location (primary, secondary or tertiary markets) and applies capitalization rates to show the relative strength of those markets and the quality of the properties. The revised standards encompass a default probability model driven by creditworthiness as measured by the loan-to-value ratio and debt service coverage. The plan implements an analogous approach to property analysis based on long-term valuation. Compare that to their previous ratings which were simply based on debt service totals and loan constants and you get a sense of how different the new CMBS market is.