CMBS *Hits a Wall*

BY DAN SMITH AND TODD RHODES

The subprime-induced meltdown in the capital markets last year changed the rules of the road in the commercial real estate market.

Imagine a hot NASCAR race in which a yellow car, a blue car and a green car are zooming along several laps into the race. The yellow car spins out of control as it banks around a curve. It smashes into the blue car, which ricochets into the green car and careens onto the apron. The green car recovers and drives ahead. The yellow car slams into the wall and bursts into flames. The blue car is hardly damaged, but getting back into the race is difficult—the course has shifted and requires new strategies. ● In 2007, a vibrant commercial mortgage-backed securities (CMBS) lending market was essentially pushed off-track by a residential subprime mortgage market that crashed and burned, and by unanticipated changes in rating agency practices. ● The result was a sudden credit and liquidity crunch that dramatically changed commercial real estate's "rules of the road" for 2008 and perhaps even longer. ● When lending conditions diverge as much as they did in early and mid-2007, it is worth asking which conditions are anomalous. Although the early part of 2007 was no doubt a borrower's ideal, the market had strayed into aggressive underwriting standards and loan structures that could have become problematic.

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The adjustment that began in mid-2007 and continues today is a return to the conservative underwriting and deal structures that have typically characterized CMBS lending and mitigated the risk of delinquencies, defaults and overbuilding. Although the short-term effects may be painful, 2007's correction should prove positive for CMBS financing and commercial real estate in the long run.

A credit crunch in the making

The volatility and credit crunch that appeared almost overnight in 2007 can be directly traced to two events: the collapse of the residential subprime mortgage market and aggressive commercial real estate lending practices in which lenders emphasized volume over pricing for risk or profit. Credit rating agencies' adjustment of subordination levels on all CMBS products also contributed to changing market conditions.

Initial indications of subprime mortgage weakness appeared in late 2006. They accelerated quickly in 2007 when it became clear that the asset class was fundamentally flawed. The value of bonds collateralized by subprime mortgages plummeted, creating significant losses for many investors. Losses for collateralized debt obligation (CDO) investors, in particular, were so heavy that the market for new CDO issues collapsed.

Unfortunately, many of these investors were also buyers of bonds collateralized by commercial real estate loans. Some investors—particularly leveraged investors such as special investment vehicles (SIVs) and CDOs—stopped buying CMBS bonds altogether. The loss of these investors disrupted a number of pending securitizations and completely eliminated buyers for certain CMBS bond tranches.

In spite of sound commercial real estate fundamentals, investor confidence was badly shaken. Remaining buyers of bonds collateralized by commercial real estate loans began to question their stability. Concern that commercial real estate—like subprime mortgages—might also prove more risky than previously believed sparked two trends: First, investors began requiring higher yields on CMBS bonds. Second, reduced investor demand made it virtually impossible to sell some CMBS bonds.

The resulting yield widening was substantial. The first few securitizations of 2007 priced at 22 basis points over the swap curve for AAA bonds. By early August, securitizations were pricing at 76 basis points over the swap curve. Spreads have narrowed and widened since then; at times, spreads for AAA bonds have spiked even higher than 100 basis points over the swap curve.

Some tranches experienced even greater volatility. The spread on BBB bonds was 68 basis points over the swap curve in early 2007; it hit 750 basis points in the winter and climbed as volume outpaced demand in the fourth quarter of 2007.

Investors also began examining loan pools more carefully. Although it is common for investors to reject a few loans from each pool, they began to do so much more actively in mid- to late 2007. Below-investment-grade loans that featured aggressive underwriting and/or structuring were particularly susceptible as investor preference swung toward higher-quality loans.

A significantly smaller investor base, reduced demand for CMBS bonds, loss of investor confidence and dramatically wider spreads over the swap curve would have been more than enough disruption for capital-markets lenders and the commercial real estate market to grapple with. But additional challenges loomed.

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The rating agency role

Early 2007 was the epitome of a borrower's market, thanks to avid competition among lenders that fueled increasingly aggressive underwriting standards and loan structures. Borrowers were no doubt pleased, but rating agencies became concerned that underwriting practices were too risky, even though commercial real estate fundamentals remained strong.

As the subprime meltdown gained momentum, rating agencies issued comments that commercial real estate finance had become overheated and that continuing present practices could lead to higher delinquencies and defaults.

Investor confidence in bonds collateralized by commercial real estate slipped further, requiring even higher yields.

Rating agencies also adjusted the subordination level on every pending securitization. Essentially, they decreased the proportion of bonds that qualified for investment-grade ratings and increased the proportion of lower-rated bonds in each securitization. Because lower-rated bonds command higher yields that cost lenders more, this move made every pending securitization unprofitable and contributed to future widening of origination spreads.

The new lending environment

Between shockwaves from the residential subprime mortgage meltdown and revised rating agency guidelines and subordination levels, CMBS financing in summer of 2007 looked very different than it had just six months earlier.

Liquidity had evaporated. For many lenders, substantial capital was tied up in delayed securitizations and bond tranches for which there were no buyers. A number of lenders stopped reviewing deals and providing quotes.

Other lenders stayed in the market, but widened origination spreads substantially. Spreads hovered near 210 basis points by fall of 2007 and reached as high as 280 or more by late November. For comparison, spreads of 80 to 90 basis points were not unusual in late 2006.

Although a few lenders remained committed to deal terms they had quoted regardless of the losses they would incur at closing, many more lenders took the prudent path and placed shareholders' interests above clients' aggressive expectations, by repricing and/or resizing pending transactions to accommodate new conditions. Deal disruption was a common consequence. According to a survey of 332 commercial real estate executives conducted by global law firm DLA Piper in September 2007, 63 percent of respondents experienced deal delays or cancellations.

The considerable increase in financing costs was not the only outcome of the credit and liquidity crunch that hit CMBS lending in 2007. Obtaining financing also became more difficult.

Stricter standards and structures

With rating agencies questioning the reliability of commercial real estate loans and investors accepting only higher-quality loans, CMBS lenders had little choice but to tighten underwriting standards and loan structures.

The aggressive underwriting, high proceeds, low debt-service coverage, interest-only features and creative structures to which mortgage bankers and borrowers had been accustomed vanished almost overnight. In their place, mortgage bankers and borrowers found CMBS lenders examining potential transactions more closely and underwriting them more conservatively.

For example, lenders focused on underwriting in-place rents, stabilized cash flow and tighter definitions of net operating income. Debt-service coverage ratios widened considerably: In early 2007, debt service of 1.05x on an interest-only loan was not uncommon. In late 2007, lenders were insisting on debt-service coverage of 1.15x to 1.20x on a loan's amortizing constant.

Borrower equity became a requirement. Full-term, interest-only loans largely disappeared. Most CMBS lenders offered only three- to five-year interest-only periods; some eliminated interest-only periods entirely. "Storied" loans that provided limited structuring around CMBS financing to accommodate temporarily transitional properties also became very difficult to obtain, if not impossible.

Investor confidence in and demand for commercial real estate–backed bonds is likely to build in 2008.

Not surprisingly, traditional lenders such as banks and life insurance companies began to build market share in late 2007. In the past, these lenders found it difficult to compete with capital-markets pricing. But volatility and wider spreads among CMBS lenders created an opening for traditional lenders to gain market share by aggressively underpricing the market and offering more appealing loan terms.

If the first half of 2007 was an ideal borrower's market, the second half was a roller coaster. Some lenders returned to the market by year-end, although often with significantly reduced staff due to reduced loan volume expectations for 2008. Spreads narrowed somewhat. But volatility still flared, fueled by the large losses of residential and commercial lenders due to market value writedowns and/or residential delinquencies and defaults.

2008: A transitional year

The outlook for 2008 is mixed. On the one hand, it is likely to be a transitional year in which investor confidence and stability return to the CMBS market. However, this should not be confused with a recovery or a return to the aggressive practices of 2007. If volatility subsides, financing in 2008 should be available, but subject to more conservative underwriting and structuring.

On the other hand, 2008's market will continue to create challenges for many market participants. Spreads will remain wide, hovering 100 to 150 basis points higher than those seen in early 2007.

Most important, an uncertain national economy could be the deciding factor in how commercial real estate plays out in 2008.

The positives

Investor confidence in and demand for commercial real estate–backed bonds is likely to build in 2008. Leveraged investors such as SIVs and CDOs are gone for the foreseeable future, as are major institutions that lost billions on subprime bonds. But opportunity funds, drawn by extremely attractive yields, have already begun to raise capital to buy CMBS bonds collateralized by commercial real estate loans. Traditional institutional investors such as life insurance companies, pension funds and opportunity funds are also returning to the market.

This investor base should reduce yield volatility, as traditional investors that buy CMBS bonds for their actual yield replace leveraged

investors that purchased CMBS bonds for a leveraged yield. In addition, overall investor confidence should improve in 2008 as the warehouse of loans originated under the old standards clears by midyear.

Improved liquidity, reduced volume

Liquidity should also improve in 2008. In addition to growing investor demand, many capital-markets lenders that left the market in 2007 will once again provide financing. As a result, CMBS financing for solid deals across all property types and geographies should be readily available in 2008.

Nonetheless, CMBS origination volume is likely to reach only half of 2007's level. This is largely due to a gap between buyer and seller expectations. Buyers facing more expensive debt and lower proceeds will pay less for acquisitions. However, sellers whose properties are performing better do not yet see any reason to accept reduced prices.

Buyer and seller expectations should adjust as cap rates rise in late 2008 or early 2009. Industry experts have projected cap-rate increases of at least 25 to 100 basis points over the next two years, with actual increases varying by market, property type and property quality.

Traditional lenders are likely to gain market share in 2008, largely by offering more aggressive pricing that undercuts most CMBS quotes. However, the lower proceeds and shorter-term financing these lenders typically provide may not suit all borrowers. In addition, portfolio lenders will likely widen their own spreads to avoid underpricing the market by too much. They will also require structural features that are common in capital-markets lending, such as reserves, amortization and standardized loan documentation.

Reduced transaction volume in 2008 will continue to present challenges to mortgage bankers and borrowers, as will the smaller pool of lenders from which to obtain financing.

It will also be a year in which selecting a lender based on price and proceeds will be extremely risky. Mortgage bankers and borrowers will be much better served by lenders that continued to lend throughout 2007's ups and down, have adjusted to new conditions, and have deep resources to withstand market fluctuations. Relationships among mortgage bankers, borrowers and lenders will become increasingly important as parties work to adapt to and complete transactions in a changing climate.

In spite of 2007's disruption, capital-markets financing will remain a viable alternative for borrowers seeking long-term, non-recourse loans in 2008. Mortgage bankers may need to work harder to educate borrowers about the opportunity capital-markets financing offers and what is required to take advantage of it. They may also need to educate borrowers about traditional lenders' changing requirements.

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The wild card

The direction that the national economy will take has the greatest potential to affect commercial real estate in 2008. On the positive side, the economy continues to grow (albeit more slowly), while compensation and employment are strong.

Yet oil prices are at historical highs, credit markets are distressed, major institutions have not fully identified or written-off their subprime losses, and the impact of a slower housing market and potentially falling home values is not yet clear. If consumers respond to lower housing values by reducing the spending that has shored up the economy in recent years, the ripple effect could tip the economy into a recession, with significant implications for commercial real estate. This risk supports the need to apply more conservative underwriting standards to new transactions.

If the theme for CMBS lending in 2007 was a racecar shoved off-course by unanticipated events that threatened investor confidence and fueled volatility, the theme for 2008 is a slower, more stable car that rejoins the race with a focus on credit-appropriate lending.

Although returning to stability may prove challenging—complicated by economic uncertainty—commercial real estate lending was riding a course of aggressive underwriting and loan structures that could have become problematic in the long run. Instead, the disruption that knocked commercial real estate off-course in 2007 has already steered CMBS lending in a more conservative, steady direction.

The transitions that take place in 2008 should help the market return to the stable, credit-appropriate lending that has traditionally characterized CMBS lending and helped reduce delinquencies, defaults and overbuilding. By early 2009, more conservative underwriting and loan structures should foster predictability and reliability—and once again make capital-markets financing the preferred source for long-term commercial real estate finance. **MB**

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