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CMBS Dislocation and its Impact on Commercial Real Estate
(March 30, 2016)

Despite a steady recovery for CMBS in both issuance and pricing since the financial crisis, 2016 has been challenging. Market uncertainty has led to a contraction in the pace of CMBS lending and an increase in the pricing of the underlying loans, which in turn negatively impacts commercial real estate values. Year-to-date CMBS issuance levels are nearly half of last year (YTD 2015), while AAA spreads are approximately 50% wider (at swaps + 138bps). While traditional lenders such as banks and life insurance companies are filling in the CMBS gaps, at least in part, the absence of a robustly functioning new issue CMBS market is causing all market participants (both CMBS lenders and property owners) to slow their pace of acquisitions and to more carefully consider their exit strategies. On the CMBS front, four major factors are contributing to the dislocation.

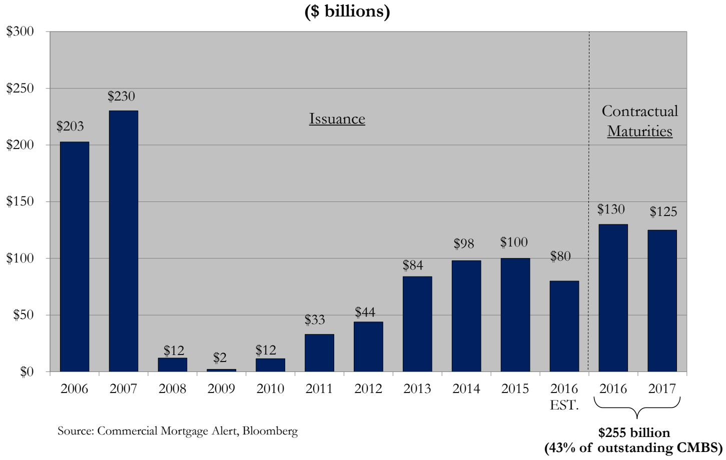
Market Uncertainty. Dislocation in the high-yield and corporate issuance markets has had spillover into CMBS. Global volatility and interest rate uncertainty has also put a number of CMBS buyers on the sidelines. Together, these factors have materially decreased new issuance and CMBS lenders' willingness to make loans.

Regulatory Pressure. CMBS lenders are facing new regulatory pressures that are increasing capital charges and calling for greater liquidity. These new requirements are curtailing CMBS lenders' appetite/ability to maintain significant balance sheet risk in the form of CMBS inventory (pre- or post-securitization).

Wall of Maturities. Over the next two years, approximately $255 billion (43% of the entire CMBS market) contractually matures and will need to be resolved. While this overhang, and the resolution thereof, will create investment opportunities, it is also casting a shadow over new originations.

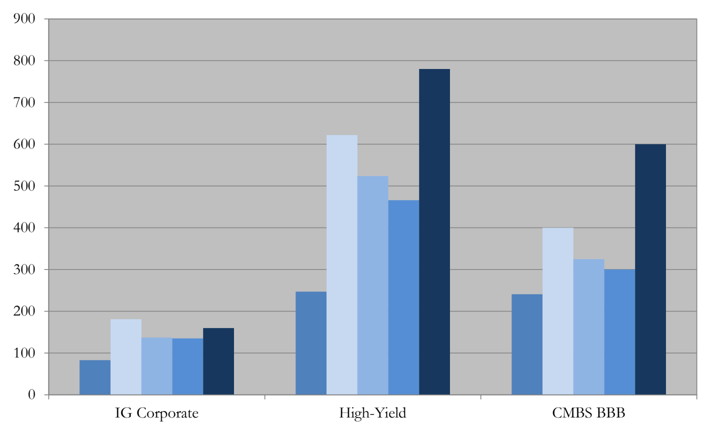
Risk Retention. In December 2016, "risk retention" will become effective requiring B-piece buyers, or issuers, to retain 5% of the CMBS trust, effectively for the life of the transaction (as compared to ~2.5% for B-piece buyers today, who have the ability to sell later on, and 0% for issuers). While the impacts are uncertain, the consensus is that the adoption of risk retention will increase the cost of CMBS financing for borrowers.

U.S. CMBS Issuance & Maturities
($ billions)



Source: Commercial Mortgage Alert, Bloomberg

U.S. Credit Spreads



Although facing recent headwinds, the CMBS market remains healthy and an active two-way market. However, until the effects of "risk retention" and new regulatory requirements are fully understood, buyers of commercial real property should model more conservative loan proceeds levels, more expensive financing costs and longer diligence periods before receiving a firm commitment. Taken as a whole, a temporary slowdown in CMBS issuance will likely temper the aggressive pace of property acquisitions seen in 2015 as well as apply downward pressure on prices, along with other factors including rent growth, inflation and overall supply/demand dynamics.