# CMBS 2.0 – State of the Market 2015

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For this article, we examine the CMBS 2.0 "State of the Market" and have brought together industry leaders who not only shape and define the CMBS market but who also represent different segments including investment (from AAA to Mezzanine), origination, distribution, trading and special servicing. With 2015 CMBS origination already 33% ahead of 2014 levels, delinquencies reaching new lows and loans in special servicing at approximately half of peak levels, we wanted to explore where the current opportunities (and risks) are, where we are in the cycle, current challenges, and what "keeps us up at night." Our participants included:

Matt Borstein — Head of Commercial Real Estate Lending, Deutsche Bank

George Carleton — Executive Managing Director, C-III Capital Partners

Michael Nash — Senior Managing Director, Blackstone Real Estate Debt Strategies

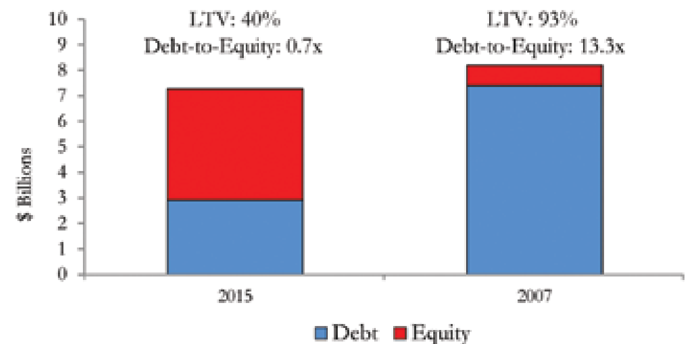
Rich Sigg — Head of CMBS trading, Bank of America Merrill Lynch

The consensus observations were that real estate fundamentals are strong and continue to improve, low interest rates will be here for some time, valuations will continue to climb and that transactions are generally more conservative and better structured than 2006/7, but that credit standards continue to gradually loosen. Global factors, including interest rates, the price of oil, currency fluctuations, and the emergence of the sovereign buyer are creating new challenges and paradigms, and all agreed that CMBS (and related commercial real estate debt) continues to provide compelling values "across the stack" if you know where to look and are able to maintain discipline.

### Where are we in the Cycle?

All of our participants agreed that we are still early (fifth or sixth inning) in the cycle for real estate fundamentals and that as the U.S. economy continues to improve/expand, so too will property occupancies, rent rolls and cash flows. While valuations are currently on the high end due to a combination of low interest rates and an influx of foreign capital, leverage levels are comparatively modest, particularly as compared to the 2006/7 vintages as illustrated by the valuations and leverage points for the ESA Portfolio depicted below.

*Exhibit 1*
**ESA Comparative Capital Structures 2015 vs 2007**




Sources: Various Offering Circulars, Public Information & Talmage Research
The Extended Stay America Hotel Portfolio is used for this illustrative example.

Additionally, new, larger "permanent capital" buyers with longer holding horizons have replaced the heavily leveraged buyer of the pre-financial crisis days. "You can't compare today's long-term, highly capitalized, and generally conservatively leveraged investors with the individual pre-financial crisis buyer of 2007 who was beholden to the capital markets at a 6x leverage ratio. While prices are higher, the structures are fundamentally more stable," noted Michael Nash from Blackstone.

It was also observed that we are now living in a global property market where prices in New York are not only being compared to other U.S. gateway cities but also to their international counterparts such as London, Hong Kong and Tokyo. On this new metric, which may take a certain amount of acclimation, the consensus was that the U.S. remains fundamentally cheap — though "rich" to historical levels.

*Exhibit 2*
**Global Class A CBD Office Rental Rates and Valuations**

| City | Rent $/SF | Valuation $/SF |
|---|---|---|
| Hong Kong | $251 | $6,510 |
| Tokyo | 136 | 2,550 |
| Paris | 165 | 2,326 |
| London | 274 | 2,093 |
| New York | 121 | 1,515 |

Source: World Property Journal, CBRE

## How is Today Different from 2006/2007?

The consensus was that we are in a totally different, more rational and more stable market today than in 2006/7. Our panelists cited several reasons, all of which serve to protect the stability of today's market:

1. More Dealer Discipline. CMBS conduit transactions are smaller (see below) and are issued more rapidly since dealers are less willing to retain/warehouse inventory.

2. More Control from CMBS Buyers. Today's 'AAA' and 'AA' buyers are able to exert more influence on CMBS credit quality — rewarding stronger transactions and punishing weaker ones — resulting in higher and more consistent asset quality.

3. Less Leveraged Buyers. Particularly in larger loans, gone are the days of unlimited leverage.

4. Better Ratings. New rating agencies have emerged post financial crisis and have created a healthier and more competitive ratings market benefitting investors.

The CMBS spreads, issuance levels, average transaction sizes and debt service coverage levels of today are presented as compared to 2007 levels.

*Exhibit 3*
**CMBS Metrics – 2015 vs 2007 ($ Billions)**

| | 2015 | 2007 | % Change |
|---|---|---|---|
| Average 'AAA' Conduit Spread: | S+90 | S+31 | 190% |
| Annual Issuance (2014): | $98 | $230 | -57% |
| Average Conduit Size: | $1.1 | $3.2 | -66% |
| Average WA DSCR: | 1.8x | 1.4x | 28% |

Source: CMA, Talmage Research

"From the issuer's perspective, all of us have several constraints (regulatory, balance sheet, risk management, etc.) that are forcing us to be very careful on asset selection and to be disciplined about securitizing, or otherwise disposing of inventory, in a timely fashion — this is healthy for the markets," commented Rich Sigg from Bank of America Merrill Lynch. Indeed, others agreed that dealers have been very mindful of inventory levels and have been better at partnering with buy-side investors as opposed to being an outright competitor.

## Rates – How low can you go?

As noted below, global interest rates are at historically low levels, and in the case of Switzerland, negative levels. Given the large scale and liquidity of the U.S. investment market, the U.S. has attracted unprecedented amounts of foreign capital which has fundamentally altered traditional equity valuation metrics. While our participants agreed that the "V" in loan-to-value was reaching record territory for Class "A" properties in gateway cities, all agreed that those investments were supported by substantial equity contributions and comparatively modest leverage ratios.

*Exhibit 4*
**Ten-Year Sovereign Treasury Yields (April 2015)**

| | |
|---|---|
| United States | 1.9% |
| United Kingdom | 1.6% |
| Canada | 1.3% |
| Italy | 1.3% |
| France | 0.5% |
| Sweden | 0.4% |
| Japan | 0.3% |
| Germany | 0.2% |
| Switzerland | -0.1% |

Source: Bloomberg

Low interest rates, it was felt, have also acted as a governor to the recovery of CMBS spreads which appear to be "range bound" at swaps+80, as compared to swaps+30 pre-crisis, as CMBS investors struggle with minimum "total return" thresholds. Despite outsized CMBS spreads (as compared to pre-crisis spreads), everyone agreed that given the combination of low interest rates, easy monetary policy and investor demand for yield product, the current environment represents an outstanding time to finance real property.

Further, despite a healthy and recovering U.S. economy, coupled with clear pronouncements from the Federal Reserve that easy monetary policy would be ending, our panel felt strongly that foreign capital would keep U.S. rates range bound at current levels for the foreseeable future, other things being equal.

## A "Three Tier" Market?

Despite the rising tide that lifted all boats equally pre-financial crisis, our participants felt that the commercial real estate market in 2015 has evolved and been refined into a three-tier market of clear winners, losers, and the overlooked assets stuck in the middle.

**The Top Tier.** The top tier markets/assets are in the 24/7 "international" gateway cities led by New York City (driven primarily by the international buyer, the availability of trophy acquisitions and the lack of new supply), San Francisco (driven more by technology and its in-fill location), and South Florida driven primarily by the Latin American buyer. Common themes are shared by these three markets: 1) attraction of foreign capital, 2) in-fill locations with barriers to entry, and 3) limited supply of available assets. In an increasingly global world, domestic buyers are competing vigorously for real assets with foreign capital which often has exogenous reasons for investing in the U.S., including capital safety and sovereign diversification.

**The Bottom Tier.** The bottom tier represents the assets with the highest loss severities and the assets that were indiscriminately lifted with the rising tide of valuations leading up to the financial crisis. These assets represent the third mall in a one-mall town, the last limited service hotel built on the edge of town, and many assets trapped in those cities and suburbs experiencing negative growth and/or bankruptcy, including cities such as Detroit. These assets are experiencing the highest loss severities (often approaching 100%) and are the loans that have taken on permanent residence in special servicing and will be the last assets of the trust to be resolved. Often performing until they are not, these assets have provided many unhappy endings for CMBS investors.

**The Middle Tier.** Assets in this tier have been overlooked and are somewhat flying under the radar. They may represent assets in markets such as Atlanta, Dallas and southern California. To be clear, not all assets here will succeed but managers who can identify the diamond in the rough in these markets will be handsomely rewarded.

As the real property (and CMBS) markets continue to become more clearly stratified and tiered by asset, CMBS investors will be rewarded and/or punished for their ability to select the winners and emerging winners from the middle tier as well as to avoid the lower tier assets. "We are focusing on the middle-tier markets and working hard to find the winners there," commented George Carleton from C-III. "This is the area in CMBS where we are finding the most value added. It is overlooked at the moment and requires substantial local knowledge."

### Where are the Opportunities?

With CMBS spreads and volumes having recovered significantly since 2009, all of our participants lamented that it has become increasingly difficult, though still possible, to generate outsized returns in CMBS and commercial real estate debt. As spreads have improved, the CMBS market has evolved from a "commodity" market with many hot money managers replacing traditional investors, to a specialist market requiring the combined skills of deep real estate know how, coupled with bond structuring capabilities. Among our participants, four general areas of opportunity emerged, domestically.

**Transition Lending.** Transition lending, as well as construction lending in top tier cities, is seen as an excellent current opportunity. These kinds of loans do not fit in CMBS and are often challenging for a traditional bank or life insurance company to provide efficiently or in a timely fashion. While transition lending has long been a staple of opportunistic lenders, construction lending represents a new frontier for non-traditional lenders.

**Risk Retention Arbitrage.** Our panelists saw an opportunity to acquire subordinate CMBS and "B-Pieces" ahead of the adoption of Risk Retention in 2016 as these investments will carry greater liquidity and tradability and will therefore contain substantial trading upside. It was also felt that the credit quality of these investments for the recent vintages was much stronger than their cohorts in CMBS 1.0.

**Manufacturing Mezzanine.** As Mezzanine loans have come back into vogue and pricing has continued to tighten, an opportunity has been identified to originate the whole loan, sell the senior and retain the resulting highly-customized Mezzanine loan with premium pricing. It was observed that the senior portions of such loans could be sold directly (to either a portfolio lender or into a CMBS securitization), or indirectly via a CLO or CDO financing which has made a comeback in 2014/2015.

**CMBS "Legacy" Markets.** Finally, all agreed that multiple opportunities remain in the CMBS "Legacy" market for those investors with the expertise to sift through the collateral and identify undervalued assets. Structured Investment Vehicles (SIVs) seized during the financial crisis, as well as "hot money" investors, are providing a steady stream of legacy CMBS opportunities to the secondary market. Additionally, as banks and dealers are facing increasing capital pressure, their CMBS inventories must be kept lean, creating opportunities for longer-term investors.

While the market opportunities are changing daily against an increasingly volatile and globally interconnected investment universe, CMBS, and related real estate debt (such as transition loans), continues to present attractive investments for seasoned investors with the requisite expertise and discipline. "We are fortunate to be in a strong capital position and to have a steady track-record of lending in the U.S. which affords us the opportunity to expand our lending envelope to more transition oriented lending

with top tier sponsors," commented Matt Borstein, the Head of U.S. Lending for Deutsche Bank, the most active U.S. CMBS loan contributor in 2014 and thus far in 2015.

### Where are the Risks?

Having enjoyed fairly consistent spread and origination improvement since 2009, where are the current risks in CMBS? Our panelists saw CMBS as having substantial stability and generally better asset quality than CMBS 1.0 but saw the major risks facing CMBS as fourfold:

**A Bolt from the Blue.** Everyone saw "A bolt from the blue" as the greatest risk facing the CMBS market and the hardest to predict/prepare for. All acknowledged that we are living in an increasingly volatile world and that despite strong underlying fundamentals, CMBS could experience significant price fluctuations from various "outside" events whether the collapse of the Euro, a terror event, or the price of oil.

**Interest Rates.** While everyone expected rates to be "range bound" for some time and any increases to be fairly well announced and gradual, all expressed concern of the unintended consequences of a sharp and sustained spike in U.S. interest rates for CMBS.

**Discipline.** Substantial concern existed regarding the market "losing discipline." Post financial crisis, the CMBS market and its participants, whether investors, dealers or rating agencies, have been conservative and disciplined in their asset selection, underwriting and investment approach. All panelists registered concern about losing discipline using phrases such as "slippery slope", "bracket creep" and "boiling frogs" to express their trepidation.

**Third Tier Assets.** Concern was raised about the potential impact of the third tier assets on loss severities in CMBS, particularly during the "wave of maturities" in 2016/7 and the echo impact that may have on CMBS, generally.

Concerns were generally forward looking and focused on items beyond the market's control such as interest rates and a bolt from the blue. All took comfort from the strength and stability of underlying property fundamentals as well as the maintenance of discipline, across the board, at least for the time being. "While discipline is here at the moment," commented Rich Sigg from Bank of America Merrill Lynch, he also noted that, "as investors stretch for yield, they continue to move further out on the risk spectrum and into increasingly "cuspy" investments."

### We're all globally connected

CMBS, though mostly a U.S. asset class, has gone global, post financial crisis. CMBS are purchased by foreign investors, the underlying assets are owned by offshore buyers, valuations are impacted by international interest rates and monetary flows, unconnected to U.S. property valuations, can significantly impact CMBS prices and investors' performance.

Top Tier U.S cities and properties, as noted previously, are playing catch-up to the international market, in terms of rental rates and valuations, and still have a long way to go. These new valuations, driven by offshore comparables, are changing property valuations across the country — positively for the "haves" and negatively for the "have nots". CMBS investors will need to carefully monitor these trends.

How far new offshore valuations of U.S. property will reach, and their impact on CMBS, is unclear. However, all agreed that foreign capital appears to have found a permanent and growing home in the U.S. and that foreign dollars bring overlays of exogenous factors such as foreign currency, interest rates and political stability/instability as dynamic overlays into the property and CMBS markets.

### Conclusions

The CMBS market is in a good place. New issuance is matching maturities and the overall size of the market has stabilized and begun to grow again. Delinquencies continue to decline, loans in special servicing are likewise decreasing and the "wall of maturities" is being whittled away, assisted by a historically low interest rate environment and by a global quest for yield. On the other hand, valuations are reaching all-time highs and global inter-connectedness is creating heightened volatility. Overall, four major themes emerged from our informal CMBS roundtable of market participants:

1. CMBS is part of a globally interconnected financial world, impacted by many factors unrelated (for better or worse) to the underlying health or performance of CMBS or its collateral;

2. Volatility is on the rise and with many indices at record highs (such as the Dow Jones, Class A office prices) or record lows (such as interest rates, the price of oil, and the Euro), CMBS is impacted by sharp changes in these markets;

3. Continued discipline — by investors, issuers and rating agencies — will be essential to the continued health and prosperity of CMBS; and

4. Opportunities continue to exist in CMBS, and related privately-traded commercial property debt, for seasoned investors with strong underwriting skills, real estate know how and discipline.

In our sixth year following the Global Financial Crisis, CMBS has recovered steadily and found a healthy "new normal" in terms of annual issuance, spreads, subordination and asset quality. CMBS is beginning to grow again and growing with new investors and borrowers. It will be up to the market participants to maintain discipline, lending standards and asset quality. Disruptions, of course, will occur in the ordinary course, often due to outside events. These events will create short-term windows of meaningful opportunity for those prepared to dive in.

Edward L. Shugrue III is the CEO of Talmage, LLC. Talmage is an independently owned commercial real estate investor and Special Servicer. Talmage professionals have made in excess of $10 billion of real estate debt investments and acted as the Special Servicer or advisor on over $40 billion of loan resolutions. Talmage is headquartered in New York City. www.talmagellc.com

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