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Commercial Mortgage-Backed Securities Make Comeback

Some Warn Market Could Be Getting Overheated

By Eliot Brown
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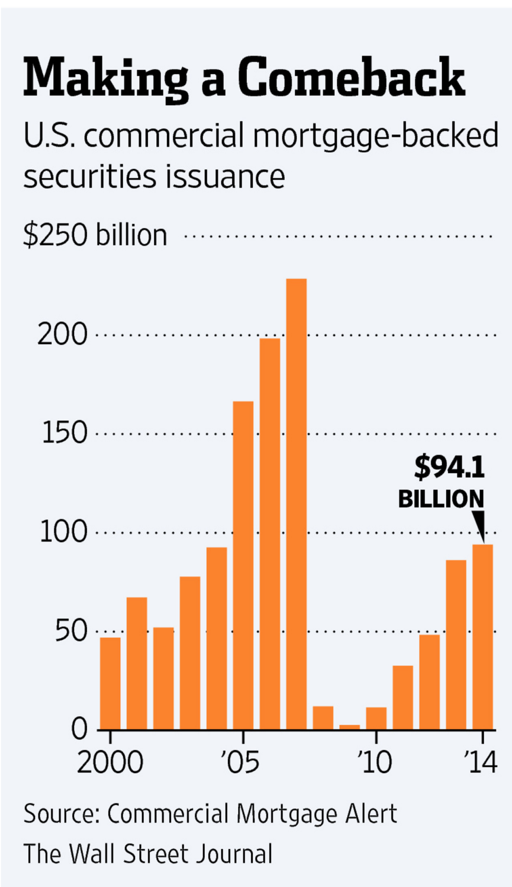
A hunt for yield and a gradually improving property market are bolstering a key engine of U.S. commercial property lending, helping borrowers to refinance but also reigniting fears the market is getting overheated.



In all, lenders made $94 billion in loans bundled together and sold off as bonds to investors in 2014, the most since 2007 for the product known as commercial mortgage-backed securities, according to trade publication Commercial Mortgage Alert.

Real-estate executives and bankers are predicting that figure will rise in 2015. Eighty-eight percent of respondents to a survey by the CRE Finance Council, a trade group, predicted lenders would make at least $100 billion in CMBS loans in 2015, with 18% predicting issuance would rise above $125 billion.

The CMBS market is a significant—and volatile—component of the broader market for commercial-property lending. It tends to grow rapidly when times are flush as Wall Street banks and other lenders can quickly turn up production so long as there is demand from bond investors.

But with annual issuance of CMBS almost tripling in the past three years, the market's growth is so robust that it is causing some to fear investors are getting ahead of themselves, making loans that could sour in a recession. Still, issuance is well shy of the record $229 billion issued in 2007

For now, the demand has been robust, thanks largely to investors hunting for yield. With commercial mortgage-backed securities often carrying average interest rates of between 4% and 5% for 10-year bonds, they are seen by many investors as more appealing than the alternatives, such as corporate bonds and 10-year Treasurys, which carry interest rates just shy of 2%.

“There’s a paucity of other comparatively attractive products to buy,” said Edward Shugrue, chief executive of Talmage LLC, a large investor in commercial property debt. “It’s harder to find attractive yields.”

Growing demand from investors, in turn, has had a magnetic pull on lenders, causing them to pile into the sector. In 2014 there were about 35 active lenders that contributed to CMBS deals, according to Commercial Mortgage Alert. By contrast, there were just 18 in 2011.

As more companies have been jousting to lend, borrowers have been benefiting. Developer Eric Blumenfeld last month secured a $25 million loan for a 205-unit Philadelphia apartment building from an affiliate of Cantor Fitzgerald LP, which then sold it off in a package of commercial mortgage-backed securities. Mr. Blumenfeld said there was more competition among lenders for the loan than he expected and there “was a little bit of a bidding war” before he ultimately went with Cantor, which he had used before.

“Money is more readily available, and for performing assets that have cash flow, there’s a lot of different options,” he said.

But as lenders fight among themselves to win deals, they are more willing to take on lower-quality loans–a concept most in the industry openly acknowledge. Of the CRE Finance Council’s survey respondents, 82% said they expected credit quality to be lower in 2015 than in 2014.

Gradually, rates have fallen while lenders have been more willing to offer riskier loans, such as those with longer interest-only periods and at higher percentages of a property’s value. And lenders also are making loans for properties with lower occupancy than they would have in the past, and for less-appealing types of real estate like trailer parks, said Tad Philipp, director of commercial-real-estate research at Moody’s Investors Service.

Mr. Philipp likened the trend of lending standards gradually but consistently eroding to a frog in a pot of water that is gradually getting hotter.

“We’re heading in a bad direction,” he said. “There’s no one increase that’s alarming…the trend and the consequences are concerning.”

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