The Never-Ending Story of CMBS

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A funny thing happened as the CMBS market picked itself up after the financial crisis of 2008 and vowed never again. The measures that were put in place to prevent another meltdown—some, admittedly at the insistence of regulators—have helped to usher in a resurgence in lending and increase in competition. Take, for example, the documentation now required for a CMBS loan. These guidelines are much more standardized, says Jordan Ray, managing director of New York City's Mission Capital Advisors. Transparency has increased, as was intended, as well as easier poaching of borrowers, which was not.

"It has made it much easier for conduits to accept other conduits' loan documents to win business," Ray says. "The end result is that the plain vanilla CMBS is now very much a commoditized business and those who want to get deals done need

to do something special." Besides the usual—interest only terms, floating rate transactions—Ray has seen lenders originate mezzanine loans and keep them on their balance sheet, as the extra edge. Or offer stronger subordination levels or shorter-term loans.

"It can be little things, but more lenders are willing to go out of the box somewhat to win business as competition intensifies."

Of course it's not just standardized paperwork that is driving this trend. In general, the CMBS market is hitting new post-crisis high notes thanks to improving fundamentals, an improved economy and the prolonged low-interest rate environment, which has also fueled alternative and competing forms of finance.

"Conduits are competing for every last scrap," Ray says.
If this sounds painfully familiar, that's because it is yet another chapter in the never-ending story of CMBS (well, all markets actually). The market moves—sometimes dramatically, sometimes not—between risk and safety depending on larger macroeconomic conditions, fundamentals in commercial real estate and what the competition is doing.

For now, the center appears to be holding sway.

"You want issuance to climb and a steady pace and not spike—and so far that is what is happening right now," says Steve Renna, CEO of the Washington, DC-based CRE Finance Council. Third quarter 2014 saw a robust $22 billion in CMBS issuance, he says, and puts the industry on track to meeting a psychological post-crisis high-note of $100 billion. "That will exceed by a healthy margin the $81 billion we saw in 2013," Renna says.

The State of the Market

This is not just a numbers story, though. CMBS is clearly on more solid footing than it has been since the crash. Originators are using more prudent assumptions in their underwriting and credit enhancements have risen to reflect declining credit profiles and the rise in leverage levels.

In fact credit enhancement levels in US CMBS are close to double those in 2006 and 2007, a recent Fitch Ratings report noted.CMBS has also been bolstered by improving fundamentals, which is reflected in the overall improvement in asset performance.

Commercial real estate performance and macroeconomic measures have slowly improved over the past few years, Fitch Ratings noted, “providing stable occupancy and, for hotels and multifamily properties especially, significant improvement in revenues.” Besides the general economic improvement, Fitch also pointed to the limited new property construction as playing a role in asset performance.

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Also, pool structures have become simpler in many cases. Fitch Ratings notes that we are seeing less “hyper-tranching” and that operating advisor and controlling class calculations have been introduced to better manage potential conflicts of interest. Finally, senior bondholders are better protected in that they now recover principal before junior bondholders receive interest when assets are liquidated.

If there is any room for angst in this cozy picture, it is the competition. Give or take, there are about 43 active conduits in the market now—each, as Ray says, scrambling for scraps.

The potential problem, simply put, is this: as competition increases, underwriting standards drop.

We saw it in the past and even now, in this CMBS 2.0 environment, we are seeing shades of it not just in such metrics as LTV and DSCR, but also in more subtle aspects such as weaker loan structures, Fitch said. It points to, as an example, the increasingly common feature of having specific dollar amount caps on so-called “bad boy” carveouts.

The competition is coming from not only new entrants in the conduit market, but also other lenders that have been used to a meek CMBS market of the past few years. Life insurance companies, for example, no longer have the market to themselves anymore. As a result, says Shelley Magoffin, SVP of Grandbridge Real Estate Capital, “they’ve gotten very creative in how they differentiate themselves from the newfound competition, including such tactics as “providing funding before a property is stabilized, offering IO and earnouts, things that they weren’t doing three years ago.”

Still, it is a fine line between weakening loan structures and more aggressive underwriting and a robust capital market that has developed the necessary chops to take on more risk with the goal of furthering development. In October, as one example of the latter, Prudential Mortgage Capital Co. loaned the Jacksonville, FL-based 22 Lantern LLC $18.1 million in a CMBS structure for Lantern Square Apartments, a failed condo conversion that the company was turning into a multifamily project.

Lantern 22 initially acquired the property in 2006. Just before the economic crash, the owners converted the apartment complex into a condo and began trying to sell units. Lantern is using the CMBS loan to refinance an existing condo conversion mortgage loan and reacquire units from third parties in the building. Also, much of the new competition entering the market has been around the block more than once and not likely to try extreme structures. Walker & Dunlop, a

Bethesda, MD-based real estate finance firm, is about to originate its first round of CMBS transactions under a new platform it launched last year.

At the end of September, the company announced it contributed its first $58 million of collateral in multifamily and retail loans for an upcoming securitization with Wells Fargo. W&D's CMBS platform is on track to contribute $200 million in collateral to future securitizations by the end of 2014. Meanwhile, its CMBS originations are likely to accelerate with Walker & Dunlop's recent acquisition of Johnson Capital, which has a respectable footprint in the CMBS market.

The origin of W&D's CMBS deal is telling, though, for the market. The main reason the firm got into this space was to diversify its offerings away from its core platform of GSE executions, and in this respect it appears to have succeeded. During a recent earnings call, CEO Willy Walker described how the deal came about: "We quoted a three-property, multifamily deal in June for execution with the GSEs. The borrower requested more proceeds than an agency loan could provide. So we quoted the deal for our conduit."

Then, in the process of quoting the deal for the conduit, the borrower asked W&D to look at three transitional properties that needed bridge financing, which also wound up being funded. "A year ago we would have lost the deal after providing the GSE quotes," Walker said. "Today, due to our new CMBS conduit and scaled balance sheet lending operation, we financed these six properties, totaling $67 million."

It is, in other words, how CMBS was meant to operate in the capital markets: as a complementary backstop when other lending doesn't quite fit the borrower's needs. All courtesy of a new provider in the market.

Preparing for the Refi Wave….

These new providers and the solid macroeconomic environment and commercial real estate fundamentals suggest that the CMBS ecosystem is ready for what is expected to be one of its biggest challenges post the 2008 financial crisis: refinancing the $600 billion or so of loans made during 2005-2006 time period.

Certainly this bonanza is one driver for these new entrants. In September, when the Macquarie Group and Principal Real Estate Investors announced they were partnering on a new CMBS platform the upcoming wave of refis was cited. “There will be a substantial volume of commercial mortgage loans maturing over the next few years,” says Timothy Gallagher, New York City-based managing director and head of commercial real estate markets at Macquarie. “That provides Macquarie with a sound opportunity to establish a CMBS debt platform in the US.”

…With New Underwriting Standards in the Background

However, there’s one tiny glitch for some of these hopeful borrowers in waiting: standards have changed considerably since that time.

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It’s a CMBS 2.0 world now and besides the statutory changes to the model, underwriters are not likely to forget the lessons of 2008. Yes, there is more aggressiveness in the underwriting, but it is nowhere close to previous iterations. “This is a major issue: a lot of these loans that have been locked up in CMBS for the past 10 years are looking to refinance out, and there have been a lot of changes,” says Matthew McGovern, a 20-year industry veteran, who recently joined the Irvine, CA-based GRS Group as director of its national leadership team.

The economic landscape changed in values, and underwriting standards have changed in some cases dramatically, he said, noting that “loans that met the underwriting criteria in the old phase 1 may not meet that same bar today.”

GRS is seeing it already, “as some of these loans are being pulled forward and are being prepaid; we’re seeing them with existing due diligence on them that was acceptable at that time, but borrowers are stunned at the increased reserve and environmental requirements.” Referring to the latter, McGovern said he has run into existing contaminated sites under monitoring programs, and even no-further-action letters are now subject to much more stringent standards.

“Unfortunately, borrowers don’t always understand why it’s an issue now when it wasn’t back when they financed. So, we’re helping them understand and work through that. It’s not without pain in some respects. Hopefully, it doesn’t impact a lot of properties, but there will certainly be enough that it will impact.”

Lather, Rinse, Repeat

Other borrowers—many in fact, as the economy continues its recovery—won’t have such concerns. They will be happily tapping the conduits to lock in low interest rates and take out proceeds, if possible.

That was the driving force behind two CMBS loans Marcus & Millichap Capital Corp. recently secured to refinance the Hampton Inn Crystal City in Arlington, VA and the Holiday Inn Capital Square in Columbus, OH. The $25-million CMBS debt placement for the Crystal City property had a fixed interest rate of 4.76% and a 65% loan to value. The Holiday Inn’s $5.8-million CMBS loan’s interest rate was 4.8% and a 70% LTV. Both loans were maturing and the borrowers wanted to advantage of the lower interest rates and take out equity.

Certainly for the rest of the year and into 2015, depending on the direction of interest rates, it will be lather, rinse, repeat, with only the end-use of the proceeds differing by borrower.

Real Capital Solutions secured a $16.5-million CMBS loan to refinance its 244-unit Eden’s Edge multifamily property in Jacksonville. The Louisville, CO-based

investment and development firm wanted the five-year loan “to continue strategic investment in their target markets,” the originator Greystone reported.

On the other end of the deal-size spectrum and the opposite end of the country is property investor David Werner, who recently secured a $700-million CMBS loan—a 10-year, fixed-rate, interest-only deal, specifically—to acquire the leasehold interest in New York City’s 1.8-million-square-foot Mobil Building. Morgan Stanley Mortgage Capital Holdings provided the financing, which was arranged by Meridian Capital Group and Eastdil Secured.

There was a lot of competition for the deal despite its size and complexity, insiders in the know told reporters. This is concerning to some, even as the CMBS market’s growing prowess is clearly a boon to commercial real estate.

Grandbridge Real Estate Capital’s Magoffin, for one, is worried, though not overly, about the growing aggressiveness of the market. “It’s great that there is CMBS money out there, though I think it’s still the loan of last resort. But it’s a little concerning that some of the CMBS money has gotten so aggressive so quickly. It might be a little too much a little too fast, but nowhere what it was in 2006.”