



# Bradford & Marzec

GLOBAL FIXED INCOME MANAGEMENT

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## CMBS Update

*Commercial mortgage backed securities (CMBS) valuations have rallied with improving economic conditions and investor sponsorship, but fundamentals remain divided by property type and access to capital. New issuance, commonly called CMBS 2.0, has emerged on a small scale but represents a meaningful development in commercial real estate financing. CMBS 2.0 features more conservative underwriting and senior-bondholder-friendly structures.*

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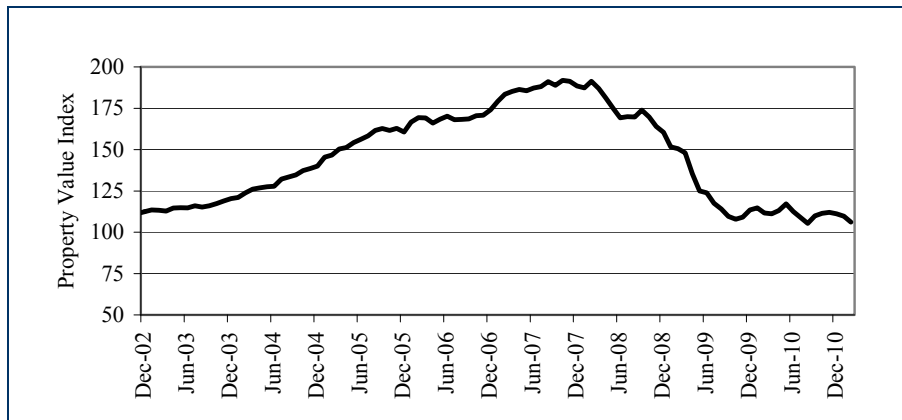
### CMBS UPDATE

Turbulent conditions have defined the recent history of the commercial mortgage backed securities (CMBS) market. Reduced demand and constrained credit acted to deflate valuations and throw the market into dormancy during the credit crisis. In 2009 and 2010, valuations improved dramatically (the CMBS asset class returned 28.4% and 20.4%, respectively<sup>1</sup>) as macroeconomic and commercial real estate (CRE) fundamentals improved, investors re-entered the markets, and securitization re-emerged as an important financing mechanism. However, significant dispersion exists in CRE fundamentals and barriers remain for newly-issued CMBS to gain broad investor sponsorship.

### COMMERCIAL REAL ESTATE FUNDAMENTALS

CRE fundamentals deteriorated dramatically in 2008 and early 2009 and only recently have shown signs of stability. The widely-cited Moody's Commercial Property Price Index has fallen 44% from its 2007 highs (Figure 1, on the following page), and while the balance of troubled loans has steadily marched higher to its current value of 9.34%<sup>2</sup>.

Figure 1 – Commercial property values have fallen to 2003 levels<sup>3</sup>



Vacancies and cap rates<sup>4</sup> rose and rents fell dramatically for all major property types as the economy slowed in 2008. By late 2009 vacancies began improving (Figure 2). However, rents and cap rates have been slower to improve (Figure 3) and considerable discrepancies remain among property types.

Figure 2 – Commercial real estate vacancies have stabilized<sup>5</sup>

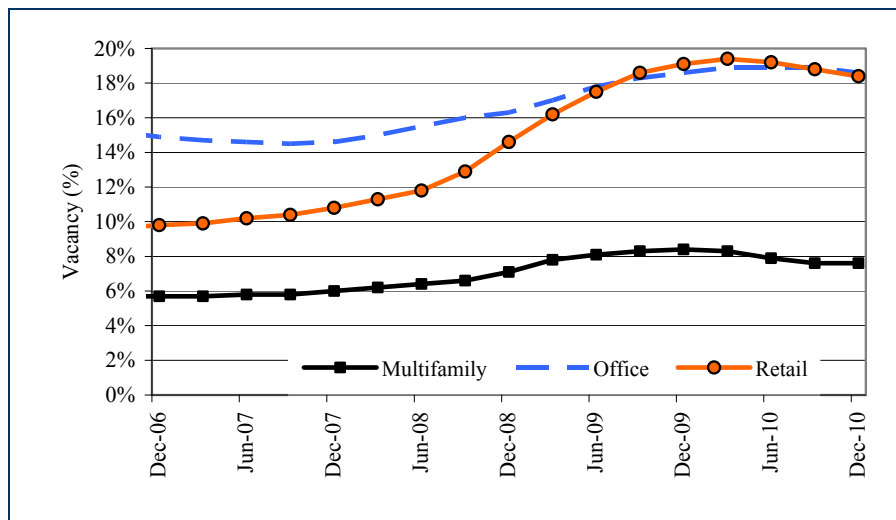
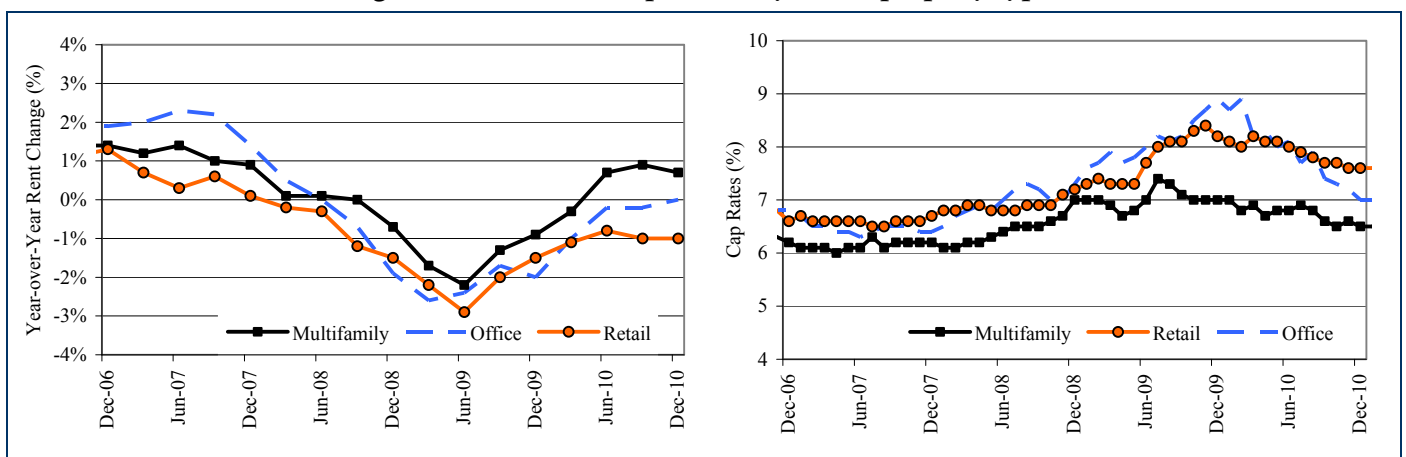
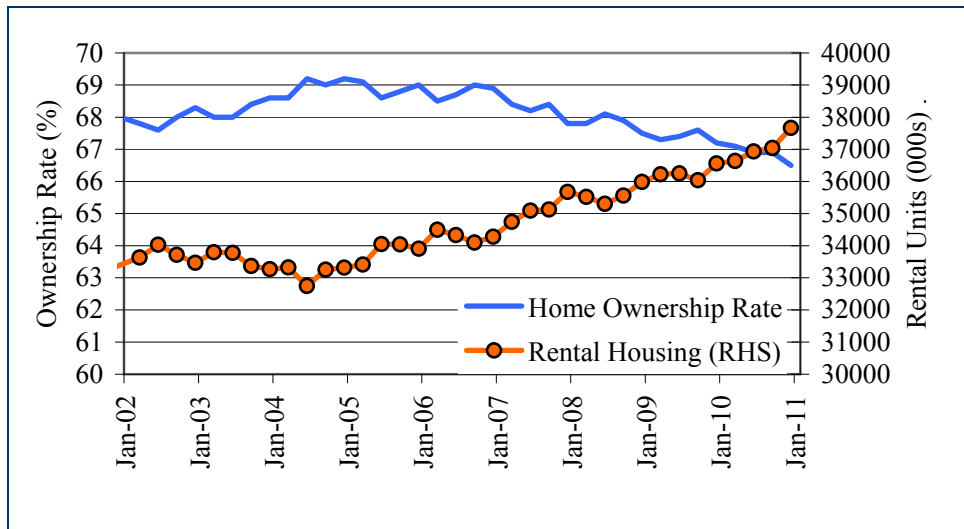


Figure 3 – Rents and cap rates vary across property type<sup>6</sup>



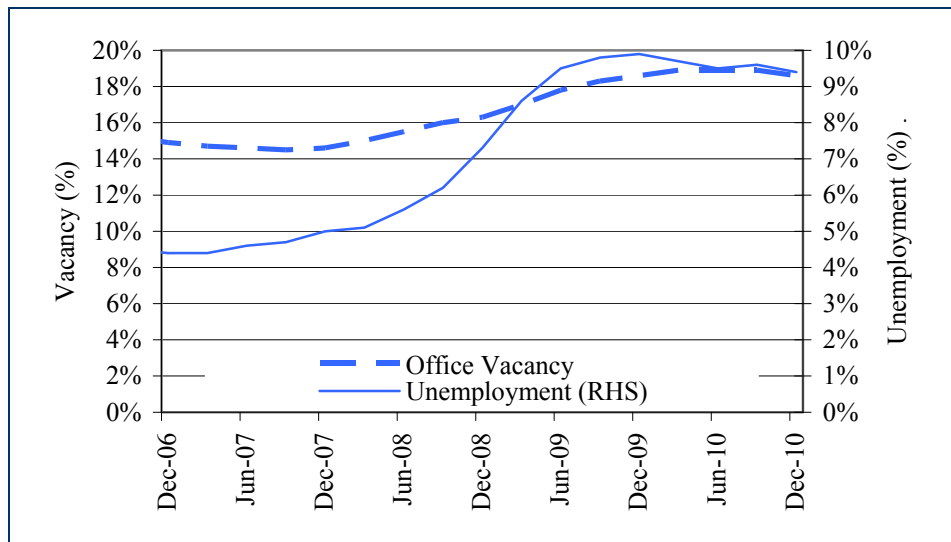
The multifamily sector led CRE property types in showing fundamental stabilization. The dramatic and widespread contraction of residential lending and a shift in preferences away from home ownership and toward renting (Figure 4) have benefited the multifamily sector.

**Figure 4 – Home ownership is declining and rental demand is increasing<sup>7</sup>**



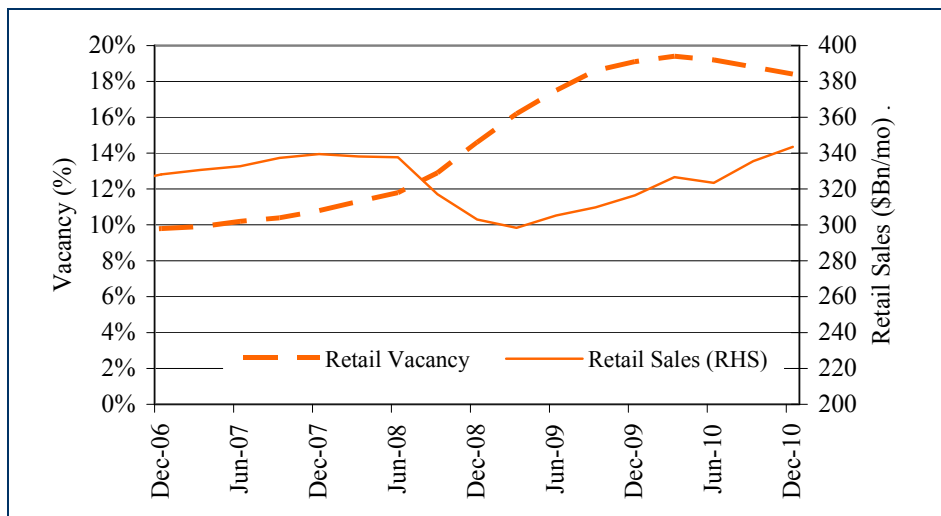
In contrast to the multifamily sector, office property fundamentals are less favorable. By merit of longer term leases, office property fundamentals were initially slow to deteriorate, but as existing leases expired and landlords faced the inevitable decline in demand resulting from higher unemployment, vacancies climbed to historic highs (Figure 5).

**Figure 5 – Office property vacancies climbed with rising unemployment<sup>8</sup>**



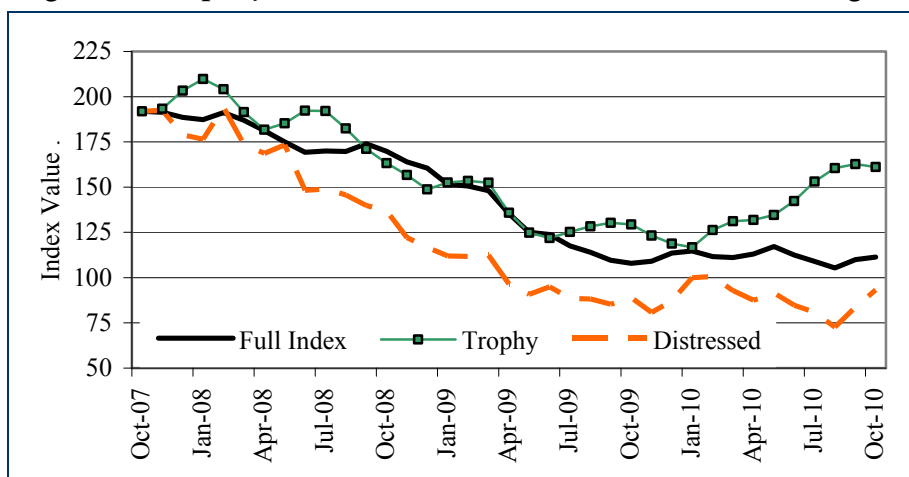
Retail properties experienced a more dramatic decline in fundamentals than office or multifamily properties. The contraction of consumer credit and discretionary spending by households curtailed demand for retail space and pushed vacancies up from about 10% before the credit crisis to nearly 18% in December 2010 (Figure 6, on the following page).

**Figure 6 – Retail property vacancies climbed with falling retail sales<sup>9</sup>**



In addition to the performance dispersion among the major property types, CRE fundamentals have become bifurcated along the lines of access to capital. Properties with access to capital - the “haves” – are in stable markets, possess solid operating fundamentals, and carry modest leverage. Properties shut-out of the capital markets – the “have-nots” – are experiencing weak demand and carry high leverage. The “haves” are experiencing stable and improving valuations while the “have-nots” face on-going weakness (Figure 7).

**Figure 7 – Property values for “haves” and “have-nots” have diverged<sup>10</sup>**

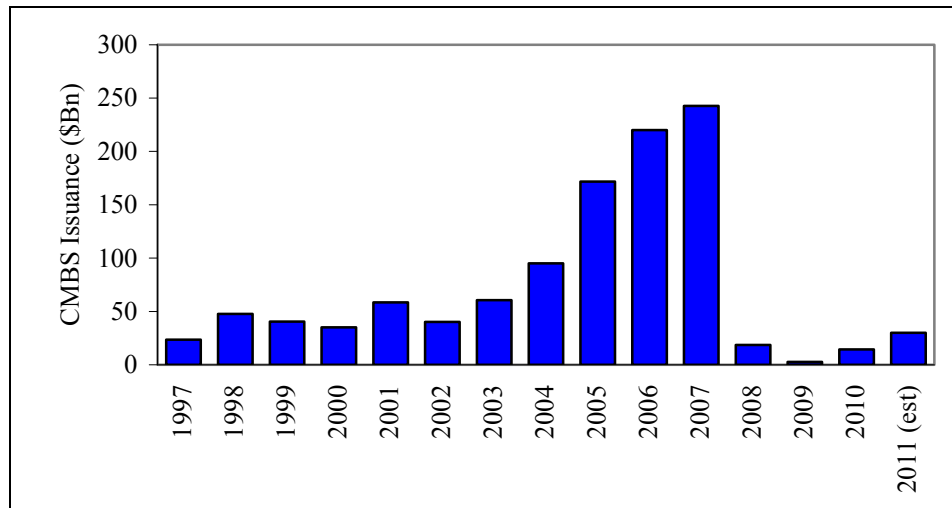


**REVIVAL OF CMBS ISSUANCE**

As global de-levering and a crippled banking system choked the availability of capital, CMBS issuance fell to a trickle after 2007 (Figure 8 on the following page). A few single borrower deals appeared in 2009 as securitization

economics improved and lenders began selectively to extend capital. Mid 2010 saw the emergence of a new variant of multi-borrower, multi-asset commercial mortgage securitization, popularly called CMBS 2.0. CMBS 2.0 differs from legacy CMBS<sup>11</sup> by merit of more conservatively underwritten collateral and a simplified, more senior-bondholder-friendly structure.

**Figure 8 - CMBS issuance diminished after 2007 but is now increasing<sup>12</sup>**



Because contracted credit availability featured so prominently in the most recent CRE downturn (as opposed to an excess supply of properties as in the case of prior downturns), the reemergence of CMBS as a financing mechanism is an important step in the normalization of commercial real estate markets. Although a far cry from the \$200+ Bn of annual issuance in the credit-boom, the \$30Bn of issuance expected for 2011<sup>12</sup> makes CMBS 2.0 a meaningful source of debt capital for the CRE market. Twelve CMBS 2.0 deals, backed by a total of \$13.4Bn of collateral, have come to the market as of the time of this writing. About 40% of the loans backing CMBS 2.0 deals refinance loans from existing CMBS deals<sup>13</sup>.

**Improved underwriting and adverse collateral composition**

The most dramatic change in CMBS 2.0 collateral relates to underwriting. CMBS 2.0 collateral features low leverage, full or partial amortization, and underwriting based largely on in-place property cash flows. In fact, about half of CMBS 2.0 loans issued to date were underwritten to property cashflows equal to or less than those realized over the preceding 12 months<sup>14</sup>. CMBS 2.0 collateral also benefits from the implicit, albeit unquantifiable, advantage of underwriting based on (presumably) bottom-of-cycle property financials. Figure 9, on the following page, compares CMBS 2.0 characteristics with those of legacy CMBS.

Figure 9 – Comparison of CMBS 2.0 and legacy CMBS collateral

	<b>Legacy CMBS*</b>	<b>CMBS 2.0</b>
<b><i>Typical Collateral Characteristics</i></b>		
<b>Deal size (\$Bn)</b>	4	1
<b>Loan count</b>	200	38
<b>Average loan size (\$mm)</b>	20	29
<b>Loan to value **</b>	94	61
<b>Debt service coverage ***</b>	1.4x	1.7x
<b>Top 10 loans (% of deal)</b>	44%	65%
<b>Largest loan (% of deal)</b>	9%	14%
<b><i>Property Composition</i></b>		
<b>Office</b>	32%	24%
<b>Retail</b>	31%	53%
<b>Hospitality</b>	8%	5%
<b>Multifamily</b>	16%	2%

Notes

\* Values for legacy CMBS are for a randomly selected sample of nine 2007 and 2006 vintage deals.

\*\* Loan to value for legacy CMBS are computed estimates of current values ("mark-to-market LTV") based on property-level financial data and regional market data computed using BMLLC proprietary models.

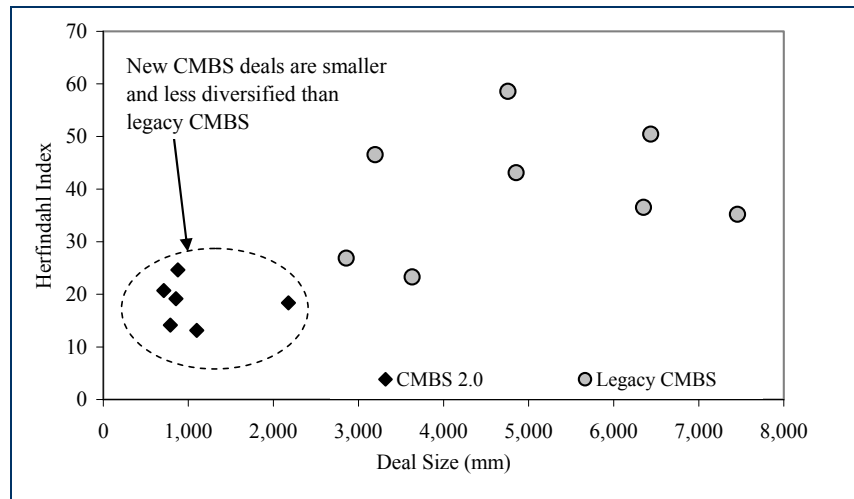
Values are subject to change without notice.

\*\*\* Ratio of net operating income to loan principal and interest payments

The property mix of CMBS 2.0 collateral differs markedly from legacy CMBS and shows the signs of adverse selection. CMBS 2.0 has a high concentration of retail properties and a near-absence of multifamily properties. The heavy representation of retail properties arises from a relative concentration of retail loans maturing recently as well as a lack of insurance company lending sponsorship of the sector. The paucity of multifamily properties in CMBS 2.0 deals is largely explained by the dominant market share captured by the Fannie Mae, Freddie Mac, and Ginnie Mae in multifamily lending since the credit crisis.

CMBS 2.0 deals have averaged about \$1Bn in size which is much smaller than legacy CMBS deals. A consequence of the small deal size is that the collateral is significantly less diversified – the 10 largest loans, on average, have accounted for 65% of CMBS 2.0 collateral. CMBS investors commonly quantify loan diversity with the Herfindahl index<sup>15</sup> which gives higher scores for more diversified deals. Figure 10, on the following page, shows the low diversity of CMBS 2.0 relative to legacy CMBS deals.

Figure 10 – CMBS 2.0 deals are significantly smaller and less diversified than legacy CMBS<sup>16</sup>



### Incremental Structural Improvements

Structural characteristics of CMBS have evolved as a result of investor demands and industry self-regulation<sup>17</sup>. CMBS 2.0 deals possess improved features related to servicing practices, investor control, deal transparency, and priority of principal and interest payments to bondholders.

The most obvious difference between legacy CMBS and CMBS 2.0 is the simplified and less levered deal structure. Deals now consist of about a dozen classes as opposed to the 25+ classes in legacy CMBS. The classes themselves are now larger which results in more stable cashflows under credit stresses and enables broader investor sponsorship. Credit enhancement levels are higher in CMBS 2.0 deals which typically have 16% - 18% credit enhancement for AAA rated bonds as compared to 11 - 13% for legacy CMBS AAAs.

A widely-cited shortcoming of legacy CMBS was that special servicers, charged with resolving troubled loans in the best interest of the deal, and subordinate debt investors, who generally benefit from delayed realization of losses, were often the same entity. This situation allowed for a conflict of interest, whether in perception or reality. For example, a special servicer who extends the maturity of a troubled loan to avoid a default will necessarily shift economic value from senior to junior creditors in the deal, as junior creditors receive interest for a longer period of time and senior creditors must wait longer to receive principal recoveries. When the junior creditor and special servicer were the same entity, senior bondholders viewed such servicing decisions with suspicion.

In CMBS 2.0 deals, the special servicer and junior debt investor have, to date, been unrelated. In addition, junior creditors, and under circumstances of high losses, senior creditors, have the ability to replace the special servicer.

Payment priorities in CMBS 2.0 deals are more favorable to senior bondholders. In a high loss environment, loans backing a CMBS deal do not produce sufficient cash flow to pay full interest on junior bonds, creating an *interest shortfall*. When a loan was liquidated and cash became available to the trust, legacy CMBS deals paid back the

interest shortfall to junior bonds before paying principal to senior bonds. CMBS 2.0 deals eliminate this inversion of priorities and pay back interest shortfalls only after senior bonds have been fully paid-off.

Investor sponsorship and secondary market liquidity have been favorable for CMBS 2.0, but not equivalent to legacy CMBS. Sponsorship should improve if deals become larger and are offered as public securities. (All CMBS 2.0 deals to date have been Rule 144(a) private placements).

## CONCLUSION

Improving CRE fundamentals and the re-entry of investors to the markets have lifted CMBS valuations and facilitated new issuance on a modest scale. CMBS 2.0 – with more conservative underwriting and senior-bondholder-friendly structural characteristics – has emerged to provide a meaningful source of capital to the CRE market. Although the moniker “CMBS 2.0” suggests a paradigm change, the changes in collateral and structural characteristics are more incremental in nature. Additional revisions to the CMBS 2.0 model and issuance in public form will probably occur for CMBS 2.0 to establish greater investor sponsorship.

## FOOTNOTES

1. Barclays Capital CMBS Index total returns = 28.4% for 2009 and 20.4% for 2010.
2. Troubled loans are defined as loans 30 or more days delinquent, in foreclosure, or REO. Source: Trepp, April 2011.
3. Source: Moody's, Bloomberg
4. Capitalization rate or “cap rate” is the discount rate used to value real estate assets based on expected income.
5. Source: Amherst Securities
6. Source: Bloomberg, Real Capital Analytics
7. Source: Bloomberg, U.S. Census Bureau
8. Source: Bloomberg, Real Capital Analytics, U.S. Bureau of Labor Statistics
9. Source: Bloomberg, Real Capital Analytics, St. Louis Fed
10. Source: JP Morgan, Moodys, Real Capital Analytics
11. Legacy CMBS is defined as multi-borrower conduit CMBS issued during 2006 and 2007.
12. Source: Barclays Capital, Morgan Stanley
13. Source: Barclays Capital
14. Source: Bloomberg, Barclays Capital, Morgan Stanley
15. Source: Barclays Capital
16. Herfindahl index is a measure of dispersion or diversification. Source: Journal of the American Statistical Association (1943), “On Measures of Dispersion for a Finite Distribution.”
17. Source: the author's analysis for selected sample of 2006- 2007 vintage “legacy CMBS” deals and 2010 - 2011 “CMBS 2.0” deals.
18. Commercial Real Estate Finance Council (CREFC), “CMBS 2.0 Best Practices Market Standards”

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