

Is CMBS Market Volatility Telling Us Something?

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As commercial property professionals who help borrowers create productive, valuable business spaces, we tend to be optimists. While some other financial professionals focus on economic risks and market instability, real estate lenders fundamentally believe in a future of limited supply and healthy demand.

In the last several years, commercial real estate markets have validated our industry's naturally sunny outlook. Lending surged, borrowers maintained good credit, investments paid off. In 2015, for example, the average net operating income (NOI) on commercial properties backing loans increased an average of 3.8 percent, according to a recent analysis from Wells Fargo. In 2014, NOIs improved by 2.66 percent, up from 2.64 percent in 2013.

Not surprisingly then, confidence is particularly robust in our industry. But is this optimism justified? Let's take a fresh look at the evidence and test our assumptions.

Upon closer examination, in fact, some disturbing signs are apparent. Data in the CMBS market and the underlying lending business suggest that we may be headed for much more difficulty in the foreseeable future. In February, we saw spreads on top rated bonds widen 30 basis points compared to late last year. Spreads on BBB paper widened as much as 250 basis points during the same time frame. New issuance volume is off significantly as CMBS conduits recognize the investor push back and are waiting for calmer sailing.

Digging a little deeper, there's more cause for concern. Look at the [underlying volume of commercial property sales. It too is weakening](#). In January, transactions totaled \$46 billion; by February only \$25 billion transactions closed, according to Real Capital Analytics, a New York City-based research firm. Anecdotal evidence reported in the press suggests that [loan rates have risen from 4.5 percent to over 5.0 percent](#).

Boycotting B-pieces

Securitization markets may be telling us that underwriting has gotten too loose. Investors may soon feel that they need to back off rather than accept excess risk. After all, plenty of today's investors remember that structured finance was the first leg to drop in 2007.

What's behind the volatility? Is there some new or deeper flaw in the structured finance market? Something that isn't generally understood by borrowers and lenders alike?

Perhaps. Let's look at the CMBS capital stack. On closer inspection, we see that a hole has developed in the mezzanine slice. As CMBS conduit lenders go to market to secure financing, they are having trouble finding investors across the entire capital stack, creating holes, where at times in the past quarter they have not been able to place all of the mezz securities.

Another issue in today's volatile market is with the riskiest slice; the first loss tranche – the B pieces. We used to see B-pieces trade in the low double digits type of level and we've recently seen them move toward 20.0 percent. Increasingly, investors are boycotting the B piece risk because they find it unacceptable or simply mispriced.

The other big shoe to drop in the B-piece market is the kick-out process. Traditionally, B-piece buyers could reject a loan they deemed too risky or poorly underwritten. In effect, kick-outs forced the originator to buy back that loan. Today, the structuring process has changed. CMBS lenders are taking loan applications to the B-piece buyer before they have closed the loan, effectively enabling the B-piece buyer to act as a second credit committee. This has led to moratoriums on different property types or other attributes.

The changing relationship between originator and B-piece buyer has created new friction and risk. Given their new status in the securitization process, the B-piece buyers can be very selective. One extreme example of this occurred recently when a B-piece buyer cut \$1 billion-plus pool almost in half.

All of this significantly affects lenders' financing costs and their ability to forecast returns. They don't know when and where they will ultimately finalize the financing of loans or, if they will be forced to contribute equity to substitute for the debt that they could not place. This, in turn, is significantly exacerbating volatility across the market. We've seen a number of situations during the first quarter of this year in which issuers were unable to place a full block of the capital stack, or in some cases, an entire transaction.

In the face of this volatility, market participants will have to weather a wave of CMBS loan maturities. Approximately \$200 billion in CMBS maturities loom in the next two years. With current estimates showing a decline in CMBS issuance to about \$120 billion, that leaves an \$80 billion void of maturities.

A healthy pull-back?

If you go back to the commonly accepted macro excuses for today's uncertainty, what's the most frequently-cited issue? Plunging oil prices that are upending the energy sector. Unfortunately, the real estate sector has a high degree of exposure to that market. The oil patch has been flashing warning signals for nearly a year and now headlines are appearing that include the dreaded "D" word: "default." In Houston, for instance, creditors are [seizing a Houston office tower after the holder of its \\$21 million loan could not refinance](#), according to a recent *Wall Street Journal* story.

It's not just the oil patch, however. We're seeing a real void of financing starting to develop in areas that are too exposed to those real estate sectors. We do have real global economic difficulties and we do have geopolitical unrest. We have domestic political friction as well. When all that is put together on top of the excess liquidity environment, a self-fulfilling cycle begins to develop where the longer volatility persists, the more likely it is that fundamentals are going to slow.

This is not a prediction that 2017 will be a repeat of 2007, but clearly, we are in the process of secular change in the real estate finance market. Certainly, today's volatility will prompt a healthy pullback of the excess leverage and excess liquidity in the market. In January alone, we saw about one-half dozen securitization-type lenders lose financing either partially or entirely. And we foresee more casualties.

When the times are good, real estate lenders have almost always taken advantage of robust demand to strap on the leverage. They turn to short-term repo warehouse finance, and rapidly add assets to their balance sheets. If markets weaken while lenders have compiled this accumulation risk, the mark to market becomes problematic and borrowers may not have the capital they need to meet likely margin calls. The more lenders you see fail, the more it tends to weaken the market.

Certainly we have much more work to do before good times, indeed more sustainable times, return.

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