CMBS
Are Firmly Established

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The big news sweeping the debt markets focuses on the increasing influence of public capital and the growth of CMBS as a force with which to be reckoned. Just as the pullback by REIT investors over perceived overbuilding risk and flattening growth prospects cooled down the real estate transaction markets, a flight to quality and liquidity by fixed-income investors has widened CMBS spreads and sent strong signals to lenders to tighten underwriting. Besides conduits, many commercial bankers have taken note, and are reining in loan officers.

While it is too early to assess the longer-term impact of CMBS on the debt markets, it seems clear that a classic paradigm shift is underway, which could help keep capital flows in better check and reduce volatility in the underlying real estate. Historically, undisciplined capital flows have ignored supply/demand trends and financed unnecessary construction that precipitated real estate downturns. The most extreme example of unrestrained lending occurred in the mid-to-late 80s, when lenders blithely continued to fund projects in the face of rising vacancies and slackening rent increases. The result was an unparalleled bust.

In this new era of public market influence, analysts and rating agencies are tracking real estate market activity, keeping close tabs on supply/demand issues, anticipating trends and providing instantaneous industry forecasts. But REIT investors got ahead of real estate market fundamentals in the 1995-1997 period, attempting to create growth stocks out of income-oriented investments. The 1998 correction generally realigned REITs with their underlying real estate values, in a volatile reaction to fears of too much development and flattening FFO outlooks.

In similar fashion, the CMBS markets pulled back and spreads widened as bond investors grew concerned about the REIT correction and world financial markets temporarily grid locked over travails in Asia and Russia. Significantly, commercial banks have paid attention to the CMBS markets and curtailed their activities, which had been marked by loose underwriting with uncomfortably high loan-to-value ratios and reduced debt service coverages, somewhat reminiscent of the mid-1980s.

Meanwhile, the real estate markets stand in relative equilibrium with low vacancies in most office, apartment and industrial markets as well as relatively restrained new construction activity, except for isolated pockets of overbuilding. In fact, insurance company loan-delinquency rates stand at negligible levels, and are reaching 20-year lows. The retreat by public market capital—from both the debt and equity markets—was arguably well-timed and has had a salutary impact on the real estate markets. Transaction activity cooled off before pricing got overheated and developers were put on notice to scale back activity.

Of course, some pending loan transactions needed to be re-priced at less advantageous terms for borrowers. A number of conduits, caught short with large loan inventories, were hurt as spreads widened and fixed income investors became more selective about CMBS offerings. But within the overall scheme of the real estate cycle, investors, including the CMBS players, appear to be well ahead of the game. Some investors who weren't surprised by the correction—cash rich institutions like insurance companies and some pension funds—are now viewing the capital market crunch as an opportunity to make excellent loans on soundly-positioned collateral or to buy CMBS at considerably more attractive spreads above Treasuries.

The CMBS markets are definitely here to stay, market fallout aside. In terms of market share among lenders, CMBS still trail commercial banks (14% vs. 40%),

but have almost surpassed life insurers (15%). Keep in mind that in 1990 CMBS had virtually no market share, and have grown in capitalization from $5 billion to about $170 billion today, outpacing the capitalization of REITs. Fundamentally, CMBS growth should continue, as these securities have become viewed more as mainstream investments. Bond buyers have come to understand the once mysterious structures, while borrowers can access cheaper capital. Most analysts no longer confuse CMBS with residential mortgage-backed securities where borrower prepayments in response to interest rate moves can wreak havoc with returns. In contrast, commercial mortgages have substantial prepayment protections, including lockouts, yield maintenance and defeasance.

The CMBS market itself has become self-fulfilling. As bonds constantly pay off, institutional buyers need to continue buying in order to replenish portfolios. Now international capital markets are taking notice and are looking to create their own CMBS structures. The Japanese are moving to establish a Resolution Trust Corporation-type of solution to their $1 trillion bad loan problem. Private placements on single asset debt securitizations are occurring in Europe.

There's no question that CMBS markets will eventually weaken in the US, regardless of exogenous financial market distress. Borrower delinquency rates will increase and some loans will fail as real estate market fundamentals inevitably become less robust. But these cyclical problems should be isolated to a small group of mostly unrated bond investors who have been well compensated for their risk-taking. Sophisticated investors have largely priced losses into the unrated-tranche transactions. Meanwhile, Triple-A bond buyers are well protected, and CMBS buyers in the 1994 to early-1997 period should take comfort in the conservative underwriting of loans during that time. Investors should expect some problems to crop up in certain loans made more recently, as conduits loosened underwriting standards in a competitive frenzy. However, healthy real estate market supply/demand fundamentals do not portend significant increases in foreclosure rates or delinquencies over the next few years, absent unanticipated general economic dislocation.

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As the CMBS markets mature, investors should anticipate a shakeout among conduits as bond buyers concentrate transactions with well-regarded brand name issuers—typically the bigger securitizers. The company standing behind the CMBS offerings has become important to investors. For brand recognition, conduits need to maintain the quality of their offerings, which in turn should lead to better underwriting. In addition, profit margins have become small for conduits, and only bigger issuers can support the overhead. Over time, investors will gravitate to issuers with smaller delinquency/default rates, putting marginal securitizers with problematic track records out of business.

If this trend holds, it will be more evidence that investors will be monitoring markets and staunching indiscriminate capital flows. Commercial banks, which are responsible for most construction lending, will continue to be hard-pressed to ignore movements in the public securities markets. In contrast to the late 1980s, odds are that new development projects won't be funded once it's clear that markets are getting out of balance. While the financial markets will show volatile swings by their very nature, underlying real estate markets should benefit from less severe cyclical ups and downs in the future. Time will tell. But the contribution of CMBS to this process appears to be a significant and welcome development.