by Thomas Mattinson

Investor Demand Keeps Pace

CMBS New Issuance Could Approach $40 Billion

New-issue volume of commercial mortgage-backed securities already has reached $25.8 billion through the end of the third quarter, and it appears likely that the market will eclipse last year's new-issue volume of $30 billion. An eye-popping $9.6 billion came to market in the third quarter, most of it arriving in the month of September. Looking ahead, there is $10 billion of new issues scheduled to price by the end of November, which makes a record-breaking year-end volume of nearly $40 billion seem possible. The tradeoff to this increased volume is some slippage in underwriting standards. While many excellent opportunities remain in the market, now more than ever, asset selection is critical from an investor's perspective.

The conduits have been fueling this fire and have accounted for 50 percent of year-to-date new-issue volume, compared with 30 percent market share in 1996. Additionally, the transactions have grown substantially in size. It is not uncommon to see new issues of up to $1.5 billion. In fact, Lehman Brothers and First Union will be coming to market in November with a $2.4 billion conduit deal. This transaction will feature approximately 500 loans and an average loan size of approximately $5 million. The increase in average new-issue size is further illustrated by comparing the average size of CMBS issues in 1996 to that of deals issued to date. In 1996, the average size approximated $260 million compared to about $400 million through the end of the third quarter.

Executive Summary

- **Third Quarter CMBS new issuance of $9.6 billion put the year-to-date total at $25.8 billion.**
- **Conduits are generating much of the CMBS volume, accounting for 50 percent of 1997 new issuance.**
- **Searching for relative value, some buyers are targeting "B" rated and unrated CMBS.**

Figure 1 Commercial Mortgage Pricing Matrix (10-year term instruments)

	Spread by Credit Rating (bp)			
Investment Category	**AAA**	**AA**	**A**	**BBB**
Industrial Bonds: Public	35	35–40	45–50	50–55
Private Placement Premium	15–20	15–20	15–20	15–20
Industrial Private Placement	50–55	50–55	60–65	65–75
Real Estate Premium	5–10	15–20	20–25	25–30
Bondable Mortgage	55–65	65–75	80–90	90–105
CMBS Premium	0	(5)	(5)–0	5–15
CMBS	55–65	60–70	80–85	95–120
Whole-Loan Premium	15–20	30	40–50	30–40
Whole-Loan Mortgage*	70–85	90–100	120–135	135–150

** Bond equivalent yield*

Source: ERE Yarmouth and Hyperion Capital Management, Inc.

In many cases, originators have formed alliances to gain critical mass. This practice enables them to achieve diversification, which affords them more favorable consideration from the rating agencies, while reducing shelf life. The rating agencies feel that increased diversification allows them to lower subordination levels, thereby increasing the issuer's securitization profit. In reality, increased diversification benefits the investment-grade bond classes, but increases event risk in the transaction, which is of greatest concern to the non-investment-grade classes. With non-investment-grade bond classes accounting for only about 10 percent of current new issues, it only takes a handful of small loans to experience a loss before subordination levels to non-investment-grade bondholders begin to erode.

Issuers have not experienced a problem placing the large amount of bonds with investors. Recently, however, two investment banks were left holding "A" through "BB" rated bond classes in their transactions, post issuance, at levels somewhat wider than those indicated at pre-issuance. This may be an aberration due to the heavy supply of paper available in the CMBS, corporate and asset-backed markets, which has partially contributed to a short-term widening of "A" and "BBB" rated classes across the board. Prior to September, investors snapped up CMBS, as spreads remained attractive relative to other asset classes, albeit at lower premiums. With this influx of capital from investors, CMBS spreads have tightened at all levels from a year ago, with the greatest relative value now coming from "B" rated certificates. In turn, lower weighted average CMBS spreads have enabled conduits to reduce coupon rates on the underlying mortgages.

With the increase in the number of conduits and with life companies and other traditional lenders hungry to

property was underwritten for a 15-year term and full amortization based on an underlying 15-year lease term from a well-established company with stable operating performance and a conservative management track record.

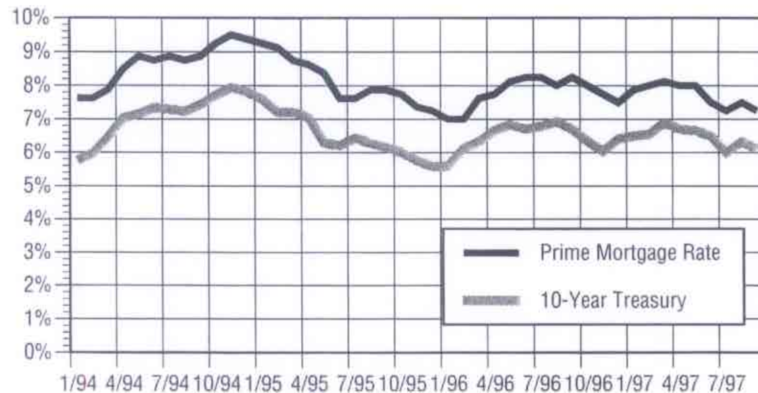
In a third scenario, a downtown office-to-retail renovation project was financed on a long-term pre-construction lease that was guaranteed by the tenant's "AA" rated parent corporation. By structuring loan terms and lease terms in a way that recognized the interwoven roles of lender, developer and tenant, the imbedded risks were appropriately shared in a fashion that benefited each participant in the transaction, reduced the effective risk to each and ultimately reduced the overall cost.

Over the next few quarters, we see little reason to expect broad changes in the market fundamentals. With the economy on an even keel, there appears to be little risk that interest rates will spike up very much (although a number of analysts continue to expect the Federal Reserve Board to take a moderately more constrictive position by year's end). REITs will continue to absorb considerable capital and acquire properties at rapid clip over the near term. Obviously, a general public equity market correction could slow this pace. Economic fundamentals in most local markets, though, should continue to support high occupancy levels, leading us to expect no reversal of delinquency rate trends.

Nevertheless, pricing will continue to be problematic for lenders, who must determine at what point tightening loan spreads become too low to cover reasonable long-term investment risks. RECMR

Robert Hess is vice president, investment research, with **Prudential Private Asset Management Group – Real Estate. Ronald Skinner** is a vice president, institutional mortgage investments, with **Prudential Real Estate Investors.**

Figure 3 Prime Mortgage Rate vs. 10-Year Treasury Yield



Source: Barron's/John B. Levy & Company National Mortgage Survey

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