PUBLIC DEBT

by Kurt L. Wright, CFA

Investor Base Continues to Expand

CMBS Offer Relative Value Despite Narrowing Spreads

The commercial mortgage-backed securities (CMBS) market maintained its impressive growth during the First Quarter with $6.1 billion of new issuance volume. While this figure is approximately 17 percent lower than the same period in 1996, last year's record First Quarter total was bolstered by an extraordinary $1.9 billion Confederation Life portfolio refinancing. Absent the Confederation Life deal, First Quarter new issuance was actually 12 percent higher this year.

This volume comes on the heels of $13.4 billion of new issuance during the Fourth Quarter of 1996. While many observers expected investors to need a break to digest this year-end activity, instead demand has remained at an extremely high level and newly issued bonds have been absorbed readily.

At the same time spreads have continued to fall to new lows with each new deal. Even "BB" rated CMBS, once the domain of only the most yield-hungry investors, are pushing close to corporate bond spreads. All this activity is very healthy for a market that remains fundamentally solid and offers very good relative value within the fixed-income universe.

Executive Summary

- **First Quarter 1997 CMBS new issuance totals $6.1 billion.**
- **CMBS spreads have compressed dramatically, especially for the "BB" rated bonds.**
- **Demand for "AAA" to "BB" rated CMBS continues to far outpace supply and most deals are oversubscribed.**

Indeed, CMBS spreads are dramatically lower than one year ago and, in certain credits, much lower than just a few months ago. In March, two deals pressed the frontier for "BB" spreads. Both Morgan Stanley Capital One, Inc. 1997-C1 and Nomura Asset Securitization Corp. 1997-MD7 achieved "BB" spreads of 235 basis points. These were seen as above-average quality deals by many investors; nonetheless, today "BB" CMBS spreads generally range from 225 to 250 basis points over same-life Treasuries. "BB"s were earning spreads of 325 basis points and 550 basis points at year-end 1996 and 1995, respectively. This eye-popping spread compression has left early "BB" investors with considerable capital gain potential and signifies a key market trend.

The number and variety of investors chasing "BB"s is increasing steadily. Many life insurance companies and a growing trickle of pension funds have targeted this credit sector based upon its perceived higher relative value than "junk" corporates. While in absolute terms, "BB" CMBS spreads are now only 50 to 75 basis points higher than "BB" corporates (compared to 200 basis points higher one year ago), in relative terms they are more than 40 percent higher. Further, across the credit spectrum, CMBS enjoy attractive call protection, inflation-hedging potential and strong market fundamentals, all of which further their appeal to traditional fixed-income investors.

As a result, demand for "AAA" to "BB" rated CMBS continues to far outpace supply, and most deals are widely oversubscribed. Appetites for "B" rated and unrated CMBS also are relatively high, but these bonds are only suited for investors with significant real estate and special servicing capabilities. A few pension funds, life companies and bond managers now have allocations for "B" rated CMBS and have aligned themselves with real estate advisers and special servicers to handle the heavy lifting. This has caused spreads over Treasuries for "B" rated CMBS to fall from 725 basis points one year ago to 600 basis points at quarter-end, and 550 basis points by early May. At these compressed levels, "B" rated CMBS are still 245 basis points (60 percent)

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	45	55	70
Private Placement Premium	15–20	20–25	25–30	25–30
Industrial Private Placement	50–55	65–70	80–85	95–100
Real Estate Premium	25	25	25	25
Bondable Mortgage	75–80	90–95	105–110	120–125
CMBS Premium	(10)–(15)	(15)–(20)	(20)–(25)	(15)–(20)
CMBS	65	75	85	105
Whole-Loan Premium	20–30	25–50	40–55	30–70
Whole-Loan Mortgage	85–95	100–125	125–140	135–175

Source: Equitable Real Estate Investment Management, Inc.

higher than "B" rated corporates, which should encourage more investors to join the fray.

Investors will face several challenges throughout 1997. First and most obvious is that the demand/supply imbalance will continue to frustrate investors attempting to reach allocation targets. CMBS issuance may grow modestly from $30 billion in 1996 to as much as $35 billion in 1997. Investor allocations, however, can be expected to grow much more rapidly. Pension funds in particular will be more of a force. For example, in the near term the San Francisco City and County Employees' Retirement Board is expected to allocate at least $75 million to non-investment-grade CMBS and is preparing a request for proposal for a CMBS adviser. This follows on a similar search performed late last year by the Pennsylvania State Employees Retirement System. Other pension funds can be expected to follow these innovators within the year.

Another challenge investors face is the shortened due diligence time frames offered by CMBS issuers. Whereas one year ago investors seeking "BB" rated CMBS had as much as one month or more to perform due diligence on underlying mortgage loan pools, today these time frames are as short as three days. This, coupled with a noticeable deterioration in collateral quality from certain conduit lenders, presents a great challenge for investors who realize that CMBS are highly heterogeneous and require tailored and extensive due diligence. The tendency is growing for investors to go the easy route and "buy off of the rating." This is somewhat unnerving, particularly as certain property types in certain markets approach their cyclical peaks.

Investors who are willing to perform extensive due diligence and patiently put money to work selectively will be rewarded with above-market performance. One significant area of opportunity for non-investment-grade buyers is the rapidly emerging secondary market. Early non-investment-grade buyers seeking capital gains and institutional investors requiring sales to support portfolio pricing are beginning to market their bonds. Often, strong performing, seasoned, non-investment-grade CMBS carry spreads that are higher by at least 25 basis points than new, untested deals due to an information-availability premium. Investors having the wherewithal to perform due diligence on seasoned deals can exploit this arbitrage.

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Starting in the Second Quarter, new issuance activity through year-end should increase steadily. Deals continue to come in many shapes and sizes. Lehman Brothers, in conjunction with First Union is expected to market a highly diversified $1.3 billion conduit deal during the Second Quarter. Conduit lenders now have captured more than 50 percent of the CMBS market share, up from less than 25 percent two years ago. Conduits are offering ever larger deals — and thereby more diversified — in an effort to reduce required subordination levels. In an effort to push out larger deals more quickly, some conduits (typically non-commercial banks) clearly are stretching in terms of asset quality and underwriting standards. Investors should be cautious; size and diversification will not cure bad lending practices (just ask any life insurance company veteran of the 1980s who is still around).

In another continuation of a key trend, Donaldson, Lufkin & Jenrette is offering a very attractive $425 million securitization backed by the 277 Park Avenue office building in New York City. This prestigious $1.7 million building is very well located and boasts an A+ tenant roster. In the past, the ownership group, a Stanley Stahl–led partnership, would have been limited to the traditional whole loan market for such a sizable financing. This transaction is indicative of the maturation and strong competitive position of the CMBS market vis-à-vis the life insurance companies and pension funds.

Finally, Teachers Insurance and Annuity Association has announced a $1 billion refinancing of portfolio loans that will come to market later in the year. This is just the latest transaction brought by one of the dominant traditional lenders who views the CMBS market as an important portfolio management tool. RECMR

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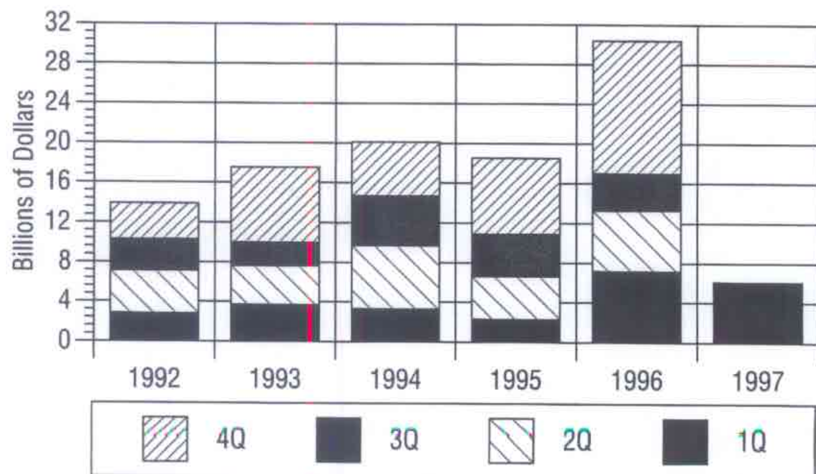
Figure 2 CMBS New Issue Volume



Source: Commercial Mortgage Alert