Global CMBS Newsletter

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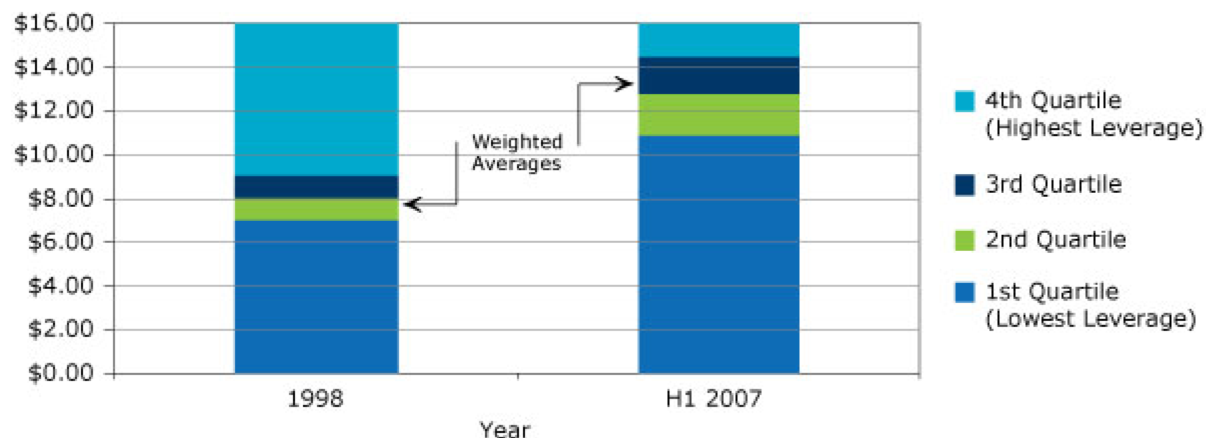
YOUR CASH FLOW $ GOES A LOT FURTHER THAN IT USED TO . . . IS THAT A BAD THING?

"Lackluster Demand for CMBS." "CMBS Spreads Widen Sharply in Choppy Bond Market." "Gloom Pervades CMBS Market as Deal Nears Pricing." Does that sound familiar? These are headlines from 1998 issues of the *Commercial Mortgage Alert.* Comparing the CMBS turmoil experienced over the past few weeks with 1998's is not new: market participants predicted we were in for a 1998-style rout, we've been reading it in articles, we've been hearing it from most CMBS issuers and we've been thinking it ourselves.

The last major CMBS market meltdown was in 1998 and it was also a consequence of a problem in another fixed-income sector. The outcome of the Russian bond defaults spilled across the fixed-income sector to the CMBS market. The CMBS market experienced similar volatility, including investor withdrawal and widening spreads. As a result, loan originations came to a halt as lenders increased loan spreads and demand nearly dissipated.

There is one thing we keep coming back to: it wasn't asset quality that impaired those hurt in 1998's liquidity crisis and most suggest it won't be asset quality that kills them today. Or will it? A property securing a loan we recently reviewed was featured in a 1998 article. The loan proceeds today are 3.3 times the amount they were when the loan was made and securitized in 1998. That equates to proceeds of about $125 per square foot (psf) versus $420 psf today. This sets a telling stage to suggest that if commercial property fundamentals falter as a result of the uncertainty of the economy, losses may be compounded.

Most market participants attribute much of today's damage to spillover from the subprime mortgage market, and others will suggest that the eroding quality in CMBS transactions also contributed to the fallout. We would agree. Leverage today has far exceeded levels in the past. The chart below accumulates data gathered from 1998 and 2007 (through Q2 2007) and shows dollars of debt per dollar of property net cash flow (NCF) at origination. Total loan originations for each year were split into quartiles based on the debt-to-net cash flow. In 1998, the worst quartile of loan originations began at $9.05. Earlier this year, in 2007, the best quartile wasn't captured until $10.90. The worst quartile begins at $14.50, suggesting 25% of loans originated earlier this year have greater than $14.50 of debt per $1 of NCF. This is significant. In 1998, 98.9% of the loans originated were originated at debt levels less than the best 25% originated in 2007 ($10.90 of debt per $1 of NCF). Today, the weighted average of $12.92 of loan proceeds for every $1 of NCF is 62% higher than the weighted average in 1998 of $7.96.



Regardless of the fact that delinquencies remain low, their staying is dependant on current property fundamentals remaining strong. There has been artificial equity infused into these transactions as cap rate compression continued to feed asset sales. But growth in rental revenue has not kept pace and is likely to subside in many markets across property types if the economy slows. Therefore, (1) borrowers are less likely to step up to protect their equity in these transactions because it was artificially created solely out of cap rate compression and they will not throw good money after bad and (2) underwritten NCF is highly vulnerable if property markets don't continue to grow in step with the last three years' historical highs. Because of that, the magnitude of losses, given the capacity of debt within these transactions, will be higher than experienced in the previous downturn. Even if delinquencies remain low, the impact of larger losses will be felt within the latest vintages of CMBS transactions.

We continue to hear and want to believe that this downturn will inject discipline into the market and improve credit standards. Let's not find ourselves saying something similar to what a former colleague of mine was quoted saying in February 1999, "The crunch wasn't deep enough or long enough to have a lasting impression on underwriting standards." Demand improvements, show discipline, differentiate. "A good loan is one you can sell." Now is a great time to make sure its one you want to buy.

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