WACHOVIA SECURITIES

Structured Products Research:
CMBS and Real Estate

CMBS Are Attractive to REITs

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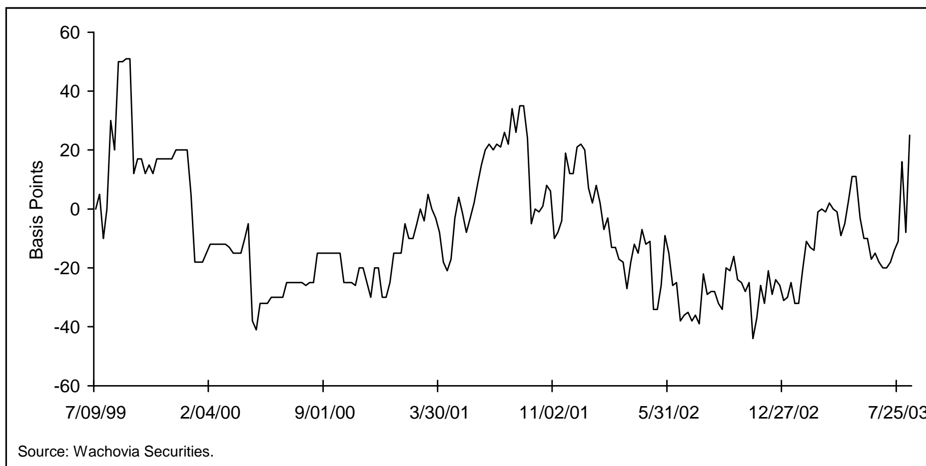
- BBB CMBS spreads are the widest they have been versus BBB REITs in two years. Currently, BBB CMBS are being offered at about 155 bps over Treasurys or 110 bps over swaps. In contrast, BBB REITs are being offered at 135 bps over Treasurys or 90 bps over swaps.

BBB CMBS spreads are the widest they have been versus BBB REITs in two years.

Exhibit 1: 10-Year BBB CMBS minus 10-Year BBB REITs



Source: Wachovia Securities.

- The reason for the unusual disparity is the strong performance in corporate bonds, which has pulled in all corporate bond spreads including REIT debt even as CMBS BBBs and other spreads have widened. For example, BBB CMBS are about 15 bps wider versus Treasurys than one month ago, whereas BBB REITs are 10 bps tighter versus Treasurys (benchmark REIT names are 0 bps–10 bps tighter, and "off-the-run" REIT names are 10 bps–20 bps tighter).
- Corporate debt has been tightening due to improving credit fundamentals and a belief that the economy may have turned the corner. For example, the global speculative-grade corporate bond default rate fell to 5.8% in July from 6% in June, and the latest forecast suggests the default rate may fall more in 2004 than previously predicted, Moody's Investors Service, Inc., reports. Last month, there were nine defaults on $8.7 billion of debt compared with June's six defaults on a far smaller $2.1 billion of debt.

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This report is available on wachoviaresearch.com.

- REIT debt, which is more affected by the commercial real estate markets than corporate profitability, has benefited from the tightening in corporate spreads. Indeed, although some institutional investors focus on and invest in all real estate products, such as CMBS, REIT debt and CRE CDOs, most place REIT debt investments in their corporate bond investment groups.
- Although we are comparing bonds with the same BBB rating, CMBS and REIT debt offer different benefits that are weighted differently by different investors. The benefits of BBB CMBS include the following:

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  - Given that the credit underlying a typical CMBS conduit deal is derived from more than 100 loans, BBB CMBS have superior borrower diversity to REIT debt. REITs have event risk as they are based on a sole obligor. CMBS also offer additional diversity as they are typically backed by different property types and geographic locations (most REITs focus on a single property type, and although some are nationally diversified, many are regionally concentrated).
  - The loans underlying CMBS deals are backed by first mortgages, whereas REIT bonds are unsecured general obligations.
  - CMBS securitizations are static pools, allowing the investor to perform due diligence without the risk of having the pool change.
  - In the past year, CMBS BBB spread volatility, hence spread risk, has been less than that of BBB REIT spread volatility, which tends to be more correlated with corporate spreads (Exhibit 2). Longer term, the two are comparable.

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Exhibit 2: Spread Volatility of BBB CMBS versus BBB REITs

CMBS 10-Year BBB		REIT 10-Year BBB	
Time Series	**SD**	**Time Series**	**SD**
8/16/02–8/15/03	18.403	8/16/02–8/15/03	26.884
7/09/99–8/15/03	32.268	7/09/99–8/15/03	32.395

SD: Standard deviation.
Source: Wachovia Securities.

- On the other hand, REIT benefits include the following:
  - Investment-grade REITs are less levered than CMBS. CMBS benefit from structured credit enhancement in the form of bond subordination and cash flow waterfall, in addition to borrower equity on the underlying collateral of typically 20%–25%. Conversely, investment-grade REITs are levered only 40%–50% (debt/market value) versus +/-75% for CMBS collateral, and REIT debt service coverage ratios (DSCRs) of 2x–4x are significantly greater than those of typical CMBS collateral.
  - REITs typically have higher property quality relative to the properties underlying CMBS.
  - REITs generally have more sophisticated property management.
  - REITs offer significant diversity in the large number of assets in which they are invested. Virtually all investment-grade REITs are significantly larger (in terms of total real estate value) than the typical CMBS transaction. In addition, virtually no investment-grade REITs own individual assets that comprise a meaningful portion of total revenue, a significant benefit over large-loan CMBS and fusion CMBS transactions.
  - The active management of REIT portfolios permits trading out of subperforming assets and acquisitions of relatively cheap ones.
  - REITs have marginally better liquidity vis-à-vis CMBS.

BOTTOM LINE

Although we leave it up to the investor to decide the importance of these subjective factors, we believe BBB CMBS are attractive now versus BBB REITs. Within BBB CMBS, we like seasoned CMBS BBBs as they typically have greater credit enhancement levels versus similarly rated new issue CMBS. In addition, seasoned BBBs typically have greater coupons with equal or greater DSCRs, which imply greater borrower equity based on current rates.

Additional information is available on request.

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