

# Mortgage Markets Robust as CMBS Market Recovers

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**T**he commercial real estate capital markets are much more than just Real Estate Investment Trusts (REITs) and Commercial Mortgage-Backed Securities (CMBS) — the overall market is roughly ten times the size of the REIT and CMBS markets combined (when counting corporate real estate). However, the volatile and dynamic securities markets continue to have significant affects on investors and other capital providers.

Some market observers suggest that the sensitivity of the CMBS and REIT markets to changing market conditions is just what the real estate industry needed, and focusing attention on these sectors is natural and appropriate. Other observers comment that the real estate securities markets overreacted to non-real estate issues, proving real estate is a poor asset class to have securitized in the first place.

Regardless of your perspective, there is no question, as demonstrated by the evidence in this article, that changes in the securities markets do have significant ramifications for both real estate property values as well as for the firms that make their living in the real estate arena.

The rest of this article will highlight the rebound in the CMBS market and the continuing troubles in the REIT marketplace, although glimmers of hope have arisen, and will provide some assessment of the implications of these securities market

changes on investors and other capital market providers.

## CMBS MARKET REBOUND

Moody's Investors Service forecast volume for 1999 is \$55 billion. It also projects that volume over the next few years should remain in a band of \$45 billion to \$90 billion, indicating a strong healthy CMBS market for years to come.

There is expected to be a slowdown in the second and perhaps third quarter of 1999, due to the dearth of lending activity during the latter part of 1998. Moody's also projects that deal structures will become more conservative over the next few years. The average conduit deal size should decline as cautious issuers focus on controlling inventories and minimizing exposure to spread volatility. Fewer esoteric assets and structures are expected. While CMBS loan to value ratios climbed 5.6% between 1997 and 1998, some reversal of this trend is expected in 1999.<sup>1</sup>

Treasury rates have risen over 100 basis points between January and the first week of June, but the CMBS market has been quite active so far this year. First quarter securitizations totaled over \$18 billion, which was 20% greater than the previous record set in last year's first quarter. Second quarter volume was sluggish during April and most of May until nearly \$6 billion in new issues hit

in the last two weeks of May. Combined with projections of near \$8 billion for the month of June, total first-half CMBS volume is expected to be \$35 billion.<sup>2</sup>

Apartment mortgages are in particularly strong demand by capital providers. Wall Street investment banks are eager to make multifamily mortgages because CMBS buyers like to see apartments make up a large percentage of securitized pools. Fannie Mae and Freddie Mac are also gobbling up multifamily mortgages at prices that Wall Street has difficulty competing with. The result is very attractive mortgage pricing for existing owners of apartment properties.<sup>3</sup>

Part of the reason investors have come back so quickly to the CMBS market is the strong historic credit performance of the mortgage loans collateralizing CMBS. Based on a recent study by Fitch IBCA, only 0.5% of the mortgage loans collateralizing CMBS conduit deals had defaulted, and none had incurred a loss through December 31, 1998. Of the 9,760 commercial mortgage loans in the 69 CMBS transactions that Fitch has evaluated since 1993, only 50 loans have defaulted, and 44 of the 69 transactions have not experienced a single loan default.

Loans secured by hotel properties have the highest cumulative default rate of 1.07%, followed by multifamily loans with a default rate of 0.81%. Office, industrial, retail, and other property types default rates have averaged less than 0.25% per year.

These loss statistics for conduit loans are particularly important given the dramatic growth and development of commercial loan conduits – financial companies that originate commercial mortgage loans with the intention of immediately selling the loans through securitization rather than holding loans on their balance sheet. Total outstanding conduit issuance is about \$105 billion, somewhat less than half the overall CMBS industry. Conduits largely came of age in 1995 with \$5.9 billion in issuance. In 1998, roughly \$53 billion of CMBS backed by conduit loans were issued.

Given the specific short-term exit strategy of conduit lenders, underwriters, rating agencies and investors often refer to them as a distinct class of loans. Strong conduit loan performance during the last six years provides a good foundation for the continued growth of the industry, but continued diligence by underwriters, rating agencies, and other participants in the industry will be necessary to continue the strong performance as real estate markets stabilize after a long ride up in recent years.<sup>4</sup>

With the resurgence of the CMBS marketplace during the first half of the year, conduit lenders are strug-

gling to meet loan production goals, a trend that is expected to result in a decline in CMBS volume in the second half of the year. Among the reasons being cited for the lending slowdown include fewer property sales, hard feelings against those conduits who pulled out of the market during tough times, and fewer refinancing opportunities due to the sustained loan rates in recent years and moderating property values. Strong and active competition by portfolio lenders is also contributing to the overall competitive lending landscape for conduits.<sup>5</sup>

Conduit lenders, despite the increased competition in 1999, are still the dominant providers of mortgages for the CMBS marketplace. Conduits originated 46% of the mortgages for CMBS transactions in 1996, 65% of the mortgages in 1997, and 73% of the mortgages in 1998.<sup>6</sup> While this percentage is unlikely to increase in 1999 due to growing interest and origination of mortgages for the CMBS market by banks and insurance companies, conduit lenders are expected to maintain their strong presence in the marketplace.

A maturing secondary market is also providing the foundation for CMBS market growth. The secondary market for CMBS has grown in recent years as documentation and market data improve, and rating agencies continue to upgrade their surveillance processes. For example, Fitch IBCA has a two-tiered CMBS monitoring process. The first tier consists of monthly or quarterly reviews of transaction level information and serves as a leading indicator, allowing surveillance analysts to determine when more thorough reviews are necessary. The second tier incorporates detailed review of loan level information to determine whether rating changes are required. While each transaction is scheduled for at least an annual review, the frequency and timing of these reviews are determined by the transaction's stability.

Fitch IBCA also analyzes other changes that might affect a transaction rating including loan defeasance, additional debt, collateral release, collateral substitution, loan assumption, easement agreements, as well as changes in management, master servicer, special servicer, liquidity provider rating, and corporate rating.<sup>7</sup>

## REIT MARKET SHOWS SIGNS OF LIFE

REITs have bounced back in the last 90 days after nearly nine months of negative news. REIT total returns for 1999 as of June 10 were up to 5.7%, as a result of over 10% returns during the last 90 days. March and April were the big months with over 12% gains followed by a

2% loss during May and early June. While REIT performance over the last 12 months is still a negative 6%, recent increases are certainly positive news.

The hotel sector, which had returns of -53% in 1998, rebounded the strongest, with year-to-date returns of 15.5%. Apartments at 12.1%, and office and industrial properties with 8.0% returns were other top performers so far this year. Health care, at -4.4%, and Shopping Center REITs at -0.7% have performed the worst.

REIT dividend yields have also declined from 7.5% at the end of April 1999 to approximately 6.9% in the middle of June. While the 6.9% REIT dividend yield is close to the average for the last six years, the yield is still up nearly a percent from much of 1997 and the first half of 1998, when REIT money raising reached its peak.

Declining REIT yields and improving performance should improve the ability of REITs to raise additional reasonably priced capital. However, new equity issuance during the start of 1999 remains down, with new activity limited to approximately \$1 billion through the end of May. This total approximately equals the amount achieved for the last half of 1998, but is well below the \$11 billion raised during the first half of 1998 and the \$22 billion raised in 1997.

Furthermore, despite funds from operations continuing to grow and real estate fundamentals remaining solid, the ability to raise new monies is still severely limited by real estate investors upset about REIT stock performance in 1998 and individual investors' tremendous success with high-flying internet stocks.<sup>8</sup>

One positive step for REITs came from President Clinton when he revealed in his State of the Union Address on January 19, 1999, that REITs should be allowed to provide non-real estate related services to tenants, a far cry from just one year ago when Clinton and Congress retracted such activities from paired-share REITs. This latest proposal would lift the restrictions on REITs that wish to operate non-real estate related subsidiaries such as those that provide services to tenants. However, the income received from those subsidiaries would still be subject to corporate income tax. While there are still some limitations related to the total percentage of income that a REIT can generate from such subsidiaries, market insiders believe that most REITs will take advantage of this change, creating enormous possibilities for REITs to increase their cash flow and earnings going forward.<sup>9</sup>

The debt picture for the REIT industry is both good and bad news. The good news is that debt spreads

have come down from highs of more than 300 basis points, if you could do them at all, to lows of 200 to 225 basis points in February. The bad, and somewhat confusing, news is that a real estate company whose debt is rated investment grade with covenants that restrict overall debt to 60% of cost, still finds its debt priced more expensively than a mom and pop company borrowing on a single asset basis from the myriad of mortgage conduits and portfolio lenders.<sup>10</sup>

## MARKET RESPONSES TO SECURITIES VOLATILITY

Robert Brunswick of Buchanan Street Partners observes that strong opportunities for private real estate investors have emerged from the REIT and CMBS market volatility in the last half of 1998. Steady economic growth, solid real estate fundamentals, lowering CMBS spreads, and less acquisition competition from REITs provide investors a solid platform for success in 1999. In addition, with strong positive leverage — mortgage rates at a point or two below capitalization rates — investors can maximize their real estate returns with acceptable risks.

Private investors are in a stronger competitive position to acquire properties as a result of the decline in REIT acquisitions due to their continuing performance and money raising problems. During the first six weeks of 1998, REITs accounted for 70% of the \$12.8 billion acquisition volume represented by the 271 transactions tracked by Institutional Real Estate, Inc. Today, most REITs have retreated to the sidelines. During the first six weeks of 1999, REITs accounted for only 30% of the 192 property deals tracked by Institutional Real Estate. In the hotel sector, where REIT returns declined 53% in 1998, only a single acquisition was noted during the first six weeks of 1999, compared to \$800 million in acquisitions during a similar period in 1998.

Private investors have been further aided by the rebound in the CMBS market. Despite serious setbacks during August of 1998, the average ten-year AAA spread in the first ten deals in 1999 averaged 123 basis points over-Treasuries compared to 147 basis points for the last ten deals in 1998. Even BBB spreads dropped from 325 basis points over-Treasuries during the fourth quarter of 1998 to 254 basis points during the first quarter of 1999. CMBS spreads on select ten-year AAA deals were back down to 105 to 110 basis points by the end of May.

In combination, the declining competition from REITs, and the continuing health in the equity and debt marketplace has established 1999 as a potentially excellent year for private investors.<sup>11</sup>

Some market participants are concerned about the aggressive rebound of the CMBS and overall debt markets. Prior to the collapse of the CMBS market in the fall, those with short-term memory will remember that there was significant concern about overbuilding and capital excess. When the CMBS market declined in the late summer and fall of 1998, what was expected was a slow and prudent return to an equilibrium market by disciplined underwriting and rational pricing. Instead, the spreads in AAA securities are down nearly 100 basis points from November 1998, and with many existing lenders and conduit programs expanding, some market observers believe we are heading into an aggressive, perhaps overly aggressive lending cycle.<sup>12</sup>

Other market observers — the majority — believe the outlook for the existing equilibrium in the real estate market to continue has improved due to changes in the capital markets during the last six months. Given slightly increased risk aversion by mortgage lenders, and the problems in the REIT marketplace, it now appears less likely that over zealous lending and building will occur. Decreased credit availability has curtailed commercial construction, which had rebounded strongly from a trough in the early 1990s. A large percentage of proposed commercial real estate activity has little or no advance leasing commitments, so many of these speculative projects have been put on hold. REITs directly and indirectly sponsored a significant portion of construction currently in the pipeline, or in the proposal stage, and many of these projects have been put on the back burner.<sup>13</sup>

Life insurance companies' involvement in the commercial mortgage sector is continuing to change as a result of CMBS market growth, risk-based capital requirements, and the trend towards demutualization. Risk-based capital requirements that increased the reserve capital for commercial real estate mortgages a number of years ago have encouraged life companies to downsize their commercial mortgage holdings. The competition from the CMBS market has also eroded market share. Finally, demutualization (mutual companies converting to public stock companies) has increased life insurance company interest in mortgage growth and profitability.

An example of a response to these trends is shown by John Hancock Real Estate Finance, Inc. They

are leveraging their existing origination infrastructure to perform balance sheet and off balance sheet lending. To capture non-conforming mortgage business, John Hancock has begun its own securitization program to allow quality nonconforming loans to be processed through its origination infrastructure, creating a new origination and securitization revenue stream. John Hancock's securitization objective for 1999 is between \$750 million and a billion dollars.<sup>14</sup>

Commercial bank activity in the mortgage markets increased strongly between 1994 and the second quarter of 1998, and is expected to be strong in 1999 as somewhat higher conduit pricing continues. Between 1994 and the second quarter of 1998, commercial bank real estate mortgage holdings increased by \$93.2 billion. During the same period, securitized mortgages increased by \$139.2 billion.

While CMBS pricing has declined significantly during the first quarter of 1999, it is unlikely that conduit pricing will go down to levels seen in 1998. Cutthroat competition for loan originations pushed profit margins to the 2% level in early 1998. These thin profit margins turned into losses when the market reversed in September and October. This year, conduit lenders are targeting gross profits in the 4% range to provide a wider cushion for unexpected spread increases. The resulting higher conduit loan pricing provides the basis for a strong competitive lending market in 1999.<sup>15</sup>

The difficult performance of the hospitality industry in 1998 has contributed to a tripling of mergers and acquisitions compared to 1997. Globally, lodging companies completed \$33.4 billion in transactions last year, compared to \$11.2 billion in 1997. There were fewer transactions in 1998, but the average size of the deals increased from \$204 million in 1997 to \$866 million last year. Consolidation trends in the lodging industry have slowed in 1999. Through April, only one transaction valued at \$128 million has closed, compared to \$21 billion in hotel deals in the first quarter of 1998.<sup>16</sup>

The strength and interest of international real estate investment was demonstrated by the quick sellout in only two months of the £\$505 million retail partnership sponsored by London-based Lend Lease Group. The partnership will seek retail acquisitions in Europe, including a 25% interest in Bluewater, the largest shopping center in Great Britain, and England's Touchwood shopping center, which currently is under development. This more favorable outlook on Europe is reflected in the CMBS market where international CMBS—much of it dealing

with distressed European real estate—dropped from 8% of the market in 1997 to 1% of the market in 1998.<sup>17</sup>

## CONCLUSION

The real estate securities markets have become so prominent that they now affect all aspects of the real estate industry. However, in keeping track of these markets and evaluating their implications, it is important to clearly distinguish the frame of reference from which the evaluation is done. For example, the implications of market changes on REIT and CMBS investors, borrowers, and capital market competitors can be quite different. Problems for one group can be opportunities for another, and the volatility introduced by the securities markets provides excellent investing prospects for those smart enough to read the signs and react accordingly.

## ENDNOTES

<sup>1</sup>Research Services Release. Moody's Investors Service, April 20, 1999.

<sup>2</sup>"Commercial Mortgage Alert." Federal Reserve Bank, May 24, 1999.

<sup>3</sup>Baron's/John B. Levy & Company National Mortgage Survey, April 5, 1999.

<sup>4</sup>"CMBS Conduit Loan Defaults by Property Type." Commercial Mortgage Special Report, Fitch IBCA, April 6, 1999.

<sup>5</sup>"Commercial Mortgage Alert." April 12, 1999.

<sup>6</sup>"1998 CMBS Market Overview." Lehman Brothers.

<sup>7</sup>"CMBS Surveillance: Evaluating Credit Risk in the Secondary Market." Commercial Mortgage Special Report, Fitch IBCA, March 4, 1999.

<sup>8</sup>"Merrill Lynch Comparative Valuation REIT Weekly." June 10, 1999; "Institutional Real Estate Securities." June 1999.

<sup>9</sup>"Institutional Real Estate Securities." March 1999.

<sup>10</sup>"The CMBS Quarterly." Duff and Phelps Credit Rating Company, March 1999.

<sup>11</sup>Finova Realty Capital FaxLink, April 8, 1999; Institutional Real Estate Newslines, May 31, 1999.

<sup>12</sup>"The CMBS Quarterly." Duff and Phelps Credit Rating Company, March 1999.

<sup>13</sup>*The Gilberto-Levy Monitor* [January 1999].

<sup>14</sup>See Green [1999] and "Financing Notes." Cohen Financial [March 1999].

<sup>15</sup>See Green [1999].

<sup>16</sup>"Institutional Real Estate Newslines." PricewaterhouseCoopers LodgingResearch.com, April 19, 1999.

<sup>17</sup>"1998 CMBS Market Overview." Institutional Real Estate Newslines, Lehman Brothers, April 19, 1999.

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