Sector UPDATE

CMBS Market Conditions a Bit **Choppy**! Why?

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Spreads are up. Way up over just a few months ago. In fact, CMBS spreads are up 120-140 basis points since late summer 2015, pushing rates into the low- to mid-five percent range. Unlike in the past, lenders report that there is not just one reason, but many for the widening and that is causing some concern. /// Not only have spreads increased, but investors are pushing back on interest-only and loan-to-value (LTV) ratios. Consequently, loans look drastically different from just six months ago. Debt yields, the main constraint for sizing up a loan, have blown out from a low of 7.75 percent to as high as nine percent (8.4 percent for high quality assets and nine percent for average assets). Interest-only periods have been dialed back from five years to 1-2 years, or in some cases none. Finally, some shops have pulled LTV ratios back to 70 percent. /// With this said, many borrowers report they have no concerns about the CMBS market since they access life company and agency debt which is much more stable and rates are in the high three percent to low four percent range. However, the life companies' annual volume is about half of CMBS. So if the elevated risk off position continues, it will most likely impact commercial real estate values and demand for acquisitions.

WHY THE TURMOIL IN CMBS?

Defaults are near all-time lows and the real estate markets show strong fundamentals. But the cliché "what happens on Wall Street impacts Main Street" is reported to be the culprit hampering the CMBS market. And, in the present case there are a variety of happenings:

Investors suffering losses on pools. The hangover of excess pools that built up late fall usually works itself out by year-end. Then, spreads usually compress as supply of new pools dwindles. Well, this didn't happen this year. A choppy market kept some lenders on the sidelines as they were intent on waiting to sell once spreads compressed. Eventually, many did sell and some reported losses on pools causing others to price new loans wider.

B Buyers kicking anything out of the box. B Buyers are kicking risky loans, and originators are being more cautious as a result because it's costly to hold a loan if it's kicked from a pool.

Headlines about China and a global slowdown, coupled with negative interest rates in Europe to stimulate growth don't help either.

Concern about Sovereign defaults of countries tied to exporting oil. This is one more reason investors are focused on investment grade bonds, and the non-investment rated tranches have seen spreads blow out, thus impacting the overall spread. Furthermore, the recent meltdown in oil prices has also caused angst in the junk bond market which has again spread to CMBS unrated tranches.

Issuers also report a shortage of bond buyers. Buyers think things got overheated during the past 24 months, and they are pushing back or not buying at current prices.

According to one lender, "Everyone's running for cover" and a few shops have shut down – naturally, the strong will survive. Additionally, issuance may be about 60 percent of what it was last year at around $65 billion.

Risk retention rules being implemented by Dodd Frank. CMBS lenders will be required to hold five percent of the pools. Additionally, CEOs will be liable for representations made in origination documents.

WHAT NOW?

Going forward and seeing opportunity to fill a gap, some lenders have rolled out hybrid programs to take advantage of the current conditions. These programs are a bit more conservative than CMBS and more aggressive than life cos. Rates for this 10-year money are in the 4.75 percent range.

JAMES DUMARS oversees the NorthMarq Capital Arizona office as Senior Vice President – Managing Director, a position he has held since 2001. He has consistently been a top producer at the company since joining in 1994, and has assisted clients with several billion dollars in transactions throughout the years. ◆