



## Subprime Sequel: The Commercial Mortgage Market's Weak Foundation

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The current troubles in the subprime mortgage market began when heightened competition among mortgage lenders drove underwriting standards down sharply. Lots of borrowers with poor credit histories received mortgage loans with no income or assets verified, higher loan-to-values and “piggyback” loans, better known as second liens. With borrowers “in over their heads” and the downturn in housing, problems surfaced abruptly in the subprime mortgage sector. The situation has become exacerbated as lenders have tightened their standards in the face of higher default-related losses, leaving some borrowers with fewer options to refinance. Consequently, we have seen the rate of delinquencies and defaults on subprime mortgages soar. Similar to subprime lending, we have seen aggressive underwriting in other areas of the real estate market.

In the commercial real estate sector, commercial mortgages, like residential mortgages, are pooled together and packaged into securities that are widely held by investors. Amid high global liquidity and low interest rates, lenders stretched their underwriting standards to capture greater fees on an increasing volume of loan originations. Because issuers encountered little difficulty in selling these securities to investors, many lenders extended credit on increasingly easier terms. Could it be possible that the sequence of events in subprime lending will similarly unfold in the commercial mortgage market? With approximately \$700 billion in commercial mortgage-backed securities (CMBS) outstanding, this is an important question for many fixed income investors.

### Sound familiar?

In this environment, we would like to point out the following reasons to be concerned about potential future risks to bondholders, given the prolonged period of lax credit conditions the market has experienced recently. This market is, after all, a cyclical one.

- ▶ Leverage is rising and as prices have gone up, many borrowers have cashed in on the equity build up in their property values. It's alarming to see the growing proportion of commercial mortgage loans with loan-to-value (LTV) ratios greater than 75%. Furthermore, using the rating agencies “capitalization rate” (cap rate) approach, leverage has climbed to over 100%, often over 120%. The leverage may be somewhat overstated because there is an inherent flaw in the agencies' methodology that discounts property cash flows using an historical interest rate that is well above the current level of market rates. Despite these flaws, today's higher leverage reflects the willingness of lenders, including bondholders, to “overextend” capital to borrowers.

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**While the fundamental picture for commercial real estate remains rosy, lending terms have been too easy.**

- ▶ Debt service coverage ratios (DSCR), which measure a property's net income relative to the debt payment, have deteriorated. This presents a problem on two fronts. First, the number of loans with weak coverage – specifically less than 1.2 times – has increased significantly. Secondly, lenders are, in many instances, grossly misrepresenting the borrowers' debt service coverage. How so? They often use what is referred to as “stabilized” net income. “Stabilized” net income is boosted by upward adjustments to assumed future rents, (supposedly to account for below market rents, ongoing property improvements, higher occupancies, etc.). For example, it is not uncommon to see loans underwritten to cash flows that are expected to be realized several years from now. Although a borrower's net income should go up over time due to these considerations, today's tight yield spreads do not compensate bondholders to assume overly “optimistic” future cash flows will, in fact, materialize. Finally, if you follow Moody's “stressed” DSCR, which measures the coverage assuming a higher interest rate, the trend for 2007 origination has dropped below 1.0 times coverage. However it is measured, debt service coverage is too low and leaves little room for error.
- ▶ The percentage of loans with full or partial interest only (I/O) terms is staggering. With most borrowers not amortizing their loans, refinancing risk on the mortgage balloon date in five to ten years has shot up substantially. On top of that, loan sizes have grown to proportions such that a single large loan needs to be divided among several different pools in order to reduce the concentration in a single CMBS deal. Similar to corporate debt, when there are “lumpy” maturities, borrowers may face difficulty refinancing and investors bear that risk.
- ▶ The percentage of loans with subordinate debt in place at origination (additional debt behind the first mortgage) has grown substantially. Additionally, the number of loans allowing subordinate debt to be added has risen. Deals now have about 50% of loans with both subordinate debt in place and the ability to add debt over time. Given that interest coverage is already low, the potential for increased debt burdens will likely pose problems in a less-favorable real estate environment than today.
- ▶ Structurally, CMBS deals have so much concentration in the top 10 loans that when you look down the capital structure to the BBB and lower rated bonds, they typically have less subordination to protect against principal losses than just a handful of the largest loans. Why is this important? The lower-rated tranches will likely still be outstanding when these loans come due for repayment.

## How bad is it?

For each point that we have made, the statistics in Exhibit 1 demonstrate the deterioration in CMBS deals issued over the past several years. You decide...

**Debt service coverage ratios have deteriorated. They are too low and leave little room for error.**

Exhibit 1

	2004	2005	2006	2007 YTD
%LTV	66	68	68	70
%LTV>75%	33	34	35	42
Moody's %LTV	87	97	100	110
DSCR <1.2x	2	4	10	18
Moody's DSCR	1.64	1.55	1.39	1.34
S&P DSCR	1.65	1.52	1.4	1.28
%Full-term I/O	14	26	32	57
%Partial-term I/O	29	38	43	26
%Full/Partial I/O Total	43	63	74	83
%Subordinated debt "in place"	19	15	18	21
%Subordinated debt "allowed"	28	29	28	30
%In Place / Allowed Total	43	63	74	83
%Top-10 Loans	44	10	41	10
%Largest Loan	9.9	8	9	10
%Mid-BBB Credit Enhancement	4.9	4.5	4.2	4.1
%Low-BBB Credit Enhancement	3.6	3.3	3.1	2.9

Source: Standish Mellon Asset Management CMBS database

## Déjà vu?

It's hard to envision lots of delinquencies and defaults for commercial mortgages in today's favorable environment. But it is also hard to imagine delinquency rates falling any further. Borrowers have locked in highly attractive financing via low fixed rate, interest only loans that allow additional subordinate debt. Against a backdrop of rising property values and a stable economic environment, does it get any better for borrowers? Probably not. Over the past few months, spreads have widened in CMBS, especially in the lower-rated bonds. Do higher risk premiums reflect the contagion in subprime mortgages? Or are investors finally demanding higher compensation for riskier loans? The answer is probably a little bit of both. While the fundamental picture for commercial real estate remains rosy, lending terms have been too easy. In three, five or ten years as these loans come due for repayment in a market with possibly higher long term rates or in a weak commercial real estate market, borrowers could find themselves with unamortized debt that is closer to 100% LTV and debt coverage less than 1.0 times.

We are just now beginning to see very modest changes in underwriting terms to reverse these trends. A return to amortizing loans with higher coupons, lower leverage and higher interest coverage will impact commercial real estate valuations as buyers adjust to higher financing costs. Will the CMBS sector feel the same pain that the residential sector feels? Over the short term, we feel the answer is “no.” But the environment can change quickly with some combination of flat or falling real estate prices, higher vacancies, lower rents and – let’s not forget – higher mortgage rates. In the past, overbuilding and economic downturns have resulted in a weak commercial real estate sector. However, over the past few years, we believe the changes in the credit cycle have allowed borrowers to overextend, which ultimately will likely impact the commercial mortgage market this time around.



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