NAI Global

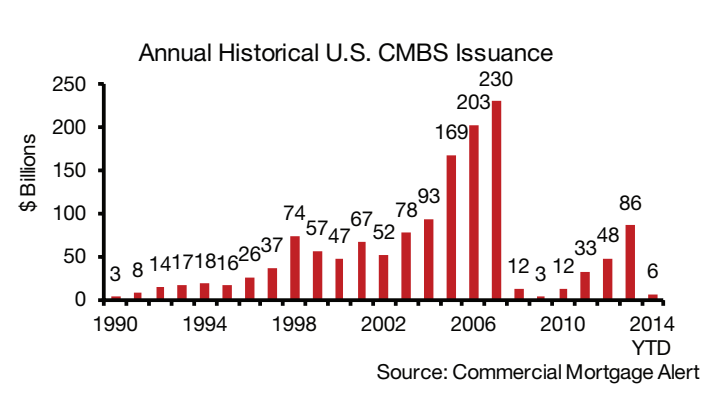
Bracing for CMBS Maturities in 2015-2017

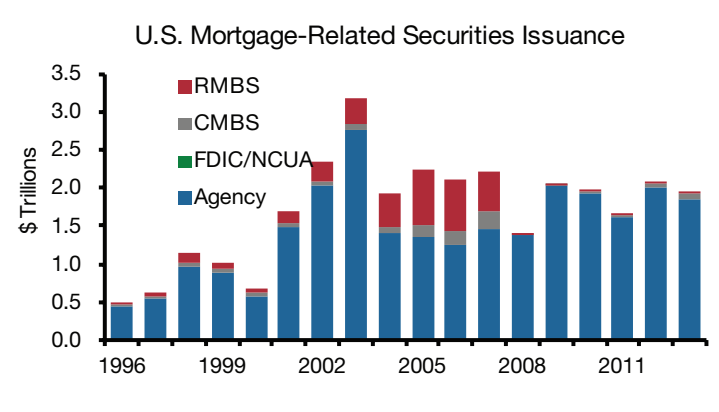
By Dr. Peter Linneman,
NAI Global Chief Economist

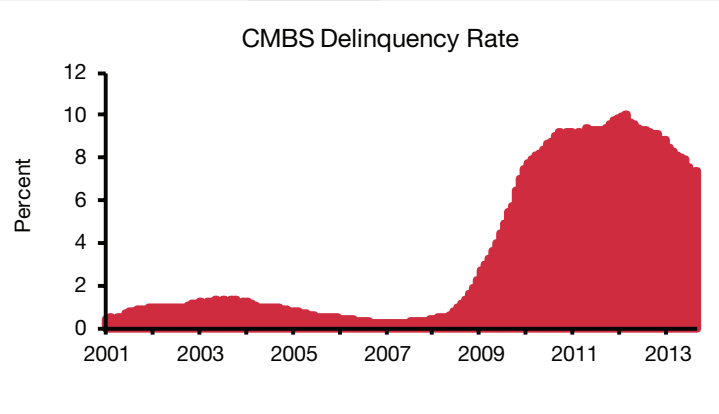
The history of commercial mortgage-backed securities (CMBS) issuance since the early 1990s reveals that, prior to the financial crisis that began in 2007, it was a net source of refinancing.

Bracing For CMBS Maturities in 2015-2017

By Dr. Peter Linneman,
NAI Global Chief Economist







When CMBS began in earnest in the early 1990s, it was a new source of capital for real estate. This mostly 10-year mortgage source resulted in a period of rollover refinancings a decade later in the early 2000s. Through 2007 there were more CMBS issuances than a decade earlier, indicating that all of the CMBS debt issued in the 1990s was refinanced and new CMBS loans were originated. Then in 2009-2011, more loans came due from a decade earlier than were financed, due to an effectively dead CMBS origination market. In 2012 and 2013, neutral financing occurred as CMBS loan volume roughly equaled CMBS issuance a decade earlier. Of course, not all of the CMBS issued a decade earlier is still outstanding at maturity, as some debt was defaulted upon or restructured. But as a first approximation, decade-over-decade issuance provides an indication of whether CMBS is a net provider of mortgage debt.

In 2014, it is likely that CMBS will be a net positive source of debt, as issuance will approach $100 billion, versus $93.2 billion in 2004. However, 2015-2017 looms as an enormous negative financing window, even if CMBS issuance continues to grow. This is because the amount of CMBS issued from 2005-2007 is literally off the charts from a historical perspective. In 2005, $169 billion of CMBS were issued, followed by $202 billion and $230 billion in 2006 and 2007, respectively. Even if in 2015–2017, $120 billion is issued annually, there will be a shortfall of roughly $240 billion during this window. Thus, 2014 promises to be the refinancing calm before the refinancing storm of 2015–2017.

The resurgence of U.S. CMBS issuance, more than $85 billion in 2013, is allowing an increasing number of stressed owners to refinance their properties. This process has been aided by historically low interest rates and the fact that most of today's maturing CMBS mortgages were written in 2003-2004, when

Doubly bad news for hopeful refinancers is that required debt coverage ratios are higher today than in 2005-2007.

rates were high and nominal rents were lower than today, with the exception of the industrial sector. For example, nominal central business district (CBD) and suburban office rents stood at $29.17 and $24.27 per square foot, respectively, in 2003, but were at $45.98 and $28.41 in 2013. Similarly, nominal multifamily rent averaged $591 per unit in 2003 but had reached $736 per unit in 2013, while hotel revenue per available room (RevPAR) grew from $49.98 to $68.69 over the last 10 years. All of these factors generate higher nominal NOI with which to service the maturing debt.

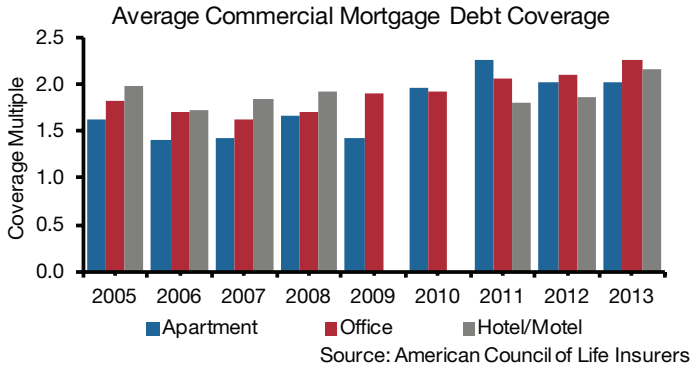
As a result, borrowers are increasingly able to roll over their loans from a decade ago, as coverage ratios and loan-to-value ratios (LTV) permit refinancing. In addition, the $78 billion and $93 billion in CMBS issued in 2003-2004, respectively, are consistent with the $80-90 billion per annum pace of today. Furthermore, the weakest properties of this vintage CMBS have already defaulted during the financial crisis.

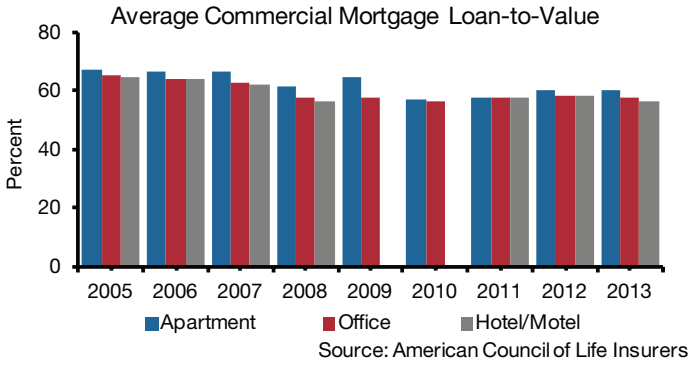
This picture may change dramatically as we move into 2015-2017. This mortgage cohort was underwritten much more aggressively and at cyclically higher rental rates. Further, the volume of CMBS loans issued in these three years far outstrips the current CMBS loan production rate. Refinancing loans from this cohort face the challenge of lower NOIs and higher interest rates, while due to lower production levels, lenders will focus on the strongest sponsors and properties.

We examined commercial mortgage data from the American Council of Life Insurers for fixed-rate loans by sector since 2005, to see how underwriting standards have changed. The most positive market condition in terms of rollover risk versus 2005-2007 is that commercial mortgage interest rates are lower today. However, this condition is unlikely to last into 2016-2017.

Doubly bad news for hopeful refinancers is that required debt coverage ratios are higher today than in 2005-2007, and loan-to-value ratios are lower. Although credit markets are easing compared to 2008-2010, they remain much more rigid than in 2005-2007.

We examined nominal rents by sector by growing them 4% per year from different starting points. That is, when new issuances were underwritten in 2005-2007, pro forma projections were made based on the latest actual rents. Specifically, we grew actual rents from 2005, 2006, and 2007 by 4% per year and compared them to rents projected from 2013 levels through 2015-2017. In the suburban office, industrial, multifamily, and hotel sectors, 2015-2017 projections from 2005-2007 starting points all resulted in more aggressive expected rents than growth projections that start from 2013. For example, nominal asking rent for suburban office space



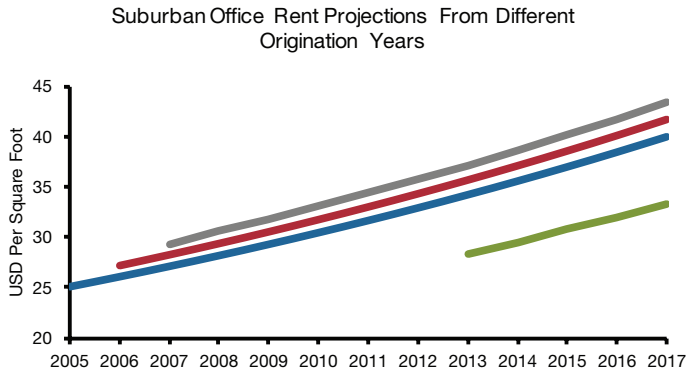


2015-2017 projections from 2005-2007 starting points all resulted in more aggressive expected rents than growth projections that start from 2013.

in 2005 was $26.03 per square foot per annum. If it grows by 4% per year, rent would be $37.05, $38.53, and $40.07 per square foot in 2015-2017, respectively. This is compared to $33.24 per square foot, which results from growing the 2013 rent of $29.55 by 4%. Thus, while rents should exceed their levels when loans were made, they will lag underwriting assumptions. For the industrial sector, projections from 2013 indicate rent of $6.18 per square foot in 2017, while projections beginning in 2005-2007 are $8.38, $8.88, and $9.02, respectively. The same trends were true of the multifamily and hotel sectors.

The same analysis for CBD office indicates that only the rent projections from 2007 would be more aggressive than projections starting from today. Specifically, the projections from 2005 and 2004, respectively, result in expected rents of $47.90 and $51.26 per square foot in 2017. This is in comparison to $53.79 per square foot based on projections from 2013. Hence, office loans maturing in 2017 pose the greatest rollover challenge.

We examine the variances between the projections series for a given year. For example, if we grow 2007



nominal CBD office rents by 4% per year, they would generate average rent of $57.26 per square foot in 2013, $11.28 per square foot above actual average rents. Similarly, rent projections beginning in 2007 would result in 2017 rent of $66.98 per square foot. In comparison, projections beginning with 2013 actual rent are estimated to be $53.79 per square foot, more than $13 lower. It is interesting to note that the projections that start with 2005 and 2006 actual CBD office rents underestimated 2013 actual rent.

In the suburban office sector, the 2005-2007-based annual rent projections resulted in variances of $5-10 per square foot in a given year, compared to the 2013-based projections. Similarly, annual industrial rent projections resulted in variances of $1.88 to $2.85 per square foot, while monthly multifamily rent variances ranged from approximately $75-$137 per unit. Hotel revenue per available room RevPAR projections from 2005-2007 outpaced the 2013-based projections by roughly $11-$19.

The same analysis was done for property valuation by growing unit prices by 4% per year from each year of origination (2005-2007 and 2013). In all cases, the likely 10-year projections from 2005-2007 were significantly rosier than 2015-2017 projections starting from 2013. Thus, while many maturing CMBS issuances from this cohort will be refinanced, it promises to be a cohort that witnesses rising delinquency rates, given that underwriting assumptions in 2005-2007 were made under booming market conditions. Given peaking valuations, we believe that underwriting projections in 2007 were most aggressive, and therefore will have the greatest difficulty in securing refinancing.