# Is the commercial real estate market the next to fall?

## *A comparison to the residential capital and property markets*

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Residential mortgage excesses over the past few years have triggered rapid worldwide de-leveraging, affecting organizations and markets in ways that were unforeseen. The scope of the financial impact to investors and institutions across the globe is still unfolding, with the financial losses only now beginning to be recognized.

Investors are now acutely aware of the impact of lax underwriting in the residential loan market. As the losses continue to mount, attention has turned to the commercial real estate market, where investors are wondering if the turmoil in the residential market is a dark precursor to a similar scenario in the commercial sector.

As the subprime housing market began to show stress, the bond market was ruthlessly efficient in pricing expected loan losses, as evidenced by the degradation in value in the residential mortgage-backed securities market (RMBS). Many believe that the commercial real estate markets experienced similar excesses in lending, and that the current pricing of commercial mortgage-backed securities (CMBS) is signaling similar loan level losses.

This paper attempts to illustrate the similarities and differences in the residential and commercial real estate markets. We conclude that while the excesses of lending in the two markets are similar, the commercial property market should outperform its residential counterpart.

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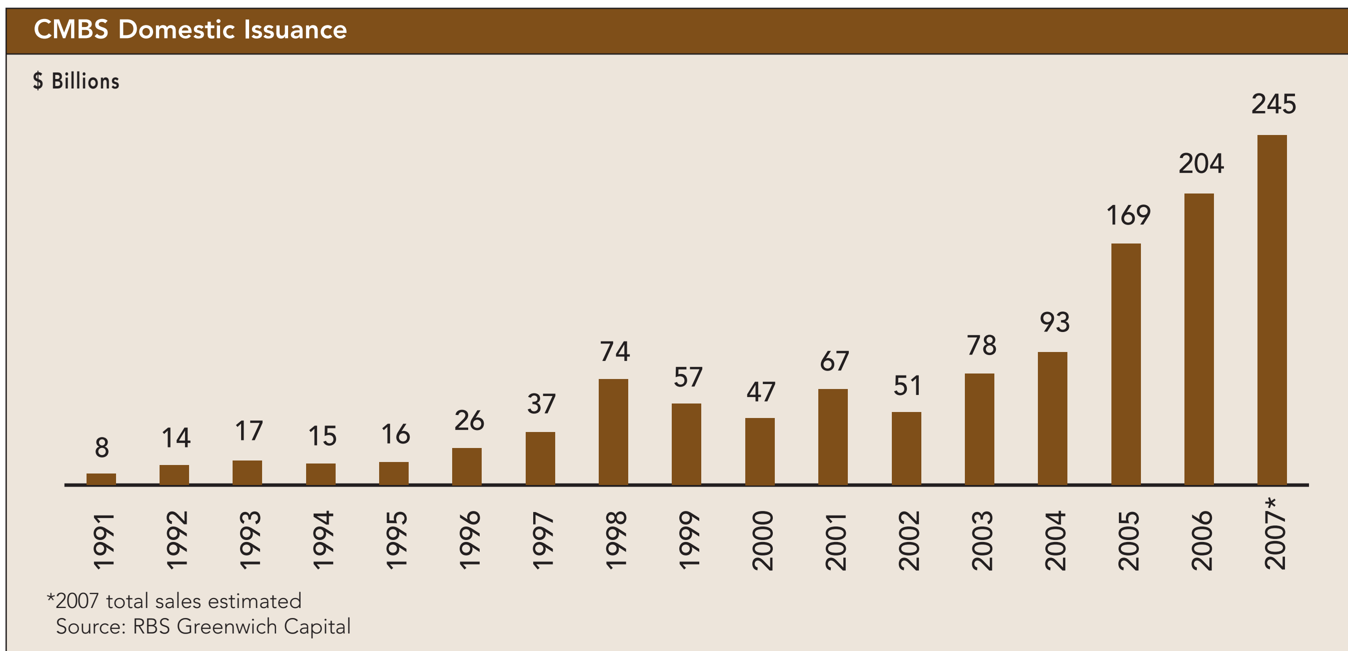

## Money, money and more money: Similar stories of excess capital

The capital markets' current liquidity retraction reflects, in part, sentiments about residential property performance and its impact on RMBS valuations. It is also a manifestation of the lack in confidence of past mortgage loan origination practices and rating agency rating methodologies. The commercial capital markets have arrived at a similar place, thanks to the same cheap capital, lax underwriting and rapid appreciation that was rampant in the run-up of the residential market.

**Increased Liquidity**

Like its residential counterpart, the commercial capital market grew at a rapid pace during the latest appreciation cycle. Innovations in bond structuring and the market's acceptance of CMBS as a valid asset class facilitated the growth in off-balance-sheet loan origination by lenders whose ultimate goal was to securitize, sell and profit from an arbitrage opportunity. From 1990 to 2006, the percentage of all commercial and multi-family loans originated by CMBS issuers increased from 4 percent to 26. The greatest increase occurred from 2003 through 2007, when conduit annual issuance of bonds backed by commercial whole loans expanded from $77.8 billion to $215 billion.

Although losing market share to conduits, on-balance-sheet lenders such as life insurance companies also increased their commercial real estate loan originations, responding to good property fundamentals and seeking higher relative yields. According to the American Council of Life Insurers (ACLI), loan origination for their reporting members grew by 4.2 percent in 2002 and peaked at a 19.7 percent growth rate in 2004.

**Cheap Capital**

Inexpensive capital was abundant in the commercial marketplace, just as it was in the residential property market. As the Treasury curve flattened, securitized debt financing became more attractive to borrowers than short-term bank financing. Wall Street innovation in processing and hedging loans helped compress the cost of capital to borrowers. In addition to the existing bond execution, funding vehicles such as the collateralized debt obligation structures (CDOs) began to use CMBS for collateral. CDO managers bought low-rated bonds backed by commercial loans, repackaged them into new vehicles and arbitraged the difference in capital costs through the sale of bonds to new investors. Demand for commercial mortgage-backed securities (CMBS) accelerated as CDO issuers and hedge funds increased their buying of CMBS across the credit curve. The demand for CMBS resulted in ever-compressing spreads in the new issue market, effectively lowering the cost of capital for lenders and individual property owners.

**Lax Underwriting**

The boom in residential mortgage loans was characterized by low equity, interest-only, Simultaneous Second and limited doc loans. (For further explanation please see the Advantus research paper "Subprime strikeout: Assessing the subprime mortgage market," August 2007). Although perhaps not as extensive, commercial mortgage loans were underwritten with similarly relaxed standards in late 2005 through 2007.

Loan underwriting standards in the commercial sector were relaxed in response to increased competition. Most securitized lenders took aggressive positions on B-notes, seconds, interest-only and mezzanine notes. Aggressive multi-family valuations were, and to an extent still are, driven by increased government-sponsored entities buying the paper and preferential rating agency treatment, not by improved property fundamentals or income growth. On occasion, the income for trophy properties was underwritten on non-realized pro forma income rather than on a more prudent historical or in-place basis. In some of those instances, the net debt service shortfall was funded by monies escrowed from the loan proceeds, until the property could produce a positive cash flow.

Lax underwriting was not just constrained to the originators. Like their residential counterparts, investors in the CMBS market abdicated their underwriting responsibilities to the rating agencies. They relied on the ratings, rather than re-underwriting the key loans and structural components inside the REMIC (real estate mortgage investment conduit). The rating agencies, in turn,

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reduced their subordination levels, while pools of loans backing the bonds became less diverse. Those managers who were buying bonds to serve as collateral for a CDO were also driven by the rating agencies, because the agencies dictated the collateral composition (and ratings profile) of the CDO itself.

**Rapid Appreciation**

Residential valuations began their dramatic increase when the Federal Reserve flooded the financial market with liquidity in the early 2000s. As rates fell, residential mortgage rates fell in lock-step. As more buyers came into the market, prices rose. In certain markets (coastal areas, for example), these increases led to affordability issues. Wall Street delivered more innovative loan products to deal with these rising costs (ARMs, option ARMs, 80/20 piggyback, no documentation, etc). On top of this came speculators and outright fraud. All of these “innovations” led to the valuation bubble that is now being deflated.

Commercial property appreciation over this last cycle was driven mostly by cap rate compression, rather than real income growth. According to Real Capital Analytics, the average cap rate dropped from more than 9.0 percent in 2001 to slightly more than 6.5 percent in 2007. During that same time, unleveraged total return on the National Council of Real Estate Investment Fiduciaries (NCREIF) national property index increased from 7.28 percent to 15.80 percent (peaking in 2005 at 20.06 percent), while the return attributable to income growth diminished.

The cap rate compression was bound at the hip with the Treasury market as 10-year yields tightened from 5.5 percent in January 2001 to a low of 3.1 percent in mid-2003. Yet, during that time the risk premium for real estate assets also tightened in the face of a bull market and improving fundamentals. Additionally, favorable tax treatment on 1031 exchanges contributed to rising property values as sellers chose to defer the tax on their capital gains and reinvest the money back into similar real estate assets. Apartment values were driven up not by rent growth but by condominium converters who arbitraged the strength of the residential market.

**Will CMBX mirror ABX?**

Two recent additions to the capital markets are playing a role in the unfolding dislocation in today’s credit markets. The ABX Index (subprime) and the CMBX Index (commercial) were developed as tools for dealers and investors to hedge pipeline and portfolio positions in their respective asset classes.

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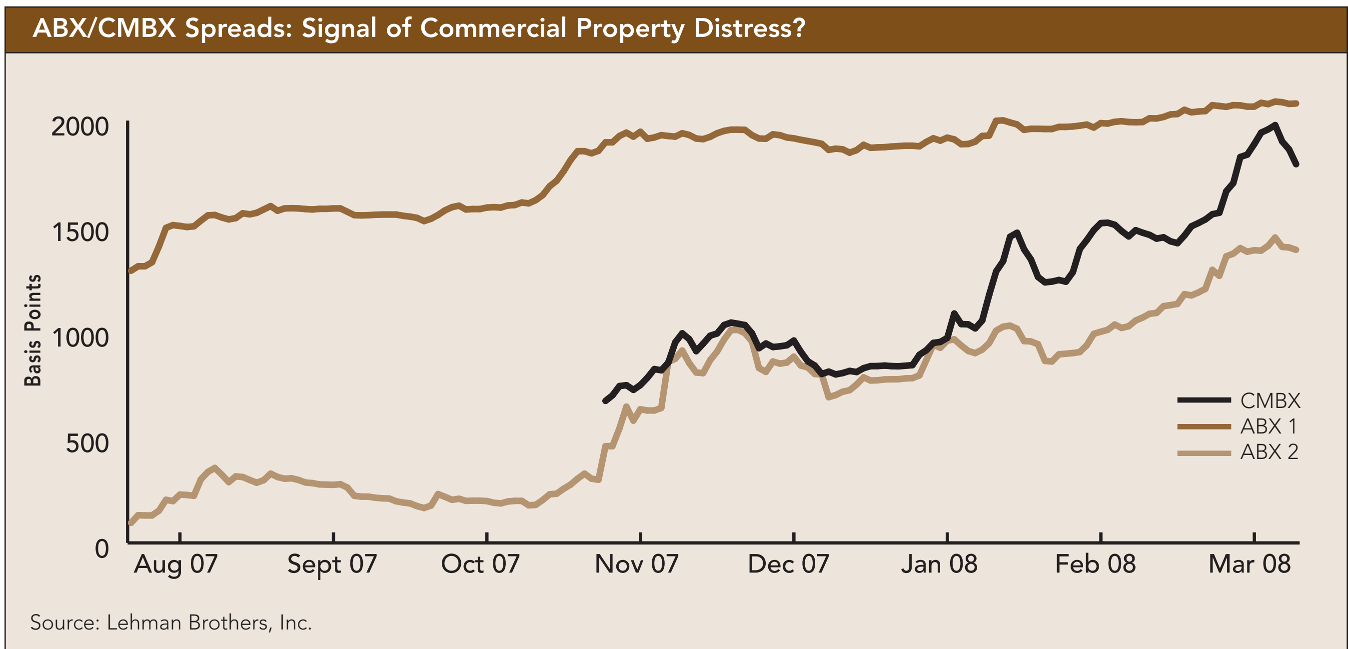

Individual indices reference certain pools of securities. As it transpired, certain market participants had a view that the residential mortgage and housing market was destined to reverse its upward valuation trajectory. The ABX Index provided a capital markets tool to express this view. Shorting the index drove the reference price wider (spreads increased). As the index went wider, pricing of all subprime securities widened in sympathy. The past year has seen the price decline move from subprime to almost all RMBS securities.

The price collapse of the ABX Index turned out to be predictive in defining the extent of the problems in the property performance in subprime mortgages. The question at hand is whether the current performance of the CMBX Index is a signal to investors of a coming collapse in the commercial property markets.

## Property markets: Fundamentals in commercial market ease concerns

While the capital markets are similar, the property markets are currently incongruent. Unlike the residential market, the commercial market is characterized by low default rates, relatively balanced supply and demand of space, moderate vacancy rates and temperate rent growth.

### Low Default Rates

Improved property fundamentals in all classes of commercial real estate in conjunction with increased liquidity have helped to drive down default rates from 2.0 percent in 2003 to less than 0.5 percent in September 2007. While defaults decreased, commercial mortgage underwriting became much more aggressive. Delinquency and default rates are now consequently anticipated to rise, albeit at a much lower rate and percentage than in the residential mortgage market. According to Moody's, U.S. commercial loan defaults were running at 0.4 percent, much lower than their 10-year average of approximately 1 percent. A rough calculation of the residential mortgage market estimates a delinquency rate of 5 percent.

Fitch anticipates that their year-end CMBS delinquency rate of 0.28 percent may double or even triple in 2008. However, after years of extremely good performance, even that increase would put delinquency rates closer to historical averages. Delinquencies will likely increase due to economic stress to property fundamentals and a reduction in available avenues to refinance ballooning mortgages.

### Balanced Supply

The residential property markets experienced a sizable increase in supply from 2002 through 2006, fueled in part by cheap and easy mortgage money. Areas with the greatest increase in number of homes are now experiencing the greatest depreciation and high levels of foreclosures.

While the commercial property market experienced an increase in construction, it was not as extensive as the residential market. Commercial development is generally capital-intensive, with long lead times for land entitlement, zoning and other project specific requirements. As such, developers and construction lenders require evidence of suitable demand prior to construction start, which generally occurs well into a business expansion. This time around, the business cycle appears to be waning, and available capital for new construction seems to be drying up just in time to prevent significant overbuilding.

## Hard or soft landings—or both?

The hoped-for soft landing in the residential markets is becoming increasingly hard. The results of the 2005-2007 vintage lending have triggered one of the worst bond markets in recent history. The economic and societal costs are just beginning to be counted. Given the bond market's forecast of the current state in the residential market (the ABX Index priced today's reality in early 2007), one is right to question whether the CMBX Index's current pricing indicates a similar fate for the commercial markets.

In our view, today's pricing in the CMBX may reflect the appropriate risk premium investors should demand for investing in credit tranches of the 2006-2007 vintage CMBS. As described earlier,

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overly aggressive underwriting in an environment of relatively low rates does not end well in a retrenching economy and a constrained capital market.

We see two outcomes that will cause headlines and headwinds for commercial real estate: tight capital and growing defaults.

**Constrained Capital Conditions**

First, properties facing refinancing in the coming months, independent of when originated, will have to do so in a severely constrained market for real estate debt. For all intents and purpose, the CMBS new loan market is completely dead. Given that this source until recently provided up to 60 percent of the available debt to this market, it is unclear how this void will be filled. Our view is that the insurance and bank lending portfolios will not increase their capacity in any meaningful way. The subprime contagion has reduced lending capacity across all asset classes, and even institutions with strong balance sheets are pulling back from the lending market. We are seeing large loan lenders reduce their exposure limits. There currently are only a few lenders who are willing to add a $100 million loan to their balance sheet.

**Increasing Defaults**

The second outcome we envision is that fully levered loans made on dubious assumptions cannot stand even a modest disruption in the economy. We expect to see term defaults increase beyond historical seasoning curves on loans originated in 2006 and 2007, particularly in five-year loans made during this time. The financial media has reported widely on the first such casualty, the Macklowe office portfolio in New York City, where highly levered bridge loans, taken out at the peak of the excess (2007), cannot be refinanced in the current environment. Balloon defaults (loans that are maturing and need refinancing) may also occur based solely on the lack of available capital.

**An Opportunity**

At Advantus, we see opportunity in this market. The excesses on the 2006-2007 CMBS market are real. However, we do not believe that the pricing of CMBS/CMBX in the capital markets is predictive of a coming commercial real estate meltdown. Commercial real estate is markedly different than residential. In-place cash flows and generally strong sponsorship protect on the downside, and the incentive to default is not as strong as with the stressed residential owner. Commercial real estate also benefits from longer-term financing. As such, most well-underwritten loans made over the past five to ten years should have the benefit of appreciation and should mitigate significant refinance stress. In the public market, we believe credit positions in seasoned CMBS transactions offer tremendous value, as do some AAA super-senior bonds in the most recent vintage. For portfolio lenders, this disruption has eliminated the CMBS competitor. Conservative underwriting and competitive risk-adjusted returns should be available for some time.

By no means do we see this opportunity through rose colored glasses. Investors should have the staff and experience to evaluate individual loans and structures in the CMBS market. Even at the AAA level, all bonds are not created equal. Investors must also have the fortitude to deal with the mark-to-market issues facing the fixed income market today. Numerous daily price swings of multiple points are becoming more of a norm. This is not a market for the faint at heart.

*This is intended to provide information to institutional investors and their consultants and should not be considered as a recommendation or as investment advice. This article contains forward-looking statements based on expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of changes to these expectations and assumptions.*

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