

## The U.S. CMBS Market Transformation Leaves Investors And Issuers Seeking Answers

**Primary Credit Analysts:**

Kurt C Pollem  
CFA  
New York  
(1) 212-438-1852  
kurt\_pollem@  
standardandpoors.com

Analytical Manager - U.S. CMBS  
New Issuance: Barbara Duka  
New York  
(1) 212-438-2447  
barbara\_duka@  
standardandpoors.com

Business Leader - U.S. Mortgages:  
Kim S Diamond  
New York  
(1) 212-438-2446  
kim\_diamond@  
standardandpoors.com

**Publication Date**

Oct. 13, 2009

The U.S. market for commercial mortgage-backed securities (CMBS) appears to be in the midst of a correction, leaving issuers and investors to sort through what remains of the market. This, in our view, is no easy task, especially given the ongoing uncertainty in the commercial real estate market and the questions that remain about lending and securitization.

With the market for commercial real estate soft at best and likely to deteriorate further, it's no surprise that there are more questions than answers. Among the most important are: Will lenders make new loans—and if so, will borrowers agree to the terms? And, will investors then buy bonds backed by such loans?

The answers to these questions foster a new set of queries: What types of loans must lenders make to entice investors back into the market? Will investors be dissuaded by the likelihood that the sector will experience more volatility before stabilizing? And finally, could heightened volatility affect the sector's major players?

It's difficult to find definitive answers to these questions, but we believe we can provide some insight into potential trends that could shape tomorrow's commercial real estate market. Standard & Poor's Ratings Services expects the market's performance to continue weakening into next year, leading to continued credit deterioration. Overall, we generally believe that property values have room to drop further before stabilizing.

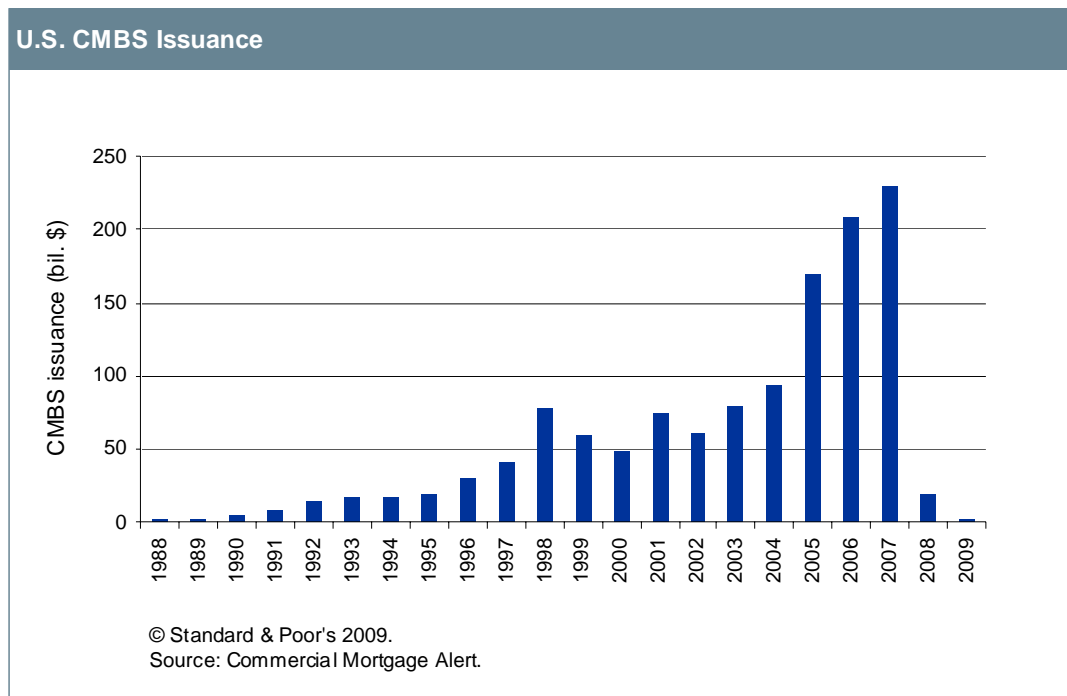
And while we believe that declining property values should be considered in the context of the surge in prices leading up to 2007, the U.S. commercial property market's current state of flux appears to have most participants merely testing the waters rather than diving in. At any rate, it is our view that how this market got here helps to inform not only where it is today, but also what lies ahead.

### ***Issuance Tends To Mirror Commercial Real Estate Values***

After a downturn in commercial real estate in the early 1990s, the market began to show signs of recovery, followed by generally increasing issuance in the CMBS sector beginning later that decade and continuing through 2007.

During the entire 1990s, there was roughly \$285 billion in U.S. CMBS issuance. During this decade, issuance grew rapidly, with \$230 billion of CMBS issued in 2007 alone. Before 1998, the pace of growth was fairly modest. Annual issuance fluctuated thereafter, ranging from \$49 billion to \$93 billion from 1998 to 2004. The pace of growth then accelerated significantly, peaking in 2007—even with fourth-quarter issuance that year reaching just half of the average of the previous three quarters. Issuance then dropped to \$12 billion for all of 2008, bringing the market back down to a level not seen since the mid-1990s. Issuance remains significantly lower, with only \$809 million in CMBS securities offered so far this year (see chart 1).

Chart 1

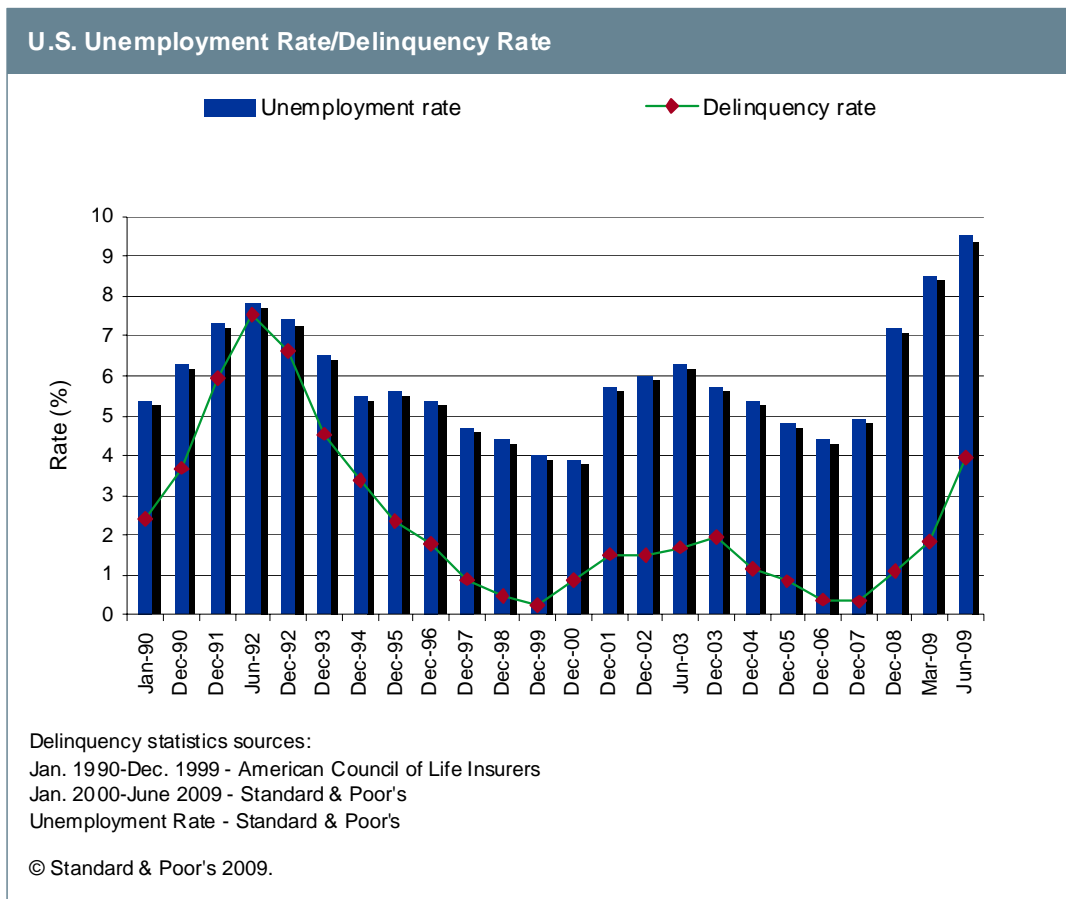


In looking at the decrease in issuance starting in the fourth quarter of 2007, it seems clear that the emerging housing crisis and the ensuing credit crunch weighed heavily on the CMBS market. In fact, the \$33 billion of CMBS sold in that quarter predominantly comprised loans that were already in the deal pipeline.

Early 2008 brought little activity as credit remained tight and uncertainty about pricing caused most originators to severely reduce lending. The first quarter of that year brought only \$6 billion in issuance, and the first half just \$12.1 billion—a 91% drop from the same period a year earlier. In the third and fourth quarters, there was no new issuance, which was the first time that had happened since 1986. In the end, 2008 volume had tumbled 95% from 2007's peak. We've seen this continue into 2009, with no issuance in the first quarter, two deals in the second, and only one in the third—all adding up to a mere \$809 million.

With debt capital scarce and the effects of the recession creeping into the commercial property market, the performance of CMBS began to show signs of weakness in 2008. The delinquency rate for CMBS loans was 0.47% at the end of the second quarter of that year and had more than doubled by year-end to 1.1%. The decline in performance has accelerated this year, with the delinquency rate for loans included in North American CMBS reaching 3.7% at the end of August and showing no signs of stabilizing. As we noted in our most recent CMBS Quarterly Insights, published Aug. 6, 2009, CMBS loan delinquencies track closely with U.S. unemployment (see chart 2). Because we expect the unemployment rate to peak at 10.4% sometime in the second quarter of 2010, we also assume that delinquency rates will climb further. Standard & Poor's projects that the overall U.S. CMBS delinquency rate could increase to 6%-7% by the end of 2009 and peak sometime in the first half of 2011.

Chart 2



***The Forecast Remains Negative Into Next Year***

Going into 2010, Standard & Poor's expects U.S. commercial real estate performance to weaken further, leading to continued credit deterioration. Our general view is that property values across all sectors have room to decline more before they stabilize. And while all major property types will contribute to this, we expect the hotel sector to experience the worst stress. Standard & Poor's midyear lodging U.S. outlook forecasts a 14%-16% decline in RevPAR (revenue per available room) in 2009,

***The U.S. CMBS Market Transformation Leaves Investors And Issuers Seeking Answers***

followed by flat RevPAR next year. This forecast may prove to be too optimistic, however. CBRE/Torto Wheaton Research's current U.S. prediction estimates a 19.3% drop in 2009 RevPAR, followed by a 0.1% decline in 2010, while Smith Travel Research forecasts U.S. RevPAR to decline by 17.1% and 4% in 2009 and 2010, respectively.

CBRE/Torto Wheaton data also suggest that the retail, office, and industrial sectors will suffer rent declines and higher vacancy rates through 2010, albeit at slower rates (see tables 1 and 2). Meanwhile, the multifamily sector is expected to perform best, although individual markets with higher unemployment (such as Michigan) will lag. It should also be noted that while the U.S. multifamily sector as a whole typically performs better than other property types, CMBS loans collateralized by multifamily properties haven't done as well. Moreover, since the CBRE/Torto Wheaton data is a sum of all U.S. markets, some geographical areas could endure greater stress than others.

Table 1

<b><i>Sum Of U.S. Market Rent Historical And Forecast Data As Of 2Q 2009 (%)</i></b>					
	<i>Office rent inflation</i>	<i>Retail rent inflation</i>	<i>Industrial rent inflation</i>	<i>Multifamily rent inflation</i>	<i>Lodging year-over-year % change revenue per available room (avg. %)</i>
2003	(7.1)	2.2	(2.5)	0.3	(0.8)
2004	(2.0)	3.5	(1.1)	2.0	9.9
2005	5.7	2.9	2.8	3.7	12.1
2006	8.6	3.9	5.3	4.5	9.4
2007	9.8	3.5	3.6	3.3	6.7
2008	3.7	0.3	0.2	1.7	(1.4)
2009	(15.7)	(1.6)	(8.0)	(3.0)	(19.3)
2010	(5.1)	(1.1)	(4.7)	(0.7)	(0.1)
2011	2.6	(0.8)	(2.6)	1.1	4.3
2012	6.3	0.0	1.4	2.1	6.6
2013	6.1	1.2	5.2	2.7	6.5
2014	4.8	2.1	6.7	2.8	5.0

Source: CBRE/Torto Wheaton Research.

Table 2

<b><i>Sum Of U.S. Market Vacancy Historical And Forecast Data As Of 2Q 2009 (%)</i></b>					
	<i>Office vacancy rate</i>	<i>Retail vacancy rate</i>	<i>Industrial vacancy rate</i>	<i>Multifamily vacancy rate</i>	<i>Lodging occupancy rate (avg. %)</i>
2003	16.8	8.4	11.7	6.41	61.7
2004	15.4	7.8	11.1	5.98	65.0
2005	13.6	7.5	9.8	4.94	67.5
2006	12.6	7.7	9.5	4.29	67.7
2007	12.6	8.7	9.5	4.66	67.4
2008	14.0	10.4	11.4	5.97	64.8
2009	17.3	12.6	14.3	7.59	58.9
2010	19.0	12.9	15.6	7.20	60.2
2011	18.2	12.6	14.8	5.89	62.1
2012	16.5	11.7	12.9	4.95	64.2

Table 2

<b>Sum Of U.S. Market Vacancy Historical And Forecast Data As Of 2Q 2009 (%) (cont.'d)</b>					
	<i>Office vacancy rate</i>	<i>Retail vacancy rate</i>	<i>Industrial vacancy rate</i>	<i>Multifamily vacancy rate</i>	<i>Lodging occupancy rate (avg. %)</i>
2013	14.7	10.9	11.3	4.47	65.7
2014	13.4	10.3	10.6	4.31	66.4

Source: CBRE/Torto Wheaton Research.

In short, the U.S. commercial property market is in a state of price discovery, with buyers and sellers testing each other and “fire sale” type transactions being avoided for the most part, although distressed selling appears to have picked up more recently. Standard & Poor’s expects to see more distressed commercial real estate eventually subjected to the realities of the new market, leading to the disposition of those properties at values well below their 2007 peak. This, in turn, could translate into higher CMBS realized losses. Standard & Poor’s data through the second quarter of 2009 show the accelerating loss trend across the major property types (see table 3).

Table 3

<b>Delinquent CMBS Loan Loss Severity Rate For Major Property Types</b>								
<i>Delinquent loan resolutions</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>	<i>2007</i>	<i>2008 1Q 2009</i>	<i>2Q 2009</i>	
<b>Total delinquent loan resolutions (\$000s)</b>	<b>2,091,883</b>	<b>3,131,692</b>	<b>3,050,086</b>	<b>2,867,363</b>	<b>2,107,919</b>	<b>2,570,996</b>	<b>745,275</b>	<b>1,431,961</b>
Became current (\$000s)	1,119,124	1,635,815	1,084,016	1,319,374	1,019,644	1,964,433	601,252	1,220,136
Became current (% of total resolutions)	53.50	52.23	35.54	46.01	48.37	76.41	80.68	85.21
Liquidated (\$000s)	972,759	1,495,878	1,966,071	1,547,990	1,088,275	606,563	144,023	211,826
Liquidated (% of total resolutions)	46.50	47.77	64.46	53.99	51.63	23.59	19.32	14.79
<b>Loss severity rate (%)</b>	<b>41.07</b>	<b>29.01</b>	<b>24.82</b>	<b>23.27</b>	<b>27.02</b>	<b>31.21</b>	<b>47.99</b>	<b>49.13</b>
Lodging	48.03	30.95	38.39	19.34	22.32	64.19	43.74	88.68
Retail	43.17	28.36	22.63	20.71	22.15	17.27	44.66	24.55
Industrial	40.48	35.63	29.31	32.12	34.24	4.74	30.72	24.24
Multifamily	27.41	17.62	19.71	16.42	27.47	29.39	45.00	74.72
Office	25.00	28.90	17.66	25.86	25.94	30.53	93.48	46.90

### **The Effects Of Government Programs**

In response to ongoing illiquidity in the real estate capital markets, the U.S. Treasury initiated the Financial Stability Plan in order to cope with legacy assets and increase credit flow.

The Treasury announced the Public-Private Investment Program (PPIP) in March of this year to encourage private investors to purchase illiquid legacy assets, defined as real estate mortgage loans held directly by banks, and preexisting real estate securities. The program is divided into two parts: the Legacy Loans Program, and the Legacy Securities Program.

Under the Legacy Loans Program, the FDIC provides a loan guarantee to a private investor who purchases the troubled loans from insured depository institutions, with leverage not exceeding 6:1. The private investor then forms a Private Investment Fund (PIF). The Treasury can contribute up to 50% of the equity capital required for the purchase, with the PIF supplying the remaining equity and issuing FDIC-guaranteed debt to finance the balance of the purchase price.

The Legacy Securities Program can be financed from the Federal Reserve through the Term Asset-Backed Securities Loan Facility (TALF), from the Treasury through PPIP, or through a combination of

both. The programs facilitate the purchase of legacy real estate securities with both the Treasury and the private investor contributing equity capital. TALF loans issued by the Fed provide capital for investors to finance their legacy CMBS purchases, but only for 'AAA' securities. TALF loans may be used to finance legacy bonds that were issued prior to Jan. 1, 2009, carry the top ratings from at least two eligible rating agencies, can't be rated below 'AAA' by any agency, and can't be tagged for review for downgrade. TALF started accepting subscriptions for legacy bonds in July and since then has issued \$4.2 billion in loans backed by legacy CMBS.

In May, the Fed expanded TALF to include financing for newly issued bonds backed by CMBS loans. The Fed initially said the program would be limited to multiborrower transactions, with single-borrower deals considered on a case-by-case basis. But single-borrower transactions are likely to dominate TALF-eligible lending in the near term. The program requires that the underlying loans be amortizing, fixed-rate loans on stable properties—e.g., no pro-forma underwriting—which has limited the potential pool of borrowers that can take advantage of the program. Since TALF financing is limited to the purchase of top-rated bonds, any debt issued below 'AAA' is ineligible and must be placed at market terms. Most lenders today are offering debt equating to 50% to 60% of current appraised values, which in turn will typically produce all-in proceeds rated below 'AAA'. The combination of more conservative lender terms and shrinking property values means that many property owners looking to refinance will likely need more proceeds than lenders are willing to extend.

The CMBS sector experienced a significant downsizing and reorganization, with neither the infrastructure, the balance sheets, nor the appetite to aggregate multiple loans for securitization. Consequently, we believe that large institutional borrowers with modest financing needs and multiple properties are likely to dominate CMBS in the short term. When the Fed expanded TALF to include CMBS, the REITs began to consider their options, since they generally own assets that are either unencumbered or encumbered by existing debt that is low enough to qualify under the lender's current terms. We have seen several REITs engage investment banks to assist in their efforts to tap the CMBS market and TALF. It appears that as they went through the process, some dropped out due to the additional requirements of TALF transactions, some have since taken advantage of their ability to issue unsecured bonds, and some are still pursuing TALF-eligible deals. Many market participants anticipate that the first newly issued transaction to qualify for TALF will meet the October subscription date, which is somewhat later than some observers had expected. Delays likely resulted from unexpected issues that arose in evaluating the first transactions and inefficiencies in the process that will be worked out over time. Once several TALF-financed transactions are completed, we expect the process to become smoother and more efficient.

### ***A New Market Brings New Players And New Opportunities***

The disruption in CMBS has, in our opinion, clearly led to changes among market participants, especially issuers. Most shops have cut staff considerably, while some have exited the business altogether. But there are new entities that perhaps hope to fill some of the void created by firms that have left the market or substantially curtailed their activities. Many of these start-ups have been created by former CMBS professionals that departed previous jobs. In our view, many of these new entrants are smaller, more nimble players looking to take advantage of the dearth in liquidity and opportunities for seasoned personnel to fill the market's needs.

We have also seen remaining players assume more of an advisory role. It seemed there was a role for CMBS professionals to advise borrowers about getting their bonds rated and sold. Upon the announcement of TALF for newly originated CMBS, it appeared that issuers originally anticipated acting as agents and advisers rather than loan originators. However, it looks as if the Fed has a strong preference or even a requirement for a loan to be closed prior to securitization, which wasn't initially anticipated by market players—though we expect them to adjust accordingly. In any event, the Fed has perhaps become one of the most influential market participants. We expect the U.S. central bank to take great interest in analyzing underlying real estate collateral and influencing the terms of the loan and/or securitization documents.

In the near term, we expect to see single-borrower transactions as the first ones to be securitized. The underlying loans will likely be to REITs and institutional owners/operators with unencumbered assets or assets with low leverage. Other potential issuers include finance and insurance companies with real estate holdings and seasoned loan pools on their balance sheets, or the ability to leverage their balance sheets to originate new loans. We expect the loans to be smaller than in the recent single-borrower transactions, with lower all-in leverage, little or no additional debt held outside the trust, five-year loan terms with 25- or 30-year amortization schedules, and terms and conditions that are more lender-friendly. The properties are likely to be underwritten more conservatively, with higher vacancy assumptions and in-place rents (without the projected upside that may have been factored into recent-vintage loans). In fact, it is possible that property values will reflect a downward trend or an expectation that rents and occupancies may fall further. We expect the first transactions to be issued with TALF financing, with the terms outlined above generally conforming to the eligibility requirements under TALF. Despite the lower loan-to-value ratios (LTVs) associated with these loans, there may still be a portion of the transaction that wouldn't be TALF-eligible and would have to be held by the issuer or sold to an investor.

The next step for issuance, we believe, may be a large loan pool, containing five to 10 loans that would be somewhat different than those in the large-loan floating-rate transactions we saw before the credit crunch. Typically, those deals contained anywhere from 10 to 40 loans indexed to 30-day LIBOR. The loans were often secured by transitional properties such as low-occupancy office buildings or hotels that were undergoing repositioning, reflagging, renovation, or some combination of the three. The loans usually included subordinate debt held outside the trust in the form of 'B' notes, or mezzanine financing with all-in debt that could exceed 80% of the purchase price or appraised value. The five-year term (including extensions) of these loans was meant to be adequate to turn the property around and secure a fixed-rate, amortizing loan for a seven- or 10-year term.

We expect that, similar to the characteristics of single-borrower loan transactions, newly originated loans will be fixed-rate, with a five-year term (to be TALF-eligible), and to amortize on a 25- or 30-year schedule. They will likely have appraised LTVs in the 50%-60% range and improved debt service coverage (based on more stable cash flows) compared with that of recent-vintage loans. These loans would likely provide financing for discounted payoffs, acquisitions of real estate owned (REO) properties, asset purchases, unencumbered assets, or seasoned loan pools. Despite the lower LTVs, there would still be a portion of the transaction that wouldn't be TALF-eligible and would have to be held by the issuer or sold to an entity akin to the 'B' piece buyer. It is likely that the buyer of the subordinate portion of the deal would be involved early in the process, analyzing properties and approving loan and/or transaction terms and conditions.

Another potential user of the TALF financing may be a more traditional conduit deal consisting of loan collateral in the \$1 million to \$20 million range. These loans could be made to refinance those from existing CMBS transactions that are near their maturity and could be paid off without any prepayment penalties. The advantage of the older-vintage CMBS loans is threefold: The loans were originally made in a more conservative environment with lower LTVs and higher debt service coverage ratios; there has been 10 years of amortization on most loans; and rents have increased since the loans were made. This combination of factors makes the loans ideal for the types of transaction that participants would be looking for as an early step in the recovery of the CMBS market. In the early stages of the recovery, this type of deal would likely be somewhat smaller than the conduit deals we've traditionally seen, most likely in the \$250 million to \$500 million range. Again, despite the lower LTVs, there would still be a portion of the transaction that wouldn't be TALF-eligible and would have to be held by the issuer or sold to an entity akin to the 'B' piece buyer. It is again also likely that buyers of the subordinate portion would be involved in analyzing properties and approving transaction terms and conditions. And there are some seasoned CMBS veterans who believe issuers may hold the subordinate non-investment-grade portions of the debt, with the thought that this "skin in game" risk-sharing model may bring renewed discipline to the loan origination process and restore confidence to the investment community. However, it is noteworthy to point out that proposed Financial Accounting Standards (FAS) Nos. 166 and 167 may require issuers to report securitized assets and liabilities on their balance sheets. Standard & Poor's is monitoring developments in this area to evaluate their effect on rated CMBS.

Some other transactions we have seen, or may see sooner rather than later, are re-REMICs (res securitized real estate mortgage investment conduits), seasoned loan pools from balance sheet lenders (particularly small regional banks), and nonperforming loan pools. In fact, earlier this year a number of re-REMICs backed by super-senior 'AAA' rated CMBS were issued. It is likely that the market will recover in much the same manner as it did in the 1990s, with regional banks recapitalizing by selling some of their real estate loans, which weren't originated for securitization. We may also see issuers structure nonperforming loan pools, particularly as the CMBS market and the general real estate sector continue to absorb the effects of the economic recession. Some participants have likened the general disposition strategy to that of the Resolution Trust Corporation (RTC) in the 1990s. Further, it's likely that as the real estate market continues to weaken and securities continue to suffer downgrades, there may be renewed interest in res securitizing existing bonds for capital relief or for sale.

### ***The Recovery: Long And Slow***

Commercial real estate has historically been a lagging indicator, and as such, we expect the performance of the sector to weaken further in the next 12-18 months before stabilizing and beginning a slow recovery. We expect the CMBS market to mirror this trend, lagging the economy out of the recession after trailing the economy into it.

Standard & Poor's believes the CMBS market will follow the real estate sector in originating simpler and more conservative loans with lower leverage, less subordinate debt, increased levels of amortization, and generally more lender-friendly terms. We expect issuer underwriting to incorporate more of an emphasis on the lower of current or sustainable cash flow. Going forward, CMBS securitizations will likely be smaller and less complex. In the near term, we anticipate that single-

borrower transactions will dominate the landscape until the market is once again comfortable aggregating collateral.

It's our view that before this can occur, issuers will need to feel reasonably comfortable that loans can be securitized at a realistic profit. Issuers will also have to rebuild an infrastructure, perhaps one that allows for more flexibility to manage less predictable levels of issuance in the near term and more diverse product types than the framework that existed before the market downturn.

In any case, we believe the CMBS market faces an uphill battle just to get back to the levels of issuance achieved in the early 2000s. With the help of TALF and time, the market will likely begin the process of returning to its status as an integral part of the commercial real estate landscape. It won't happen overnight, but it is our opinion that CMBS still has a vital role to play.

Copyright © 2009 by Standard & Poor's Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved. No part of this information may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written permission of S&P. S&P, its affiliates, and/or their third-party providers have exclusive proprietary rights in the information, including ratings, credit-related analyses and data, provided herein. This information shall not be used for any unlawful or unauthorized purposes. Neither S&P, nor its affiliates, nor their third-party providers guarantee the accuracy, completeness, timeliness or availability of any information. S&P, its affiliates or their third-party providers and their directors, officers, shareholders, employees or agents are not responsible for any errors or omissions, regardless of the cause, or for the results obtained from the use of such information. S&P, ITS AFFILIATES AND THEIR THIRD-PARTY PROVIDERS DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall S&P, its affiliates or their third-party providers and their directors, officers, shareholders, employees or agents be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the information contained herein even if advised of the possibility of such damages.

The ratings and credit-related analyses of S&P and its affiliates and the observations contained herein are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or make any investment decisions. S&P assumes no obligation to update any information following publication. Users of the information contained herein should not rely on any of it in making any investment decision. S&P's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of each of these activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P's Ratings Services business may receive compensation for its ratings and credit-related analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, [www.standardandpoors.com](http://www.standardandpoors.com) (free of charge) and [www.ratingsdirect.com](http://www.ratingsdirect.com) (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).

Permissions: To reprint, translate, or quote Standard & Poor's publications, contact: Client Services, 55 Water Street, New York, NY 10041; (1) 212-438-7280 Option 2; or by e-mail to: [research\\_request@standardandpoors.com](mailto:research_request@standardandpoors.com).