by
Kurt L. Wright, CFA
Equitable Real Estate Investment Mgmt., Inc.

CMBS Market Continues Impressive Growth

Maturing Conduits Provide Steady Deal Flow

Executive Summary

- **Second Quarter 1996 new issue volume totaled $6.1 billion**
- **Conduits account for 40% of Second Quarter issuance activity**
- **Single-asset securitizations provide investors with easy due diligence, but no diversification**

The commercial mortgage-backed securities (CMBS) market remained on its record-setting pace during the Second Quarter with new issue volume of $6.1 billion as compared to $3.8 billion one year ago. **Volume for the first half of 1996 was $13.3 billion versus $6.7 billion and $10.0 billion during the same periods in 1995 and 1994, respectively.** Market observers will remember that 1994 was a break-out year for the market with $20.3 billion of CMBS issued during the year, the bulk of which were private-label (i.e., non-RTC) securities. All indications are that 1996 will be the strongest year yet, with full-year volume in the $22–$24 billion range. Total new issuance volume since 1990 has eclipsed $95 billion and is well on the way toward $175 billion by the year 2000.

Obviously, the market is maturing rapidly from an RTC-induced experiment as late as mid-1993 to the self-perpetuating private market of today. This maturation is further evidenced by the significant role that conduits are playing today as compared to a short time ago. Like their sisters in the single-family residential market, commercial mortgage conduits lend in a highly standardized, production-line fashion, generally on smaller properties (i.e., $1 million to $15 million). Conduits warehouse these loans until a critical mass is achieved, at which time the loans are securitized and sold. In contrast, many of the securitizations to-date were not conduit deals, but instead, simply packages of existing loans that financial institutions, such as life insurance companies or the RTC, needed to sell. While good opportunities, portfolio sales come to the market sporadically and are not a reliable source of deal flow. This is important because many large fixed-income investors require evidence of long-term viability, such as consistent deal flow, before committing resources to a new market.

While still fairly young, the commercial mortgage conduit business is growing fast and has begun to provide this steady deal flow. For example, 40 percent ($2.5 billion) of the Second Quarter issuance activity was conduit deals. **All six of the Second Quarter conduit deals were large deals, each exceeding $300 million.** The trend toward larger conduit deals will continue as large pools are favored by both the rating agencies and investors. This results in lower subordination levels, more liquidity, better pricing and, ultimately, more profits for the issuer. Profitability is enhanced further by the fact that many of the costs of securitizing a loan pool are fairly fixed, such as fees for rating agencies, attorneys and accountants.

The conduits' growth potential is all but unlimited as they are filling the huge gap left by the defunct savings and loans (S&Ls), lending on smaller "B" and "C" quality commercial properties. Typical conduits today are lending on all the major property types in addition to nursing homes and mobile home parks. Loan terms include interest rates based on spreads over Treasuries ranging from 225 basis points for apartments to 300 basis points and more for hotel properties.

Wall Street is beginning to make headway filling another significant niche, that is, lending on very large high-quality properties. Previously, the large life insurance companies, banks and pension funds dominated the market for traditional whole loans on major CBD offices and regional malls. Since the turmoil of the early 1990s, however, these investors have shied away from taking large positions in large assets, instead

Commercial Mortgage Pricing Matrix (10-year term instruments)

	Spread by Credit Rating (bp)			
Investment Category	**AAA**	**AA**	**A**	**BBB**
Industrial Bonds: Public	30	35-40	45-50	70
Private Placement Premium	15-20	20-25	25-30	25-30
Industrial Private Placement	45-50	55-65	70-80	95-100
Real Estate Premium	25-30	25-30	30	25-30
Bondable Mortgage	70-80	80-95	100-110	120-130
CMBS Premium	5-15	5-20	15-20	20-40
CMBS	85	100	115-120	150-160
Whole-Loan Premium	0-20	15-35	10-35	0-40
Whole-Loan Mortgage	85-105	115-135	125-155	150-190

Source: Equitable Real Estate Investment Management, Inc.

preferring smaller deals and greater portfolio diversification. This has left a gap and created an opportunity for Wall Street as many of these large loans are natural candidates for securitization on a single-asset basis. First, they are large enough to justify the fixed costs of securitization. Second, these deals are very appealing from an investor's viewpoint because it is relatively easy to analyze the credit aspects of single assets as compared to a deal backed by a large pool of loans. This is especially appealing to traditional whole loan lenders who have reservations about investing in conduit deals where it is difficult to perform hands-on due diligence on a large number of small properties. The trade-off is that single-asset deals lack a pooled deal's diversification benefits, which are especially relevant for investment-grade bond buyers.

A recent transaction underwritten by UBS Securities typifies the single-asset securitization opportunity. In May, UBS offered a $265 million, five-tranche CMBS deal with credits ranging from "AA" to "BBB." The securities were backed by a first mortgage on a single asset, 1345 Avenue of the Americas, a 1.9 million-square-foot, class "A" office building in Manhattan. The property value is estimated at $423 million, indicating a loan-to-value ratio (LTV) of approximately 60 percent and debt-service coverage (DSC) of 1.77 times. In addition to the typical "bells and whistles" that a traditional lender would require, such as a reserve for tenant improvements and a letter of credit, the deal also featured a cash lock-box and the enhanced reporting requirements common in the CMBS market.

This deal offered excellent relative value for traditional whole lenders for a variety of reasons. First, in terms of yield, the "BBB" rated tranche (60 percent LTV, 1.77x DSC) was offered at a spread of approximately 150 basis points over Treasuries. For a whole loan with comparable LTV and DSC, one would expect a spread in the 115 to 125 basis point range. In addition, the liquidity of the "BBB" security is significantly better than a whole loan position. Finally, as noted, the lock-box, formal rating, etc. add value to the CMBS. As a result the "BBB" tranche was purchased by traditional whole loan investors at both life insurance companies and pension funds.

A similar single-asset securitization — backed by an approximately $435 million mortgage on 277 Park Avenue in Manhattan — is expected to be marketed later this summer. Unlike the 1345 Avenue of the Americas deal, the 277 Park Avenue deal likely will have a large ($90 million) noninvestment-grade component composed of "BB" and "B" rated tranches, which will offer equity real estate–like returns of 11.5 percent and better. This deal will validate further Wall Street's role in the market for jumbo commercial mortgages.

Generally speaking, relative value in the CMBS market remains extremely strong, although spreads have compressed throughout the year. For example, spreads on "AAA" rated CMBS have fallen about 10 basis points from 90 basis points in January to 80 basis points in June. "BBB" spreads have fallen approximately 25 basis points (from 185 basis points to 160 basis points) during the same period. Going forward, "BBBs" have room to fall and could settle in the 130 to 140 basis point range by year-end. Even at these lower levels, "BBB" spreads would be 55 to 65 basis points higher than "BBB" corporate bonds. Allowing for a liquidity premium of 25 basis points (which is too generous), CMBS still represent a real bargain.

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As the market grows and matures, investors can be expected to grow more sophisticated and will be willing to pay for perceived quality differences between deals. For example, in May, Goldman Sachs underwrote a CMBS deal on behalf of the IBM employee pension fund that was backed by 13 regional malls. The deal was perceived to be very high quality due to several factors, including the sponsorship (IBM and Equitable Life), significant owner's equity position (45 percent) and a cross-default/cross-collateralization feature. In addition, the number of assets was enough to give the diversification that traditional bond investors covet, while it was few enough assets that real estate investors could perform significant due diligence. As a result, the deal was a blow-out with the fixed-rate "BBB" tranche receiving a spread of 125 basis points, a full 25 to 35 basis points below other "BBBs" in market. At a time when investors have an extremely cautious attitude toward retail properties, IBM was able to reduce exposure to the property type while borrowing at a very low cost of funds. At the same time, CMBS investors were willing to pay premium prices despite the retail issue. This is merely the best recent example of why securitization is here to stay. RECMR

Kurt Wright *is a senior vice president and portfolio manager of Equitable Real Estate Investment Management, Inc.*