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CMBS Market Set for Fourth Quarter Boom
Slow Year May End with Flurry of Deals

Executive Summary

- **22 deals totaling $3.7 billion came to market in the Third Quarter**
- **A Fourth Quarter boom could produce $8 billion of CMBS**
- **CMBS spreads remain 50 to 200 basis points higher than same credit corporate bonds**

The commercial mortgage-backed securities ("CMBS") market gained significant momentum during the summer after a relatively slow first half of 1995. The market was buoyed by a number of factors, including excellent fundamentals, strong relative value, lower market interest rates, growing investor familiarity with the vehicle and regulatory relief. All of these factors remain intact and will sustain strong activity in the CMBS market throughout the balance of the year.

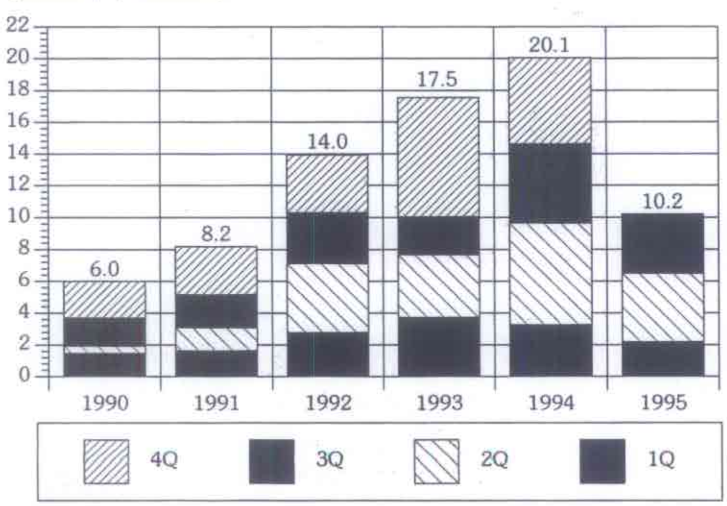
On the surface, 1995 has been a slow year relative to the record-setting activity of 1994. As reported by *Commercial Mortgage Alert*, new-issue volume during the Third Quarter was $3.7 billion, down 26.6 percent from the Third Quarter of 1994. Twenty-two deals came to market (see Public Debt 3), with the largest being a $454.7 million offering from Lehman Brothers.

Year-to-date 1995 new-issue volume totalled approximately $10.2 billion, down 32 percent from the same period in 1994. This downturn is viewed by many observers as a temporary pause resulting from growing pains, structural shifts and the lagging effects of the onerous year-end 1994 interest rate environment. In fact, the Fourth Quarter has started off with a bang with several large deals "blowing-out" during October. **Based upon October activity and the deal calendar for November and December, Fourth Quarter activity could reach a whopping $8 billion.** This would close-out 1995 with over $18 billion of new issues, as compared to $20 billion in 1994. This in turn would bring CMBS new-issue volume during the 1990s to over $84 billion.

As noted, there were several causes for the fall-off in market activity during the first three quarters of this year. For example, the spike in market interest rates at the end of 1994 (10-year Treasury rates reached 8 percent) forced many potential borrowers to the sidelines. Since then, rates have fallen more than 150 to 200 basis points and borrowers have returned to the market in droves in the Second and Third Quarters. However, as it takes several months for commercial mortgage lenders ("conduits") to close loans and assemble portfolios of sufficient critical mass for securitization, conduit-originated CMBS new-issue volume lagged until the Third Quarter. In addition, the re-entry to the market of lenders who had been on the sidelines — especially life insurance companies — has greatly increased the competition for deals.

Other structural shifts have been occurring that led to temporary pauses in the market. For example, real estate investment trusts ("REITs") have shifted away from collateralized, property-level borrowing toward non-collateralized, entity-level borrowing. This trend will continue to grow, especially for stronger REITs with BBB or better credit ratings. In addition, RTC-issues, which dominated market activity in the early 1990s, have nearly ceased. This gap is now being filled in part by large insurance company portfolio offerings. For example, during October, Provident Life Accident and Insurance Co. brought to the market a $963 million CMBS offering that essentially comprised its entire portfolio of performing whole loans. By year-end, Confederation Life Insurance Co. will securitize $2.3 billion of its whole loan portfolio in a single CMBS offering.

CMBS New Issue Volume
(by quarter; $ billions)



Source: Commercial Mortgage Alert

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On the regulatory front, a watershed event occurred in May which lifted a pall that had been hanging over the market since late 1994. On May 16, the National Association of Insurance Commissioners ("NAIC") formally approved bond rating treatment for all rated CMBS. For nearly six months prior to this decision, it was unclear whether the NAIC would elect to treat CMBS like bonds or commercial mortgages for purposes of calculating reserve requirements by life insurance companies. Generally, bonds require significantly lower reserves than commercial mortgages. Therefore, favorable NAIC treatment of CMBS was critical for sustaining the enormous life insurance company interest in CMBS. Under the final NAIC ruling, the reserve requirements for CMBS range from .3 percent for AAA-rated issues to 1 percent for BBB-rated issues. In contrast, the reserve requirement for a performing whole loan is 3 percent.

This has become a key issue for many life insurance companies weighing relative value. For example, BBB-rated CMBS today often receive spreads of 190 basis points and more over Treasuries and face a 1 percent reserve requirement. This is often extremely competitive with traditional whole loans at spreads of 150 basis points and 3 percent reserve requirements. **As life insurers become comfortable with giving up the control and structuring ability available in whole loan deals, more will turn to the CMBS market to augment, or even replace, their whole loan programs.**

While life insurance company interest clearly is growing rapidly, pension funds have been slower to respond to the CMBS market opportunity. This is natural given the newness of the product coupled with pension funds' staffing constraints, fiduciary obligations and ERISA impediments. Nonetheless, pension funds will discover that CMBS spreads and relative value are very strong today as compared to corporate bonds. CMBS spreads remain 50 to 200 basis points higher than same credit corporate bonds. Further, this is an excellent time in the asset cycle to be investing in commercial real estate products. Fundamentals and underwriting remain quite strong. In addition, while CMBS spreads are still very attractive, they continue to compress somewhat.

For example, during July, Column Financial, Inc. offered a $293 million conduit securitization backed by 78 loans in 22 states, including approximately 49 percent multifamily and 41 percent retail loans. This diversified offering had strong call protection and was extremely well received with investment-grade classes oversubscribed by two to three times. The most senior AAA-rated class, which carried a 44 percent loan-to-value ("LTV") ratio and 1.93x debt-service coverage ("DSC"), was priced at 80 basis points over the five-year Treasury. This was about 5 basis points tighter than most deals in the market at that point and 20 basis points lower than mid-1994 levels. The BBB-rated tranche was 56 percent LTV and 1.58x DSC and received a spread of 190 basis points. The overall strong pricing on the deal was attributable to several factors including: Column's reputation for quality underwriting, solid collateral, standardized loan documents and pent-up investor demand.

The classic conduit CMBS transaction has a large number of small loans on B- and C-quality assets to many borrowers. Given the large number of borrowers, each property tends to stand on its own, i.e., only a small portion of the Column offering was cross-defaulted and cross-collateralized. **Diversification is a major plus in these deals, especially for investors in the investment-grade tranches. However, the benefits of diversification are less clear for investors in lower-rated tranches, particularly the first-loss piece.** This is because, given the large number of properties, the probability of any one property defaulting and causing a value loss is higher than for a pool with fewer properties. Thus, on pools

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Commercial Mortgage Pricing Matrix (10-year term instruments)

	Spread by Credit Rating (bp)			
Investment Category	**AAA**	**AA**	**A**	**BBB**
Industrial Bonds: Public	30-40	40-50	50-60	70-80
Private Placement Premium	10-15	15-20	25-30	25-35
Industrial Private Placement	40-55	55-70	75-90	95-110
Real Estate Premium	25-30	25-30	25-30	25-30
Bondable Mortgage	70-80	80-100	100-115	120-140
CMBS Premium	5	10-15	10-25	45-70
CMBS	75-85	95-110	110-140	165-210
Whole-loan Premium	10-20	20-25	15-35	(15)-(20)
Whole-loan Mortgage	85-105	115-135	125-175	150-190

Source: Equitable Real Estate Investment Management, Inc.

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without cross-collateralization, investors in low-grade tranches must perform extensive due diligence on the riskier assets in order to fully analyze expected return and volatility.

During the Third Quarter, only three CMBS issues received downgrades.

In contrast, Nomura's MegaDeal structure involves a small number of large loans to a few borrowers. These loans are typically backed by a large number of assets on a cross-defaulted, cross-collateralized basis. For example, MegaDeal IV was a $968 million offering backed by nine loans to nine separate borrowers. One loan is backed by a single property, one loan is backed by a pool of 93 properties, and the remaining loans are backed by pools ranging from four to 13 properties. Several of these pools have enough properties and geographic diversification to make the cross-collateralization features truly meaningful. Therefore, the probability of a default on one of these cross-collateralized loans is greatly reduced, perhaps as much as one-half, depending upon the lack of correlation of performance between particular properties. On the other hand, should there be a default at the loan level, the severity would be quite high. **Investors need to carefully evaluate the trade-offs between the probable incidence and severity of default for "crossed" and "uncrossed" transactions in order to understand relative value.**

With respect to performance, during the Third Quarter, only three CMBS issues received downgrades by rating agencies, which is a significant drop-off from the last few quarters over which 32 downgrades occurred. Again, the recent downgrades were focused on CMBS backed by California multifamily assets and RTC issues. In addition, the American Council of Life Insurance reported a drop in delinquent loans to 3.58 percent from 3.68 percent in the First Quarter and a high of 7.53 percent in 1992. Continued improvement in the real estate markets, loan portfolio values and commercial mortgage securitization can be expected. This, coupled with an increased awareness and understanding of CMBS by life insurance companies, pension funds and other investors should increase demand for securitized mortgage products. RECMR

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CMBS Deals Completed in the Third Quarter

Date	Issuer	Seller/Borrower	Lead Manager	Amount ($M)
7/7	Fannie Mae, 1995-M1 (Part 2)	(Multiple borrowers)	CS First Boston	$25.6
7/20	Merrill Lynch Mortg. Investors, 1995-C1	Merrill Lynch & Co.	Merrill Lynch	$213.3
7/28	Prudential Securities Sec. Fin. Corp., 1995-C1	(Multiple borrowers)	Prudential Securities	$105.6
7/28	Morgan Stanley Capital I Inc.	(Multiple borrowers)	Morgan Stanley	$257.9
7/28	Fannie Mae, 1995-M3	(Multiple borrowers)	DLJ	$69.9
7/31	American Southwest Financial Sec., 1995-C1	(Multiple borrowers)	DLJ	$293.0
7/31	J.P. Morgan Commercial Mortg. Finance, 1995-C1	(Multiple borrowers)	J.P. Morgan	$172.2
8/7	Mortgage Capital Funding Inc., 1995-MC1	(Multiple borrowers)	Citicorp Securities	$228.8
8/14	KS Mortgage Capital LP, 1995-1	Kearny Street R.E. Co.	Morgan Stanley	$165.4
8/15	Lakewood Mall Finance Co.	Macerich Co.	Lehman Brothers	$127.0
8/16	WHP, 1995-C1	Whitehall Street R.E. Fund LP	Goldman, Sachs	$355.0
8/16	Malan Mortgage Securities Trust, 1995-A	Malan Realty Investors Inc.	Natwest Markets	$63.0
8/18	Asset Securitization Corp., 1995-D1	(Multiple borrowers)	Nomura Securities	$210.9
8/25	Structured Asset Securities Corp., 1995-C3	Lehman Brothers Inc.	Lehman Brothers	$454.7
8/30	Fannie Mae, 1995-M2 (Part 2)	(Multiple borrowers)	Nationsbanc	$21.3
9/12	Morgan Stanley Capital I Inc., 1995-TNE1	Morgan Stanley & Co.	Morgan Stanley	$87.2
9/19	Freddie Mac, C007	Criimi Mae Inc.	Merrill Lynch	$249.3
9/22	Queens Funding Ltd.	Park Faith Invest., Hong Kong	BT Securities	$121.8
9/27	Freddie Mac, W00065/W00066	(Multiple borrowers)	Nationsbanc	$55.9
9/28	Mutual Life Insurance Co.	Mutual Life Insurance Co. of NY	Goldman, Sachs	$86.8
9/29	Oregon Commercial Mortgage Inc., 1995-1	Oregon PER Fund	Bear Stearns	$161.5
9/30	Kearny Street II Real Estate Co. LP, 1995-1	Morgan Stanley R.E. Fund LP	Morgan Stanley	$210.0

Source: Commercial Mortgage Alert