Fundamental change

US CMBS investor focus switches on performance concerns

Investor focus in the US CMBS market has switched from being technical to fundamental. As last year's rally fades, differences in performance are expected to become more pronounced, leading to increased tiering between bond prices.

The US CMBS market has been driven by strong technical factors – limited supply and lots of demand – for the last year, but underlying property and loan fundamentals appear to be becoming more relevant now. "We're beginning to see problems on larger loans impact cashflows higher up in the capital stack and investors are starting to differentiate between bonds based on performance. This wasn't the case last year when the market was hot," confirms Tom Zatko, md capital markets at Cornerstone Real Estate Advisers.

He adds: "If it is a problem loan, investors want to understand the potential outcomes of its resolution and get paid appropriately for the range of work-outs. Where an investor chooses to sit in the capital stack is also important."

For example, an AJ position could be hit with a downgrade because the bonds below it are impacted by a cashflow problem. AJ and AM tranches outperformed during last year's grab for yield, but now investors are paying closer attention to possible credit issues within them.

David Tobin, principal at Mission Capital Advisors, agrees that fundamentals were left behind last year as the CMBS market came off its 2009 lows. "It felt like you could buy any issuance and it would make a gain. This environment was driven by structural issues in terms of liquidity returning to the market, supported by low rates."

He points out that credit crunches are liquidity-driven and fundamentals-driven. "All of the liquidity-driven profits have been squeezed out of the market, so now it's all about fundamentals. It is important for investors to drill into analytics to figure out property-level performance and compare what they see with what's reported; for example, economic occupancy compared with physical occupancy."

The aim is to determine whether the individual anchor tenants are overpaying the rent. For leases written in 2007 and 2008, the rent could potentially reset downwards as leases come up for renewal. Alternatively, the leases could be below market and thus there could be an upside for certain properties.

The frequency of lease resets is another important consideration, according to Tobin. "Hotel leases are essentially a day long – a factor which contributed to the rapid decline in performance in the hospitality sector," he says. "Although hotels have rebounded dramatically, values in the sector remain volatile. In comparison, multifamily leases reset every year, while retail and office leases are typically 10 years long."

The focus on fundamentals is likely to drive increased tiering between CMBS bonds, although it won't be formulaic. "The credit approach is different for each tranche, with the risk priced on a custom basis," explains Zatko.

He continues: "Lots of information is available on legacy bonds, so it's possible to express a credit view specific to an individual loan. But because there isn't so much historical loan performance information for new issues, investors can look at whether they like the pool composition based on sector and geography, then drill down to the loan level and analyse the properties and borrowers. It's more of a fundamentals-driven analysis."

Tiering in prices will reflect the fact that underlying fundamentals are weak or weakening. Equally, if a sponsor is known to have poorly performing properties, certain issuers or vintages will be avoided.

However, some investors may overcompensate and this could, in turn, present opportunities. In the case where a sponsor has good and bad properties, it could be ranked lower due to poor performance, thereby creating mispricing for the good deals.

The less crowded area of the market is for bonds that are out of favour and consequently offer more yield. "If there is any compression, it will be on credit-sensitive and heavily distressed bonds," observes John Lonski, CMBS portfolio manager at Cornerstone Real Estate Advisers. “Paper that trades at a heavy discount hasn't really benefitted from the buoyancy in the market. Heavily distressed bonds are thinly traded at the moment and are typically small-sized, so the amount of work necessary to get comfortable with them rarely justifies the reward.”

At the height of the market, hundreds of loans were securitised and so one shortcut was for investors to identify a shelf that reflected the characteristics they were looking for. As post-crisis issuers don't have a track record, the underlying pools have been relatively small to make it easier to do credit work.

In addition, new issue underwriting over the last year has generally been more conservative than before the crisis; for example, featuring lower LTV ratios and no use of pro forma underwriting. The underlying assets have also typically re-priced and the borrowers are solid, according to Zatko.

He says: "Certainly post-crisis CMBS new issues have been received well, albeit there have been a limited number of deals. The yields on new issues are less than those required for similar legacy CMBS, so investors appear to recognise their quality."

Four transactions are said to be in the pipeline for Q1, including deals from JPMorgan and Goldman Sachs. The trend whereby two or three sponsors band together to bring a CMBS is expected to continue this year, driven by originators trying to get deals to market sooner and on a more frequent basis rather than holding the loans on their books for a long time.

Tobin suggests that there is plenty of investor interest in new issue CMBS because they can protect their risk through fundamental analysis. “Residential mortgages are at the mercy of macroeconomic issues, whereas commercial mortgages are empirical and scientific – it is possible to anticipate how a security will perform,” he observes. “Investors can reverse-underwrite a CMBS down to the property level and figure out whether they have principal risk. You can’t do this kind of analysis on residential mortgages.”

Tobin believes that the return of the conduit lenders represents the market rising to meet the challenge posed by CMBS maturity defaults. “Originators are helping themselves to fix the problem. Even if only 80% of a loan is refinanced through a CMBS, it should see the loan past its maturity date,” he concludes.

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