B-piece boom

CMBS B-piece investor revival underway

Interest in US CMBS B-pieces is returning, with a wave of new investors getting involved in the market. The return of lending has helped to spark the revival and, although the upcoming risk retention regulations could still disrupt it, should this resurgence continue then the benefits could be wide-reaching.

David Tobin, principal at Mission Capital Advisors, believes that while the entrance of new B-piece investors is good news for the market, it does not come as any surprise. "There is strong interest in lending again in the US. It started as part of QE2, with Fannie Mae and Freddie Mac and their multifamily lending programmes," he says.

Tobin continues: "This spurred interest in CMBS lending, putting the market into second gear. What we are seeing now is that regional and super-regional banks are back into doing floating rate loans, so that kicks the market into overdrive – relative, of course, to recent years."

A full complement of lenders is providing a perfect environment at the moment. From Fannie Mae and insurance companies, through banks to CMBS conduits – all grades are provided for in the short, medium and long term. This means that 2011 could be a very active year for the market.

"Given the secondary whole loan market sales volumes and origination market return, including the strongest first quarter we have ever experienced, we expect that 2011 is going to be a great year. Our primary business is secondary market loan trading, but Mission recruited a team of origination executives two years ago and they currently have a US$1bn pipeline of loans that we are originating as a commercial mortgage broker. It is the biggest our pipeline has been since we entered that business," says Tobin.

A combination of good loan pricing, transaction volume and improving fundamentals has made the B-piece market more attractive than it has been for years. Real estate sales are frequently seeing discounts or mezzanine lenders taking haircuts and it is reduced pricing expectations that have been an important factor in the increased transaction volume now being seen.

Fundamentals also matter. Tobin notes: "There are also improving fundamentals, such as office and industrial leasing activity. Everybody thought retail leasing was going to fall off the cliff, but the retail sector has rebounded nicely with the return to normalcy in consumer spending."

Tobin adds that as QE2 has driven financing costs and people have moved from home ownership back to rentals, multifamily has come back strongly. Hospitality has also rebounded, with

occupancy and rates driven by increased business activity and tourism, which in turn is being encouraged by the strong Euro.

Although not traditionally large investors in the B-piece market, hedge funds such as Elliott Management (SCI 31 March) have emerged as significant new players. Strong expected yield, with B-pieces offering a large spread to US Treasuries, means that these assets are an attractive prospect that hedge funds are particularly well-positioned to capitalise on.

"The attractiveness of the CMBS B-piece market is that it is set up perfectly for hedge funds and private equity structures. These funds can enter the market in partnership with a special servicer and conduct fairly extensive due diligence on the underlying loan portfolio and really drill down into potential losses and look at the risk of a transaction," says Tobin.

He continues: "Hedge funds and private equity funds typically are cash-heavy and overhead-light, making them a good partner for CMBS special servicers. The other attractive element of the market is control. The B-piece investor can kick out loans, they can dictate terms and they can structure the transaction the way they want to structure it."

However, regulatory change threatens to throw a spanner into the works and dampen appetite. The widely discussed 5% risk retention rule could see B-piece buyers who retain risk being forced to buy a larger chunk of the deal than they might want to.

Citi MBS analysts note that in 2011 multi-borrower deals B-piece holders retained an average of 5.1% of the deal's face value. The concern is that such investors might be required to retain 5% of market value, which would double what they purchase on a par basis. With so many other factors pointing in B-pieces' favour, though, this might not prove too much of a stumbling block.

"If risk retention means that somebody has to hold twice as much as an alternative investment option, this is still not a deal-breaker. The amount of capital that is looking to invest in high yield real estate deals is astounding. There is so much capital that has been raised in the last two years for both distressed and high yield real estate investments that I do not think there will be any trouble for the market adapting to these risk retention requirements," says Tobin.

He continues: "For example, market estimates state that origination volumes in 2011 will be US$50bn of CMBS this year. At a 10% retention, that is only US$5bn; at 5% it is US$2.5bn. One fund could easily take that down by itself and they would still be able to design a well-diversified portfolio."

Finally, while all of the increased B-piece activity and interest is good news for the CMBS market, there may also be a knock-on effect for CRE CDOs. Where B-piece investors once freed up resources by putting assets into a CRE CDO, the lack of a viable CMBS market constrained that. The influx of investors being seen now for CMBS could also help to restart CRE CDO issuance, although Tobin notes it is not quite that straightforward.

"It is certainly possible that this will help to restart CRE CDO issuance. The one challenge I would see there is that while CMBS bonds went down pretty dramatically in value, they rebounded quite quickly. For CDOs, the picture is different," he explains.

"Even though the CRE CDO market should be similar to the CMBS market, there is such a negative connotation associated with CDOs that it is simply not the case. It is almost as though they need to rebrand that financial instrument, if they want it to sell again," Tobin concludes.

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