

Global CMBS Newsletter

Volume 2, Issue 23, November 5, 2007



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POST-CANADIAN CMSA: CANADIAN CMBS STILL STRONG

Over the past decade, the challenges experienced in the CMBS market have largely been caused by disruptions in external capital markets rather than fundamental problems within the commercial property markets. In 1998, the capital markets experienced a crunch from the Russian bond crisis, which had an effect on CMBS. In large part, however, CMBS was among the first products to demonstrate liquidity-earning status, as a flight-to-quality alternative to treasuries. Similarly, when the Enron and WorldCom meltdowns occurred; investors saw structured finance and real estate (CMBS and RMBS) as alternative investments to corporate bonds.

The current hiccup is not very different, as it is primarily caused by problems within a sector external to CMBS. This time, however, CMBS is perceived as being very closely linked with RMBS, and has been declared guilty until proven innocent. Although this is clearly guilt by association, CMBS has been unable to distinguish itself sufficiently to retain the flight-to-quality alternative status that it previously enjoyed.

In Canada, CMBS has performed quite well. With the exception of a few large loans that have ballooned amounts in excess of replacement costs, property and underwriting fundamentals remain strong. What continues to constrain the Canadian CMBS market is a mismatch of appetite for some of the securities, with a ripple effect on the market that has resulted in a significant slowdown. Traditional long-term investors in Canada (life insurance companies and pension funds) have yet to fully embrace CMBS, and the void had been filled by buyers of short-term products such as ABCP conduits. The ABCP conduits have been absent from the Canadian CMBS market since earlier in the year, which has made it difficult to place all of the newly issued Canadian CMBS.

The primary outcome of the Canadian CMSA conference this month was the consensus that the mismatch that has halted the industry is not long term, and investors will eventually come back into the market because of the strong fundamentals that are prevalent in Canadian CMBS. Investors are looking for something to like, and it's not interest-only loans, excessive debt or a high concentration in retirement homes, hospitality, self-storage and auto dealerships.

As a basis for comparison, we offer some relevant statistics on the Canadian and U.S. CMBS markets.

The Canadian CMBS market exhibits better credit dynamics than the United States or Europe. For example, terms frequently thrown about in the U.S. CMBS market in 2007 include: (1) aggressive underwriting, (2) interest-only loans, (3) high leverage, and (4) unprecedented cap rate compression, with the latest being (5) increased delinquencies. As mentioned earlier, those terms in Canada would be the exception and not the norm. To understand why, let's take a closer look at each of these points of comparison:

(1) Aggressive Underwriting: This is a difficult point to reference other than to say in DBRS' experience, Canadian underwriting of transactions has generally been far more prudent and consistent with traditional lending practices, and has not been nearly as aggressive as U.S. underwriting. DBRS notes that the tactics employed in the United States such as projection exit strategy, short-term master leasing to market occupancy with no history of achieving market, rents to marked up to a projected market, DSCRs below 1.0x on actual net cash flow, building growth through re-measurement, below-market TI/LC assumptions and little-to-no structural reserves are rare in Canada, and used much more infrequently. That isn't to say it doesn't happen, or isn't contemplated, in Canadian CMBS loans. But more often than not, if it is used, the investor base will be looking for strong support as well as full recourse from a financially capable sponsor, if not an investment-grade entity.

(2) Interest-Only Loans: U.S. CMBS transactions experienced an influx of interest-only loans beginning in late 2004. In 2007, the full-term, interest-only concentration in one transaction reached as high as 83.1%. The average U.S. CMBS transaction issued in 2007 had 78.1% by balance of full or partial interest-only loans, compared to 19.4% in Canadian CMBS transactions, signifying that the use of full or partial interest-only is rarer in Canadian CMBS. DBRS looked at a sample of transactions issued in 2007 in both the United States and Canada. In the United States, the loans in the CMBS transactions amortized on average 6.54%, compared to the average 18.7% amortization occurring in the Canadian CMBS transactions.

(3) High Leverage: Coupled with interest-only loans, high leverage has the potential of creating huge balloon risk. On their own, if the leverage is reasonable, interest-only loans are not bad. However, if coupled with higher leverage and no principal burnoff, interest-only loans can contribute to higher losses given default. To effectively measure the comparative risk, DBRS tracks net cash flow as a percentage of balloon balance. This measure is known as Exit Yield on Debt. The higher the Exit Yield on Debt figure, the less vulnerable the loan is to interest-rate risk at maturity (refinance). Loans in the Canadian CMBS market on average have a higher Exit Yield on Debt. In 2007, the 75th percentile of U.S. CMBS loans resulted in an Exit Yield on Debt of 9.6% or lower. That same exit debt yield is equivalent to only the 4th percentile of Canadian CMBS loans.

(4) Cap Rate Compression: Both the U.S. and Canadian markets have experienced record cap rate compression, and both markets have properties trading for sub 6% cap rates. Some of these assets trading at record cap rate levels are trophy assets, and some are assets that one would generally not expect to trade for such a tight cap rate. Keep in mind that cap rates really have no where to go but up, and a market that amortizes its loans will be better positioned for rising cap rates.

(5) Increased Delinquencies: Midland Loan Services (Midland) has recently been on record stating that they have seen a sharp increase in delinquencies for loans originated in 2006 and 2007 (in its US CMBS portfolio); 70% of new loans transferred to special servicing are of these vintages. (*Real Estate Finance & Investment 10/29/07*). Midland is also the largest master servicer in the Canadian CMBS market and as a comparison, the Canadian CMBS 2006 and 2007 vintages have not experienced a dramatic rise in delinquencies; there is only one out of over 1,000 loans that is delinquent.

As one can see, the Canadian CMBS market has performed well, and has not been victim to as much aggressive underwriting and high leverage as its U.S. counterpart, and also has not experienced an alarming increase in delinquencies. With the Canadian market, as with other global markets, the current issue remains the mismatch of the investor base of long-term securities with short-term buyers, or lack thereof. The performance of the Canadian CMBS asset class will speak for itself, and eventually attract investors back to this asset class. In addition to the strong performance track record, one thing that may aid the Canadian CMBS market is the elimination of the withholding tax on cross-border interest payments. The withholding tax is currently an additional cost that has kept U.S. investors away from the Canadian market, as the tax eroded the yield. Without that tax hurdle, and with continued strong performance, Canadian CMBS may find themselves attractive to more traditional long-term investors from North America, leading to a deeper market and support of Canadian CMBS secondary trading.

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