

New Issue CMBS – Is it an illusion?

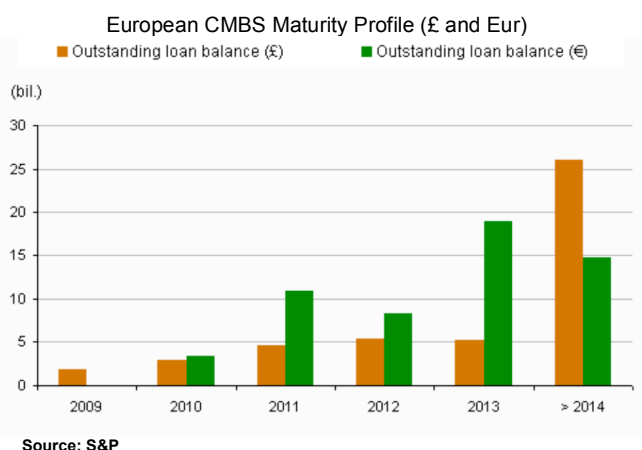
London, 26 April 2010, by Steve Curry

Almost everyone in the market noticed the flurry of activity in new issue CMBS in both the US and this side of the Atlantic over the last couple of weeks. In this Market Insight we consider how these new issues differ from pre-crisis CMBS, the investor appetite, the stance of the rating agencies towards such deals, and what these new issues may signal to the market.

Depending on whether you are a property bull or bear, two questions continue to dominate debate within the industry: first, how to capitalise on the market distress and buy properties that are now “cheap” and, second, how will the huge volumes of maturing European real estate debt (much of it originated during the boom years of 2006, 2007 and 2008 and due to mature between 2011 and 2013) be refinanced?

The extent of the refinancing challenge is enormous. S&P have forecast that the refinancing requirements for European CMBS between 2011 and 2013 exceed EUR 50 bln. This comes on top of the real estate lending held on bank balance sheets which will also mature over the same period.

Here at Bishopsfield Capital Partners we have commented before in our Market Insight that we expect the bank market to be an important contributor in the refinancing story. We stand by this view, of course. However, we have always felt that the CMBS market would slowly re-emerge. With the RBS Commercial Funding 2010 issue in the US a couple of weeks ago and the Vesteda Residential Funding II B.V. issue last week we feel that our view has begun to be vindicated – you may of course want to argue that our crystal ball did not need quite so much polishing as usual as Bishopsfield Capital Partners had been rating advisor on the Vesteda deal since Q4 2009.



The New Issues - Fundamentals

We could dedicate an entire book to the details of each of the deals just mentioned but for Market Insight there are a few key points worth dwelling on. Firstly, the deals are different not only by the fact that one references US and the other Dutch collateral but the RBS deal is underpinned by 81 retail and office properties and the Vesteda deal by 309 multi-family/residential properties. Furthermore, the Vesteda issue was a tap of an existing larger financing with only the AAA notes placed whilst the RBS issue placed AAA through to BBB-notes.

There are, however, two facets of the deals which we believe have been critical to the undoubted success of both transactions, namely their relatively small size and the low LTV's compared with legacy CMBS deals. The RBS issue was US\$ 309mln and the Vesteda issue was EUR 350mln. With LTVs of 55% and 35%

for RBS and Vesteda respectively, both deals clearly fall into the conservative box. Such low LTVs might even have been viewed as suicidal by borrowers a mere two years ago when maximising leverage was the name of the game.

RBS (Commercial Funding) 2010

Tranche	Issue Amount (mln)	Rating	Margin (Swaps +)	WAL (yrs)
A1	\$18.7	AAA/Aaa	80	2.5
A2	\$222.1	AAA/Aaa	90	4.9
B	\$18.6	AA/Aa2	190	4.9
C	\$20.9	A/A2	290	4.9
D	\$29.4	BBB-/Baa3	425	4.9

Vesteda Residential Funding II B.V.

Tranche	Issue Amount (mln)	Current Rating (F/M/S)	Margin (bp pa)	WAL (yrs)
A7	€ 350.0	AAA/Aaa/AAA	163	4

Investor appetite

So we arrive at the ultimate question. Who bought these deals? Well, as ever, the precise names are a closely guarded secret (so as not to spoil the party for investment banks). What we can derive from the rhetoric is that the leads on the deals followed different strategies. The RBS deal was apparently “well received by multiple investors and oversubscribed across all tranches”. The Vesteda deal was however “privately placed with one investor”.

It would be wrong to draw too many parallels on investor appetite for the deals – one being a fixed rate deal the other a floater – as the investor universe is clearly different either side of the “pond”. However, we would observe that the combination of the inherently conservative nature of both transactions together with their relatively small size would appeal to both “universes” alike. Notwithstanding the different distribution

strategies, it is likely that the Originators and Lead Managers would have been scratching their heads long and hard trying assess the optimal approach. Would investors have any appetite for a new issue when secondary prices for legacy deals offers such strong value in the current market? Would the argument about a deal having been structured in a more stringent credit environment and recently rated be seen as sufficiently attractive? How far down the capital structure would investors be willing to play and obviously at what price?

We now know the answer to all of these questions and, for both deals, we believe that both Issuers will be extremely happy with the price they achieved (see tables above) with such an uncertain backdrop. Whether these prices are “good” or not is a moot point. Here at Bishopsfield Capital we look at it this way: if these prices were to be achieved for larger deals and in volume, the CMBS market would be a strong viable alternative to the bank market and, for borrowers, having more than one funding alternative can only be “good” for their credit and market profile.

Ratings – How is it in the new world?

As far as CMBS is concerned, the rating agencies have spent a large part of the previous 18 months thoroughly reviewing and monitoring existing transactions and assessing whether downgrades are necessary. To give a flavour for the outcome, Moodys downgraded 242 of the 657 tranches that they rate. Rating a new issue CMBS is therefore somewhat of a novelty for any rating agency. With the Vesteda transaction being the first new issue CMBS in the Netherlands since the crisis and the first in Europe this year, from our position as rating adviser, we are one of the few with true insight into how the ratings process is now being conducted, the differences and the hot buttons.

Notably, none of the three rating agencies have made wholesale changes to their rating methodology. “Why not?”, you may wonder. The point to stress (if you’ll excuse the pun) is that although the methodologies may be similar, the severity of their starting base case downside assumptions are more severe now.

It is of course difficult to generalise but there are a few pointers worth noting for any borrower contemplating a CMBS rating. Firstly, do be prepared for even more intense scrutiny of all aspects of the portfolio and transaction structure. Secondly, don’t assume that an external valuation draws a line under the portfolio value debate. Thirdly, the consequences of Lehman’s demise on swaps related to securitisation transactions means that the hedging arrangements will be firmly under the microscope. Lastly, do be prepared for very detailed evaluation of operational aspects of a transaction and in particular what roles are the various counterparties (i.e., trustee, servicer, issuer, etc.) required to perform in a default and how a property will be liquidated and how long will it take.

What do the recent CMBS new issues signal to the market?

The first thing to say is that two deals don’t make a market and it is still too premature to see such as a true revival. There remain serious challenges ahead for the legacy (i.e., pre-crisis) CMBS transactions. Refinancing is a main theme but we still envisage further downgrades as well as further defaults for those transactions most severely impacted by property value declines and/or tenant defaults. Having said this, the new issues have created a number of important signals:

Market – CMBS is not dead and will be a viable alternative to bank borrowing for some real estate companies, especially for 5 year or longer terms.

Portfolio – the underlying property portfolio (and its valuation) must be robust to appeal to investors and rating agencies alike.

LTV – LTV’s not higher than c. 40% to 55% are expected to drive new issuance for CMBS (not dissimilar to bank lending).

Equity – for legacy transactions it is difficult to see how these deals can be refinanced without some form of debt forgiveness and/or equity raising or through extension.

Investors – will be very selective and only the very best issuers, portfolios and structures will be considered at this point in the recovery. We expect that in Europe we will remain in a transition phase for a while where some investors prefer the yields on secondary paper whilst others prefer a new start with new issues.

Ratings – AAA is possible but only for the most robustly and conservatively structured deals.

Pricing – having any new issue pricing with which to compare secondary prices (which can be unreliable given low trading volumes) is helpful.

In conclusion, the benchmarks set by the recent new issue CMBS will not be capable of being delivered by all borrowers but for those that can CMBS should be evaluated against bank borrowing and may be a much more viable alternative than most property investors believed likely, post the crisis.

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