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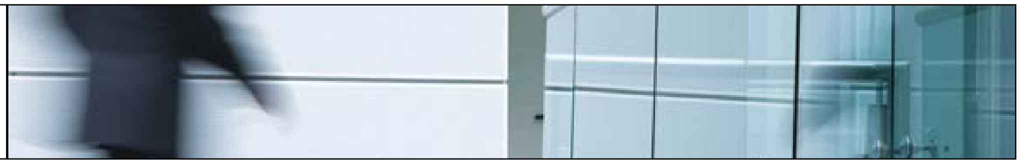


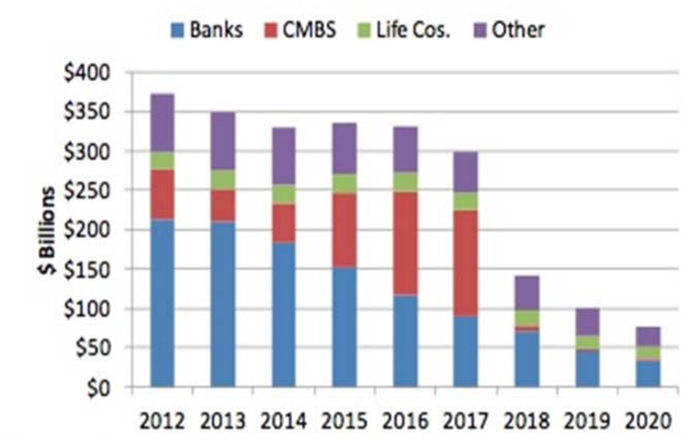
CMBS: Feeding the Elephant in the Room

May 2012

At the height of the U.S. property boom from 2005 to 2007, the allure of Commercial Mortgage-Backed Securities (CMBS) seemed without limit. During that 3-year period, more than 30,000 loans were pooled into $602 billion of new CMBS bonds. Then came the reckoning now recorded as the Great Recession when the CMBS industry collapsed, issuing a paltry $28 billion in three combined years from 2008 to 2010. In 2011, the fragile recovery in commercial real estate included $32.7 billion in CMBS.

As delinquencies began to mount for CMBS assets, special servicers aggressively used multiple modification strategies to mitigate losses, with maturity extensions being the primary avenue. Since the 2008 crash, maturity extensions effectively pushed the wall of debt forward.

Chart 1: U.S. CRE Debt Maturities 2012-2020



Source: Morgan Stanley, Foresight Analytics, Trepp, Intex

The days of reckoning have arrived. Analysts' forecasts range upwards of 30% for CMBS fallout in loans that will default or not re-finance because of underlying fundamentals.

Maturing CMBS performance in the first few month of 2012 provide a harbinger of things to come. According to Trepp LLC, more than $9 billion worth of loans that originated in 2007 were due in the first three months of 2012. About 48% of those loans paid off at or prior to their maturity date or

Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

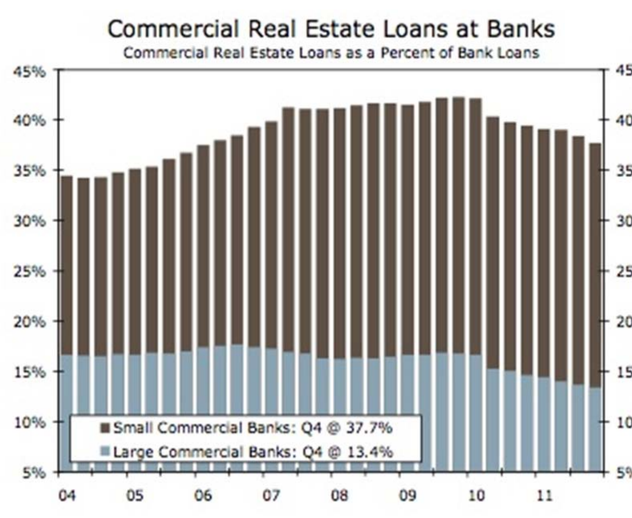
were resolved with a loss. Of those retired loans, about 80% paid off in full and about 20% suffered a loss—although in many cases the loss was less than 2%. Of the remaining 52% of the loans that failed to pay off, 49% were listed as non-performing balloon loans. The properties of another 23% were in some stage of foreclosure.

"We can't keep pushing this wall of leveraged debt forever into the future. The reality is the leveraged finance industry is charting new territory, and it's going to be a bumpy ride," says Jack Mullen, Founder of Summer Street Advisors.

The Hungry CMBS Elephant
The enormous pile of ex-CMBS assets needing restructuring can be likened to a hungry "elephant in the room" eating up capital that would otherwise provide some support to the secondary bank loan market. Somewhat out of necessity, the market likely will continue this feeding trend certainly into 2013.

The CMBS overhang effectively retards the pace of work-out of distressed CRE on the books of small- to mid-sized banks, already hard-pressed because the high concentrations in their portfolios – 37.7% compared with 13.4% for large commercial banks.

Chart 2: CRE Loans at Banks



FDIC data shows roughly a third of Bank CRE loans are backed by owner-occupied properties and another 20% to 30% by land and construction loans. These loans are usually not candidates for securitization. In addition, regional and small banks also make much smaller loans than those usually seen in CMBS pools or in insurance company portfolios. These non-CMBS worthy loans have performed differently during this recent financial crisis, exposing the need to create new default and loss models that are not driven by experience with institutional-grade loans.

The CMBS defaults are here, and they are being moved out of the debt pool. New CMBS collateral is being discovered and sold, and money available for special situations is undoubtedly being allocated to previous CMBS assets, lowering prices for the lower rung of the "special situations" universe.

"The higher yields available from restructuring maturing loans from CMBS 1.0 raise the cost of capital to banks needing to restructure their distressed assets. The largest banks have more options, but small- and mid-sized banks can't escape the pain, especially those whose portfolios are heavily invested in the hardest-hit cities and regions," Mullen explains.

"Everybody wants this problem to go away and the CRE market to return to some degree of health and normalcy. The limiting factor is the underlying fundamentals that stretch beyond CRE through the financial markets. Although the variables and the actual mechanics of this recovery are made more complex by the CMBS, the simple story that is unfolding is one of supply and demand for investment dollars," says Tyler Shubert Director of Summer Street Advisors.

Pockets of opportunity
Delinquency levels in Bank portfolios have been steadily rising and are estimated at more than $100 billion going into April, according to CoStar Group.

Inevitably, Banks will have to sell their non-performing loans. Unlike the RTC-fueled flood of distressed sales in the 1990's recovery, this time, opportunities are more likely to flow like a relative trickle, at least in the short run. The sheer volume of transactions and the need to untangle the CMBS web have required regulatory, banking and securities industries to develop and implement processes in response. It took at least two decades to create the current situation, and it will take many years to undo recession damage in CMBS and Bank portfolios.

Patience and due diligence will pay off for investors willing to make the effort to find opportunities in sales of bank-owned assets and non-performing loans. As an example, an April report from Trepp identified 30 banks holding more than $700 million in seriously delinquent CRE loans and foreclosed commercial properties on their books at year-end 2011.

The latest Ernst & Young survey of investors confirms the market is making adjustments. Responses gathered at the end of 2011 show investors expect to bring more of their own money to the deal in return for higher payoffs (25% want returns upwards of 20%, compared with only 8% in the 2010). Investors who are hunting for higher yields relative to CMBS 2.0 will have to prospect farther down the food chain, for example among restructured ex-CMBS assets.

Jack Mullen adds this caution: "Investors who rely on pure capital muscle may be disappointed. The dynamics of this recovery really highlight the need for specialists with ground-level knowledge about the property markets, product types and business plans to adequately assess the risks and rewards for opportunities in banks' distressed asset sales and off-market deals."

Living with the elephant

The 'new normal' continues to shape up as a prolonged environment of global economic lethargy, historically low benchmark interest rates, a flat yield curve, and the elephant blocking capital in the commercial real estate sector. Having a process to efficiently identify opportunities within this unprecedented commercial real estate market becomes increasingly relevant, especially for non-securitized deals.

Strip away regulatory mandates, business maneuvering and geo-political challenges and what is left is the interplay of supply and demand for capital seeking the best return along the risk curve. Markets are not always efficient, but the market-clearing prices for commercial real estate assets and CMBS provide information in good times and bad. The lengthy recovery from this current financial crisis likely will reveal inconvenient truths, like the capital-hungry 'elephant in the room' that serve as much-needed reminders of the need to stand on solid fundamentals.

Summer Street Advisors LLC (SSA) is a commercial real estate and financial services advisory firm. SSA offers a rigorous, data driven approach in providing commercial real estate and loan investment valuation and analysis, transaction due diligence, bank and REIT advisory, asset/portfolio management and loan underwriting.

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