The Good, the Bad, and the Ugly of 2014

This time last year, investors were pondering the eventual tapering of quantitative easing, slipping CMBS underwriting standards and growing global unease touched off by war in Syria. Today, investors are forecasting the effects of an inevitable Federal Reserve rate hike, increased competition in commercial real estate lending pushing LTVs higher and DSCRs lower, and global tensions exacerbated by an unprecedented drop in oil prices and the Russian Ruble. The more things change, the more they stay the same.

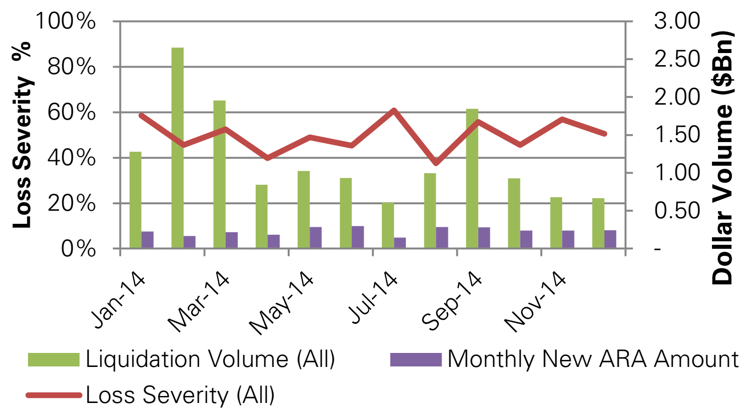
In keeping with tradition, we will start with the bad (and unfortunately the ugly) highlights in CMBS from the year. In the first quarter, when most of the country was dealing with the Polar Vortex, legacy CMBS was dealing with CWCapital Asset Management's bulk auctions of distressed assets. CWCapital listed $2.6 billion in specially serviced loans on Auction.com and with CBRE, resulting in some big losses for a number of very large loans. The $470 million Two California Plaza (Los Angeles) in GSMS 2007-GG10 posted a 43% loss, while the $175 million Four Seasons Resort and Club (Dallas) in WBCMT 2006-C28 posted a 35% loss.

Although the losses on the liquidated loans were ugly for the lower end of the capital stack and often caused acceleration of principal for the top of the stack, the positive was a quick improvement in the credit quality of several legacy deals. There was very little positive to be found in the Polar Vortex unless you were long rock salt.

Sears, Kmart and JCPenney provided more bad headlines in 2014, announcing hundreds of store closures that sent CMBS analysts scrambling to find exposures to the beleaguered retailers. Corinthian Colleges, Bi-Lo, Dominick's and Staples were some of the other tenants closing locations during 2014.

Although liquidation volumes last year were relatively low, severities remained elevated and new appraisal reductions were consistently hitting remittance reports.

The Bad: Monthly Loss Severity, Liquidation, and New ARA Volume



More Bad and Ugly Headlines from 2014:

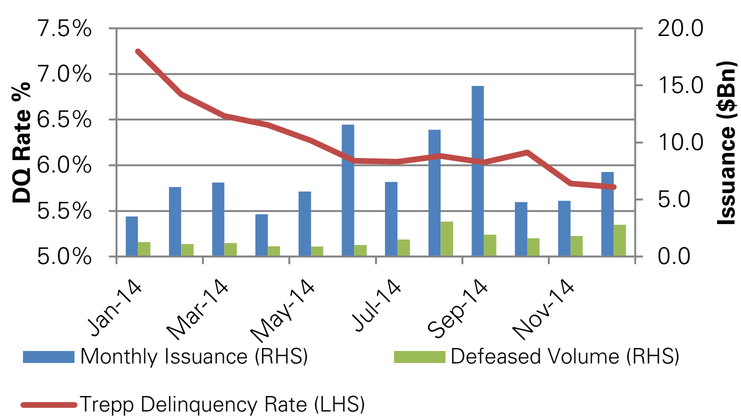
- January: BACM 2007-3 clobbered with $100 million in losses, wiping out six tranches.
- February: Russia annexes Crimea. $95 million Eastpoint Mall in Baltimore sold for 65% loss.
- March: GG10 sees next wave of losses from CWCapital auction, 48.8% loss on $583.3 million across seven loans.
- July: Loss severity reaches record high 60.8%. $82.9 million Babcock & Brown FX 2 liquidated for 95% loss.
- September: First Ebola case in the US Winning streak ends as CMBS delinquencies inch up.
- October: American Realty Capital replaces CFO amid accounting controversy. ARCP backs at least $3.5 billion in CMBS loans. Risk-retention rules finalized with few changes suggested by CREFC.

- December: Oil drops as much as 40% from highs. Sanctions and oil slump pummel the Russian ruble. $146.4 million COPT office portfolio hit with $56.3 million appraisal reduction.

There was, of course, some more reassuring news from the year. Despite a stumble out of the gate, CMBS issuance in 2014 reached a post-crisis high of just under $90 billion. Fundamental performance and valuations of CRE properties continued their steady upward trend as occupancies and rents increased in the aggregate across the major property types.

On the economic front, unemployment fell consistently and the major US equity indices reached all-time high after all-time high. The Dow Jones Industrial Average ended the year up 8.2% and the S&P 500 ended up 11.8%, despite a slight correction over the past few weeks of 2014.

The Good: CMBS Issuance and Delinquency Rate



As stocks rose, the Trepp CMBS delinquency rate dropped in 10 of 12 months in 2014, falling 167 basis points year-over-year. Rates remained low and appetite was strong for CMBS bonds in 2014 despite the tapering of quantitative easing leading up to its end in October. Looking to lock in low rates, borrowers increasingly defeased their loans, indicating property values high enough and rates low enough to justify the added cost of defeasance. Defeasance volume in 2014 reached $18.9 billion, almost double 2013's total.

More Good Headlines from 2014:

- January: Dovish Janet Yellen becomes head of Federal Reserve. First conduit of the year prices at relatively healthy spreads.

- February: Delinquency rate plunges due to huge CWCapital liquidations.

- March: Private sector payrolls surpass pre-recession peak.

- June: Maui Four Seasons loan sees repayment of hope note.

- September: Dow Jones Industrial Average and S&P 500 index hit all-time highs. Derek Jeter ends career at Yankee Stadium with a game-winning RBI.

- December: Drop in gas prices brings some relief to consumers; Almost $3 billion in CMBS defeased.

Total issuance for 2014 failed to crack the $100 billion mark, but momentum and demand are strong going into the new year. Delinquencies are set to crack the 5% threshold at some point in 2015 as long as rates remain low and issuance continues apace. ■

For inquiries about the data analysis conducted in this research, contact press@trepp.com or call 212-754-1010. For more information on Trepp's CMBS products, contact info@trepp.com.

About Trepp

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