CMBS Defeasance Activity Drops Sharply As Maturity Wall Is Hurdled

The dwindling size of the legacy CMBS market has had a profound impact on defeasance activity. Only 449 CMBS loans totaling $6.4 billion were defeased, or replaced by government securities, last year. That compares with the 1,059 loans totaling $15.9 billion that were defeased in 2016. While market conditions last year were ideal for defeasance transactions, there just weren't that many loans to defease.

Defeasance activity flourishes when interest rates are low and property values are high, as was the case in 2016. Activity is further bolstered when the difference between short- and long-term interest rates narrows and the yield curve flattens, which also took place in 2016. A large wave of defeasances occurred between 2013 and 2016, when some $70.6 billion of loans were replaced by government securities. That spike in defeasance activity coincided with the CMBS Wall of Maturities.

CHART 1: 2017 CMBS DEFEASANCES BY MONTH

MONTH OF DEFEASANCE	TOTAL DEFEASED BY COUNT	TOTAL BALANCE OF DEFEASED LOANS
201701	75	892,518,456
201702	42	1,333,078,869
201703	44	460,963,596
201704	21	161,780,649
201705	31	233,823,276
201706	39	327,963,444
201707	32	245,276,840
201708	29	231,263,446
201709	35	634,828,980
201710	26	240,661,411
201711	39	1,154,244,826
201712	36	523,324,980
Total	**449**	**6,439,728,772**

Source: Trepp

Maturing Debt Fuels the Defeasance Engine

"We're nearing the 10-year mark from the financial crisis," explained Dan Kahler, Director of Defeasance at Chatham Financial, a Pennsylvania advisory firm with a substantial defeasance business. "After the crisis, not a lot of CMBS was issued. With fewer maturities, we're seeing fewer defeasances in the pipeline."

Now that maturity volumes are declining, so are defeasance volumes. The expectation is that volume will remain steady, but muted thanks to the dearth of 10-year loans issued following the 2008 financial crisis. After all, only $12.1 billion of loans were securitized in 2008; just $3.6 billion were issued in 2009; and $11 billion hit the market in 2010.

According to Eitan Weinstock of AST Defeasance Services of Los Angeles, the big variable is the expectation of dramatic interest-rate hikes. He explained that rate increases would move borrowers to lock in current rates and defease existing loans, but the rate moves have to be dramatic. "LIBOR moved up one percentage point," Weinstock explained, "and it wasn't enough to scare people" into completing transactions. "It has to be a real number … then, even if they have six years left on their loans, they'll say, 'let's do it.'"

Prepay Today or Defease Later?

Commercial mortgages – particularly those which are securitized – are typically structured with prepayment restrictions to ensure that lenders receive the expected cash flows for the life of their loans. Borrowers who decide to pay off their loans before they become open to prepayment — say, in the event of a sale or if interest rates drop sharply — would face potentially onerous penalties. However, they could replace their mortgage collateral with government securities that would mimic the cash flow of the mortgage.

So, the longer a remaining term for a mortgage is, the higher the cost to defease. As a result, most defeasance activity takes place within two years of a loan's maturity.

If a property's value climbs – as generally has been the case – its owner could refinance the property through defeasance to access the added equity. That increased value would otherwise remain trapped. But for a defeasance transaction to make financial sense, interest rates would typically have to remain low. Otherwise, the benefits of a prepayment could be nullified.

However, the process could be costly and time-consuming, given that it involves negotiations with servicers and rating agencies (among others) and the selection of appropriate substitute securities. As a result, a number of advisory firms have been formed to specialize in the process. Those include AST Defeasance, Chatham Financial, Bank of America, Wells Fargo Bank, Trimont Real Estate Advisors, Commercial Defeasance, and Waterstone Capital Advisors.

Show Me the Money

An example of just how costly a defeasance transaction can be was the refinancing of $875 million of debt against Manhattan's Worldwide Plaza. The 2.1 million-square-foot office was recapitalized late last year when RXR Realty and SL Green Realty Corp. bought a 48.7%

CHART 2: LARGEST CMBS LOANS DEFEASED IN 2017

PROPERTY NAME	CMBS DEAL	MONTH OF DEFEASANCE	OUTSTANDING BALANCE ($)	PROPERTY TYPE	CITY	STATE
Worldwide Plaza	COMM 2013-WWP	201711	710,000,000	OF	New York	NY
IWEST Portfolio	JPMCC 2009-IWST	201702	373,818,045	RT	Various	–
60 Wall Street	COMM 2007-C9	201702	285,000,000	OF	New York	NY
Trust Withheld - July 2017	MLCFC 2007-8	201709	134,503,408	–	–	–
60 Wall Street	CSMC 2007-C5	201702	130,000,000	OF	New York	NY
60 Wall Street	MSC 2007-IQ16	201702	125,000,000	OF	New York	NY
Airport Industrial Park	JPMCC 2005-CB11	201709	90,456,768	IN	Honolulu	HI
Pappas Commerce Center	MSBAM 2014-C17	201712	78,900,000	MU	Boston	MA
Hyatt Regency Austin	MSBAM 2012-C6	201703	71,912,942	LO	Austin	TX
231 South LaSalle	UBSBB 2013-C5	201710	68,125,808	OF	Chicago	IL
Harmon Corner	COMM 2012-CR5	201712	68,030,370	RT	Las Vegas	NV
Sheraton Chicago Hotel & Towers - Fee Interest	JPMCC 2011-C4	201711	68,000,000	OT	Chicago	IL
Mellon Independence Center	COMM 2014-CR18	201705	63,799,241	MU	Philadelphia	PA
Cabin John Mall & Shopping Center	MSC 2008-T29	201702	63,249,083	RT	Potomac	MD
Westin New York at Times Square - Leased Fee	WFRBS 2014-LC14	201712	55,000,000	OT	New York	NY

Source: Trepp

stake in the property from New York REIT. The property was appraised at a value of $1.74 billion last year, nearly 30% more than the $1.35 billion value pegged to it in 2013 when it last was financed.

As a result, the property was able to support a much larger financing package. Goldman Sachs had provided $1.2 billion of interest-only debt, including $260 million of mezzanine financing, all with a blended coupon of 3.98%. That was used to defease the existing debt, a $710 million senior piece that was securitized through COMM 2013-WWP. The debt, with a 4.52% blended coupon, required only interest payments for the first five years, then amortizes on a 35-year schedule. The cost to defease the old financing was $109 million.

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