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CMBS Research

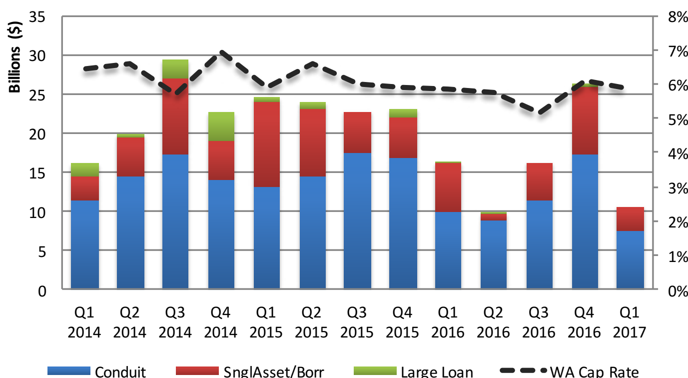
April 2017

Q1 2017 Issuance Recap: Smooth Sailing for CMBS Market in First Risk Retention Voyage

The year 2017 marked a major turning point for the CMBS industry as the risk retention era officially began. Risk retention regulations, which were formulated to hold banks more accountable for their own investment operations and boost credit underwriting standards, impose higher capital requirements that force issuers to hold more "skin in the game." The implementation of Dodd-Frank provisions and other regulatory frameworks that govern asset-backed securitizations have given rise to anxiety over a potential slowdown of CMBS lending. The fear was that CMBS would become less competitive than other sources of CRE financing. With the first quarter of the year firmly behind us, we observe that the industry has digested these changes better than most would have predicted, and the favorable pricing and reception garnered by risk retention deals issued so far bodes well for upcoming CMBS transactions in the pipeline.

Between January to March of 2017, 13 traditional private-label CMBS deals closed, tallying a modest $10.5 billion. Conduit loans comprised the overwhelming majority of the first quarter's securitized balance with $7.6 billion, while single-asset/single-borrower loans totaling $2.9 billion represented the remaining 27.8%. For the most part, market participants widely anticipated lower issuance activity in early 2017. Many issuers rushed to clear out their loan inventories before the rules were officially enacted by year-end 2016, and the first quarter transition period was needed for players to engage in price discovery and test out the various structural strategies.

Q1 CMBS ISSUANCE: DEAL TYPE

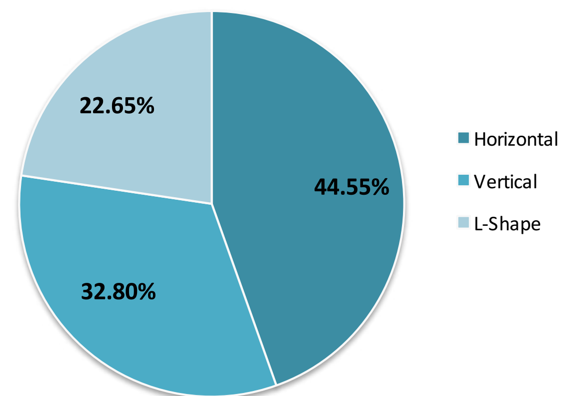


Source: Trepp

RISK RETENTION STRUCTURES: Horizontal, Vertical, and Hybrid

Seven of the 13 deals issued were structured with a horizontal risk retention holding, which means all of the risk retention classes were at the bottom of the deal waterfall. About $4.7 billion (44.6%) of Q1 issuance adopted the horizontal structure, while 32.8% of the balance was securitized under the vertical risk retention option. Two loans comprising 22.7% of the issuance total employed the L-shaped strategy. The "vertical" structure requires that a 5% interest in each class of the securitization is represented as a risk retention "slice." Often referred to as the "hybrid" structure, the "L-shaped" option is characterized by any combination of vertical and horizontal interest such that the sum of the subordinate fair value and vertical interest held equals at least 5%.

Q1 CMBS ISSUANCE: RISK RETENTION STRUCTURE



Overall, deals across all risk retention categories were underwritten with relatively conservative credit metrics. Loans issued within each risk retention structure posted a weighted average DSCR over 2.1x and an LTV below 59%. Horizontal deals carry the lowest weighted average cap rate among all structure types at 5.86%.

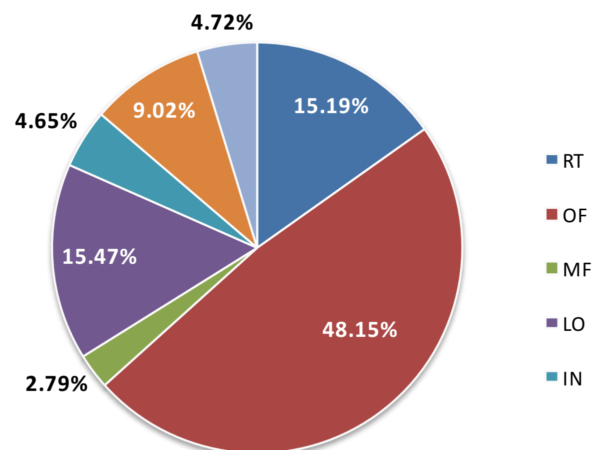
	Horizontal	Vertical	L-Shape
Balance	$4.70 bln	$3.46 bln	$2.39 bln
% of Q1 Issuance	44.55%	32.80%	22.65%
# of Deals	6	5	2
WA LTV	53.60	58.01	57.24
WA Cap Rate	5.86	6.79	6.11
WA DSCR	2.45	2.20	2.15

PROPERTY TYPE BREAKDOWN: Office Sector Takes Lion's Share

A total of $5.08 billion issued last quarter – or nearly half of the total Q1 balance – is secured by office properties. This was due to the securitization of several large single-asset loans backed by trophy towers in central business districts (CBDs) of cities like Chicago, New York, and Washington, D.C. Lodging loans commanded the second-largest volume by property type at $1.63 billion. In terms of CRE sectors that have been dominating headlines in recent months, retail loans accounted for a much smaller share of the issuance pipeline than previous quarters at $1.60 billion, or 15.19% of the quarterly total. Amidst investor scrutiny and uneasiness surrounding store closures and bankruptcies, new issue retail loans generally showcased conservative underwriting, as well as minimal exposure to lower-producing shopping malls. For the first quarter of the year, private-label multifamily issuance also dwindled to below 3% of total CMBS transaction volume. Non-agency multifamily loans going into securities have pulled back slightly, while government agencies like Fannie Mae and Freddie Mac continue to take on higher lending risk and post record issuance activity.

The largest loan issued during this time period was the $1.02 billion Willis Tower note, which fully comprises the CST 2017-SKY deal. The loan is a refinancing that was used to retire an existing CMBS mortgage secured by the property that was paid off in February. Ranked as the tallest building in Chicago (and the second-tallest in the Western Hemisphere), the 3.8 million-square-foot skyscraper currently serves as the main headquarters for United Airlines. The firm consolidated its operations to Willis Tower in 2013 and occupies 22.32% of the building's space with a lease that runs through 2023. Another noteworthy new issue is the $975 million One Market Plaza office

Q1 CMBS ISSUANCE: PROPERTY TYPE



Source: Trepp

5 LARGEST LOANS ISSUED IN Q1

Deal Name	Property Name	Deal Type	Prop Type	Securitized Balance	LTV	DSCR
CST 2017-SKY	Willis Tower	Single-Asset	Office	1,020,000,000	67.0	3.57
OMPT 2017-1MKT	One Market Plaza	Single-Asset	Office	975,000,000	55.2	2.16
GSMS 2017-485L	485 Lexington Avenue	Single-Asset	Office	350,000,000	45.5	2.68
GSMS 2017-GS5	350 Park Avenue	Conduit	Office	100,000,800	41.7	2.98
CD 2017-CD3	229 West 43rd Street Retail Condo	Conduit	Retail	100,000,000	60.6	1.75

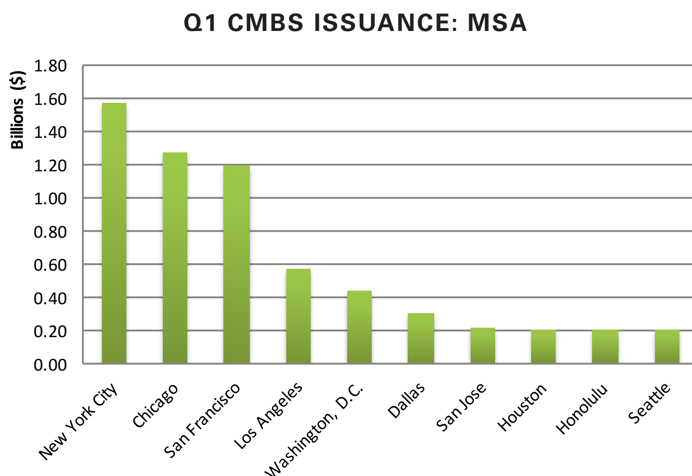
**Based on current "as-is" values at securitization*

loan. The collateral is a newly-renovated, 43-story high-rise office located in San Francisco. The 1.58 million-square-foot tower is listed as 97% occupied, and features Google as its largest tenant.

BREAKDOWN BY MSA: Secondary Markets Gain Ground on Top Dogs

Major markets such as New York City, Chicago, and San Francisco each received over $1.1 billion in CMBS issuance last quarter, with NYC topping the list at $1.57 billion. The Dallas MSA* came in fifth with just over $308 million issued, followed by $210 million for

Q1 CMBS ISSUANCE: MSA



Source: Trepp

San Jose, California. The issuance levels for these two MSAs, along with Houston, Urban Honolulu, Seattle, and other secondary cities are starting to exceed those for some gateway markets, such as Miami and Boston.

Although the MSAs listed above received the largest volumes of Q1 issuance volumes, nearly all of them underwent negative year-over-year growth, with the exception of Urban Honolulu and San Francisco. The markets with the highest issuance volume over the last four quarters and the highest year-over-year growth were Urban Honolulu, Columbus (OH), Las Vegas, Memphis, and Cape Coral-Fort Myers (FL). Each of those markets posted issuance growth rates in excess of 100%.

NEW ISSUE CONDUIT SPREADS DRUM-TIGHT IN Q1

The CMBS sector has recovered significantly from the rout in spreads that occurred in late 2015 and early 2016, where spreads on fixed-income products blew out to new highs as a result of falling oil prices, macroeconomic volatility, and uncertainty from pending regulatory mandates. AAA spreads on new issue conduits later tightened up to 80 basis points throughout 2016 from a high of 173 basis points in early March 2016. Lower-rated bonds for that segment endured a more severe spread blowout, and recovered for an even greater rally. CMBS deals issued in 2017 have established new pricing levels with the average benchmark AAA clearing at 20 to 30 basis points tighter than the batch of non-risk retention deals from December 2016. This has capped prevailing AAA spreads for commercial mortgage securities in the post-risk retention era to below the 100-basis point barrier for the first time since mid-2015. The tight pricing, driven by limited supply and the assumption that risk retention deals possess greater implied credit quality, has shown that investors favorably regard the fact that issuers now carry some of the risk in the very loans that they originate.

OTHER KEY INDUSTRY TRENDS:

- Higher capital charges under risk retention have made it more difficult for smaller conduit shops to participate in CMBS. The current securitization landscape favors a consolidation of larger bank issuers and institutions with sizable balance sheets, causing many smaller players to pull back.

- Risk retention-induced credit barbelling, which refers to the wide dispersion of credit risk within a CMBS deal, continues to be a focal point among investors. However, many argue that concerns have largely been overblown.

- Price tiering is becoming more prevalent in the secondary market. Risk retention has resulted in increased differentiation among

*For more information, read our research piece 'Dallas in High Demand as Commercial Properties Fill Up

Q1 Conduit Transactions - Pricing				
Closing Date	Deal Name	AAA Spreads	BBB- Spreads	RR Structure
2/14/2017	CD 2017-CD3	90	380	L-Shape
2/16/2017	BACM 2017-BNK3	88	350	Vertical
2/27/2017	BBCMS 2017-C1	94	450	Vertical
3/14/2017	WFCM 2017-RC1	95	450	Vertical
3/21/2017	GSMS 2017-GS5	88	315	L-Shape
3/29/2017	JPMCC 2017-JP5	92	NA	Horizontal
3/31/2017	JPMDB 2017-C5	89	NA	Horizontal
3/30/2017	WFCM 2017-RB1	93	325	Vertical

Source: Trepp

deals since there are more factors to consider for analysis, such as the type of risk retention structure being used and a transaction's vintage and credit quality, among other things.

- There is greater transparency in the market as a result of new disclosure requirements that now publicize information on deal proceeds and third-party investor yields.

- Lower CMBS activity under risk retention has reduced market liquidity, while perceived credit quality of newly issued deals has increased, both of which have positively contributed to tight spread pricing and investor appetite.

- The vertical option has been the risk retention deal structure among conduit deals most commonly utilized thus far, while the hybrid approach is viewed favorably since it involves a sponsor keeping "skin in the game," as well as B-piece buy-in. The market was originally skeptical of the viability of the horizontal risk retention structure in conduit transactions due to indemnification issues between issuers and third-party purchasers

- Although risk retention places a greater emphasis on credit quality, the policy's higher capital demands could make CMBS less competitive for high quality collateral compared to other lending sources.

- The issuance pipeline for the second quarter appears strong, with issuance for the first half of 2017 currently projected to be roughly $30 billion. Total issuance for the year is estimated to hit about $60 billion.

OUTLOOK

Overall, the securitized lending space was met with various new challenges this year as market uncertainty from changes in political leadership, regulatory headwinds, and pending rate hikes have resulted in sector-wide changes. On a positive note, persistent low rates, the large maturing volume coming due, and investors bearing some of the risk in their own deals could help drive future issuance as uneasiness around risk retention subsides. The low market supply and generally heightened underwriting standards have made CMBS products very popular among investors on the whole, and there is hope that the stance of deregulation the new administration has taken could provide some level of overhaul to present Dodd-Frank requirements.

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

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