Trepp®

CMBS Research

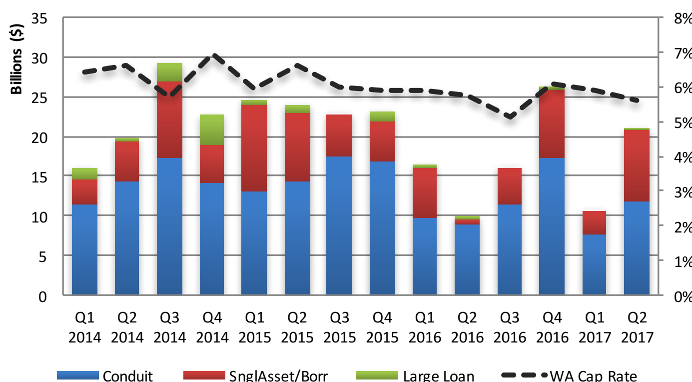
August 2017

CMBS Issuance Skyrockets in Q2 as Market Continues to Warm Up to Risk Retention

The narrative for the first half of 2017 proved to be markedly different than the one that prevailed during the same period a year earlier. In contrast to the market volatility that characterized early 2016 amidst macroeconomic and regulatory uncertainty, the CMBS industry in 2017 has welcomed a bullish post-election equity rally, tighter bond spreads, a more stable global economic outlook, and a fairly accommodative monetary policy that favors the current low interest rate environment.

While 2017 initially began at a sluggish pace after issuers cleared out their loan inventories prior to risk retention, issuance activity later picked up with over $21.2 billion in CMBS loans closing in the second quarter. This more than doubled the $10.5 billion tallied between January and March, and brings the half-year total to roughly $31.7 billion. Despite some noticeable differences in the securitization realm resulting from the exit of smaller loan contributors and greater alternative lending competition, the CMBS space has made much progress in adapting to the regulatory requirements at this point. Overall, the market has gained a better sense of how the process is carried out under risk retention, and new benchmark pricing levels for these deal types are slowly stabilizing.

GRAPH 1: QUARTERLY CMBS ISSUANCE BY DEAL TYPE

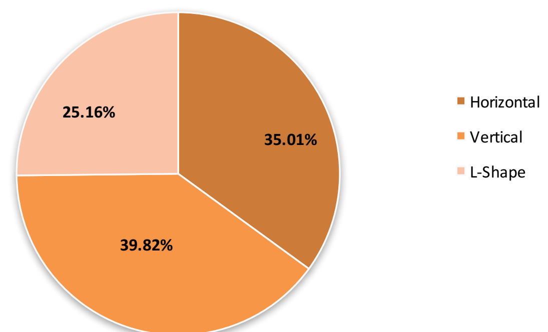


Source: Trepp

Paying Attention to Risk Retention

According to Dodd-Frank risk retention rules that went into effect last December, sponsors and third-party investors of an asset-backed securitization are required to retain a 5% interest in the transaction under the form of a vertical (5% of each class), horizontal (5% of the lowest bonds in the deal waterfall), or hybrid structural holding (combination of the vertical and horizontal structures equal to 5%). Out of the 30 CMBS transactions that closed between April and June of this year, 12 deals amounting to just less than 40% of the issuance balance fell under the vertical risk retention category. Vertically-structured deals from the second quarter showcase the lowest weighted average LTV and cap rate ratios among the three structural options, perhaps as a result of the added risk borne by the issuers. For the remaining transactions that closed during this time frame, 12 deals totaling $7.41 billion (35.01%) adopted the horizontal structure, while another $5.32 billion (25.16%) from six securitizations took on the hybrid or "L-shape" strategy. As of this writing, no single-asset transactions have employed the hybrid alternative. From a credit perspective, this has led to slightly higher leverage figures and lower DSCR values for loans with this structure since it effectively excludes single-asset deals backed by trophy offices in major metropolitan areas, which are historically well-performing.

GRAPH 2: Q2 2017 CMBS ISSUANCE - RISK RETENTION STRUCTURE



Source: Trepp

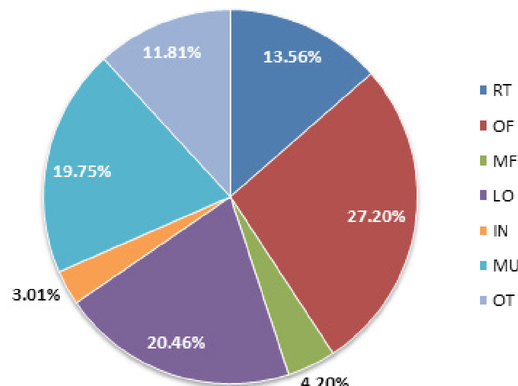
CHART 1: Q2 2017 CMBS ISSUANCE - RISK RETENTION STRUCTURE

	HORIZONTAL	VERTICAL	L-SHAPE
Balance	$7.41 bln	$8.43 bln	$5.32 bln
% of Q2 Issuance	35.01%	39.82%	25.16%
# of Deals	12	12	6
WA LTV	56.84%	54.00%	57.18%
WA Cap Rate	6.56%	5.56%	6.26%
WA DSCR	3.04	2.71	2.15

Retail Receives a Smaller Piece of the Pie

The continued retail malaise and the rise of alternative lending sources, among other sector changes, have created noticeable shifts in the CMBS issuance landscape in terms of property type exposure. The challenges impacting brick-and-mortar retail due to ecommerce growth will persist for some time, while strong activity from GSEs demonstrate the dominance that agency lenders have gained in the multifamily sphere. Consequently, loan originations and issuance for both property types have fallen substantially from previous periods. Although retail has historically backed about one-fourth of newly securitized mortgage totals, the share of retail loans in total issuance fell to 13.56% in the second quarter, down from an already reduced percentage of 15.19% in Q1. Multifamily loan purchases by government-sponsored agencies are poised to hit another record in 2017. This has diminished the presence of apartments in private-label transaction volume to roughly 2-4% in the past two quarters. In addition to heightened lending on hotels, CMBS loans against trophy office towers in central business districts (CBDs) like New York have been the main drivers of year-to-date issuance.

GRAPH 3: Q2 2017 CMBS ISSUANCE - PROPERTY TYPE



**A sizable portion of loans categorized as mixed-use include collateral consisting both office and retail space*

Source: Trepp

The $1.56 billion senior portion from a $2.3 billion refinancing on the General Motors skyscraper in Midtown Manhattan ranks as the largest loan issued in Q2 2017. Sponsored by Boston Properties, the loan fully comprises the single-asset BXP 2017-GM deal. The 50-story, mixed-use building at 767 Fifth Avenue has changed hands several times after being sold by namesake tenant General Motors in 1982. Prominently known for housing Apple's iconic glass cube flagship store, the building is frequently pegged as one of the most expensive offices in the US and received a recent valuation of $4.8 billion this May. The largest conduit loan issued in Q2 is a $98.0 million piece behind 245 Park Avenue, another Midtown Manhattan office tower. The debt behind 245 Park is split across four deals: there is a $500 million single-asset loan, and three separate conduit pieces totaling $271.8 million. Second on the list of largest conduit notes from last quarter is the $95.5 million loan behind the office at 1999 Avenue of the Stars in Los Angeles, California.

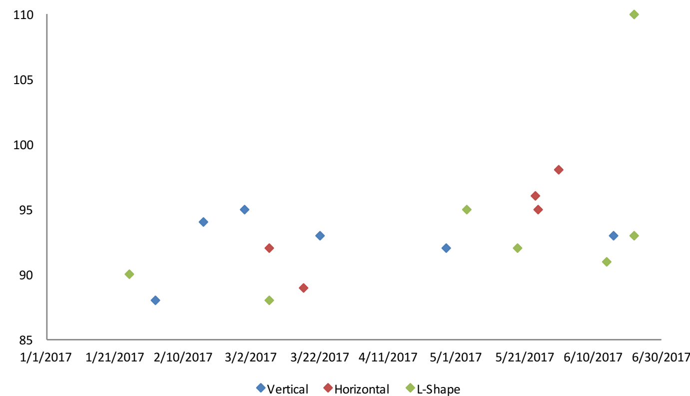
CHART 2: FIVE LARGEST CMBS LOANS ISSUED IN Q2 2017

DEAL NAME	PROPERTY NAME	DEAL TYPE	PROP TYPE	STATE	SECURITIZED BALANCE	LTV	DSCR
BXP 2017-GM	General Motors Building*	Single-Asset	OF	New York	$1,555,000,000	47.9%	2.77
COLD 2017-ICE3	Lineage Cold Storage Portfolio	Single-Asset	WH	Various	$1,295,000,000	56.47%	5.92
HOSPITALITY 2017-HIT	Equity Inns Portfolio	Single-Asset	LO	Various	$805,000,000	61%	3.61
CSMC 2017-CHOP	CLNS Portfolio	Single-Asset	LO	Various	$780,000,000	73.6%	1.83
Various	245 Park Avenue*	Single-Asset/Conduit	OF	New York	$771,750,000	54.3%	2.45

**Based only on deals that have closed in Q2; loan balance may increase after notes securitized in other quarters are included*
**LTV and DSCR are based on values reported for the largest loan piece*

Spreads for New Conduit Issues Continue to Tighten

GRAPH 4: Q2 2017 CMBS ISSUANCE - AAA SPREADS ON NEW CONDUIT ISSUES



Source: Trepp

Warm investor reception has allowed spreads for new conduit issues to tighten significantly following the implementation of risk retention. Aided by limited supply and the market perception that risk retention encourages conservative underwriting standards owed to a stronger credit pool, conduit spreads for 10-year AAA bonds have fallen between 91 and 110 basis points. From Q2, 13 conduits featured an AAA class that priced below 99 basis points, wider than the 88 - 95-basis-point range seen in the first quarter. Two conduit deals considered to be outliers settled above the 100-basis-point mark. On the other hand, spreads at the lower end of the credit spectrum have undergone a more pronounced variation in bond pricing. BBB- conduit spreads have ranged anywhere from 340 to 500 basis points in the first six months, but are still at levels that are materially tighter than those recorded during the 2016 spread rout.

There has been some talk that the favorable and minimally volatile pricing environment could change in the latter half of the year once the market corrects itself after the financial stock rally eventually loses momentum. A semi-annual survey by *Commercial Mortgage Alert* indicated that industry participants anticipate that spreads on subordinate bonds will rise in the coming months. Others have forecast that instead of an extensive widening effect on CMBS spreads, the market will likely encounter increased price differentiation and tiering between deals based on risk retention structure, vintage, and collateral quality.

Additional Market Trends

- A considerable share of CMBS debt issued in H1 was comprised of central business district (CBD) office loans that were securitized in various transactions on a pari passu basis. In many cases, single-borrower loans were split into pari passu notes and retained for inclusion in conduit deals.
- Industry participants feel that it is still difficult to determine whether risk retention has led to an improved CMBS credit profile. Deemed riskier than loan structures that require principal payments, a growing percentage of new issues have adopted interest-only term structures (partly attributed to the greater prevalence of pari passu notes), which has offset any effect of lower leverage and stronger credit metrics seen in post-risk retention deals.
- The recent influx of single-borrower deal activity has introduced a large selection of floating-rate securities in the market. The single-borrower segment represented over 40% of the issuance pipeline in the second quarter.
- Market chatter suggest that annual issuance under the first year of risk retention is on track to surpass 2016's tally of $69.3 billion.
- For the most part, borrowers have not seen the increased costs of higher loan spreads associated with risk retention thus far. The tight recent pricings have enabled loan sellers to pocket decent-sized margins, which can now be calculated thanks to new disclosure clauses on deal proceeds and yields.

What Lies Ahead?

Looking at the rest of the year, there's already a steady supply of new offerings in the pricing pipeline slated to hit the market. If spreads continue to remain at tight levels while interest rates are controlled with more gradual increases, the CMBS sector should still expect to see significant deal activity considering the strong investor interest and vast amount of untapped opportunities currently present in the market. On the flip side, recent indicators reveal that economic growth has remained relatively tepid for some time, while decelerating CRE fundamentals, a Fed-imposed tightening, and a prolonged legislative standstill hindering deregulatory potential could pose as additional hurdles for the industry.

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For more information about Trepp's commercial real estate data, contact info@trepp.com

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