First Quarter Issuance Update: Are Underwriting Standards Slipping?

In late 2014, industry pros and research desks weighed in with predictions of 2015 total CMBS issuance, which range from $90 billion to $150 billion. Many believed borrowers would be looking to get ahead of any Federal Reserve rate hikes later in the year and refinance before the real wave of maturities hit the market. While conduit issuance came out of the gate slower than initial expectations, total issuance (including Conduit, Single Asset/Borrower, and Large Loan deals) ended the first quarter of 2015 at $25 billion, well above the $16 billion in the first quarter of 2014.

One of the main drivers behind CMBS originations over the past several quarters is the more than $300 billion of maturing loans that will come due over the next three years, the majority of which are still subject to prepayment lockout or penalty provisions. Despite the added cost of paying down their loans early, many borrowers are refinancing to lock in low rates now and defeasing their pending maturities. Defeasance volumes have skyrocketed over the last two years, from about $5 billion in 2012 to almost $20 billion in 2014. Through the first quarter of 2015, $5.5 billion in loans have been defeased, indicating a simple annualized volume of about $22 billion, the majority of which will most likely end up in new CMBS loans.

Much has been made of deteriorating credit quality, or for the more optimistic, credit loosening. While Trepp does not go through the process of projecting stressed LTVs, debt yields, and DSCRs, it still provides the raw numbers as they have been presented by the underwriters and issuers over the past five quarters.

Cap rate is a measure of real estate income relative to property value (Net Operating Income/Appraised Value). Year-over-year, average cap rates on a national basis have compressed in each property type, with lodging staying the most consistent and industrial falling the most on an absolute basis. (See Figure 3.) Continued property appreciation and competition for loans can drive cap rates lower as lenders require less income per dollar of property value to write a loan.

Figure 1. National Origination

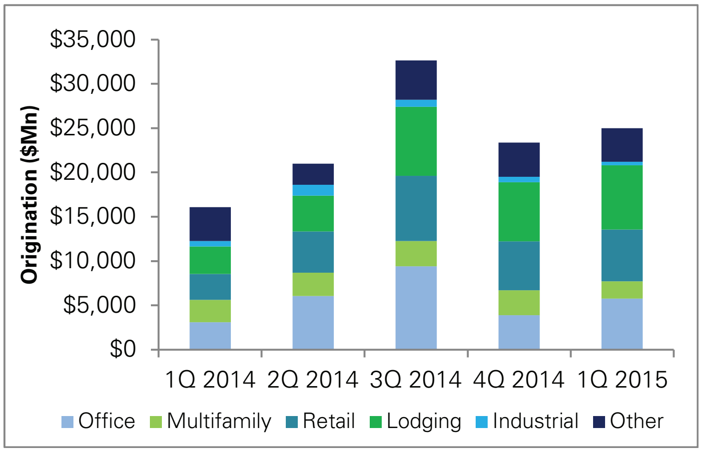
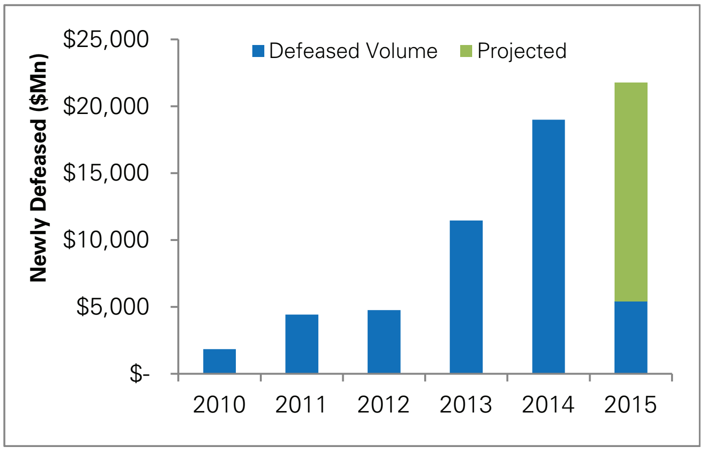


Figure 2. Annual Defeasance



As credit conditions loosen, average LTVs move upward. Nationally, lodging loans saw the largest increase in average LTV, while the other major property types remained fairly constant to slightly higher. (See Figure 4.)

Amortization type is also seen as a reflection of underwriting standards. Loans with Interest Only (IO) terms are generally considered riskier than loans that pay down principal during their term. An increase in IO loans can indicate loosening credit conditions, so an upward trend may call for a watchful eye. The proportion of full-term IO loans has been steadily increasing over the last five quarters. (See Figure 5.)

The loosening underwriting stems from two sides. On one side, fundamental improvements in property cash flows and values make it more attractive to invest in and lend on commercial real estate properties. On the other side, increasing competition in the lending sphere and demand for relatively high yielding CMBS bonds pump more and more capital into the market, pushing LTVs up and standards down. To what extent each side—fundamental improvement vs. excess capital searching for yield—is causing underwriting standards to loosen remains to be seen. The answer may come when rates finally start moving upwards and properties yet to refinance have to cover higher debt service payments.

Figure 3. National Cap Rates

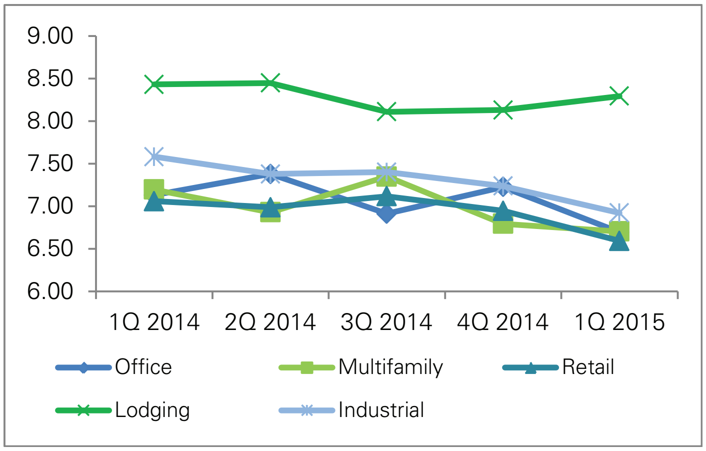


Figure 4. National Weighted Average LTV

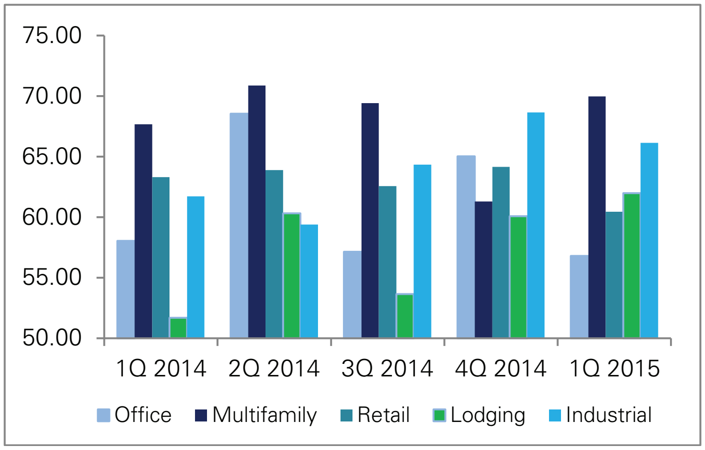


Figure 5. National Amortization Types

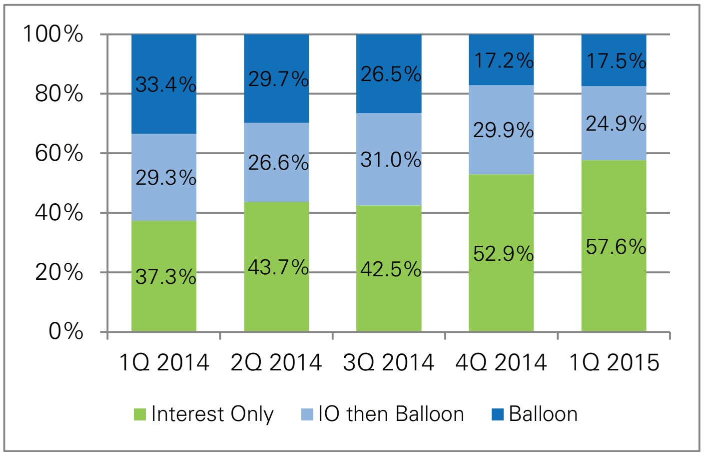


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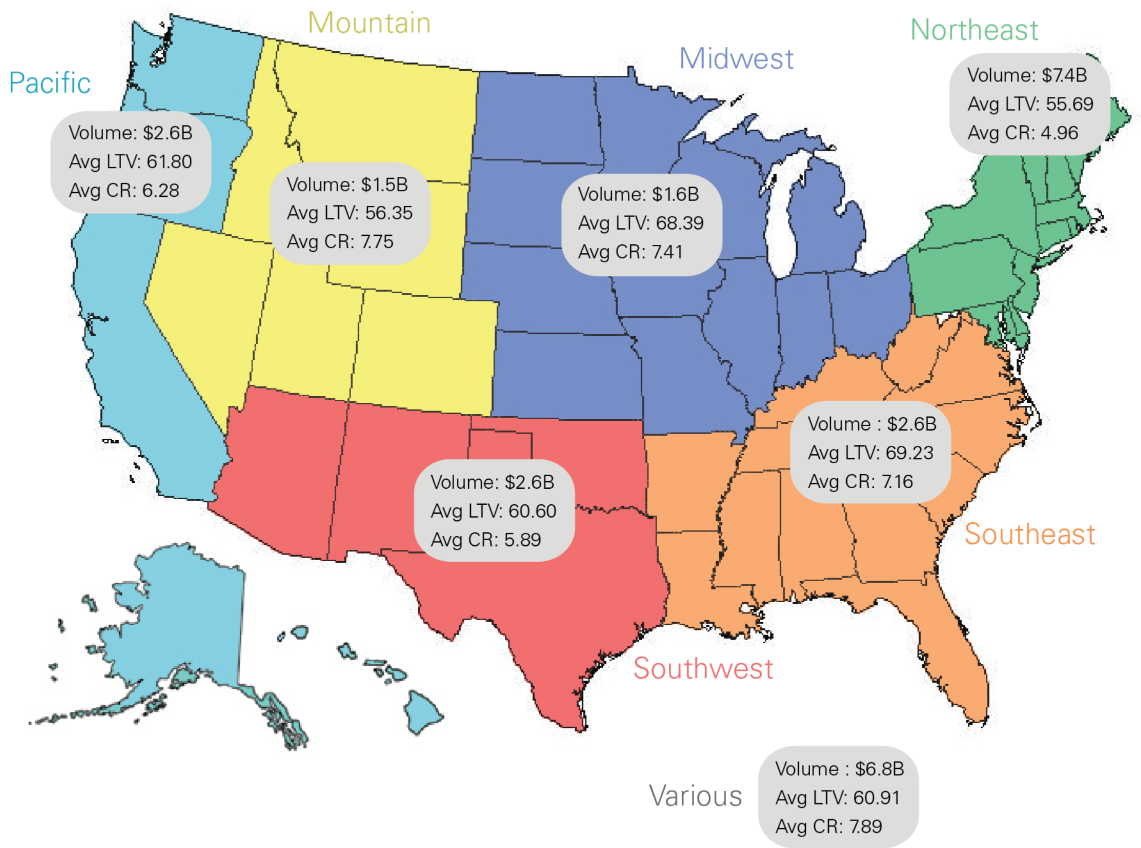
Figure 6. National Issuance Statistics - 1Q 2015



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

About Trepp

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