



The CMBS – the Slow Train Crash

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We look at the implications for CMBS valuations of both the huge amount of commercial property lending due to mature in the next few years and the fact that in some cases it is not clear where the cash will end up even if fully recovered.

Commercial Property Loan Maturity Tidal Wave

There is a tidal wave of commercial property backed lending in Europe which is due to mature in the next 2-3 years. Due to the bilateral nature of the commercial property loan market, the exact amount is hard to establish, but various estimates have the figure at approximately Euro 600 bln.

Looking at the CMBS market, since 2007 approximately 60% of commercial property loans included in CMBS have not been fully repaid at the scheduled loan maturity¹.

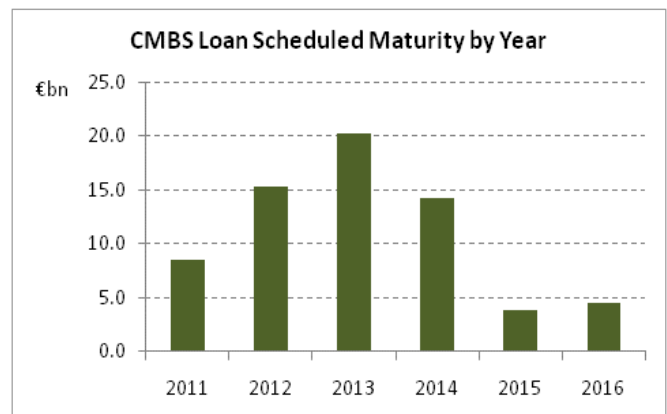
If this performance were to apply across the whole commercial property market, then projecting forward, this would imply roughly Euro 360 bln of current notional of commercial property loans will not fully repay at maturity by the end of 2013. Clearly this would imply that the characteristics of the securitised loans were replicated across the whole market, which may not be the case.

This would dwarf the already alarming figure of Euro 7.2 bln of securitised loans already matured but still outstanding.

This has large implications not only for the value at which these loans are currently being carried on banks' balance sheets, but also for the valuation of CMBS bonds.

A significant proportion of larger commercial property loans were used during the period

approximately 2004 – 2007 as collateral for CMBS in Europe. The maturity of these loans peaks between 2011 to 2014².



This phenomenon is largely due to the fact that CMBS in Europe was a relative late comer to the party. Prior to 2003 there were very few deals in the market. Post that time, there was an explosion of transactions, followed not many years later by the credit crunch. The maturity of the underlying loans is therefore very concentrated with the loan maturity having been set to gain optimal rating agency treatment at the point of issue. The 2013 peak merely reflects the accepted 5-7 year maturity during the peak issuance of European CMBS around 2005-2007.

CMBS Structural Issues

In addition there has recently been a worrying development with a lot of noise around the validity and robustness of some

¹ Source: Fitch Ratings: European CMBS Maturity Bulletin – May 2011

² Aggregate annual maturity data compiled from monthly data



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CMBS waterfalls. These issues are unexpected and usually only brought to light when there is stress on the transaction due to a loan default or maturity breach. This is the exact point where investors are relying on the structure to distribute the transaction proceeds as per expectations.

Examples of this are:

- **EPRE 1, UK CMBS:**
A quirk in the Offering Circular drafting prevented the allocation of principal from switching to the post-default (sequential) waterfall, even though losses were accruing to the deal. It appears that no losses could be allocated to particular bonds, and hence the sequential pay-down trigger could not be tripped, until the final maturity of the transaction. Hence senior notes only receive pro-rata payments from any disposals. This means that all classes of notes receive the same proportional cash flows even where there may not be enough money to pay back the full principal of the notes, effectively removing the benefit of subordination.
- **Fleet Street 3, German/Dutch CMBS**
As the trustee (Deutsche) is unable to make a decision with regard to the correct waterfall for allocation of principal proceeds, the High Court has been asked to define the Sequential Payment Trigger. Clearly the outcome of that case will have a fundamental influence on the value of each class of notes.

- **Talisman 1, German CMBS:**
A property backing the deal was sold for more than the loan balance. This would normally imply a full recovery on the part of the note-holders. However liquidation fees due to the special servicer turned out to be payable by the SPV – wiping out 25% of the remaining principal of the junior class of notes, rated investment grade at the time. This meant that as soon as the loan breached its maturity date, a loss would be taken by the CMBS due to the servicer fee, regardless of the sale value.

We expect more of these issues to come to light as more loans breach their scheduled maturity and proceed through workout and sale.

Non-Granular Nature of CMBS

The effect of this on CMBS valuations must not be understated. For example, a documentation issue for a single residential mortgage within an RMBS could usually be absorbed easily as it would only represent a very small portion of the pool. However, CMBS tends to be (outside of Germany) the securitisation of a handful of loans against large properties. As seen in Talisman 1, the payment of a 1% special servicing fee on just one loan led to a 25% write down on the most junior note.

With the non-granular nature of most deals combined with the huge amount of refinancing required, CMBS bonds could be vulnerable to further extension and unexpected losses.

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