USAA Real Estate Company

WILL CMBS REACH $100 BILLION?

RESEARCH ARTICLE

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The U.S. Commercial Mortgage-Backed Securities (CMBS) market may surpass the $100 billion dollar mark this year, according to Commercial Mortgage Alert (CMA). This would be a significant milestone considering the market has not reached this level since 2007. The increased liquidity is generally a positive sign for the debt market; however, loose underwriting standards have raised concern that the CMBS market is repeating behaviors that led to previous boom-and-bust cycles.

In 2007, the CMBS market reached $230 billion, an all-time high, but collapsed the following year due to the economic downturn. Afterward, investor interest dissipated and the market essentially came to a halt for 17 months. In 2010, CMBS barely produced $3 billion in loan origination. The market improved gradually each year until 2013 when originators issued more than $86 billion of CMBS. Heading into 2014, opinions varied among analysts as to whether CMBS would reach the $100 billion milestone. At the end of Q3 2014, the market completed only $70 billion in originations, and it seemed unlikely to reach the threshold. An end-of-year surge in loan activity, however, has propelled the CMA forecast to $97.8 billion, which does not include a few rumored deals that could push the total amount over $100 billion. A decline in credit quality accompanied the surge in originations, which has become a concern for some CMBS investors.

Overleveraging and relaxed lending standards are two main investor challenges for the CMBS market. According to Moody's, interest-only loans totaled more than two-thirds of all new issuance during the third quarter, a 50% year-over-year increase. In contrast, during 2007, interest-only loans accounted for 90% of all CMBS loans. The market is quickly approaching the previous peak, which is evident in the recent quarter loan profile. Moody's describes the current lending environment as "déjà vu" because 25% of the loans backing Q3 deals had loan-to-value ratios that were consistent with 2006-2007. Even though commercial real estate property fundamentals are strong, excessive debt is still a cause for caution.

The rise in CMBS origination activity has not changed our outlook on the debt market opportunities available over the coming years. We expect the market to lack sufficient capacity to support $1.7 trillion in loans coming due over the next four years. With growing reports of credit quality slippage, it is unlikely that investors will allow CMBS originators to refinance many of the ten-year loans that originated in the 2005 to 2007 period, and still face some credit headwinds today.

Dr. Will McIntosh
Global Head of Research
Phone: 210-641-8416
Email: will.mcintosh@usrealco.com

Mark Fitzgerald, CFA
Research Analyst
Phone: 210-690-6706
Email: mark.fitzgerald@usrealco.com

John Kirk, CCIM
Research Analyst
Phone: 210-690-6715
Email: john.kirk@usrealco.com

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