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Who Is Minding the Store? Part IV

In part four of our series that attempts to understand and identify exactly when and why the economic objectives of the various classes of investors diverge; we focus on the investors in the multiple classes of “AAA” rated securities.

Over the past year, the structure of the AAA classes has changed from what was traditionally duration-based differentiation to what now also includes credit-based differentiation. The class structures introducing the super-senior with 20% subordination (SS20), and the super-duper senior with 30% subordination (SS30), have increased liquidity in the sector by expanding the investor base to include those investors with little or no specific real estate experience. As a result of the creative structure, credit risks that were traditionally shared pro rata by all AAA investors have now become concentrated in the junior AAA (AJ) class, compounding the magnitude of any such losses experienced by this class.

AAA Classes (Hypothetical Deal)				
Class (common name)	Subordination	Weighted-Average Life	Payment Window (months)	Repayment Requirement
A-1	30.00%	2.7	1 - 57	100% Amortization
A-2	30.00%	4.8	57 - 60	100% Balloons
A-3	30.00%	6.9	80 - 84	100% Balloons
A-SB	30.00%	7.3	60 - 115	100% Amortization
A-4	30.00%	9.8	115 - 120	98%(+/-) Balloons
AM	20.00%	9.8	120	100% Balloons
AJ	13.00%	9.8	120	100% Balloons

The largest balance of AAAs now falls within SS30, which is frequently sliced into classes with a weighted-average life of 3, 5, 7, and 10 years. Issuers have further segmented the SS30 AAAs to include a planned principal class that captures a large portion of the SS30’s principal. Given the payment window of the 3-year class, it is paid from scheduled amortization with no reliance on balloon payments. As such, the short-term SS30 AAA class is isolated from extension risk. Early prepayment as a result of a default within the first five years of the transaction is the only event likely to change the yield on the short-term SS30 class.

The 5-year and 7-year SS30 class investors, however, very much need to factor in extension risk given the high proportion of interest-only (IO) loans that will require significant cash flow growth or historically low refinancing constants in order to refinance. Repayment of the 5-year and 7-year classes generally do not include amortization and are frequently entirely reliant on the balloon payments of a specific group of 5- and 7-year loans within a 2- to 4-month time window. As many of these loans are highly levered and IO, they are particularly vulnerable to extension risk. In the event a loan within this group is granted the seemingly automatic 2-year extension, the next subsequent ballooning loan is frequently 12 to 24 months away. Each such event will result in a proportional adjustment to the weighted-average life of that class as well as subsequent classes that are reliant on balloon payments. While the 10-year SS30 class investor may depend on 10-year loan balloon payments, the remainder of the pool will be reaching maturity simultaneously, reducing the reliance on the timely repayment of any specific loans. The universe of 10-year loans has a higher concentration of amortizing loans. In the current interest rate environment, even 30-year amortization can pay down 20% of the principal balance prior to balloon, further reducing default and extension risks associated with accessing the debt markets at a specific date in the future.

While the effects of defaults during the term are anticipated to be limited across the AAA classes, balloon risk, and the resulting extension risk, is concentrated in the 5-year and 7-year AAA classes. Applying the payment window to the list of underlying loans (Annex A) sorted by maturity date will clearly identify exactly which loans need to pay off on time to achieve the anticipated weighted-average life. Investors in the SS30 5-year class must be either highly confident that each loan within the payment window will be able to refinance, on time, or be capable of and willing to accept an extension of 12 to 24 months without additional yield. Investors in the 7-year classes must realize that they may be extended as a result of the cumulative extensions in the 5-year as well as the 7-year payment window. It is particularly prudent to look beyond the colorful pictures as 30% credit enhancement will not help you on this one.

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