Global CMBS Newsletter

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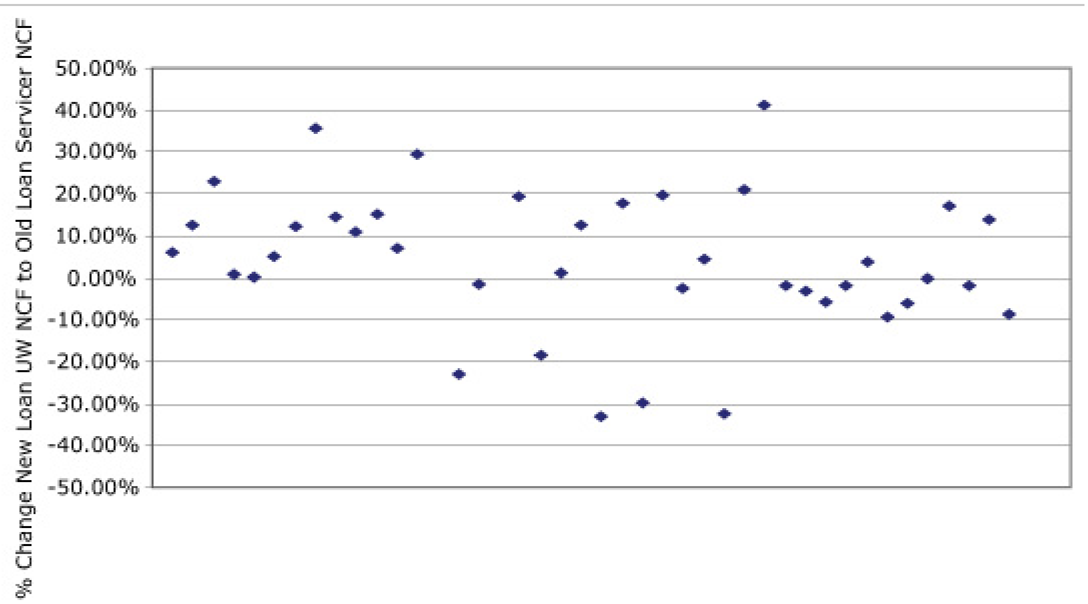
NET CASH FLOW INFLATION FOR THE 2007 VINTAGE BETTER THAN EXPECTED

In February 2007, this DBRS newsletter asked you, our readers, to submit an "educated guess" as to what the weighted average net cash flow (NCF) inflation would be for loans in existing CMBS pools that were refinanced into new 2007 CMBS transactions. Many of you submitted your best guess as to the potential inflation figure, and we responded with an "Over/Under" bet. Our thought was that tracking of these loans would expose the cash flow inflation that was occurring in transactions by underwriting to upside. A July newsletter followed up by reporting on the NCF inflation and cap rate compression through mid-year. At that time, we reported that underwriting fundamentals were expected to improve; however, average NCF inflation was 15.8% and the average take out loan amount increased by 51.3%. Today we can report that because of all of our "Over" bets, we owe many of you drinks at the CMSA Investors Conference.

To expose cash flow inflation, DBRS reviewed a sample of loans that matured in 2007 and were immediately refinanced into 2007 CMBS pools. While it isn't always easy to match loans, we were able to find a representative sample that includes most loan originators, and a variety of property types and loan sizes. The NCF inflation statistics based on the loans in the sample are illustrated in the chart below. Of course, the sample is impacted by the outliers, which bring into question the quality of the data. While we tried to determine the reason for the large discrepancies, we were not always successful.

Chart 1: Range of Inflation to UW Numbers



The average NCF inflation from the most recent servicer-reported net cash flow of the original loan to the underwriter's net cash flow for the refinanced loan is 7.2%, but NCF inflation over the whole sample ranges anywhere from -33% to +77%.

The other difficulty we found with the data is that depending on how you slice it, it tells you different stories. Whatever way we slice it, cash flow inflation in 2007 was not as significant as we had expected. What is unclear to us is whether cash flow inflation was less extensive toward the end of 2007, although we hope and expect that loan originators will and have started to listen to investors' demands for underwriting to actual in-place cash flow.

While the picture today seems rosier than expected with regard to cash flow, the same cannot be said of the debt amount. The loan balances in our sample increased 40.7% from the original loan. An increase in loan sizes of this scale cannot be attributed solely to net cash flow inflation. Cap rate compression is affecting the sampled loans as well. We measured cap rate compression by looking at the original appraisal amount and comparing it to the new appraisal amount, and found that the average increase in value was 59%.

Note that the loans in our sample are not the trophy assets that one would expect to see in the "Top 10" loans of a newly-issued CMBS transaction — the average loan size is only US$5.7 million, which would be more indicative of a typical conduit loan. Yet a number of these loans appear to be subject to NCF inflation and extreme cap rate compression. The compounding effects of a reversion to the mean in underwriting standards and cap rates can exacerbate losses in the event of default. Since we are already beginning to see this reversion to the mean, the 2007 vintage may be more vulnerable to higher loss given default than other vintages.

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