

Global CMBS Newsletter

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THE WALL OF MONEY HAS SUBSIDED: WHO KNEW? WHAT NOW?

On the heels of conference season, having attended CMBS and commercial real estate (CRE) finance conferences in Toronto; Rome; Washington, D.C.; Miami; Beaver Creek, Colorado; Whistler, British Columbia; and Disney World over the course of the last four months, it is appropriate to reflect on the cumulative insights and interpret the undeniable changes that will affect the CMBS market going forward.

The “wall of money” has subsided; perhaps it wasn't the paradigm shift that many investment bankers were espousing.

Issuers, borrowers and even traders are making several interesting revelations these days, echoing a common refrain: “The indiscriminate investors have left the market and that limits our ability to sell the bonds.” A flood of indiscriminate investors dominated the CMBS market over the last few years. This muted the voice of the discriminating investors and shifted a disproportionate market share and profitability to the lenders, issuers and rating agencies that compromised credit quality and underwriting standards the most. Common sense should tell you that a market with declining standards that has become highly reliant on an abundance of “dumb” money is overdue for a correction.

As alluded to by Sam Davis of Allstate Life, “When portfolio lenders seem to have become irrelevant, it is a sure sign that the market is going to blow up.” I interpret this to mean that you know there is a cliff approaching when seasoned lending professionals are being viewed as obsolete simply because they recognize some measure of accountability for getting paid back.

The good news is that we have a correction. More importantly, we have a correction before experiencing widespread loan defaults, losses to investment-grade CMBS bonds and reactionary downgrades. Traditional, well-capitalized borrowers understand this and many have been preparing for such a correction for several years. Most CRE borrowers are well positioned for the impending correction. In time, the CMBS sector will rightsize to become a solid \$100 billion-a-year business. Investors, lenders, issuers and rating agencies that have consistently exhibited discipline will come through relatively unscathed.

The bad news is that many of the most highly leveraged loans are concentrated in the 2006 and 2007 CMBS vintages. Furthermore, as some issuers exhibited discipline, others displayed a flagrant disregard for underwriting standards and structural features that insulate debt instruments from the inherent cyclicity of CRE assets. Although there are a number of CMBS transactions from the 2006 and 2007 vintages that have high concentrations of these conspicuously overleveraged loans, discriminating investors have had little trouble identifying and avoiding the afflicted transactions.

Each of the CMBX index issues, by design, has a full representation of the good as well as bad transactions from the vintage. As such, each CMBX series is exposed to disproportionate risk all the way up the structure. The silver lining is that, by performing a moderate level of analysis, avoiding transactions with disproportionate risk and holding lenders, issuers and rating agencies accountable for their performance, choosing transactions within a vintage that will outperform the CMBX of that vintage should not be difficult.

In the coming weeks, we will devote our newsletters to various measures, tools and methods that identify comparative risk and enable investors to make better investment decisions.

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