

Global CMBS Newsletter

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IDENTIFYING DISPROPORTIONATE RISK IN CMBS

Attempting to analyze the mountain of data provided in the Annex A of a CMBS prospectus can be intimidating. In an effort to demystify the analytical process with simplified analytical measurements and bring common sense to the process, we tend to revert to two simple ratios in the context of historical levels: entry and exit debt yields

Although debt service cover ratios (DSCR), loan-to-value ratios (LTVs), refinance DSCR and balloon LTVs are frequently quoted measures of risk, each can be skewed dramatically by making assumptions based on essential components that are generally not disclosed. Rather than get lost in variant assumptions, a simple calculation of entry debt yield and exit debt yield allows for a direct comparison of the debt load supported by the property-level cash flows. The good news is that the primary components in each of these measures are the net operating income (NOI), the in-coming loan balance and the balloon loan balance.

In our last [Global CMBS Newsletter](#), we promised to provide some methods and tools to identify comparative risk. Although we discussed the concept of exit debt yield in a [newsletter issued in May 2007](#), examining the entry and exit debt yields can be a straightforward, effective measure of risk. For example, a market participant recently issued a report saying that the vast majority of fixed-rate loans that had come due in the previous eight months were able to refinance during this stressed credit environment. This shouldn't come as a surprise, considering the debt load of the older vintage loans, the principal repayment through amortization and the value appreciation that was likely achieved.

Entry and exit debt yields can be calculated using the simple formulae below. This measure alleviates the need to estimate the future fluctuation of capitalization rates or debt constants to compare risks. If you get the calculation components right, the measure becomes very standard.

Entry Debt Yield = NOI ÷ Original Whole Loan Balance

Exit Debt Yield = NOI ÷ Whole Loan Balloon Balance

Calculation Components: NOI

The first task in the process is to determine the most reliable proxy for property-level NOI. Recognizing that issuer underwriting practices fluctuate over time, the most reliable proxy for future performance is the lower of the borrower's last full year NOI (the trailing 12 months (T-12)) or the issuer underwritten NOI, both of which can typically be found in Annex A. It is necessary to apply a discount or haircut to the issuer underwritten figure, depending on the vintage and the originator. If your discount fails to return historical numbers or a well-supported pro forma in the case of a new or recently rehabbed asset, you will know it was too small.

Calculation Components: Whole Loan Balances (Original and Balloon)

The second task is to determine the mortgage loan balance, not to be confused with the trust loan balance, which is likely to recognize only the A-note, or senior, portion of a mortgage. U.S. CMBS loans are almost universally secured by a single first mortgage. The third task is to determine the balloon balance of the full mortgage loan, taking into consideration that amortization is generally applied pro rata across the senior and subordinate portions of the mortgage loan.

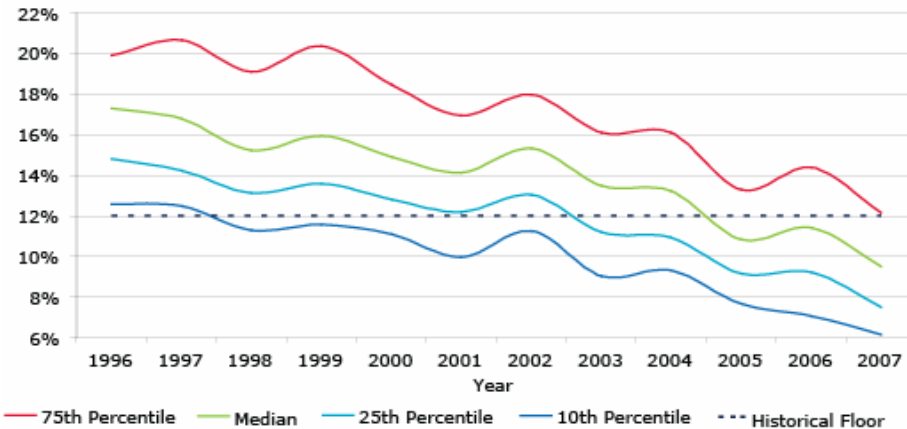
CMBS Historical Entry Debt Yield



Source: American Council of Life Insurers (ACLI).

The chart above shows historical entry debt yield and its relationship to the ten-year U.S. Treasury. The calculation gives us a way of measuring the debt load placed on properties. Looking back 40 years, the entry debt yield has rarely dipped below 12% and in the last 18 to 24 months it has plunged. This is a clear indication to DBRS that the debt burden on commercial real estate has become unbalanced over the last two years. However, one must consider the exit debt yield as well because what may be unbalanced to begin with may right itself during the loan term (e.g., amortization can relieve the burden). Therefore, in the chart below, we examine exit debt yield of historical CMBS.

CMBS Exit Debt Yield (Based on Borrower NOI)



Source: DBRS Annex A data.

What we find is that in the first nine years of a CMBS transaction, exit debt yield tends to be above 12%. Only in the last 18 months has the median exit debt yield fallen below 12%. With two-thirds of the market issuance completed in the 2005–2007 period, there is increasing evidence that the debt burden on these properties is much higher than historically acceptable. This puts unprecedented reliance on having low cost of capital and continuation of compressed capitalization rates. If your entry or exit debt yield is 6%, the confidence you have in the likelihood of refinance is low; in fact, it may be about as high as your exit debt yield. Given the yields on investment-grade bonds, having little confidence in the exit strategy that is needed to return your principal investment is not conducive to increasing buyer confidence. Common sense and some basic math will tell you that you would rather have a 90% confidence level than a 10% confidence level.

We would like to believe that if entry and exit debt yields have been above 12% historically, then there is a high likelihood they will return to that level in the future. In our next newsletter, we will highlight certain property types that might be more averse to this reversion in CMBS pools.

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