CMBS Research

Soft Landing for the Next Maturity Wave

May 2019

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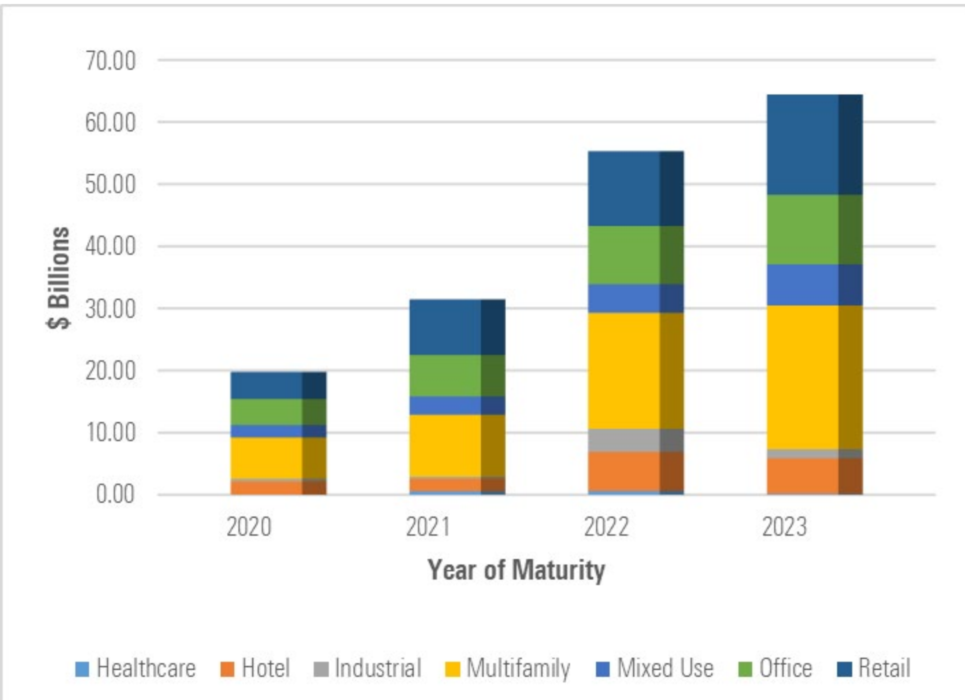
Morningstar Perspective

More than $170 billion in loans packaged in commercial mortgage-backed securities will mature during 2020-23, and Morningstar Credit Ratings, LLC believes the on-time payoff rate will remain healthier than that during the $222.48 billion maturity wave of 2015-17 because of more selective underwriting standards, rising valuations, and the Fed's dovish interest-rate outlook amid a slowing economy. The pipeline of maturities through 2023 rises progressively by year, with $19.76 billion of CMBS debt scheduled to mature in 2020, climbing to nearly $65 billion in 2023, resulting from originators steadily ramping up lending volume coming out of the Great Recession. Using debt yields, loan proceeds, and loan-to-value ratios as benchmarks, Morningstar projects the maturity payoff rate will remain steady at roughly 80%-85% through 2023.

With maturing CMBS 2.0 loans exceeding precrisis loans for the first time, the first year following the postcrisis maturity wave went well, as the 2018 payoff rate for $10.13 billion of maturing CMBS loans bounced back to 84.3%, following two years of weak performance, when the payoff rate sank to a low of 72.3% in 2017. The loans maturing in 2020-23 are almost exclusively postcrisis and generate less concern than precrisis loans because of lower leverage, and the underlying assets have generally benefited from rising property valuations throughout the loan term, bolstering the borrower's equity and easing refinancing concerns. By year of maturity, 2023 has the greatest portion of maturing loans, with 37.7% by balance, and they have weaker metrics, with an identical 80.7% refinance rate based on loan proceeds and based on the percentage of loans with a debt yield below 9.0%.

Among the property types backing maturing CMBS, industrial loans will likely have the highest payoff rates because demand for warehouses and flex spaces is outpacing supply and rent growth and strong absorption are squeezing already-tight industrial vacancy rates. Unlike during the prior maturity wave, when overleveraged retail loans were a major concern, we expect maturing retail loans to have the second-best payoff rate because lenders have shifted toward lower-leveraged, higher-quality properties and retail sales remain healthy.

Chart 1 – CMBS Loans Maturing 2020-23



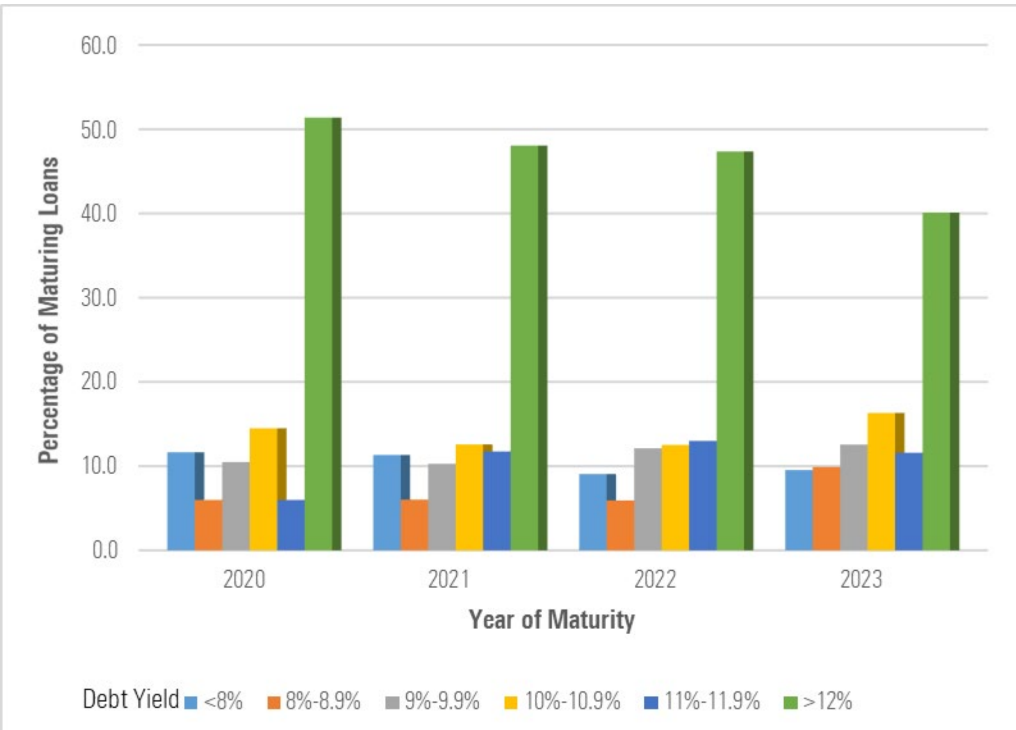
Source: Morningstar Credit Ratings, LLC

In this report, Morningstar excluded certain floating-rate loans because they have not reached their fully extended maturity date, even though that may not be reflected in the servicer data, as reported floating-rate loan maturity dates can be subject to extension options.

Debt Yield, Loan Proceeds, and LTV Hit Similar Targets

Our projected payoff rate based on debt yield (using the most recent 12-month net cash flow) is in the low- to mid-80% range over the four-year period. Based on a conservative debt yield hurdle of 9.0%, our expected on-time payoff rate ranges from a low of 80.7% in 2023 to a high of 85.0% in 2022. However, lowering our minimum required debt yield to 8.0% increases the successful on-time payoff rate to a range of 88.3% in 2020 to 90.9% in 2022.

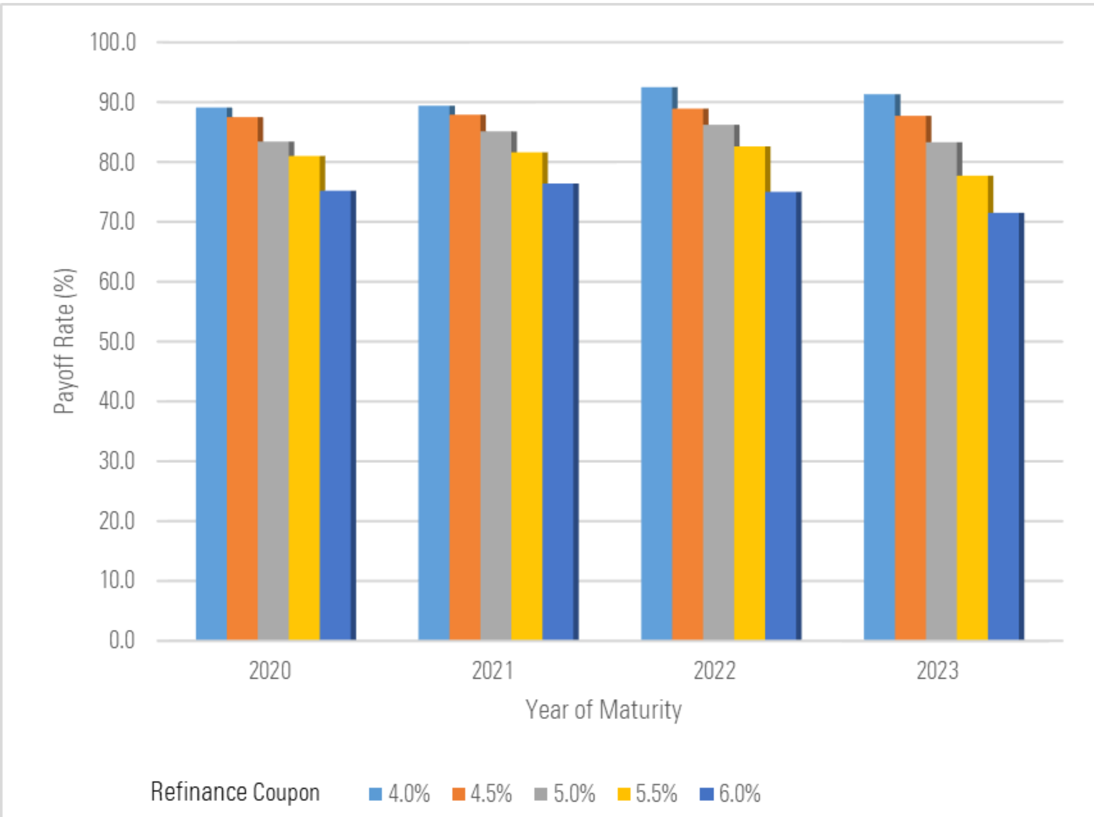
Chart 2 – Current Debt Yield for 2020-23 CMBS Maturities



Source: Morningstar Credit Ratings, LLC

Refinance proceeds tell a similar story. Morningstar estimates that 83.3% (2023 maturities) to 86.2% (2022 maturities) of the maturing loans during the 2020-23 period will generate enough cash flow to successfully refinance the existing debt. This assumes a 5.0% interest rate and a 1.35x debt service coverage ratio. Although the 2019 CMBS new issue average DSCR is 1.95x, we used a less restrictive DSCR hurdle because maturing loans have benefited from a growing appetite among other traditional lending sources such as commercial banks, life insurance companies, and pension funds, as well as nontraditional debt funds and mezzanine lenders with less stringent underwriting requirements, many of which took out overleveraged loans that came due during 2016-17. Further, while CMBS issuance has been tepid, dropping to $83.0 billion in 2018 from a postcrisis high of $95.0 billion in 2015, commercial real estate loan growth from all sources persists, as the Mortgage Bankers Association reported record commercial loan origination in 2018 of $573.9 billion, up 8% from 2017.

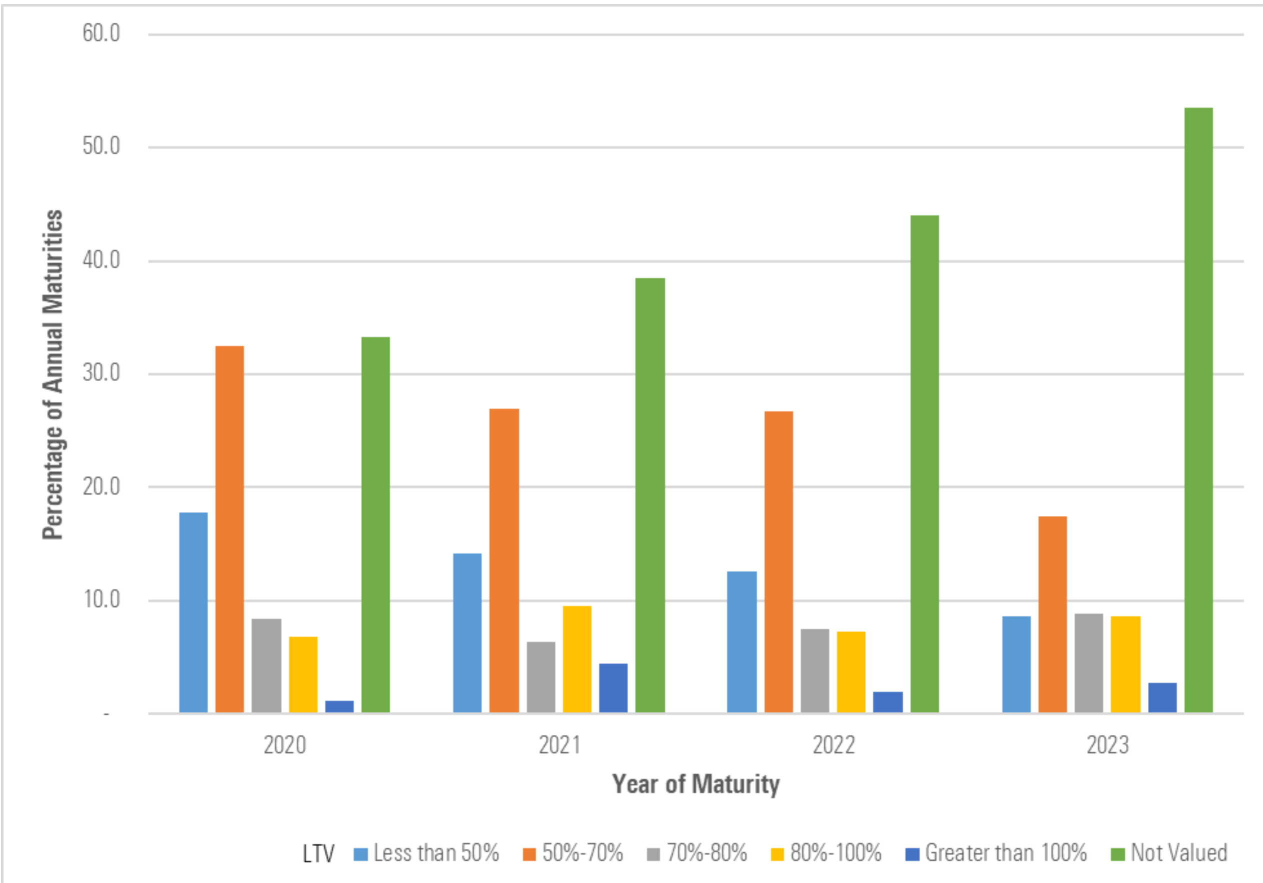
Chart 3 – Payoff Rate by Refinance Coupon on Maximum Loan Proceeds at 1.35x DSCR



Source: Morningstar Credit Ratings, LLC

The maturity payoff rate fares better based on Morningstar's calculated LTV, which incorporates factors beyond individual property performance, such as capitalization rates and specific real estate market trends. Morningstar has valued $13.18 billion, or 66.7%, of the $19.76 billion of loans maturing in 2020. We believe the 2020 payoff rate will be about 92% because 8% of the loans maturing during the year, with a total unpaid principal balance of $1.59 billion, have LTVs greater than 80% and may have difficulty refinancing. Looking farther out, we valued roughly 50%-60% of 2021-23 maturities, and our payoff projections are 86.0%, 90.8%, and 88.7%, respectively. Based on our experience covering most of the CMBS universe, our historical analysis indicates that an 80% LTV threshold may be a reliable barometer of a loan's likelihood to successfully pay off on time.

Chart 4 – Morningstar LTVs for 2020-23 CMBS Maturities



Source: Morningstar Credit Ratings, LLC

Office Loans Could Free Fall to the Lowest Payoff Rate

Weaker metrics among office loans are a major concern. We project office will sink to the lowest payoff rate because it ranks near the bottom of all three payoff metrics. The property type faces the third-largest exposure with about 18.4%, by unpaid principal balance, of the 2020-23 maturities. It has the second-highest percentage (behind retail) of Morningstar LTVs greater than 80%, and it has the second-highest percentage of loans (behind multifamily) with debt yields greater than 9%. Our concerns include the large volume of new supply that will continue to weigh on occupancy and rent growth as well as large office tenants frequently opting not to renew their leases and relocating to a more competitive property. Examples of limited refinancing prospects include the $270.3 million 175 West Jackson loan split among COMM 2013-CR12, COMM 2013-CR13, and COMM 2013-CR14 and the $108.7 million World Trade Center I & II loan in JPMCC 2013-LC11. Both mature in 2023 and have low debt yields and high LTVs. Further, our estimated refinance proceeds for both loans will be insufficient to retire the outstanding debt.

Separately, while the projected payoff rate is consistent across our benchmarks for most property types, several factors explain the divergence within multifamily and retail. The low multifamily payoff rates based on loan proceeds and debt yield are skewed by cooperative apartment properties, which typically have lower net cash flow than their conventional brethren. Because of this, we place more emphasis on LTV, which, as mentioned earlier, incorporates factors beyond individual property performance. Conversely, retail has the most concern hanging over it in the future, as lenders and investors shy away from the sector amid bankruptcy filings, store closures, and stiff rivalry from online competition. The shifting retail landscape is reflected in higher cap rates and, in turn, lower pay off rates based on LTV. A closer look at property performance provides additional context. The retail sector has benefited from rental rates and occupancy levels that have rebounded to precrisis highs. Because of improving property performance, the loan proceeds and debt yield hurdles suggest a strong payoff rate.

Table 1 – Projected Payoff Rate by Property Type and Metric

	Healthcare	Hotel	Industrial	Multifamily	Mixed	Office	Retail
Loan Proceeds (1.35x DSCR/5.0% Interest Rate)	87.9	91.3	96.7	75.9	82.8	84.3	93.6
Debt Yield < 9.0%	87.3	92.1	96.9	73.1	85.2	84.2	92.7
LTV > 80.0%	100.0	90.2	96.3	97.5	88.3	82.6	81.1

Source: Morningstar Credit Ratings, LLC

Good Conditions Ahead

With slow but steady economic growth keeping interest rates low, and ample liquidity in the commercial real estate market, Morningstar expects the maturity payoff rate to remain stable over the next several years. Specifically, the substantial liquidity indicates that lenders and investors don't anticipate property values declining anytime soon. While we see pockets of risk around office loans as large tenants seek better office space, the industrial sector will be the prime beneficiary of the stable economic activity, as e-commerce drives industrial demand for warehouses and flex spaces. Retail loans should also fare well because they boast lower leverage than their precrisis counterparts and tend to be secured by premium assets in superior locations.