CMBS First-Quarter Market Outlook: Will Year-End Market Cheer Keep Spirits Bright into 2020?

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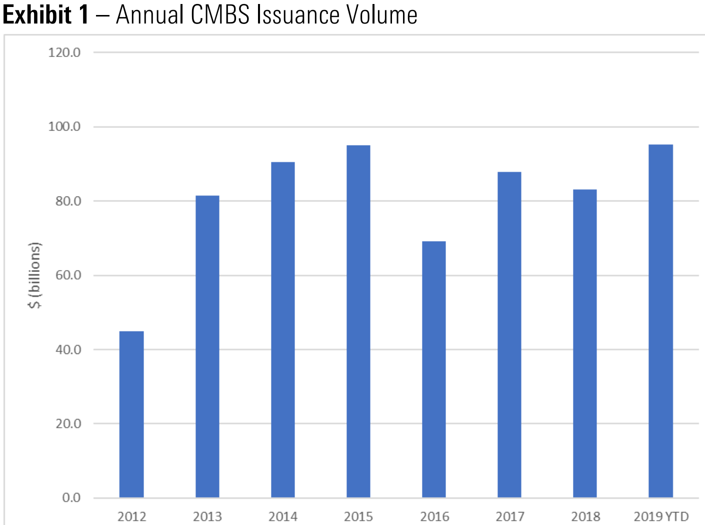
- DBRS Morningstar expects more growth ahead for the U.S. commercial real estate industry in 2020, although the pace of expansion could slow thanks to already strong fundamentals that will be tough to improve upon.
- Uncertainty surrounding trade negotiations, weakness in manufacturing, and the approach of the presidential election season will hang over the industry in 2020.
- Despite fewer troubled loans, rising interest-only exposure could hamper refinancing down the road.

After starting out the first nine months of 2019 on a down note, U.S. CMBS new issue volume came roaring back. According to Commercial Mortgage Alert, an industry newsletter, year-to-date issuance of $95.3 billion through December 13 is now ahead of the pace set in 2018 by 25.9%. And with a strong pipeline of deals to close out the year, lending volume will likely exceed $100 billion in issuance, setting a postcrisis high. With the Federal Reserve on the sidelines for at least another year and the volume of available credit remaining high, we believe originations in 2020 will likely meet or exceed 2019 volume.

The recent issuance surge can be traced back to September, when benchmark rates fell to new depths. Early that month, the 10-year Treasury sank below 1.5% for the first time since mid-2016. In the spring, it was 125 basis points higher. That encouraged borrowers to jump into the market and close the loans that went on to populate the fourth quarter's surge of conduits.

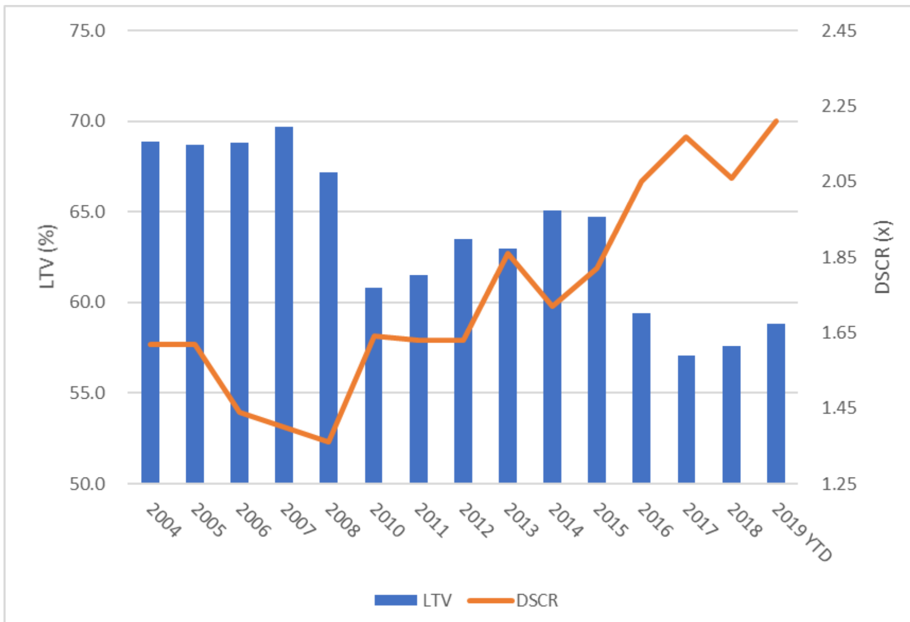
Exhibit 1 – Annual CMBS Issuance Volume



Source: DBRS Morningstar

Further, thanks to more selective underwriting standards since the Dodd-Frank risk-retention requirements became effective in December 2016 requiring banks to have skin in the game, lenders have shifted to lower-leveraged, higher-quality properties for loans packaged in CMBS. Conduit loans issued in 2019 boast an average loan-to-value ratio of 58.8% through November, according to Trepp, LLC data. That compares with 57.6% and 57.2% for the prior two years and the postcrisis high of 65.2% for conduits issued in 2014. Similarly, the same pattern holds with debt service coverage ratios. The volume of loans with higher debt service coverage ratios (DSCRs) has increased since 2016, while the balance of loans in the lower DSCR categories has continuously diminished.

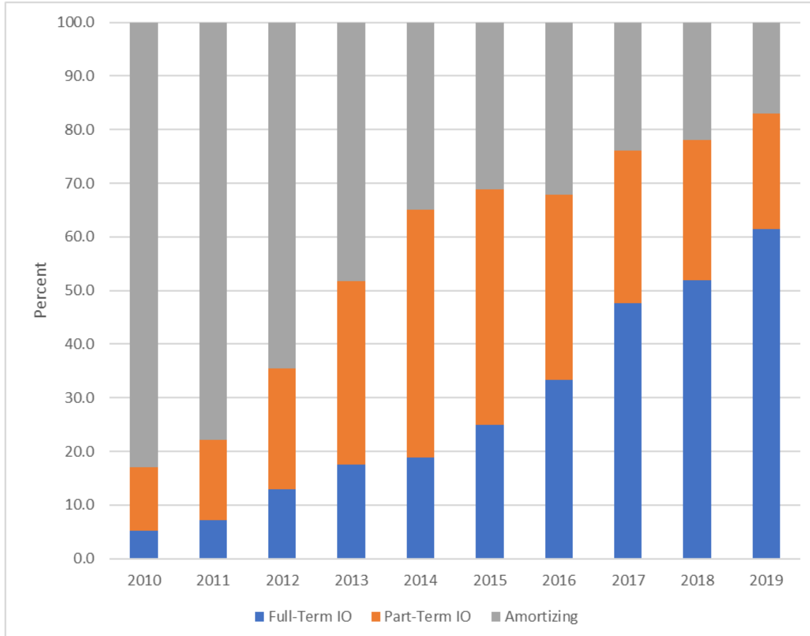
Exhibit 2 – CMBS New Issue loan-to-value (LTV) and DSCR Trends



Source: Trepp, LLC

Lenders nevertheless are finding an edge by offering more interest-only loans, which have steadily increased over the past three years. This can be optimal for maximizing cash flow during the loan period, but a few years down the road, the combination of a potential higher-interest-rate environment and prevalence of maturing loans with little or no amortization could squeeze borrowers at maturity. Interest-only exposure, which serves as a gauge of long-term balloon risk, represented 83.0% of all conduit loans originated for the first 11 months of 2019, up from 78.0% in 2018 and 76.1% in 2017, per Trepp data. In fact, the percentage of full-term interest-only loans has increased every year since 2010, surpassing the previous peak of 60% in 2007, while partial-term interest-only loans have declined to 21.5% so far in 2019, down sharply from a peak of 46.2% in 2014.

Exhibit 3 – CMBS New Issue Interest-Only Trends



Source: Trepp, LLC

Meanwhile, economic growth is likely to slow in 2020. Factors weighing on growth include lower capital expenditures by corporations amid heightened uncertainty, slowing global growth compounded by ongoing trade tensions, and waning effects of fiscal stimulus. The economy is in its 10th year of expansion, and the labor market is near full employment. Despite positive fundamentals, consumer debt is worryingly high with the debt-to-GDP ratio rising to 106% as of Q3 2019, up from around 60% in 2008. Nevertheless, low inflation, low interest rates, healthy wage gains supported by a 50-year low unemployment rate, and strong consumer sentiment provide a reasonably good outlook for consumer spending in 2020.

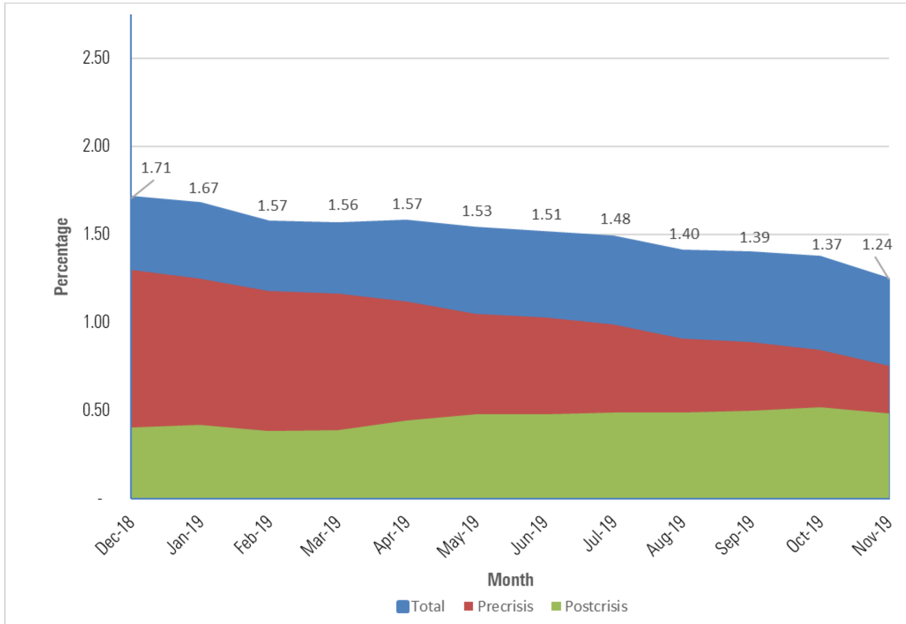
Fewer Troubled Loans

Steady new issuance volume and ongoing resolutions of pre-2010 loans underpin the falling CMBS delinquency rate and special-servicing rate. Since peaking at 8.5% in May 2012, the delinquency rate has steadily declined; however, we believe the rate will continue to drop and reach an inflection point in 2020.

Dwindling legacy loans have been a significant factor in the steady decline in recent years, though their effect will fizzle, with the legacy balance representing less than 1.8% of the CMBS universe in November and declining rapidly. However, the volume of delinquent loans in the CMBS 2.0 universe continues to increase, hitting $4.49 billion in November, up from $3.08 billion in November 2018.

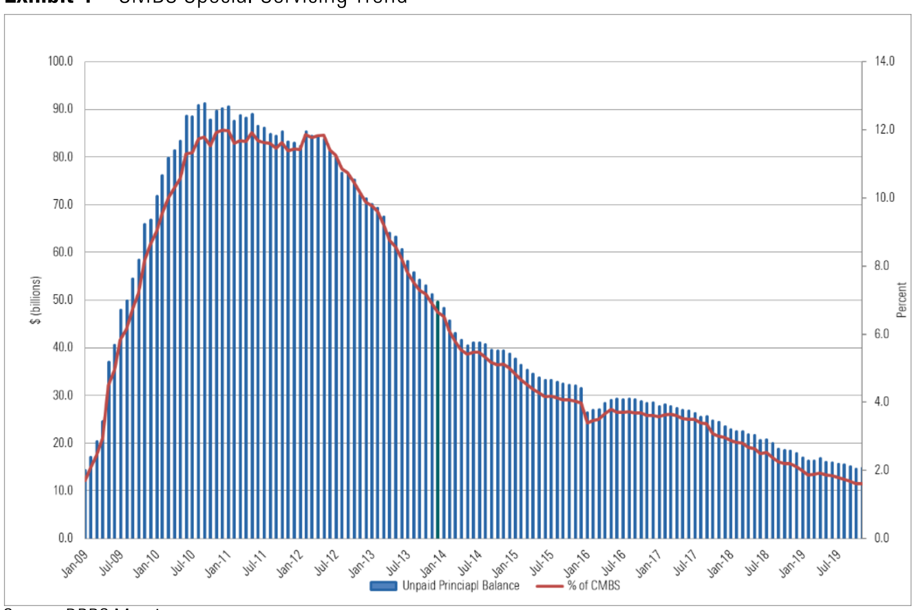
Meanwhile, the special-servicing unpaid principal balance had continued its descent, registering another postcrisis low in October of $14.61 billion, followed by a slight uptick in November to $14.83 billion. The special-servicing rate remained at a postcrisis low of 1.61% for the second consecutive month, down 58 basis points from November 2019. Similar to the delinquency rate, we expect the special-servicing rate to reach an inflection point in 2020 as legacy loans are resolved and the balance of specially serviced postcrisis loans continues to rise, registering $7.13 billion in November, up from $5.14 billion the prior year.

Exhibit 4 – Monthly CMBS Delinquency Rate



Source: DBRS Morningstar

Exhibit 4 – CMBS Special-Servicing Trend



Source: DBRS Morningstar

Industrial Completions Will Outpace Absorption

With demand remaining high and recent deliveries providing more available space options, strong gains in net absorption should continue into 2020—though at a slower pace than completions, leading to slightly higher vacancy over the next few years. We expect the year will see a record number of industrial property deliveries in response to very strong leasing demand. More than 300 million square feet is currently under construction, with most of it delivering over the next year. Third quarter industrial data reveal a roughly 24% quarter-over-quarter increase in completions to 61.6 million square feet and a 21% quarter-over-quarter increase in net absorption to 46.3 million square feet, according to CBRE Econometrics, Inc. These increases yielded a slight rise in the availability rate, to 7.2% from 7.1% last quarter. With increases in availability and completions in 2020 and 2021, rents will grow at a decelerating pace as supply catches up with and outstrips softening demand.

One area that we anticipate rapid growth in is micro-fulfillment centers, which help grocery retailers tackle e-commerce challenges. These warehouses are equipped to autonomously fulfill online orders fast and efficiently. By squeezing warehouses into dense urban areas, retailers can reduce the cost of last-mile delivery by cutting down the distance to customers.

Multifamily Demand Catches Up to Supply

Third quarter data show the vacancy rate for apartments to have dropped another 40 basis points to 3.6%, the sector's lowest vacancy rate since 2000. Rent growth remained healthy as well in Q3 2019, rising 2.9% on a year-over-year basis. Rent growth is expected to moderate slightly as economic growth slows, dropping from 2019's 3.2% to 2.7% in 2020. Looking forward, we expect the national vacancy rate to begin inching upward in 2020 and to rise through 2021. Though demand will remain strong, we expect that a slowdown in employment growth, coupled with a robust supply pipeline, will lead to supply overtaking demand by the second half of 2020, pushing the vacancy rate up to 4.2%.

A slowing economy and slower job growth mean fewer new households, and less demand for housing. And that means the 660,000 apartment units currently under construction may be competing for a shrinking pool of renters. With mortgage rates near record lows and house prices that have stabilized somewhat, many potential renters may be taking a long, hard look at homeownership.

The rent growth leader is once again Phoenix, where rents are up about 7% over this time last year. The leaderboard includes other fast-growing markets facing insufficient housing construction, including Raleigh and Charlotte, North Carolina; Nashville; Austin, Texas; and the Inland Empire. Markets posting the weakest rent growth include energy markets like Houston and Oklahoma City, as well as demographically challenged Midwest and northeast markets like New Jersey; Columbus, Ohio; Rochester, New York; and Cleveland.

Is Brick-and-Mortar Making a Comeback?

The tight labor market and stable unemployment underpin strong consumer confidence keeping the retail sector stable nationally. That said, trade tensions remain a large risk to retail sales and shopping centers. Nevertheless, overall leasing activity held up in recent months, despite decreased activity from big-box and apparel users, benefitting from a lack of new construction. Construction starts have trended lower, to less than 10 million square feet in the third quarter. The availability rate for neighborhood, community, and strip centers was 8.7% in Q3 2019, down slightly from the previous quarter. This rate is 48 basis points below the year-earlier figure and more than 4% below the post-recession peak of 13.0%. Rent growth has been steady for the past few quarters; Q3 registered 2.7%, year over year.

One of the hottest trends in retail is brick-and-mortar. Amazon Go, Untuckit, Warby Parker have have opened storefronts to raise their profile, and BrandBox, launched by the Macerich REIT, provides move-in ready space for online retailers wanting to try their hand at actual shopkeeping. Further, landlords with empty big-box space are finding other creative approaches to replace traditional tenants. Indoor golf simulators, ax-throwing, yoga studios, e-sports arenas, and indoor trampolines have emerged as new-concept tenants suited to backfill large footprints.

Although many regional malls are experiencing declining sales and occupancy from hundreds of store closures, we found that not all commercial mortgage-backed securities loans backed by these properties are at risk. With roughly $3.6 billion of mall-backed loans that mature through 2021, most have performed well, averaging a roughly 15% increase in net cash flow since underwriting. We also found that many of these loans have additional characteristics that will likely buoy their refinance prospects including amortization, a strong location, and borrowers that invest in their properties.

Despite Tight Vacancies Hot Office Markets Continue to Grow

The office market's streak of 38 straight quarters of positive net absorption might be hard to sustain in 2020 with vacancies historically tight. Vacancy as of Q3 2019 remained stable at 9.7%, which matches the lowest point of this expansion, according to CoStar Group, Inc. But new construction will outpace net absorption, resulting in a slight increase to the national vacancy rate and a slowing of rent growth to a 1.6% gain. While fundamentals look to soften a bit, there's nothing overly alarming on the horizon other than some turmoil in the coworking segment. Coworking giant WeWork is a collateral tenant in roughly $5 billion in loans packaged in CMBS, and its turnaround plan after a filed initial public offering and bailout by SoftBank will be closely watched. Most of WeWork's properties are in strong markets. Because of this, we expect physical occupancy to remain high.

The tech markets of Nashville and Austin have the most new supply on the way because they have the greatest population and employment growth. Further, tech and research markets continued to record the nation's lowest vacancy rates, including San Francisco (4.9%), Austin (7.1%), Seattle (7.3%), Raleigh (7.5%), San Jose, California (8.3%), Boston (8.6%), and New York (8.6%).

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