
CMBS Fourth-Quarter Market Outlook: Despite Market Volatility, No Major Disruption to Property Fundamentals

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- ▶ The CMBS sector is relatively well prepared for slower economic growth.
- ▶ Despite noise surrounding the U.S.-China trade war and the job market, CMBS performance will be steady for the rest of the year.
- ▶ Multifamily and industrial will continue to be strong commercial asset classes.
- ▶ Competition for multifamily loans has intensified, as loans issued more recently have become riskier, underwritten with even lower debt yields and higher leverage.

Morningstar Credit Ratings, LLC believes that the Federal Reserve's recent rate cuts, the first in over 10 years, bring a hint of optimism to what was expected to be a down year for issuance of commercial mortgage-backed securities, while moderating economic growth should lead to slower but still positive real estate demand and absorption.

Most economic indicators show favorable conditions, and the current expansion does not have the makings of a boom and bust cycle. The U.S. economy has created 20.5 million jobs (2.3 million per year) from 2010 to 2018, according to the U.S. Bureau of Labor Statistics, one of the strongest stretches ever. According to the Urban Land Institute's Real Estate Economic Forecast, the national unemployment rate is forecast to remain at its current level of 3.7% (as of July) in 2019, approximating the lowest rate of the past 50 years. States in the West posted the highest annual job gains as of July 2019, led by Nevada and Utah (3.1% each) and Idaho (2.8%).

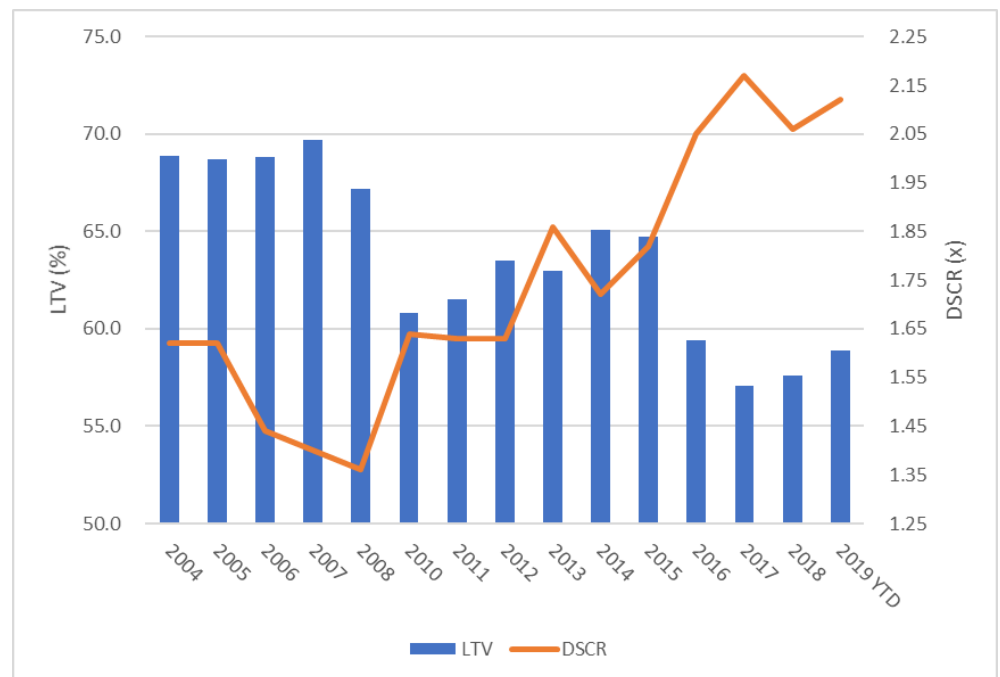
This cycle's average annual real gross domestic product growth rate is only 2.3%, roughly half the 4.2% annual average during the prior 10 cycles, according to the U.S. Bureau of Economic Analysis. The three-month rolling average job growth fell to a near two-year low in July, according to the U.S. Bureau of Labor Statistics, as the baby boom generation ages out of the workforce faster than the younger generations are entering the workforce. This shows there are no huge imbalances or signs of overheating in the economy, which usually precede a recession.

Growth in commercial property prices will likely moderate as well. Commercial real estate price growth as measured by the RCA Commercial Property Price Index will moderate over the next three years (5.0%, 3.7%, and 2.8%, respectively), after averaging 7.7% over the past three years. If the forecast holds true, 2021 will mark the 11th year of real estate price appreciation.

The upshot of this slow and steady expansion is that it may prolong the current business cycle. Commercial real estate will benefit from this pace of growth. Demand for commercial space is strong but not so robust as to spur excess lending and speculative new development.

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. According to Trepp, LLC, conduit loans through third-quarter 2019 had an average loan-to-value ratio of 58.9%, compared with 65.4% for all of 2015. Similarly, underwritten debt service coverage ratios have improved as well, hitting an average of 2.12x so far in 2019, up from 1.75x in 2015.

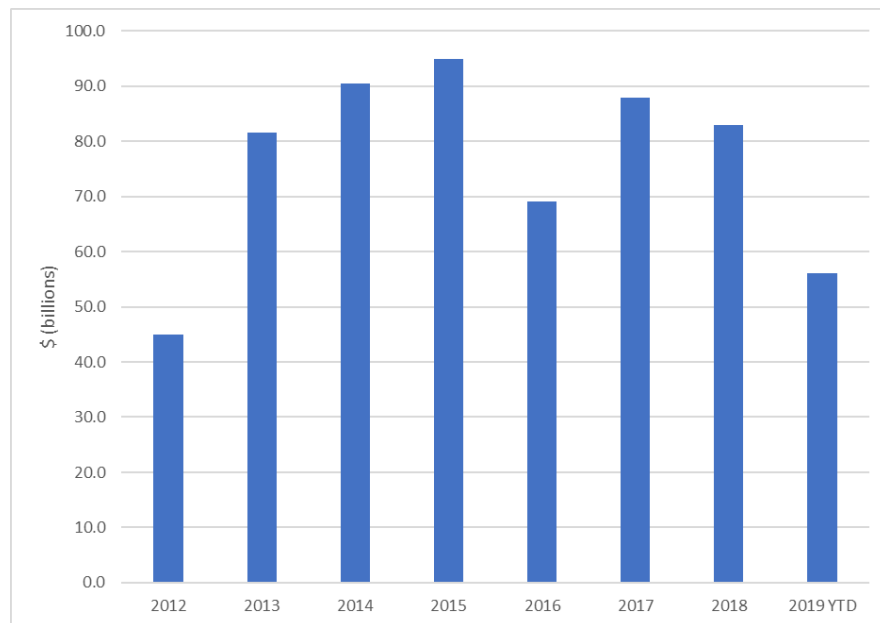
Exhibit 1 – New Issue LTV and DSCR Trends



Source: Trepp, LLC

Slowing New Issue Volume

CMBS new issue volume dropped to \$83.0 billion in 2018 from a postcrisis high of \$95.0 billion in 2015. The declining new issue volume carried over to the first nine months of this year. Through Sept. 27, new issue volume of \$56.1 billion was 3.6% less than the same period last year. While there are fewer new loans being originated compared with recent years, rates have compressed over the past four months, stimulating activity, both on the refinancing and acquisitions front. But CMBS isn't the outlet it once was for borrowers, despite a more conducive interest rate environment. Competitors, from mortgage real estate investment trusts to private debt funds, have increasingly stepped in to offer borrowers an array of alternatives. Because of this and a lull in refinance volume, we expect CMBS originations to finish the year around \$75 billion.

Exhibit 2 – Annual CMBS Issuance Volume

Source: Morningstar Credit Ratings, LLC

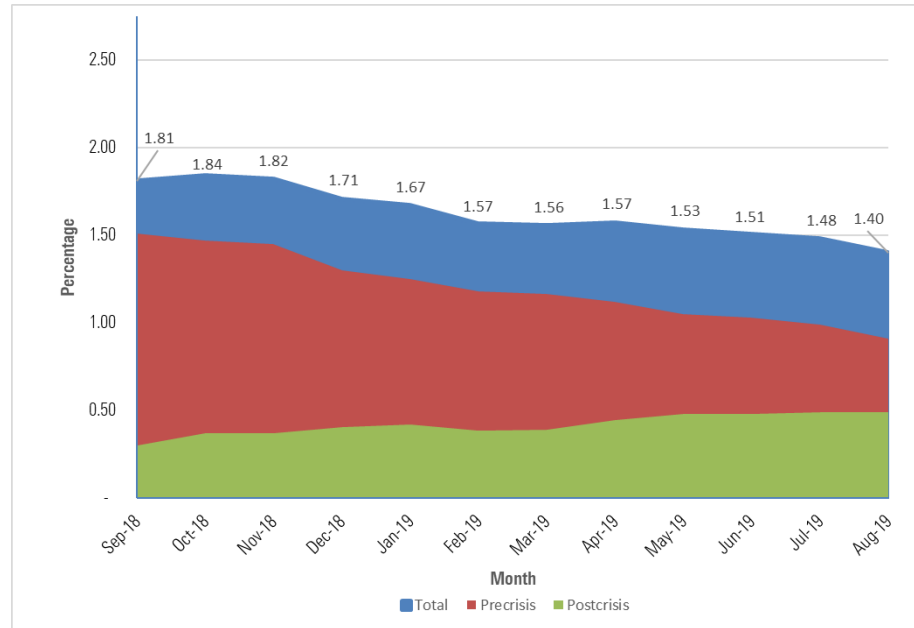
Fewer Troubled Loans

Steady (but slowing) 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 2.5% of the CMBS universe in August and declining rapidly. The volume of delinquent loans in the CMBS 2.0 universe continues to slowly increase, hitting \$4.36 billion last month, up from \$2.91 billion in August 2018.

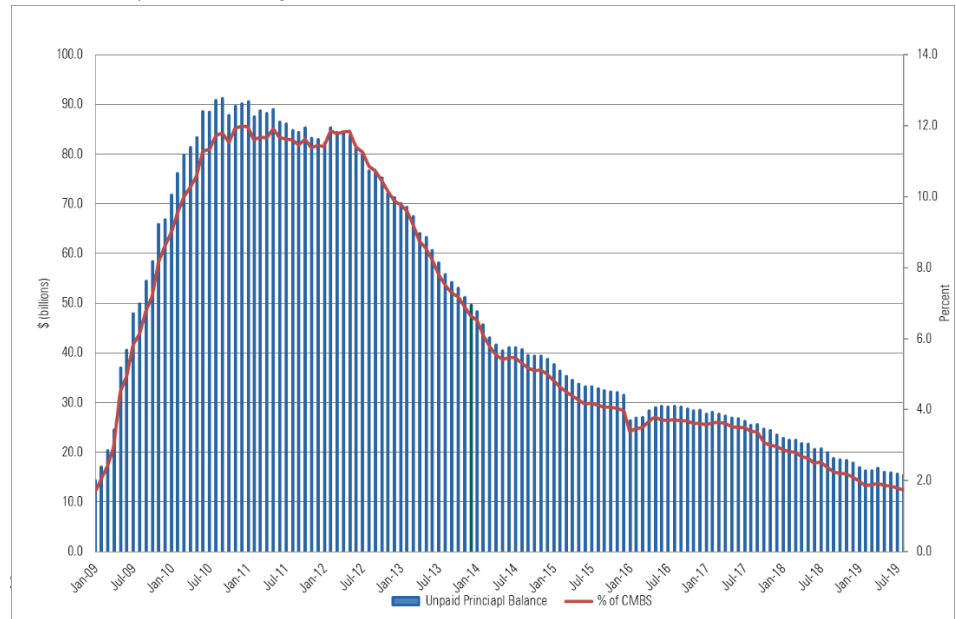
Meanwhile, the special-servicing unpaid principal balance continues its descent, registering another postcrisis low in August of \$15.55 billion. The special-servicing rate also hit a postcrisis low of 1.74%, down 12 basis points from January. Similar to the delinquency rate, we expect the special-servicing 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 \$6.49 billion in August, up from \$5.22 billion the prior year.

Exhibit 3 – Monthly CMBS Delinquency Rate



Source: Morningstar Credit Ratings, LLC

Exhibit 4 – Special-Servicing Trend



Source: Morningstar Credit Ratings, LLC

Tight Industrial Availability

Although a steady stream of industrial supply will likely come online nationally, tight availability and, in some markets, too few properties to meet tenant demand will continue to put upward pressure on rents. According to CBRE Econometric Advisors, the next two years will continue to see a strong supply pipeline across the top 25 markets. Given healthy net absorption, solid supply will limit availability declines. Markets that serve a core distribution function—Atlanta; Dallas; Denver; Fort Worth, Texas; and Riverside, California—continue to see strong completion rates. Secondary markets like Baltimore; Columbus, Ohio; Phoenix; and St. Louis are also receiving new supply as investors seek out more attractively priced markets. The data center hub of Reno, Nevada, ranks the highest for under construction space as a share of inventory with 6.9 million square feet representing nearly 8% of stock, according to CoStar Group, Inc. Reno has gained prominence as a growing logistics and data center market thanks to its geographic position between western states, as well as its friendly regulatory environment.

E-commerce and discount retailers will continue to sustain demand for industrial properties, particularly flex properties. Prominent leases include Amazon taking 2.5 million square feet for its custom-built, four-story fulfillment center in Tulsa, Oklahoma. With completion still underway, move-in is set for early 2020. Amazon also signed for another 2.6 million square feet in a second new fulfillment center in Oklahoma City, which opened in August. Another deal took place in the Inland Empire where DMSI, third-party logistics leader provider for Ross Stores, TJ Maxx, HomeGoods, and other discount retailers, took 1.1 million square feet of distribution warehouse space in Moreno Valley. This Riverside submarket has evolved into a formidable logistics hub.

Multifamily Demand Catches Up to Supply

Strong apartment demand continues to push down the national vacancy rate, even with multifamily construction returning to its prerecession peak. More than 160,000 units were absorbed in the second quarter, which easily outpaced the 72,000 new units that were completed. The U.S. Census Bureau reported that the homeownership rate sank to 64.1% in the second quarter of 2019 from 69.2% in 2004. As a result, quarterly multifamily vacancy has improved or held steady for the past nine years, according to CBRE EA, and it reported a healthy vacancy rate of 4.3% for the second quarter of 2019, a level not seen since before the recession. Along with improving occupancy levels, the sector has experienced steady rent growth, with second-quarter national rents about 30% higher than first-quarter 2010 levels. It's no surprise then that the delinquency rate on multifamily loans is the lowest of the major property types at just 0.38%.

But we believe that demand has begun to wane despite these positive fundamentals. America's working-age population is shrinking, increasing at less than half the rate of the rest of the population, according to a University of Virginia report. This demographic shift will tap the brakes on rent growth, which has already showed signs of slowing. While the year-over-year rental growth rate of 1.6% through July is slightly ahead of the 1.2% rate from this time last year, it still lags growth rates from 2014 to 2017, which ranged from 2.3% to 3.6%. The sector will benefit, however, from rent growth that is still well behind growth in average hourly earnings, which have increased by 3.2% over the past 12 months. Consequently, CBRE EA projects the national vacancy rate will begin inching upward at about 10 basis points per quarter as high inventory growth persists while employment growth remains positive but begins to weaken.

Competition for multifamily loans has intensified, as loans issued more recently have become riskier, underwritten with even lower debt yields and higher leverage. More than 66% of multifamily loans were underwritten in 2018 with a debt yield less than 8% as lenders and issuers ramped up their competition for deals. While multifamily isn't typically considered a risky property type, lower debt yields are a concern because an economic slowdown is likely to hamper refinancing of loans in weaker markets.

What Retail Apocalypse?

This property sector should remain stable nationally, buoyed by a lack of new construction and continued strength in consumer spending. But bankruptcy filings, store closures, and stiff rivalry from online competitors have led to projections of more than 8,200 store closures through year-end. According to CoStar, most of the closures announced so far this year are from smaller inline tenants, so the overall square footage is set to come in below the record 155 million square feet of announced closures in 2018. These closures have taken a toll on fundamentals, as net absorption slowed to the lowest level since the recession. Despite weakening demand, retail sector vacancies are holding near record low levels, 4.5% as of the second quarter, as supply continues to edge lower as well. Completions in the first half of the year slowed to a crawl, and construction starts have dropped. As the retail landscape shifts, development activity is mostly limited to areas with strong population and income growth.



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