CMBS Third Quarter Market Outlook: Could Macro Speed Bumps Slow Market's Roll?

By Steve Jellinek
Vice President, CMBS Research

- The CMBS delinquency rate has remained low, as liquidations and originations outnumber new problem loans. As servicers wind down their legacy (pre-2010) portfolios throughout the year, we expect the delinquency rate to stay low.
- Retail consolidation will continue to make headlines in 2018; however, in contrast to 2017, we do not expect a wave of regional mall defaults.
- The multifamily sector, which has been the star performer of this real estate cycle, could experience slower growth, especially in markets that have had sharp increases in supply, but we expect secondary markets with weaker supply growth to outperform.

Despite concerns about rising interest rates and the Federal Reserve's self-imposed downsizing of its balance sheet, fewer maturities in need of refinancing, and signs of overbuilding in certain commercial real estate sectors, commercial mortgage-backed securities issuance started 2018 strong, and Morningstar Credit Ratings, LLC expects it to continue to be robust through the third quarter. By the end of June, new issuance will total $44.30 billion, according to Trepp, LLC, a healthy increase over the $34.45 billion issued in the first half of 2017. Issuance volume for single-asset, single-borrower CMBS deals will remain strong in 2018, as most of the year-to-date gains came from the continuing surge of SASB transactions. Trepp expects SASB issuance will total $18.06 billion by the end of the second quarter, versus $11.88 billion from the same period a year ago. Some of the factors behind the market's growing appetite are the ease of re-underwriting the collateral, better credit enhancement, and the higher-quality assets backing the deals. Fueled primarily by heavy deal flow on trophy skyscrapers in major metropolitan areas, office loans made up the largest portion of total issuance with $4.48 billion, or 29.1% of 2018 volume.

Exhibit 1 Issuance Volume Comparison ($ Bil)

	Conduit	Single-Asset Single-Borrower	Floating Rate	Total
Expected Through June 2018	16.44	18.06	9.80	44.30
First Half 2017	19.57	11.88	3.00	34.45

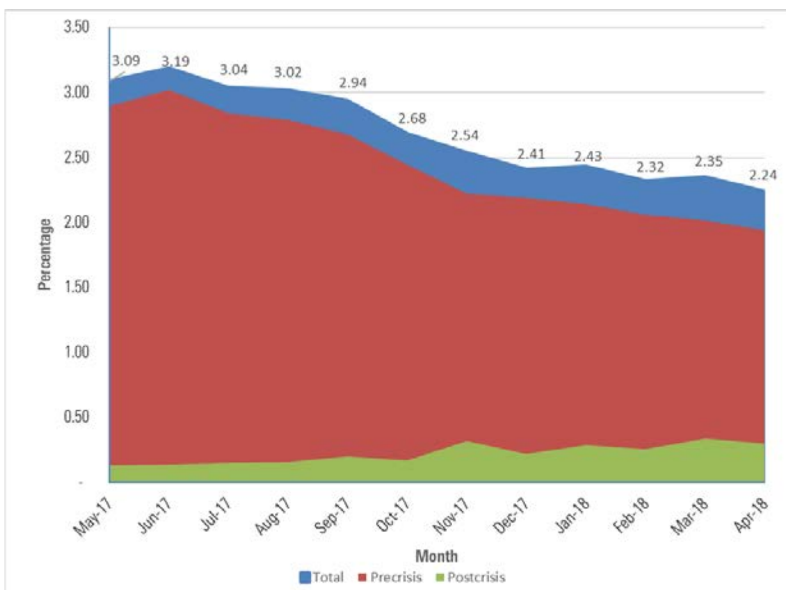
Source: Trepp LLC

After contracting during the first quarter of 2018 spreads on new issuance CMBS bonds began to widen during the second quarter, according to Commercial Mortgage Alert. Spreads on 10-year AAA rated conduit bonds, which averaged 80 basis points over swaps for the previous 52 weeks, were at 83 basis points over swaps as of June 6, an increase of 4 basis points from a week earlier. The widening at the BBB- level was similar; having averaged 356 basis points over swaps for the past 52 weeks, they were 337 basis points over swaps on June 6, 12 basis points wider than a week earlier. Regardless, we don't see a clear commercial real estate-specific catalyst that would send spreads wider.

Fewer Delinquencies

Driven by the liquidation activity of specially serviced legacy loans, delinquency rates should remain low. The delinquency rate hit a postcrisis low of 2.24% in April and is down 90 basis points from a year ago. With steady new issuance volume pushing the outstanding balance of CMBS loans higher and special servicers actively resolving or liquidating assets, we believe the delinquency rate will hold below 2.5% for the rest of the year. Delinquencies from deals issued from 2010 through 2018 represent just 0.3% of the CMBS universe, while delinquent precrisis loans account for 1.9%.

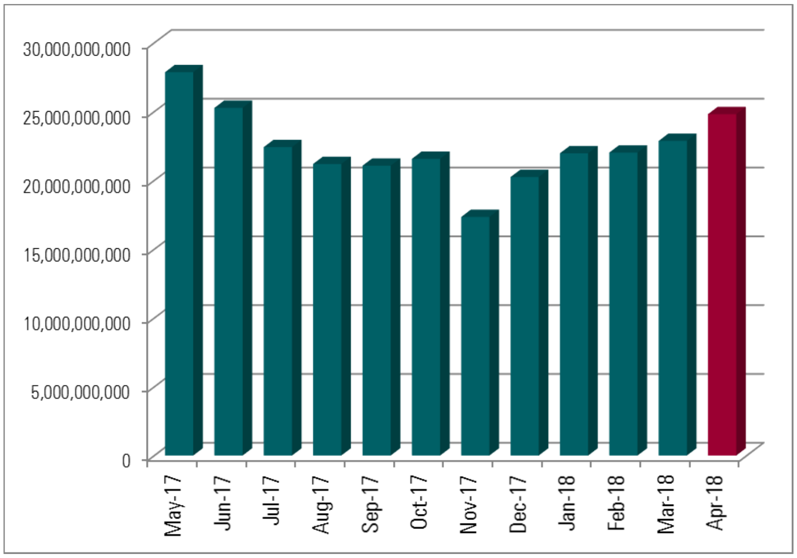
Exhibit 2 Monthly Delinquency Rate



Source: Morningstar Credit Ratings, LLC

However, driven in part by continuing retail weakness, especially in shopping centers with exposure to troubled tenants, the volume of watchlist loans should continue its gradual upswing in the coming month. The wave of retail bankruptcies that began in 2017 and has continued into 2018 could lead to higher vacancy rates over the next year. In addition, consolidation in the grocery and apparel sectors could result in further store closures, especially at Class B and C assets.

Exhibit 3 Monthly Watchlist Volume ($)



Source: Morningstar Credit Ratings, LLC

The wave of mall defaults should subside in 2018. We have discovered that mall loans tend to default more often at maturity, rather than during the loan term, and fewer mall loans are scheduled to mature over the next few years. As long as cash flow remains above break-even on these assets, mall owners have little incentive to hand properties back to their respective trusts prior to loan maturity and will collect cash flow until then. However, as valuations on Class B and C malls adjust to lower levels of revenue, borrowers are often unable or unwilling to invest additional capital to refinance.

Retail and Office Concerns Remain, Multifamily Secondary Markets to Outperform

Morningstar expects property fundamentals will remain stable in the coming year. While there may be some pockets of risk, continued economic growth should buoy demand across most sectors. The industrial sector may be the prime beneficiary, and the multifamily, hospitality, and office sectors may slow after several years of gains and more new construction. Retail could be at higher risk, as the industry consolidates and attempts to cope with the increased competition from online retailers.

While talk of a retail apocalypse is likely overblown, we have concerns for the sector in 2018. The wave of bankruptcies in 2017 has increased vacancy rates. In addition, consolidation in the grocery and apparel sectors could result in further store closures, especially at Class B and C assets. Grocery-anchored properties could be of particular concern as **Amazon** AMZN, via its Whole Foods acquisition, competes more heavily against the traditional players, and discounters, like Aldi and Lidl, expand their presence in the United States. Lenders have traditionally held the view that grocery-anchored centers are less risky assets, allowing for smaller risk premiums in capitalization rates and higher leverage. This paradigm may shift as margins in the industry are further compressed and the Amazon effect could shrink size needs over time.

Other anchors that affect CMBS loans include Bon-Ton, which began liquidation sales in April, and Toys 'R' Us, which started closing down its U.S. operations in March. Our ongoing concerns include office supply chains—Staples and Office Depot—**Macy's** M, JCPenney, Sears/Kmart, and PetSmart. Although high-quality assets will likely have little difficulty in backfilling the spaces left vacant as these chains shutter stores, Class B and C assets may have more persistent vacancy.

Meanwhile, we are most cautious on the office sector given a combination of the late stage corporate credit cycle, less demand as companies become more efficient, and potential disruption from technology, reducing space requirements. Further, new construction in the office market may weigh on occupancy in the coming year. CBRE projected 73 million square feet in new office space in 2018, the highest level since 2008. While economic growth should help maintain strong absorption, this likely signals a turn in the market. Through 2021, CBRE forecasts the national vacancy rate will rise to 14.8% from 13.0% as of 2017. The increased availability may slow rent growth, particularly in markets that are seeing the greatest increase in supply. The four most active construction markets are New York, Washington, D.C., San Francisco, and Seattle.

On the other hand, the multifamily sector has been a star performer in this economic cycle but may take a breather after several years of strong growth. Apartment owners had reasons to cheer as millennials eschewed homeownership in favor of rentals and improved multifamily fundamentals across the country. According to the Federal Reserve Bank of St. Louis, the U.S. homeownership rate bottomed out at 62.9% in second-quarter 2016 from about 69% before the crisis. In addition, between 2010 and 2017, the national vacancy rate dropped to 5% from over 7% according to CBRE Econometric Advisors, while asking rents soared. However, the average asking rent growth has since stabilized to a more sustainable 2.0% after topping out 4.6% in 2015, and CBRE projects a more moderate annual rent growth of 0.4% over the next two years as demand in gateway markets slows. Secondary markets with weaker supply growth and stronger growth in professional services employment are expected to outperform gateway markets in demand growth. Among markets topping the rent growth forecast are Orlando, Florida; Oakland, California; Colorado Springs, Colorado; and Sacramento, California, while CBRE forecasts lower-than-average rent growth for gateway cities such as New York, San Francisco, Washington, D.C., and Chicago. Primary coastal markets such as Miami, San Diego, and Seattle will lag, according to CBRE.

Guarded Optimism

Despite macro catalysts that could tap the brakes on the CMBS market, borrowers seeking to lock in low rates should help maintain the robust volume of CMBS issuance. Meanwhile, a growing number of yield-hungry investors tied to large projects too capital intensive to finance via other lending vehicles will likely turn to CMBS. The lower tax rate stemming from the recently passed GOP tax legislation will provide additional incentives to partake in acquisition and development activity, while Morningstar expects spreads and the delinquency rate to hold steady.

22 West Washington Street
Chicago, IL 60602 USA