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VIEWPOINT

Kicking the Can Down the Road... at Origination

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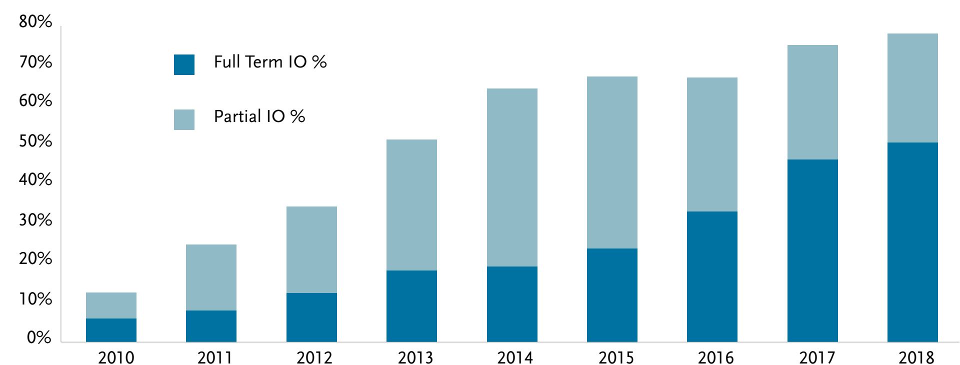
The weighted average percentage of interest-only (IO) loans – including partial and full-term IO – securitized in conduit CMBS increased from less than 15% in 2010 to over 75% in 2017. While IO benefits borrowers by making debt more affordable and B-piece buyers by reducing term default risk, it may present incremental risk to the majority of CMBS investors with lower carry and principal aligned with loan maturities. CMBS investors should recognize that the significant increase in IO removes an important mechanism for improving credit quality over the loan term and mitigating maturity risk: amortization.

Weighted Average Conduit Interest Only (IO) Percentage by Vintage



Source: Morgan Stanley Research (March 2018); IO percentage reflects the vintage weighted average

Why IO Is More Affordable During Term:

Ceteris paribus, IO debt offers borrowers a lower monthly payment, which results in a higher debt service coverage ratio (DSCR) on the loan, calculated as the property cash flow over the mortgage payment. In a normal operating environment, CMBS borrowers with lower monthly payments benefit from higher excess spread (higher proceeds to equity) – which enhances leveraged carry and increases funds available for reinvestment in the property.

If property net operating income (NOI) were to suffer temporarily, perhaps due to the departure of a tenant, the higher DSCR on the loan is more likely to absorb the NOI haircut. If the impact to NOI is severe enough to trigger cash management (cut off proceeds to equity), the borrower may find it affordable and worthwhile to come out of pocket to cover debt service and any additional property expenses until the vacant space is re-tenanted and NOI recovers. Ultimately, cheaper debt reduces term default risk by providing a greater NOI cushion to absorb property performance issues.

Why B-Piece Buyers Benefit from Reduced Term Default Risk:

To contextualize the significant increase in IO, it is worth considering the party benefiting most from the trend: the B-piece buyer. As the first-loss risk, the B-piece prices at a high yield (roughly mid-to-high teens gross yield, non-loss adjusted) and a discount dollar price (roughly $H30s-$L50s). Due to the high yield and discount dollar price, B-piece buyers can recover their cost basis within five years (assuming no losses) – with upside from additional years of carry and principal repayment. As such, B-piece buyers are highly motivated to minimize term default risk.

Pre-securitization, B-piece buyers perform diligence on conduit pools and request changes – ranging from structural adjustments to outright rejection of certain loans (“kick-outs”) – to manage credit risk. Post-securitization, B-piece buyers are designated as the Controlling Class Representative (CCR) of their respective CMBS trusts, which entitles them to make decisions regarding defaulted assets.

Following the global financial crisis, CCRs strategically delayed default resolutions in outstanding CMBS (CMBS 1.0 or “legacy”) to avoid losses that would trigger change in control provisions – a strategy of “kicking the can down the road” to protect their position (and the related perks, such as exercising purchase options on defaulted assets). In post-crisis CMBS (CMBS 2.0/3.0), revised change in control language addresses the realized-loss loophole by including implied losses, evidenced by appraisal-based tests (required within months of default). However, this effort to reduce conflicts of interest with respect to defaulted assets can be largely circumvented by CCRs in their pre-securitization review. By favoring loans that reduce term default risk, B-piece buyers are effectively “kicking the can down the road” at origination.

Why Amortization Improves Credit Quality:

Unlike the first-loss B-piece, the remainder of CMBS debt prices at lower yields – roughly 3.5% on LCF AAAs (30.0% credit enhancement) to around 6.5% for BBB-s (around 7.25% credit enhancement) – with most classes pricing at or above par (typically all but the BBB-s). Without leveraged carry to reduce the cost basis, and with principal largely contingent upon loan repayment, most CMBS investors are more exposed to maturity default risk than term default risk. The fact that conduit amortization declined from a weighted average of over 85% in 2010 to less than 25% in 2017 suggests it is worth reviewing the benefits of requiring monthly principal payments from CMBS borrowers.

First and foremost, amortization is the most assured way to improve the credit profile of CMBS debt over time and reduce maturity default risk. Amortization delevers the encumbered asset, which improves the borrower’s ability to repay, and it builds equity in the property, which improves the borrower’s willingness to repay. When amortization is removed from the CMBS loan structure, NOI growth and/or cap rate compression are the only options remaining to delever the debt. Unfortunately, unlike amortization, lenders cannot structure NOI growth or cap rate compression into automatic monthly installments.

Secondly, by increasing the cost of debt, amortization provides a safeguard against aggressive lending practices and opportunistic borrowers. If property NOI cannot meet a minimum DSCR threshold when responsible for monthly interest and principal payments, then the asset is simply overleveraged (irrespective of appraisal-implied leverage) and the loan balance should be reduced until a prudent DSCR is achieved. By requiring amortization, lenders avoid financing weaker-capitalized borrowers looking for stretch acquisitions (properties they cannot afford) or opportunistic refinancings (properties suffering from underinvestment and/or deteriorating market fundamentals).

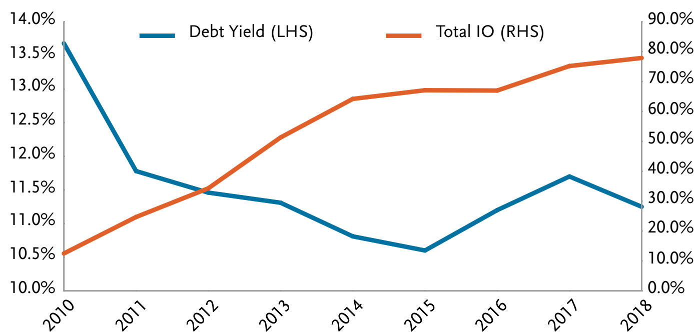
Reviewing Justifications for IO:

IO debt is not inherently risky – it is often the preferred loan structure for very high quality borrowers with trophy assets (such as large public REITs accustomed to corporate unsecured debt). IO also helps CMBS originators compete against other lenders to maintain market share. While recognizing that IO debt has its merits, its significant increase in CMBS issuance is a credit negative.

Conduit originators try to neutralize IO concerns by arguing that the borrowers "pay" the amortization upfront by agreeing to more conservative loan-to-value (LTV) ratios. In theory, this makes some sense, but in practice, there are two major deficiencies in the argument. First, LTVs can be artificially deflated through exaggerated valuations (the ratio denominator). Second, many borrowers are able to execute cash-out refinances that return substantial proceeds to equity – removing any incremental cost (or upfront "payment") that could qualify as a substitute for amortization.

If investors reject underwritten LTVs as a useful credit metric due to valuation concerns, originators may pivot their credit-quality argument to NOI debt yields (DYs), calculated as property NOI over the mortgage balance. Although valuation-agnostic, DYs have their own limitations because underwritten NOIs (the numerator) may include pro-forma assumptions while historical NOIs may represent unrealistic expectations for the next 5-10 years of property performance. Reservations aside, reviewing DYs for the 2017 vintage and year-to-date 2018 vintage shows they do indeed track closer to the 2011-2012 vintages. However, the 2017-2018 vintages include 2-3x more IO debt – which means (assuming a static NOI) that while 2011-2012 vintage DYs increase over time (due to amortization of the denominator), 2017-2018 debt yields will remain largely flat. Furthermore, earlier cycle originations, such as the 2011-2012 vintages, are more likely to benefit from NOI growth (imbedded valuation gains) than more recent issuance.

Weighted Average Debt Yield (LHS) and IO% (RHS) by Conduit Vintage



Source: Morgan Stanley Research (March 2018); DYs and IO percentage reflect the vintage weighted average

Conclusion – Why We Remain Disciplined:

While B-piece buyers, as the first-loss position, are exposed to significant credit risks that cannot be mitigated (namely idiosyncratic risk), they do have the ability to curate conduit pools that enhance their risk-reward profile. Due to the discount dollar price and leveraged carry of the position, B-piece buyers can recover their cost basis within five years (assuming no losses) – incentivizing them to reduce term default risk as much as possible. One method to reduce term default risk is to make CMBS debt more affordable by offering borrowers IO loans. The preference for this method is evidenced by the significant increase in IO debt securitized in conduit CMBS – from a weighted average of less than 15% in 2010 to over 75% in 2017.

The fact that IO loans represent over 75% of the 2017 vintage – and nearly 78% of the 2018 vintage year-to-date – reinforces our view that we are late-stage in the credit cycle and need to remain disciplined as investors. We appreciate that amortization is an important tool to improve credit quality over the loan term and mitigate refinancing risk at maturity. We also recognize that high-level metrics, such as LTV and DY, are insufficient (if not unreliable) measures of loan quality – and thus wholly inadequate justifications for the substantial increase in IO. We continue to favor moderately leveraged debt secured by high quality assets owned by well capitalized and committed sponsors. ■

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