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INSIGHT

VIEWPOINT

CMBS Pro Forma Cashflows

SAGAR PARIKH | DECEMBER 13, 2017

Pro Forma Underwriting

Stuyvesant Town. With a $3BN senior mortgage, it was the largest CMBS conduit loan ever issued and was the bellwether of everything that went wrong during CMBS 1.0. The rent-controlled apartment complex had limited ability to increase rents due to its status as a beneficiary of J-51 tax abatements in New York City. Despite that, the CMBS lenders who underwrote the loan in 2007 assumed that a portion of the units would be converted to market rates and that net operating income (NOI) would increase 300% within four years of the loan's origination date. Unfortunately, not only would the property not come close to reaching those aggressive underwriting targets but the owners of the property would hand the keys of the property back to the lenders within 36 months.

Fast-forward ten years to 2017 and CMBS underwriting standards are not nearly as aggressive as those used during the bullish lending periods of 2006 and 2007. However, some of the assumptions that haunted properties during that time period are starting to creep back into CMBS underwriting. This year, nearly 19% of all conduit loans originated have an underwritten NOI 20% or greater than the loan's most recent actual NOI. For loans with underwritten NOI of 10% or greater than the previous year's NOI, that number jumps to 29%. Both of those levels are the highest for any CMBS vintage since 2007 and leave CMBS investors with higher leverage than what would appear based on the underwritten financials.

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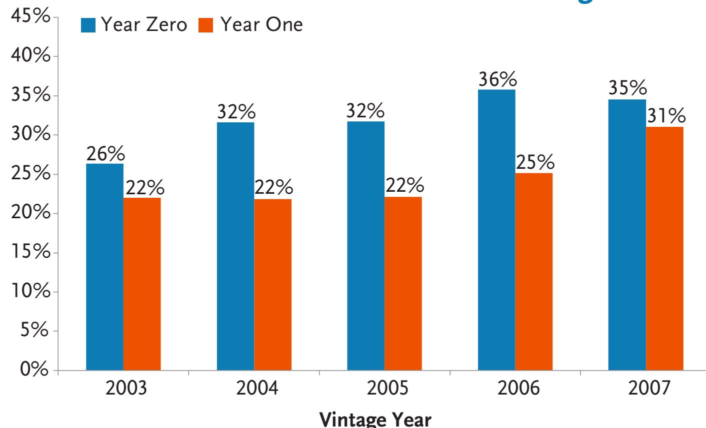
UW NOI vs. MR NOI by Vintage Year*

Vintage Year	<0%	>0%	>10%	>20%	>30%
2010	74.74%	25.26%	10.19%	7.14%	3.89%
2011	49.96%	50.04%	21.35%	10.23%	6.04%
2012	51.68%	48.32%	23.33%	13.44%	8.29%
2013	49.80%	50.20%	19.83%	10.93%	8.47%
2014	39.59%	60.41%	30.15%	18.35%	12.27%
2015	43.26%	56.74%	25.38%	15.93%	10.73%
2016	42.68%	57.32%	25.20%	14.14%	10.14%
2017	37.05%	62.95%	**33.62%**	**21.88%**	**16.31%**

Source: TCW/Intex
*Data excludes loans without historical financials

Percent of Loans with Actual NOI More than 10% Below Underwriting



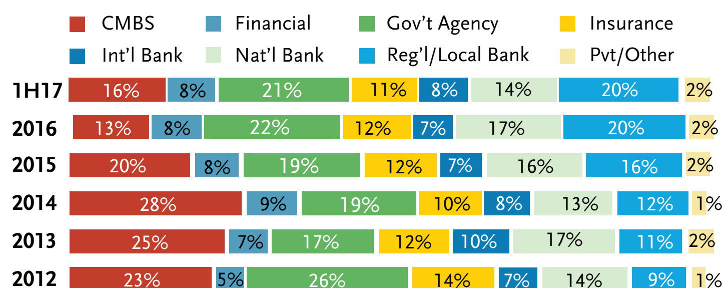
Source: Intex Solutions, Inc., and Wells Fargo

With risk retention beginning in December 2016 and rating agency LTVs lower for 2017 vs. 2016 (thus implying more conservative underwriting), how are issuers able to account for the differences between a property's most recent financial performance and the assumptions of the underwritten financials? A couple of trends used by CMBS issuers involve contributing future contractual rent bumps for a large tenant in either an office or retail building and amortizing those rent bumps into today's underwritten rent. Also, issuers will incorporate rent from a tenant that has signed a lease, but has yet to take physical occupancy in the space. While none of these underwriting assumptions are particularly nefarious, the assumptions create less room for error, especially if financial conditions change quickly and the tenant decides to back out of its letter of intent (LOI).

Part of the reason why CMBS issuers are pushing the envelope in terms of underwriting assumptions is the competitiveness of the overall commercial real estate lending environment. For two consecutive years, CMBS market share within the overall CRE lending universe has remained below 16%. For CMBS lenders to compete, they are forced to incorporate more aggressive underwriting assumptions than an insurance company or a traditional bank lender. Historically, banks and insurance companies have provided lower rates than a CMBS lender, but CMBS originators will typically provide more leverage. In order to keep the UW LTV's low but provide more proceeds based on the properties' existing cashflows, CMBS issuers have been required to be more creative in their assumptions. Thus, while UW LTVs for the 2017 vintage have come down, the basis between the adjusted LTV (which incorporates the most recent net operating income) and underwritten LTV has actually increased in 2017.

CRE Lending Marketshare

CMBS Remains Below 16% of the CRE Lending Marketplace



Source: Morgan Stanley

Basis Between WA Underwritten and Adjusted LTV

Vintage Year	WA UW LTV	WA ADJ LTV	LTV Basis
2010	58.20%	65.27%	7.07%
2011	61.96%	71.82%	9.85%
2012	63.25%	74.97%	11.72%
2013	62.98%	73.72%	10.74%
2014	65.46%	77.60%	12.15%
2015	64.52%	76.59%	12.06%
2016	59.79%	71.22%	11.43%
2017	56.89%	70.18%	13.29%

Source: TCW/Intex

Weighted Average Adjusted LTV – Using the loan's most recent NOI and adjusting it for the senior loan LTV (not just the A-note portion that may be part of a Single-Asset/Single-Borrower Transaction)

One way to identify loans with more aggressive pro forma underwriting is by size. Loans over $75MM tend to be in larger MSAs with stronger sponsors and thus, tend to have significantly more competition from multiple lenders. Large loans (those above $75MM) are significantly more likely to have an underwritten NOI 20% or higher than the previous year's actual NOI. CMBS issuers try to mitigate the risks arising from high pro forma NOI by requiring sponsors to reserve a certain amount of cash up-front for the period it may take for a new tenant to fully occupy the space or by requiring a cash flow sweep if a larger tenant has decided not to renew their lease. These reserve provisions, which decreased significantly from 2004 to 2007, have largely remained in place in 2017, as investors have pushed back against inadequate reserve provisions. Nonetheless, the basis between the underwritten and most recent NOI, as loan size increases, is quite glaring.

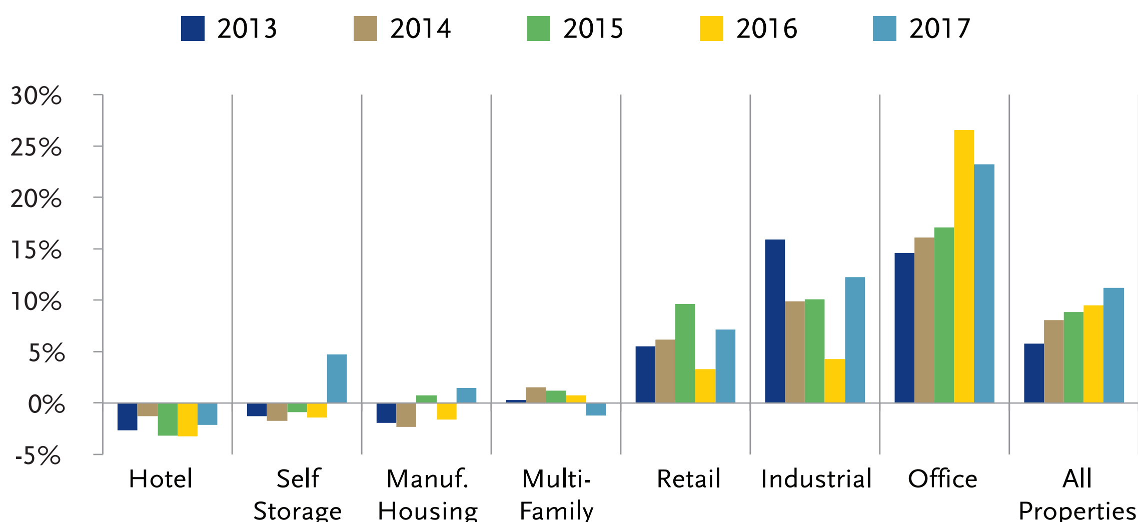
% UW NOI vs. MR NOI by Loan Size

Loan Size	<0%	>0%	>10%	>20%	>30%
<25MM	39.88%	48.00%	22.98%	13.60%	9.11%
>25MM	27.04%	58.31%	32.90%	22.17%	17.25%
>50MM	21.24%	63.56%	34.46%	23.81%	19.98%
>75MM	11.17%	**74.42%**	**47.89%**	**38.28%**	**33.97%**

Source: TCW/Intex

Another distinguishing characteristic between CMBS 1.0 and 2.0 is the lack of pro forma within multi-family properties. In CMBS 1.0, multi-family properties such as Stuyvesant Town, Riverton and the Belnord were rent-controlled properties that were underwritten with the assumption that a certain percentage of the units would convert to market-rate. However, with the economy entering into a recession fairly quickly after origination, none of these properties were able to execute on its business plan and they all moved fairly quickly into special servicing. Today, a majority of the multi-family loans within the CRE space are wrapped by Fannie and Freddie with the GSE-approved originators typically requiring at least 12 months of stabilized occupancy before loans may be contributed to the pool. In this cycle, the vast majority of the pro forma loans have been in office, industrial and retail properties. Office properties in particular have a significantly lower number of tenants than other properties and as a result, the underwriting assumptions for any one particular tenant can have a significant effect on the loan's financials.

% UW NOI vs. MR NOI by Property Type



Source: Wells Fargo/ Intex Solutions

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In the end, CMBS investors must adjust for overly optimistic underwriting assumptions and try to account for pro forma in the loans' property financials. CMBS underwriting practices have not returned to the days of 2006 and 2007 when dark space in a building was incorporated into underwritten NOI or assumptions were made on expected rent increases for certain MSAs. As we move later into the cycle, however, the pool of large sponsors continues to constitute a larger portion of the CMBS universe and exert ever-increasing leverage when it comes to underwriting assumptions. Today, there are fewer loan originators compared to the pre-crisis period and even during the pre-risk retention period of 2014 and 2015. In contributing loans to conduit pools, the CMBS originators have been able to remain somewhat stringent in terms of requiring lease rollover reserves, cash flow sweeps for tenant rollovers and TI/LC (tenant improvements/leasing commission) reserves, but those practices are bound to slip as we move further through the cycle and more lenders enter the marketplace. ■

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