IPF Research Programme 2006-2009

A review of the current state of the UK CMBS market

IPF Research Programme Short Paper Series Paper 12

February 2011

This research was commissioned by the IPF Research Programme 2006–2009

IPF Investment Property Forum

This research was funded and commissioned through the IPF Research Programme 2006–2009.

This programme supports the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high quality analysis on a structured basis. It will enable the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

The programme is funded by a cross-section of 24 businesses, representing key market participants. The IPF gratefully acknowledges the continuing support of the contributing organisations.

IPF Research Programme Short Papers Series

A review of the current state of the UK CMBS market

IPF Research Programme 2006–2009

The IPF Research Programme Short Papers Series has been established to address current issues facing the property investment market in a timely but robust manner.

The aims of the series are:

- **to provide robust information in a short format on specific issues;**
- **to generate and inform debate amongst the IPF membership, the wider property industry and related sectors;**
- **to publish on topical issues in a shorter time-scale than we would normally expect for a more detailed research project, but with equally stringent standards for quality and robustness;**
- **to support the IPF objectives of improving awareness, understanding and efficiency of property as an investment asset class.**

The IPF Short Papers are published in full and downloadable free of charge from the IPF website. For more information on these and other IPF Research Programme outputs contact Sue Forster, IPF Executive Director (sforster@ipf.org.uk) or log on to the IPF web site at www.ipf.org.uk.

IPF Research Programme Short Papers Series

A review of the current state of the UK CMBS market

IPF Research Programme 2006–2009

February 2011

Author

Mark Nichol, *structured finance analyst at BofA Merrill Lynch Global Research, Bank of America Merrill Lynch*

Project Steering Group

Mark Callender, *Schroders*
Peter Clarke, *Recept Consulting*
Philip Cropper, *CBRE Investors*
Louise Ellison, former Research Director, IPF
Alan Patterson, *Axa Investment Management*
Caroline Philips, *Eurohypo*

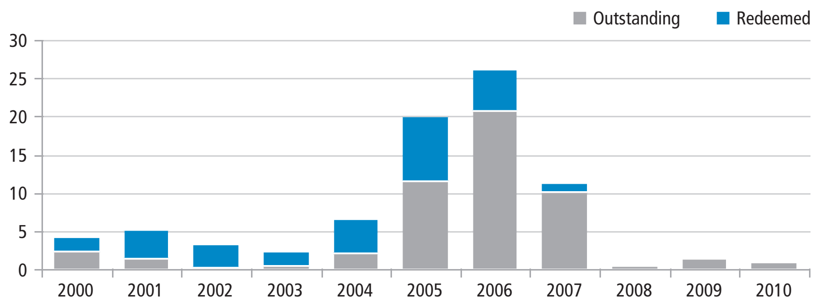
Disclaimer

CMBS in a historical perspective

The commercial mortgage backed securities (CMBS) sector has become a point of interest in the UK among property participants and regulators as a number of CMBS transactions have made the headlines recently. It is important to recognise that CMBS has been around since the early 1990s in the UK and has always represented a small portion of total lending to commercial property. Traditionally, bank lending has provided the bulk of financing to the sector. There is roughly £56bn of CMBS outstanding compared to £250bn of bank loans secured on commercial property in the UK. Therefore, CMBS represents about 18% of outstanding debt in the sector. By comparison, the market share of CMBS is roughly 45% in the US and 10% in continental Europe.

Prior to 2004, much of the CMBS issued in the UK was created by listed property companies and other corporates or used by the government to finance disposals of commercial property and municipal housing. For property companies, CMBS provided a means to borrow directly from the capital markets to finance investments more cheaply, for longer terms, or on a larger scale than banks or more traditional capital markets could provide.

Chart 1: Public issuance of UK CMBS by year (£bn)



Source: Bloomberg, BofA Merrill Lynch Global Research

Since 2005, CMBS issuance increasingly came from investment banks' 'conduit' programmes, which advanced loans to property investors and sold the loans via CMBS. Conduit CMBS issuance brought a shift in the use of CMBS from providing long term financing for governments and property companies to providing shorter term funding for highly geared investors such as property funds, private equity funds and high net worth individuals. CMBS was attractive to borrowers because the interest rate was often lower than on conventional bank debt, owing to the prevailing high demand for CMBS from capital markets investors. Under this model, CMBS issuance boomed in the UK and Europe; three quarters of outstanding CMBS bonds were issued from 2005 to 2007, almost all through conduits.

These bonds were bought largely by the treasury departments of banks, Structured Investment Vehicles (SIVs) and Asset Backed Commercial Paper (ABCP) conduits, which the banks funded but which were treated as being off balance sheet by virtue of them having no claim to the bonds. Thus, these bonds remained within the banking system and, due to the subsequent default of underlying investment vehicles, in effect, many have reverted to being on bank balance sheets.

In 2007, problems with the US subprime market caused a banking liquidity crisis that largely shut securitisation markets in many countries, including the UK. Since H2 2007 most of the commercial property loans that banks securitised in the UK and Europe were not sold to investors but, rather, retained by the banks and used as collateral to obtain liquidity from the Bank of England and the European Central Bank.

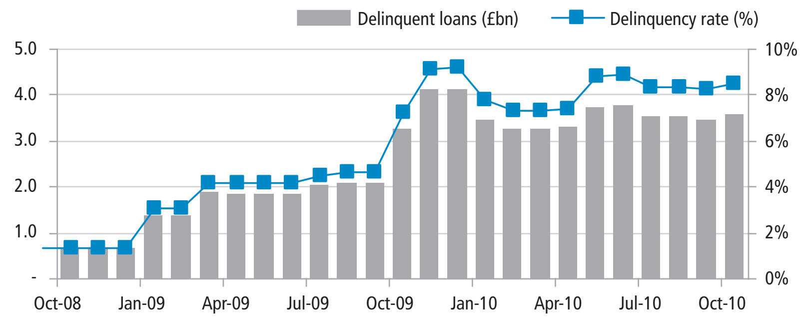
Since 2008, two corporates have used CMBS to raise funding totalling £3bn. Tesco brought four CMBS issues to the market, totalling £2.64bn, backed by rental payments from properties occupied by Tesco. Land Securities issued £360m of CMBS backed by rental payments from a UK government body. The four bond issues had several common characteristics that appealed to institutional investors: they were single tranches with no subordinate debt; they were backed by investment grade credits; carried fixed coupons; and were relatively long dated, with maturity dates ranging from 2027 to 2040. As such, they resembled investment grade corporate bonds and did not represent a true re-opening of the CMBS market, as investors were primarily taking credit risk rather than property risk.

The four bond issues were heavily oversubscribed and we expect there is likely to be more appetite for this type of paper, which offers a yield premium to the corporate with a similar corporate credit exposure. This type of structure was used in the early years of European CMBS issuance and we view such issuance as a positive for attracting interest in the product and, ultimately, restarting the market. The number of companies that are suited to sale and leaseback transactions is limited, however. Likewise, the number of trophy buildings that could be securitised in single asset transactions is also limited.

Performance

In recent years, some commentators and regulators have branded securitisation products as being 'toxic' assets, which contributed to the credit crisis. In this regard, it is important to differentiate between the US and Europe (including the UK). In the US, certain products, such as subprime residential mortgage bonds and Collateralised Debt Obligations (CDOs) created from these bonds, have performed poorly through the credit crisis. The delinquency rate of US subprime loans is currently above 50%. In Europe, however, these same products were not created and the assets backing most securitised products, including CMBS, have performed reasonably well since the crisis. The delinquency rate of CMBS loans in the UK is 6.7% according to Standard & Poor's. Interestingly, the default rate among bank loans backed by UK commercial property was 9.4% as at H1 2010, according to DeMontfort University's Commercial Property Lending Report. This suggests that the commercial property loans that were securitised may be of higher quality on average than the commercial property loans that were not securitised in the UK.

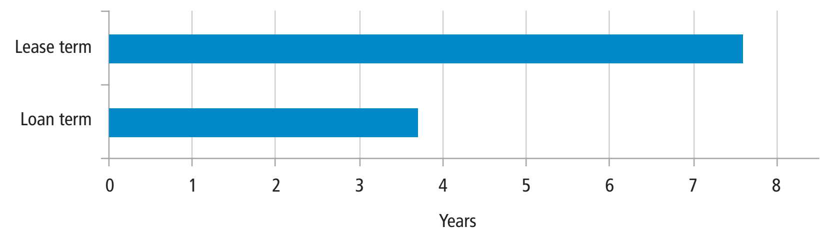
Chart 2: UK CMBS loan delinquencies



Source: Standard & Poor's

Most commonly, UK CMBS loans are hedged to pay fixed interest rates and pay little, if any, amortisation. As such, their debt service requirements do not vary significantly over time. Due to the relatively long lease terms and upward only nature of UK lease rent reviews the rental income backing UK CMBS has proven resilient since the commercial property market turned in 2007. Many loans in UK CMBS were designed to have limited exposure to lease rollover risk.

Chart 3: Lease v loan term for CMBS backed by UK offices, as at issuance



Source: Standard & Poor's

The strength of the income in UK CMBS reflects the generally good quality of the underlying properties. In aggregate, the quality of UK CMBS properties is comparable to or slightly better than that of the properties comprising the IPD index. Over 90% of UK CMBS is backed by standard property types, office, retail, industrial and multi-family. The remainder includes nursing homes, hotels and leisure-related properties. Development loans do not feature in UK CMBS. By contrast, most of NAMA's €81bn portfolio comprises development loans with just 25% expected to be income producing.

Property quality is not the main risk facing CMBS. Rather, the main risk is the high degree of leverage used by borrowers and the lack of refinancing available. Among the loans that came due in the past 12 months, just 8% repaid in full at their maturity dates according to data compiled by Fitch Ratings. In other words, the bullet default rate for European CMBS loans stands at 92%. This figure includes loans that were extended, restructured or did not make the full payment at maturity and were subsequently enforced or worked-out by the special servicer.

The refinancing challenge

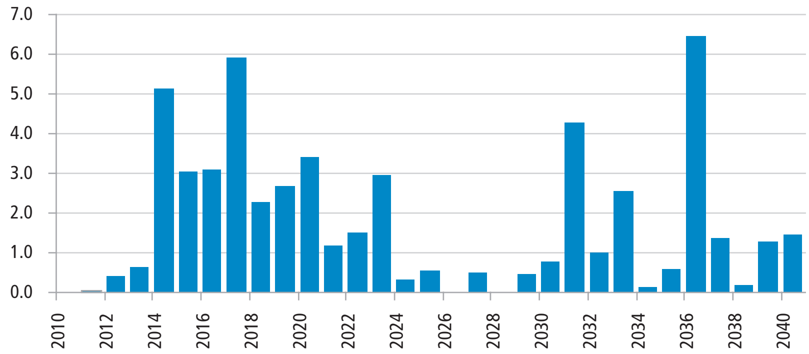
Since 2007, UK commercial property values have fallen sharply, causing loan-to-value ratios (LTVs) to rise, which makes refinancing CMBS loans more challenging. The LTVs of many of the loans originated in 2006 and 2007 are currently above 100%, meaning that many borrowers are in negative equity. As CMBS loans typically do not amortise significantly, in the absence of dramatic capital value appreciation, these high LTVs are likely to persist for some time.

Of the £56bn of UK CMBS bonds outstanding, £27bn is due to be repaid over the next ten years. These bonds are predominantly of the 'conduit' variety, which were issued by investment bank programmes from 2005 to 2007, as described above. Preceding the peak in CMBS bond maturities in 2014, a wave of CMBS loans, totalling £19bn, is due to mature from 2011 to 2014.

This wall of refinancing continues to attract significant attention. However, focussing on loan maturities misses the point that there are implicit extensions built into the loans. As we have seen this year, loans can be extended without necessarily giving any compensation to bondholders. For this reason, without the ability for borrowers/loan servicers to renegotiate it, the maturity profile of the CMBS bonds is arguably more important than that of the loans.

Between 2021 and 2040, roughly £29bn of UK CMBS bonds are due to mature. These bonds are characterised by the longer term debt that was created by listed corporates and government privatisations of property.

Chart 4: Maturity schedule of outstanding UK CMBS bonds (£bn)

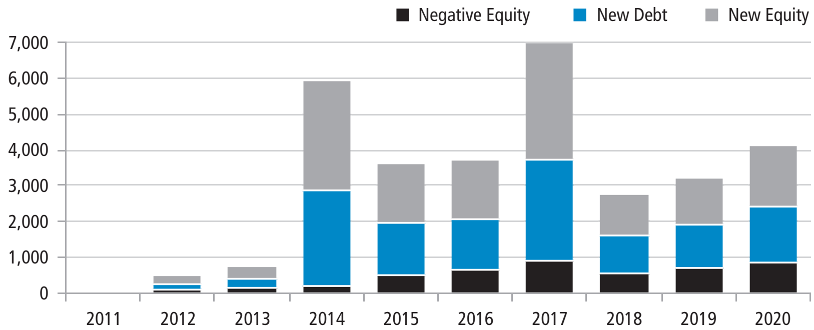


Source: Bloomberg, BofA Merrill Lynch Global Research

Many of the loans originated near the peak of the market will fail to refinance when due and, as a result, we will see a combination of debt restructuring and liquidations of the underlying properties in order to repay bondholders. CMBS structures require repayment to bond holders by the bond maturity date - typically three or more years after the maturity dates of the underlying loans - and so restructurings must conform to this deadline. Extending the bond maturity date is a cumbersome process, requiring the consent of the majority of each class of bondholder. However, we are seeing an increasing number of such restructurings being successfully completed as discussed below.

Debt restructurings may postpone and reduce losses but will not avoid them altogether. Enforcement and forced selling of properties has already begun to occur and more liquidations, administrations and receiverships appear inevitable. We illustrate the scale and timing of potential property disposals and the scale of losses that could result below. Based on current property values, we estimate there is £4.6bn of negative equity in UK CMBS properties. This amount of loss will need to be realised as bond maturity dates approach, unless it can be reduced or postponed via restructurings or rising property values. The £6.2bn of bonds that mature by 2014 could translate into forced selling of £6.8bn of UK property. We would expect to see most of this property come to market in 2012, two years before the peak in bond maturities in 2014. As a result, disposals could put pressure on UK commercial property values from 2012 onwards.

Chart 5: Projected negative equity and re-capitalisation of UK property backing CMBS, by year of bond maturity (£m)



Source: BofA Merrill Lynch Global Research

White Tower sales

One high profile example of a CMBS liquidation is White Tower 2006-3 plc. In 2006, nine London office properties, with a combined valuation of £1.8bn, were refinanced using a £1.45bn loan, corresponding to a LTV of 80.1%. The loan was split into a £1.15bn senior ranking portion and a £300m junior ranking portion. The senior portion was subsequently securitised in five tranches by Société Générale under their 'White Tower' CMBS conduit banner.

The owner of the properties continued to be liable for interest and principal payments on the whole £1.8bn loan amount, which was due to be repaid in October 2009. The CMBS bonds, on the other hand, are due to be repaid in October 2012. The period in between is a typical characteristic of CMBS and is designed to allow time to liquidate the properties, if the loan fails to repay on its maturity date, and repay the bonds by their due date.

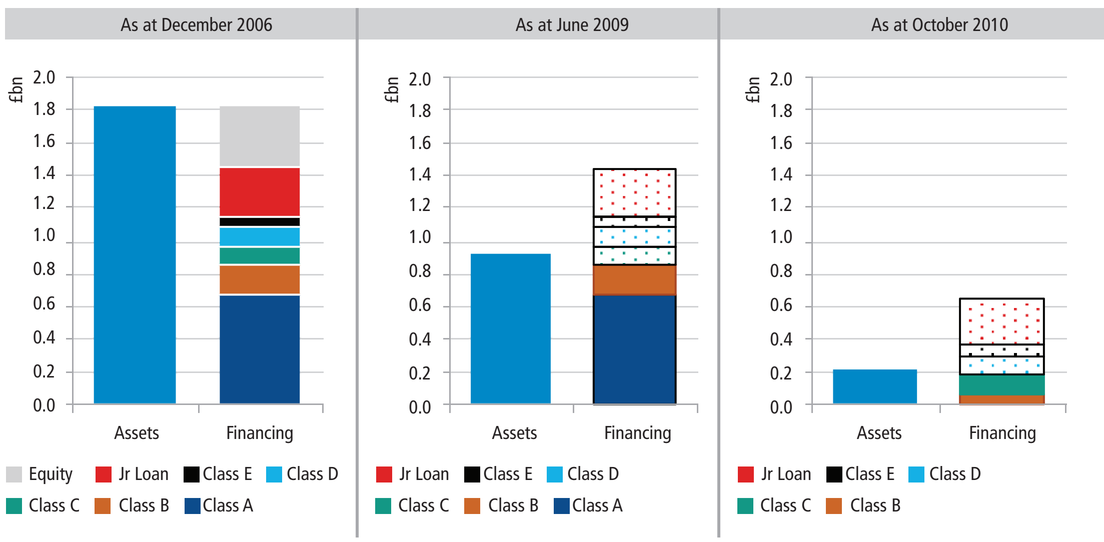
In June 2009, a new valuation revealed the portfolio value had fallen by half to £929m and, consequently, the loan was in breach of its LTV covenant. The owner of the properties failed to cure the default and the loan servicer, acting on behalf of the creditors, accelerated the loan served notice on the borrower.

In October 2009, the loan failed to repay on its maturity date, leaving the special servicer, CBRELS, with the job of disposing of the properties so as to maximise recoveries for the secured creditors. This posed several challenges, such as seizing control of the properties from multiple offshore holding companies without compromising their offshore tax status and an attempt by an unsecured creditor, HMRC, to put the properties into liquidation (that threatened to subordinate the secured creditors), which was successfully blocked by CBRELS.

Finally, to attract the best prices for the properties, CBRELS needed, on the one hand, to avoid the perception of being forced sellers but, on the other, to complete the sales in time to repay the CMBS bonds by their October 2012 maturity date.

To date, eight of the nine properties have been sold and £830m has been repaid to the most senior ranking CMBS bonds. Some losses appear inevitable and are likely to be borne by the junior ranking of the secured lenders, namely the £300m junior loan and the class E bonds, which were originally rated BBB by S&P and Fitch.

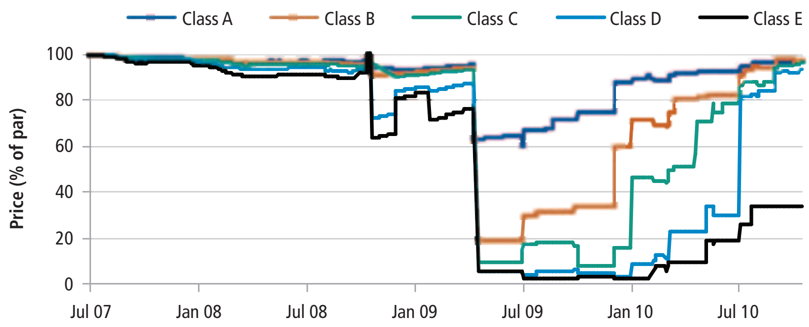
Chart 6: Chronology of White Tower 2006-3 plc property values and indebtedness



Source: Commercial Real Estate Finance Council Europe

The White Tower 2006-3 CMBS bonds have been traded in the secondary market since issuance. Quoted prices have reflected the events described above, as well as general market sentiment.

Chart 7: Price history of White Tower 2006-3 bonds



Source: Markit, BofA Merrill Lynch Global Research

Debt restructuring

As an alternative to enforcement and liquidation, we have begun to see borrowers and bondholders negotiate restructurings of CMBS debt. Typically, this includes an extension of the maturity date for the borrower in exchange for increased coupons and amortisation for the bondholders. In light of the relatively low yields available in the current environment, some bondholders have been willing to grant bond extensions of 1-3 years in exchange for a 50bp to 715bp increase in bond margin.

To date, CMBS bondholders have granted extensions to borrowers in two transactions in the UK, totalling £1.7bn, and one in Germany, totalling €1.2bn. The first UK transaction was The Mall Funding plc, a £1.1bn securitisation of 20 regional shopping centres managed by Capital & Regional. Bondholders agreed to extend the maturity date of the CMBS bonds by three years, from 2014 to 2017, in exchange for a 50bp increase in the interest rate paid on the bonds. The extension is intended to give the company time to sell properties and delever the portfolio.

The second UK CMBS to be extended was Titan Europe 2006-4FS plc, a £600m securitisation backed by 301 Four Seasons Healthcare homes. When the loan struggled to refinance, the bondholders agreed to extend the maturity date of the CMBS bonds by one year, from 2013 to 2014. In exchange, Four Seasons increased the bond margins from 28bp to 375bp over Libor for the senior bonds and from 35bp to 750bp over Libor for the subordinated bonds. The extension is intended to give Four Seasons time to complete a refinancing of the debt.

CMBS 2.0

Where Next?

As the next evolution of CMBS begins to emerge, we suspect some transaction features may not reappear for many years, if ever. For example, super senior Class X tranches and similar features that strip out excess cash at the issuer level have a negative influence on the credit strength of the bonds in our view. Instead, future structures could trap excess cash in a reserve fund to cover anticipated principal deficiencies. Junior debt that sits outside the securitisation has resulted in inter-creditor conflicts in some instances and is likely to be shunned by CMBS investors for some time. Future transactions are also likely to restrict loan sponsors to cancelling any bonds bought in the secondary market, rather than being able to control voting rights. Finally, future issuance is likely to be single jurisdictional, which may offer greater certainty about the timing and success of enforcement than multi-jurisdictional structures.

Investor appetite for new UK CMBS could begin to return as the hunt for yield intensifies in a prolonged low rate environment. However, several obstacles could limit the potential for new issuance.

Challenges to CMBS

Would-be borrowers may be unlikely to choose to fund via CMBS compared to cheaper sources of funding such as covered bonds. Access to Pfandbrief markets currently gives German banks a liquidity advantage over other would-be lenders, including UK banks and CMBS.

Regulatory changes could also create uncertainty for commercial property markets and CMBS. The European Commission's proposed derivatives legislation could force European commercial property companies and funds to collateralise their interest rate swaps on floating rate loans. In Europe, CRE loans are typically floating rate and swapped to fixed in order to hedge the risk of interest rates increasing.

If borrowers were forced to cash collateralise these swaps, the cost of borrowing on a floating rate basis would increase. Chatham Financial estimates that €64.9bn of working capital could be required across EU member states to comply with the legislation.

If the proposed legislation is passed, borrowers may prefer to use fixed rate loans or to hedge via out of the money caps. Fixed rate loans could be conducive for issuing fixed rate CMBS, as is the norm in the US. However, European borrowers have traditionally rejected fixed rate loans due to the prepayment penalties that are incurred if the property is sold and the loan prepaid.

In addition, European and UK regulators have created numerous new regulations targeted specifically at securitised debt products, including CMBS, with little regard for their cumulative effect. These new regulations, as well as changes to IFRS accounting standards, may raise the cost of securitisation and create uncertainty for investors and originators.

Outlook

While CMBS is unlikely to reappear in the same form and volume as we saw in 2007, having some form of securitisation product for commercial real estate debt would provide capital to the sector and help to close the property funding gap. Securitisation could also provide a means for banks to reduce their current holdings of property loans. There is a series of questions that needs to be considered as the market evolves, including:

- Will the capital markets re-engage with real estate as a supplier of debt (other than in the credit linked deals already seen in the market) and, if so, what sort of product will borrowers and lenders require?
- What implications do forthcoming regulatory changes such as Basel III and Solvency II have for the evolution of CMBS?
- Can products be created that differentiate between different levels of risk at the asset level while addressing conflicts between creditors?
- What lessons can be learned from markets outside the UK, including the US and Germany?

Having established the context and key issues facing current CMBS funding, the next IPF Short Paper in this series will begin to address these questions as we look to the future of funding options for this industry.

Printed on recycled paper

Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH

Telephone: 020 7194 7920
Fax: 020 7194 7921
Email: ipfoffice@ipf.org.uk
Web: www.ipf.org.uk