CMBS Commentary:

Wine or Vinegar: How Have 2016 and 2017 Maturing Loans Aged?

February 2016

Authors:

Steve Jellinek | Vice President | steve.jellinek@morningstar.com | +1 267 960-6009

Edward Dittmer | Vice President | edward.dittmer@morningstar.com | +1 267 960-6043

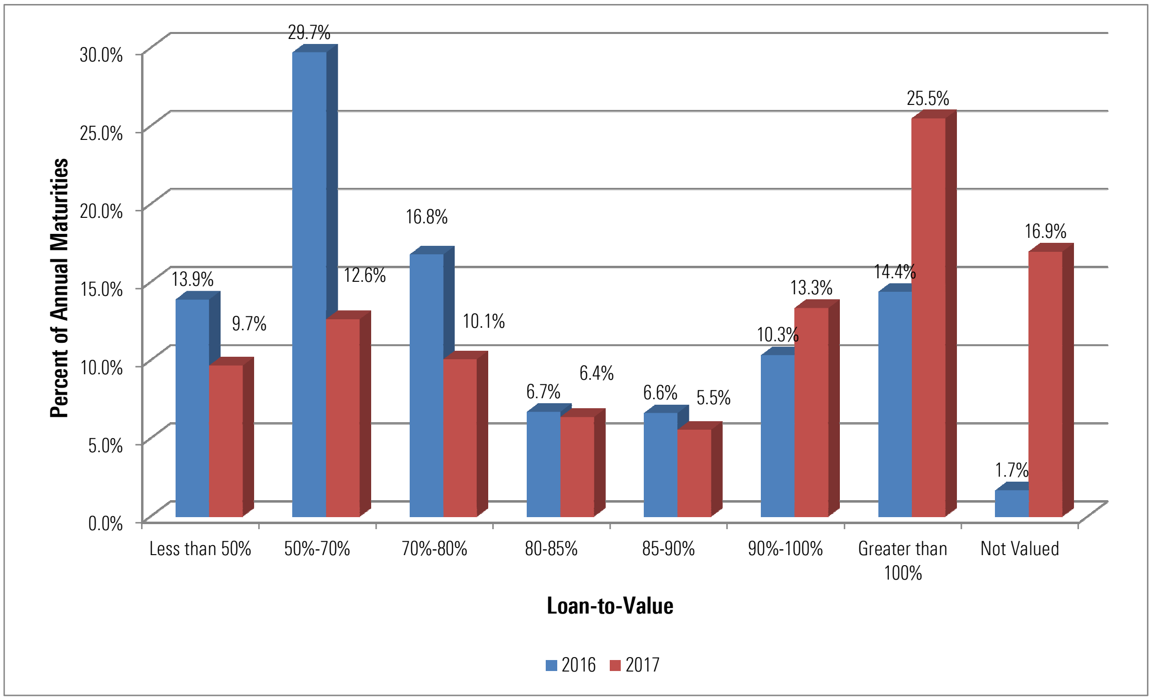
Morningstar Perspective

Morningstar Credit Ratings, LLC projects that paying off commercial mortgage-backed securities loans on time will become progressively more difficult through 2017, as many of the maturing loans were aggressively underwritten near the peak of the market and remain overleveraged. The balance of CMBS loans scheduled to mature throughout 2017 continues to shrink, with $80.49 billion scheduled to mature in 2016 followed by $103.29 billion in 2017, for a two-year total of $183.78 billion, down 17.4% from $222.48 billion at the beginning of 2015. Using loan-to-value ratios (Chart 1), debt yields (Chart 2), and loan proceeds (Chart 3) benchmarks, Morningstar is predicting a decline in the 2016 maturity payoff rate to 65%-70%, while the 2017 payoff rate may slide below 60%, depending on the market's appetite for loans with borderline metrics.

The first year of the so-called three-year maturity wave went well, with the 2015 payoff rate for $60.39 billion of maturing CMBS loans ending at 84.9%, in line with what Morningstar forecast at the end of the first quarter of 2015. The benign interest-rate environment contributed to the high rate of loans paying off at maturity in 2015. In the wake of the decision by Federal Reserve policymakers in December 2015 to raise the benchmark federal-funds rate for the first time in nearly a decade, we factored into our estimates for 2016 and 2017 how an environment of rising interest rates will affect borrowers' ability to refinance. However, the prospects of a March rate increase are fading given market volatility.

In this report, Morningstar excluded certain floating-rate loans because they have not reached their fully extended maturity date, even though that may not be reflected in the servicer data, as reported floating-rate loan maturity dates can be subject to extension options.

Chart 1 - Morningstar Loan-to-Value Ratios: 2016 and 2017 CMBS Maturities



Figures may not add to 100% because of rounding

Source: Morningstar Credit Ratings, LLC

2016 CMBS Maturities

This year marks the beginning of the two-year peak of the maturity wave. As noted, Morningstar expects $80.49 billion of CMBS loans to mature in 2016, which is based on the balance of performing loans that six months earlier faced impending maturity, as CMBS loans typically can pay off without any fees within three to six months of maturity. About $9.22 billion of these loans have already paid off, and we also exclude $312.9 million of loans that have defeased, leaving about $70.95 billion remaining.

Morningstar has valued $69.77 billion, or 98.3%, of the $70.95 billion of active performing loans maturing in 2016. After including the loans that already paid off, we expect the payoff rate to be about 66.5%, as 38% of the loans maturing this year, with a total unpaid principal balance of $26.95 billion, have LTVs greater than 80.0% and may have difficulty refinancing. Based on Morningstar's experience covering most of the CMBS universe, our historical analysis indicates that an 80% LTV threshold is a reliable barometer of a loan's likelihood to successfully pay off on time. However, given the market's appetite for loans with higher leverage, the projected payoff rate would increase to about 75% with an increase in the LTV threshold to 85%. By year of issuance, 2006 has the greatest portion of maturing loans, with 78.7%, and 39.6% of the loans originated in 2006 have LTVs greater than 80.0%.

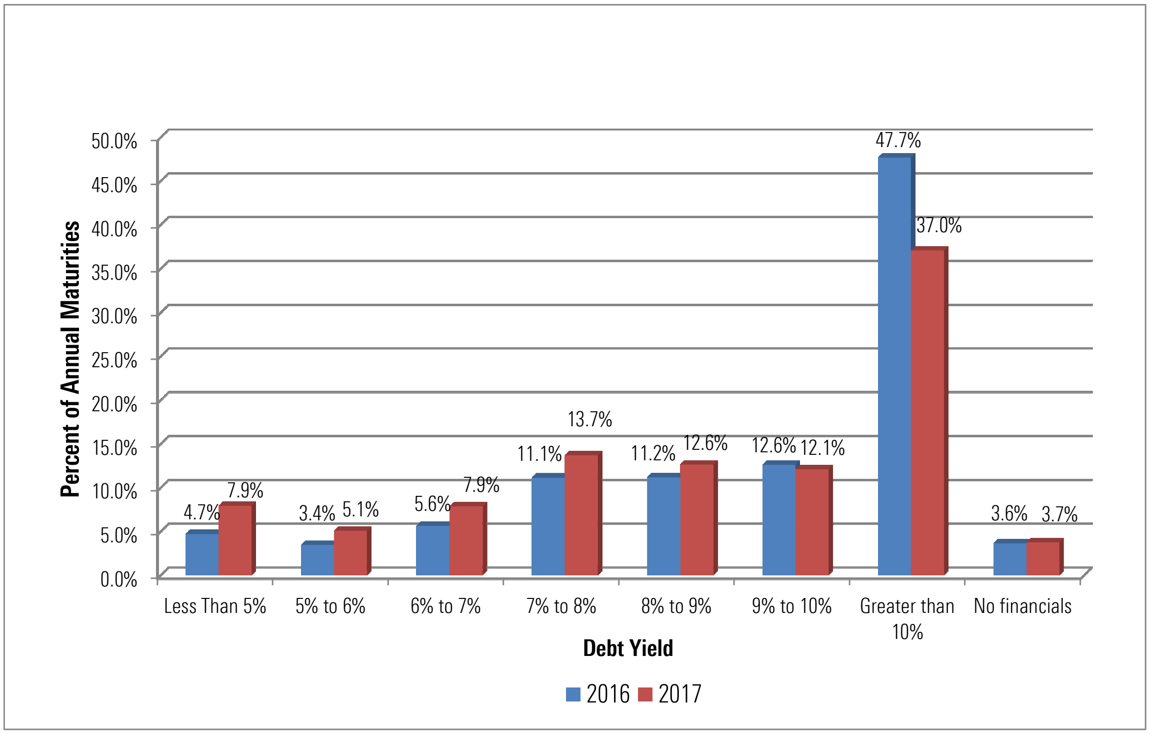
Weaker LTVs among retail and office property loans are a major concern, as the two property types face the greatest exposure with about 30% apiece, by unpaid principal balance, of the 2016 maturities. We project both property types to vie for the lowest payoff rate, as, by combined unpaid principal balance, about 45% of the loans in each property type have LTVs greater than 80%. The $101.5 million Southern Hills Mall, the second-largest loan in Banc of America Commercial Mortgage Trust 2006-3, and the $140 million Plaza America Towers I and II loan (in Greenwich Capital Commercial Funding Corp. Commercial Mortgage Trust 2007-GG9) are examples of maturing retail and office loans whose refinance prospects may be limited by LTVs of more than 100.0% and debt yields less than 8.0%.

Conversely, Morningstar expects loans with healthcare collateral to have a much better payoff rate, as just 6.9% of the 2016-maturing loans backed by healthcare facilities have LTVs greater than 80.0%. To keep that in perspective, the $77.9 million in loans backed by healthcare collateral comprise 0.1% of the balance of maturing loans.

Debt yields (based on the most recent 12-month net cash flow) among 2016 maturities tell a similar story. Based on a debt yield of 9.0%, the expected on-time payoff rate is 63.9%, which is in line with Morningstar's projection based on LTV. However, lowering the debt yield to a less conservative 8.0% increases the successful on-time payoff rate to 75.1%. (We note that the most recently available net cash flow figures, which vary among servicers, may date back as far as 2013.)

Refinance proceeds paint a similar picture, as Morningstar estimates that only 66.8% of 2016 maturities generate enough cash flow needed to successfully refinance the existing debt. This assumes a conservative 5.0% interest rate and a 1.35x debt service coverage ratio. If we lower the interest rate to 4.5%, which is average in today's market, we estimate that 71.9% of loans maturing in 2016 could be refinanced.

Chart 2 - Current Debt Yield: 2016 and 2017 CMBS Maturities



Figures may not add to 100% because of rounding

Source: Morningstar Credit Ratings, LLC

2017 CMBS Maturities

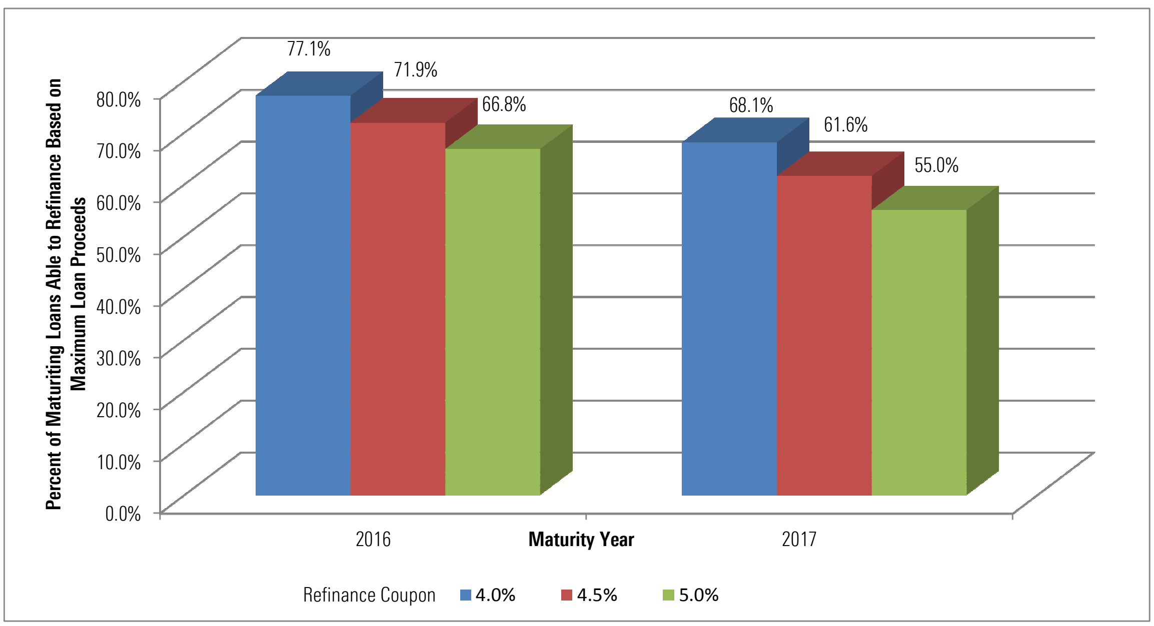
As industry participants know, CMBS new issuance peaked at $228.56 billion in 2007, and Morningstar estimates $103.29 billion in performing CMBS will mature in 2017, 88.0% of which, or $90.85 billion by UPB, was issued in 2007. Not surprisingly, given the underwriting standards and real estate values during that time, 53.5% of the 2007-vintage loans by UPB have LTVs greater than 80%. For 2017, Morningstar has valued approximately 83%, or $85.77 billion by UPB, and projects the on-time payoff rate to drop to less than 60% based on more than 50.7% with LTVs greater than 80.0%. About $7.9 billion of the 2017 maturities, or 7.6%, that were underwritten at the height of the market under the most lax underwriting standards are specially serviced and are unlikely to successfully pay off without a loss.

Looking at 2017 maturities by collateral type, office collateral represents the bulk of 2017-maturing CMBS at just over one third, or $34.91 billion by UPB, while retail, with 29.5% of the 2017 maturities, has the highest exposure to LTVs greater than 80.0%, at 56.1%. The $305 million Riverchase Galleria loan, the largest loan in Banc of America Commercial Mortgage Trust 2006-6, is an example of a full-term interest-only loan maturing in February 2017. The loan is backed by a regional mall near Birmingham, Alabama, whose current LTV and debt yield will make it unlikely that the loan will get refinanced. We added the loan to the Morningstar Watchlist more than six years ago because of deteriorating net cash flow. The loan's February 2012 modification carved out a $90 million B note, which we are modeling as a complete loss.

Looking at the 2017 maturities by debt yield, about 52.9% by balance will successfully pay off based on a debt yield of 9.0%, and using a less conservative 8% debt yield, the on-time payoff rate increases to 65.5%, by balance.

Based on calculated refinance proceeds, our payoff projections are similar, as Morningstar estimates that only 55.0% of 2017 maturities generate enough cash flow needed to successfully refinance the existing debt without additional borrower equity. As with the 2016 maturities, this assumes a conservative 5.0% interest rate and a 1.35x debt service coverage ratio. If we lower the interest rate to 4.5%, we estimate that 61.6% of loans maturing in 2017 could be refinanced without the borrower injecting additional capital.

Chart 3 – Effect of Change in Debt Constant on Maximum Loan Proceeds at 1.35x Debt Service Coverage Ratio



Source: Morningstar Credit Ratings, LLC

Morningstar's Bottom Line

While the payoff rate for 2015 showed impressive refinance demand for maturing loans, it will not be possible to refinance many aggressively leveraged loans made between 2005 and 2007 that haven't achieved the net cash flow assumptions made at origination. LTV and debt yield are reasonable barometers in maturity analysis, but the ability of loans with higher LTVs to refinance is also subject to debt service coverage ratio, amortization, and lease expiration risk. Beyond individual property performance, factors such as capitalization rates and specific real estate market trends also will influence a loan's refinance prospects.

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