CMBS explosion

story by zilla efrat

There appears little but the Australian market's limited size to hold back growth as CMBS continue to prove their worth by delivering cheaper and longer-term funding for listed property trusts. Forum Magazine examines trends in structures, execution, leverage and ratings.

The domestic commercial mortgage-backed securities (CMBS) market is well on its way to achieving a record breaking year in 2006. Towards the end of October, new CMBS issuance in Australia had already topped A$3 billion (US$2.3 billion), and is set to power past a previous record of A$3.1 billion set for the year in 2002.

Similarly, at the time of going to press, CMBS markets in both the US and Europe appeared likely to break through the heights they reached in 2005 of around US$170 billion and euro44 billion (US$56 billion) respectively.

Like others, Moody's Investors Service (Moody's) vice president and senior analyst, Paul Ovnerud-Potter, attributes the growth of CMBS in Australia to a solidly performing domestic commercial property market, which has a low rate of defaults and which isn't expected to deteriorate much in the near future.

He believes the growth has mainly come from the refinancing of earlier programs as issuers acquire additional assets and from tap issues as ever-acquisitive listed property trusts (LPTs) use their existing programs to raise more debt following new property purchases or redevelopments.

But, according to Standard & Poor's (S&P), only two of this year's transactions have involved new participants to the CMBS universe, with the bulk of the activity – over 80 per cent – coming from tap issues, refinancings and restructures from existing sponsors.

Tap dancing

S&P also notes that the frequency of CMBS issuers returning to the markets with tap issues appears to be increasing, with the likes of Australand Finance, Macquarie Office Finance, Quay 62 (supported by AMP Wholesale Funds – retail and office) and Centro, among others, all coming back for more, sometimes repeatedly.

Tap issues are popular because they are simple to execute and cost less than new programs. They also have typically had low overall gearing levels, which enables issuers to access tranches further down the rating scale and to take advantage of current, attractive pricing levels.

Mark Gleeson, general manager of corporate finance at Australand, says a tap issue helped his company avoid further costs when it needed to raise more money. "Investors are used to it. They have done all the credit work already and have assessed the borrower," he says.

Similarly, St.George Bank (St.George)'s head of customer securitisation, Michael Auer, adds: "In the early days of CMBS, rating agencies weren't comfortable with tap issues but a lot of work has now been done and they are also more comfortable with them."

He adds: "Taps allow issuers to gear their growth as values rise, or as they acquire new properties. Certain types of issuers also need the flexibility of being regular issuers and they get this from tap issues."

Nonetheless, tap transactions appear to be a peculiarity of the Australian CMBS market, largely because it is dominated by LPTs which generally like to act alone and are always in search of greater flexibility.

According to Moody's Ovnerud-Potter, this is in contrast to the US, where most CMBS transactions are multi-borrower programs, and even to Europe, where about half are. But things could be about to change.

"We haven't seen much multi-borrower CMBS in the Australian market, but we believe we will see more of them, possibly in 2007," comments Ovnerud-Potter. "That said, I still expect the market to remain dominated by issues from single borrowers, especially in the LPT sector, as they move to refinance their debts and use a combination of CMBS and other sources to do this."

St.George's Auer adds that some single issuers get a better result than they would as part of a multi-borrower program.

"To date, Australian credit managers have favoured detailed research of a specific LPT issuer rather than blended pools similar to collateralised debt obligations (CDOs) structures," he says.

Likewise, S&P director of structured finance ratings, Peter Eastham, says: "We are starting to see some interest in multi-borrower vehicles but this is limited by the size of the Australian market.

We are already seeing the concept talked about in Asia, but for CMBS conduits to work you need scale and volume and good quality issuance. The Australian market just isn't there yet at this stage, but we still expect to see a couple of these issues coming through."

Eastham adds: "Much of the commercial real estate market is controlled by the major banks and they aren't particularly looking to move their loans into this type of vehicle. There are, however, some potential drivers that could influence the banks to take these loans off their balance sheets.

"One is Basel II. This is because commercial real estate attracts a higher risk weighting under it. Another could be a poorer performance from the residential real estate market. But I don't expect this to happen in the Australian market anytime soon. The Aussie residential mortgage-backed securities (RMBS) market is one of the best performing in the world. It's very stable."

However, Macquarie Real Estate (Macquarie) treasurer, Stuart King, isn't that optimistic that multi-borrower programs in the commercial property space are about take off any time soon in Australia.

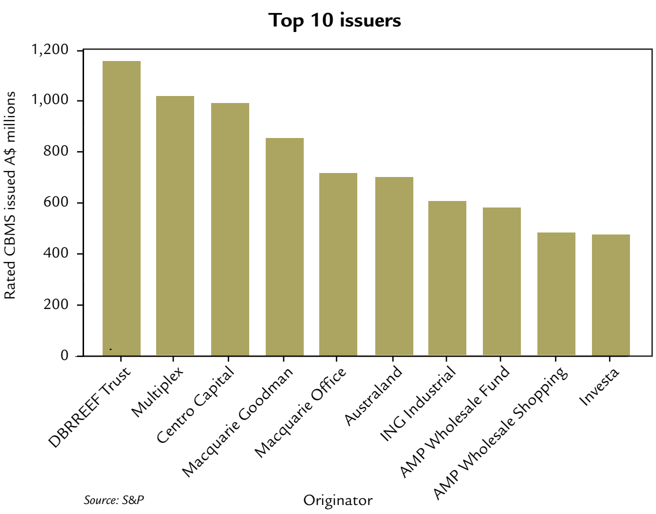
"When it comes to larger property issues, whether listed or unlisted, there isn't a natural fit for the multi-borrower structure in Australia. Some banks and issuers have looked at this, but the pricing or flexibility isn't there for CMBS versus borrowers going at it alone. It's the nature of the CMBS product which compartmentalises the structure" he says.

If anything, many pundits believe that any momentum in multi-borrower programs will come from the small to medium enterprise (SME) sector and the loans this sector has sitting on banks' books, most of which hasn't historically been securitised.

"We are seeing more interest in the space. SMEs are on the radar screen," says S&P's Eastham, who

A critical issue facing the CMBS market both here and abroad is the significant cap rate compression.

Paul Ovnerud-Potter, Moody's Investors Services



points out that some transactions in this area have already been done – for example, by Commonwealth Bank of Australia through a credit swap with the Medallion Trust in 2003.

St.George's Auer adds: "We've heard that several issuers are working on small ticket transactions or small ticket warehouses which are likely to be announced in 2007."

He also agrees that Basel II could underpin growth in this area because lenders will get more capital relief by selling small ticket CMBS than through RMBS issues. "Besides, building societies, for example, are only allowed limited borrowings on their balance sheets, so if they are writing this business they will have limited capacity to carry it. There will be other non-financial institution originators wanting to get into this market as well."

However, Satish Chand, director of National Australia Bank (NAB)'s securitisation division, cautions that any growth in this area will also depend on the ability of non-banks to develop origination, service capacity and track records.

What is big in the US, starting to take off in Europe, but hasn't yet been seen in Australia are commercial real estate CDOs.

"Commercial real estate CDOs are getting some airtime in the US and Europe. This is an interesting sector. Here, the market is looking to arbitrage real estate with CDO technology," says S&P's Eastham.

But he doesn't expect to see huge activity in this area in Australia. "You need the scale to make it effective. The ingredient that would make it efficient just isn't here in Australia," he says.

Unlisted versus listed

Like others, he has also picked up an increase in interest in CMBS from the unlisted sector, despite the fact that in Australia CMBS backed by unlisted property trusts tend to trade at discounts to those backed by their listed counterparts.

These types of CMBS also don't enjoy the same secondary market liquidity that LPT-backed CMBS do, mainly because of the differences in the levels of ongoing disclosure which investors can analyse.

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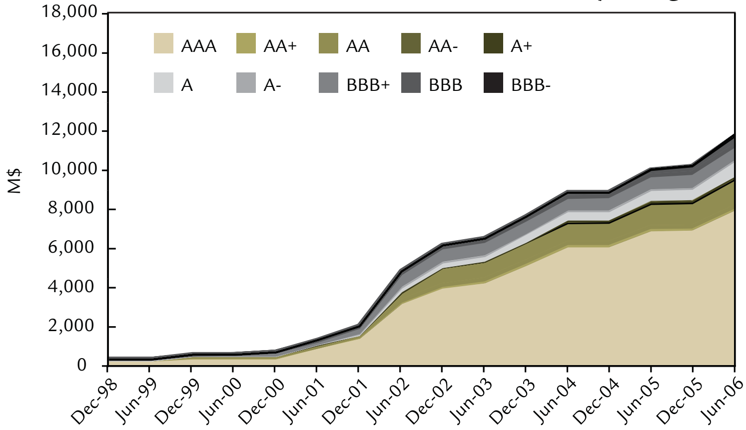
Australian cumulative CMBS issuance by rating



Source: S&P

"There are only one or two unlisted syndicates that access the CMBS market. And, there are many more out there that haven't," says S&P's Eastham.

But he believes that although accommodation hotels haven't been active in this market in Australia, this could change in the future.

It's Australia's fast growing super funds, bolstered by compulsory superannuation contributions and strong returns in recent years, that are tipped by many to drive the future growth in unlisted wholesale property vehicles. Many are looking for ways to ensure their allocation to property gets fully invested and to increasingly diversify their property investments.

"These wholesale vehicles appeal to institutional investors because they give them a closer ownership of properties than LPTs. Listed vehicles may have thousands of shareholders, but there may only be 15 to 20 investors in a wholesale vehicle. They can also develop a relationship with the sponsor or manager," says St.George's Auer.

NAB's Chand also expects to see more growth from the unlisted market, "not so much in 2006, but in the third and fourth quarters of 2007", bolstered by the strength of the underlying commercial property market.

He comments: "Many of the unlisted issuers are outgrowing their existing financing mechanisms and are becoming more sophisticated. They will require more capital to fund their activities and will look to diversify from their existing sources. In the pricing sense, CMBS is favourable compared with bank debt."

When it comes to larger property issues, whether listed or unlisted, there isn't a natural fit for the multi-borrower structure in Australia.

Stuart King, Macquarie Real Estate

Chand adds: "It's a question of the scale of their acquisitions. And, some will reach a level of mass that makes CMBS more attractive."

Although strong growth from the unlisted sector is likely, Macqaurie's King says the primary driver of growth in the CMBS market will remain the listed sector.

"Unlisted issuers are typically smaller than listed. They tend to drive gearing a bit harder. That isn't as good in CMBS and they would need to issue lower rated tranches, for example, double B and lower. That doesn't stack up for the issuer or the investor," he says.

"Smaller unlisted issuers need flexibility, but the CMBS market doesn't offer that level of flexibility and they may find the bank debt market more attractive."

Lengthening tenor

Be that as it may, the experts agree that the trend in CMBS will always be towards greater flexibility in how issuers manage their debt programs, particularly as they get more sophisticated. One area in which this is likely to be felt is tenor.

NAB's Chand says: "Issuers are demanding longer tenor. From an investor perspective, this provides greater opportunities for yield. It also enables them to build a relationship with the issuer."

Likewise, in the future, Macquarie's King expects to see longer-dated issues beyond three to five years. In the US market, for example, the standard tenor is usually seven to 10 years, driven by investors

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AAA

AA+ AA-

DUEL RATINGS

It won't happen overnight, but it will happen. Market experts expects commercial mortgage-backed securities (CMBS) issues in Australia to be increasingly rated by more than one ratings agency.

For historical and other reasons, Standard & Poor's (S&P) has been the dominant player when it comes to rating CMBS in Australia. It has rated just about every program although a small number have also been rated by either Moody's Investors Service (Moody's) or Fitch.

S&P director of structured finance ratings, Peter Eastham, says this is pretty much the case for S&P across all asset classes. He attributes his organisation's dominance to the size of its team and its depth of experience in the market.

"The use of ratings agencies is investor driven and very much depends on what investors want," he says.

Nonetheless, Australia appears to be one of the few markets in the world that has so many singly-rated transactions. However, some market experts believe this will change in the future.

Macquarie Real Estate (Macquarie) treasurer Stuart King observes: "There's been a fair amount of talk about Moody's and Fitch moving more into this market. It's starting to happen – there aren't any big leaps, but I do think it will change slowly."

One factor that could change the situation is the increasing globalisation of the commercial property market. Overseas investors are used to, and like to see, more than one rating of an issue. And, as local issuers go offshore, they will find it common to have two ratings of an issue, and sometimes even three.

Another is a new analysis model, called the MoRE model, which Moody's is starting to apply to Australian CMBS.

Moody's vice president and senior analyst, Paul Ovnerud-Potter, says Moody's coverage of CMBS in Australia is far lower than it is globally. "We are certainly keen to be more involved in the market.

We have some runs on the board already and we are receiving more inquiries from issuers and bankers," he says.

"But we hope that the MoRE model will provide us with a point of differentiation. European investors will be familiar with the model."

He adds that the model has the advantages of greater accuracy, flexibility, timeliness and consistency across deals. "It's more accurate because we've moved from old school static analysis and because it models cash flows more accurately. It also allows us greater flexibility to respond if issuers chop and change their structure."

But Ovnerud-Potter cautions: "We are not a rubber stamp of S&P. We have a different approach to analysis and could reach a different opinion. In CMBS, it might be that we are a little less conservative in some areas and perhaps more conservative about certain structural features."

Christine Hickman, director of commercial property securitisation at Australia and New Zealand Banking Group (ANZ), observes: "Both Moody's and Fitch are working to obtain market share in CMBS. Both have capability in the product and are supported by strong and experienced teams offshore. Their success will be partly driven by acceptance of domestic investors in their ratings, potentially standalone from S&P.

"We are more likely to see a second agency on large or more complex structures. The value of their presence is in attracting a greater level of offshore interest. Another obvious benefit for the CMBS market is that increased competition between the agencies should drive down the cost of obtaining a rating, therefore maintaining the cost effectiveness for issuers in accessing the CMBS market."

For his part, Macquarie's King believes that having more than one rating agency on a deal could make the issue more expensive, which could force some issuers to look at other products when raising finance.

In addition, he notes that any change will require a change in investors' mandates – for example, many mandates only allow the purchase of S&P rated issues.

He also believes that in Australia, until we see a change in investor mandates, an S&P rating will be required on all large issues while in the future Moody's and Fitch may be able to be used as sole rater of small issues.

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who will accept lower spreads for longer tenors. "To accommodate longer tenors in Australia, we may also see a re-rating of longer-dated issues," he says.

He adds that another way to boost flexibility will be through a greater use of prepayment. "This isn't typically used. Macquarie Office Trust has used this twice and we expect to see it used more often."

Real estate goes global

One of the most significant trends issuers and investors are mindful of is the increasingly globalised nature of real estate, which has some key implications for issuance of CMBS. As LPTs run out of local opportunities, they are increasingly looking offshore for new prospects.

According to S&P's Eastham, LPTs are buying property in the US, increasingly looking to Europe and more will look to Asia in the future. "But the trend is to be debt financed in the currency the property is held and in that market," he says.

Ovnerud-Potter at Moody's notes that this globalisation is changing the risk profile of LPTs which in turn may affect the rating agencies' views on LPTs.

And, while commercial property investors increasingly scour the globe for opportunities, their international counterparts are scrutinising the Australian market more closely.

Macquarie's King notes: "International investors are getting to know Australia. The LPT market here is more established by world standards. In addition, Australian issuers and banks have been marketing themselves more offshore. There's more of an education push overseas."

He adds that as issuers become more globally oriented, the market will have to become more accepting of multi-jurisdictional holdings of property within CMBS.

Indeed, Ovnerud-Potter notes that in Europe there's an increasing trend towards pan-European deals. "They have been set up in London and then have spread across Europe."

Leverage and cap rates

Many market participants note that leverage creep in CMBS is another consistent theme across global CMBS markets.

Macquarie's King says there is a greater acceptance of lower-rated tranches as investors hunt for more yield. They also now have longer trading histories to examine and are comforted by Australia's low default rate. "Before investors were willing to go to single A-. Now they are willing to look at triple B-. This is because their mandates are changing," he says.

Similarly, S&P's Eastham observes: "A few years ago most issues were triple A transactions, but a number of new issuers have entered the market and are doing triple B or triple B- programs. Leverage used to be at a low 30 per cent, but it's now trending to 40 per cent and even higher, although we are not yet approaching the levels of 50 per cent plus seen in the US."

He attributes the upward trend to equity markets becoming more comfortable with leverage, which in turn has encouraged LPTs to increase theirs.

However, Eastham notes that in Australia we aren't seeing much of the sub-investment grade issuance being seen in the US and Europe.

He believes that sub-investment grade issues could start to emerge as issuers look for more leverage, but he doesn't expect there to be many of these.

"You get into situations where single B grade investors want to sit at the table to protect their equity. Single B grade investors are more hands on. If things go wrong, they want to be able to protect themselves," he says.

Moody's Ovnerud-Potter adds that a critical issue facing the CMBS market both here and abroad is the significant cap rate compression. This situation, bolstered by the sheer weight of money chasing property deals in a market that has limited supply, has certainly helped commercial property investors over the past 18 months.

He says: "Property values have been trending up on paper because of cap rate compression, but it seems unlikely that cap rates can go much further. If cash flows from properties don't improve, one could argue that property values may be close to peaking."

Christine Hickman, director of commercial property securitisation at Australia & New Zealand Banking Group, observes that despite a strongly performing property market, the performance of the CMBS market will depend on how it stacks up against competing sources of funds from say, bank debt, vanilla corporate bonds (domestic and offshore) and increasingly the US private placement market, both from a pricing point of view as well as flexibility.

"There is a great deal of liquidity chasing property finance opportunities and CMBS needs to remain competitive from an all-in cost of funds perspective to ensure that holders of commercial property continue to securitise their assets," she says.

Maccquarie's King adds: "There's no immediate threat. But as with many things, there's a price/flexibility trade off. While improving, CMBS are not the most flexible vehicles, but they have the lowest cost. As long as they can maintain this, they will keep their place."

That said, St.George's Auer notes that the market keeps evolving and some players have had the ability to source funds through their corporate structure as well as CMBS in managing their costs and retaining desired flexibility.

"They are going for commercial paper, corporate bonds or bank debt," he says. "There's a lot of competition for funding out there."