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CMBS Outlook Finds Conditions Are Bad and Getting Worse for Office, Retail and Hotel Sectors

Deteriorating CMBS Loan Performance Indicates Worst May Not Be Over

Judging from the latest analysis coming out on the commercial mortgage-backed securities (CMBS) market, the worst may be yet to come for commercial real estate.

Recent reports issued by Deutsche Bank, DBRS and Fitch Ratings find that commercial real estate fundamentals have dramatically weakened across most major property segments and markets, with some starting to reach the depressed levels of the last major recession in the early 1990s.

And as conditions worsen, borrowers and workout specialist may have fewer and fewer options, the reports warn, which could further depress the industry.

Richard Parkus, head of CMBS Research at Deutsche Bank, projected in his firm's commercial real estate outlook last month that property prices are expected to decline 35% to 45% (or more) overall during this recession. That would exceed the sale price declines seen in the early 1990s. Parkus added that declines in rental and vacancy rates may also approach levels of the early 1990s.

CMBS collateral performance are currently deteriorating at a historically fast pace and Parkus predicted the total delinquency rate could likely to exceed 3.5% by year-end. That is one of the highest estimates that have been projected by CMBS analysts. Worse still, Parkus added, it could go as high as 6% by 2010. The peak delinquency rates in early 1990s were 6% to 7%.

CRE at a Precipice
By far the greatest risk facing CMBS loans right now is maturity default/extension risk, not term default risk, Parkus of Deutsch Bank said.

A large percentage of CMBS loans made in 2005-2008 may not qualify for refinancing without substantial equity injections due to much tighter underwriting standards, massive price declines and declining cash flow.

Multifamily loan performance has been deteriorating at a dramatic pace, Parkus said, with Midwestern "rust-belt" states plus Florida, Georgia and Texas among the worst performing markets. Interestingly, California and Arizona, ground zero for residential mortgage problems, continue to experience very low multifamily delinquencies.

Parkus also noted that the deterioration of office properties values are beginning to accelerate due to job cuts. "We expect office to be one of the hardest hit property segments," Parkus said.

Parkus noted what happened with 1540 Broadway in New York. Macklowe Properties purchased the office building in Time Square two years ago from Equity Office Properties for $1,080 per square foot.

Last month, CBRE Richard Ellis Investors purchased the building for $403 per square foot -- an almost 63% price decline in two years.

Retail CMBS Loss Severities To Climb
Meanwhile, Fitch Ratings put out a particularly bleak outlook for retail loan performance, projecting that

loss severities on retail loans are likely to trend upward for the next several years as defaults on retail loans increase.

Exacerbated by declining consumer spending and the shrinking U.S. economy, retail vacancies will likely increase to new highs as bankruptcies, store closings and retail consolidation continues, the bond rating agency said.

Consumer spending has declined 4.3% as of year-end 2008. That contrasts with the Internet-bubble reduced recession of 2002 and 2003 when consumer spending remained positive.

Retail delinquencies account for $1.7 billion of the $6.2 billion total delinquencies in the Fitch Loan Delinquency Index. The Loan Delinquency Index across all property types is 1.28%; with 1.17% of all retail loans within the index currently delinquent. Fitch expects defaults in the retail sector to contribute a greater percentage of the index into 2010.

Specifically, Fitch said it expects losses on retail loans may increase as much as 34% to 60% from the 5-year cumulative average of 44% for current defaults.

"Increased vacancies in the retail sector will lead to longer resolution times as it will take longer to re-tenant space which will ultimately result in higher losses," said Mary MacNeill, managing director of Fitch Ratings.

Hotel CMBS Loan Performance Deteriorating Rapidly

In a report issued on hotel loans held in commercial mortgage-backed securities by DBRS, the bond rating agency noted that, in a declining economy, commercial real estate investors are seeking long-term leases, low tenant rollover, low expense ratios and the ability to pass along increasing operating expense to tenants. Unfortunately, hotel properties offer none of these features.

"News coming out of the hotel market is, quite simply, not good. Well, bad actually. No, make that terrifying," the bond rating agency said. "Predicting hotel performance over the next 12 to 18 months is like juggling chainsaws while riding a unicycle."

Most informed market participants seem to be gathering consensus around a high single-digit percentage decrease for revenue per available room (RevPAR). Given the apparent inability for most individuals to grasp just how bad the economy is and how bad it will get, it would not be surprising to see decline in RevPAR by well more than 10% in 2009, DBRS said.

Options Narrowing

As CMBS loan delinquencies climb, Parkus of Deutsch Bank said, the options available for borrowers will likely start to narrow.

As CMBS special servicers are appraised out of their controlling class positions over the next two years, they may have less incentive to extend maturing loan, Parkus said. In addition, senior bondholders are becoming much more activist against extensions.

"We expect this conflict to intensify significantly over time, bringing the threat of legal action against special servicers that practice widespread extensions," Parkus said.

Fitch Ratings also said special servicers may need to explore several different options to maximize recoveries. For example, with single-tenant retail, spaces can be marketed to non-traditional entertainment tenants. Conversely, they can also be subdivided in order to attract smaller tenants. Large vacant mall locations, such as those left vacant by Steve & Barry's or Macys, typically find more interest by subdividing the space or even selling the space back to the mall operator for redevelopment.

Barring such options, special servicers could be more likely to foreclose on properties as borrowers become unable to fund operating shortfalls due to the loss of tenants, Fitch Ratings said.

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