



# Merganser Investment Memorandum

## CMBS Extension Risk: Timing is Everything

The commercial real estate (CRE) market has been battered by repeated alarmist headlines over the past 12 months. Unfortunately, there is plenty of data to corroborate the stories – vacancies are increasing, rents are decreasing and delinquencies are building. What is missing, however, is a thoughtful connection to the mortgage debt that supports a quarter of the CRE debt market – commercial mortgage backed securities (CMBS). Negative real estate fundamentals impact the different tranches of CMBS deals in unique, and often surprising, ways. While our pessimism about the prospects in commercial real estate continues to swell, we are finding many attractive opportunities among the bid list carnage in the secondary market.

### Market Fundamentals

CMBS delinquencies have been increasing significantly in the past few months. Factors driving this increase include:

- Aggressive underwriting that led to an excess of credit availability
- High levels of unemployment
- An overall capital constrained market

While CMBS delinquencies have been increasing at a rapid pace, the absolute level seems modest compared to other fixed income sectors. Exhibit 1 compares CMBS to credit card loans, prime residential mortgages and subprime residential mortgages. When comparing subordination levels, it is important to note that not all AAA rated CMBS tranches are created equally. The AJ tranche typically has 11-14% credit support. This is the most junior AAA class. The AM class, also rated AAA, has credit support of 20%. All of the AAA classes senior to the AM, known as super senior or dupers, have credit enhancement of 30%. Clearly, the rating

agencies made a lot of mistakes across structured product markets, but the additional credit support in AAA CMBS provides a substantial buffer against future losses. CMBS has the attractive combination of the lowest delinquency pipeline and among the highest credit support levels. This leads to a delinquency coverage ratio, defined simply as original credit support divided by the current delinquency pipeline, that is well into the double digits, as shown in Exhibit 1. A high delinquency coverage ratio implies that the deal was underwritten with enough credit support to withstand a writedown of the entire current delinquency pipeline.

When confronted with these facts, investors are compelled to wonder why yields on AAA super senior CMBS securities range from 300 basis points to over 1,000 basis points more than Treasuries. It would be naïve to assume that the market dislocation is the only reason for the high and disperse yields. A quick overview of CMBS structures will help uncover the truth.

### CMBS Structures

Most commercial mortgage loans are either five or ten year balloon loans. This means that commercial mortgage securitizations are heavily weighted toward the five and ten year average life tranches. While transactions can differ significantly due to loan compositions, the allocation of principal to the different tranches as shown in Exhibit 2 is common.

Average Life	Tranches Typically Represented	% of Deal Market Value
3	A1	5%
5	A2	15%
7	A3	5%
10	A4, AM, AJ, All Subs	75%

Source: Bloomberg

The CMBS structure is sequential in priority, which means that the A1 tranche receives all principal payments first and must be paid off before the A2 tranche receives any principal payments. The A1 tranche is typically paid off by amortizing principal, the A2 tranche is paid off by five year loans, the A3 tranche is paid off by seven year loans and the bulk of the deal is paid off by ten year loans. Losses are applied to the most

	CMBS	ABS: Credit Cards	RMBS: Prime	RMBS: Subprime
30+ Delinquencies	2%	4%	15%	40%
Typical Original AAA Credit Support	20-30%	12-20%	5-20%	15-25%
Indicative Delinquency Coverage Range	10-15x	3-5x	0-3x	0-1x

Sources: Bloomberg, Intex, Fitch

subordinate class or the lowest rated tranches until the only remaining classes are the most enhanced AAA tranches (A1-A4, the super senior). At this point losses become pro rata, which means they will reduce the principal of each remaining tranche in proportion to their size. These details are important for a few reasons. The A1 tranche not only has 30% credit support, it also has payment priority over the other 30% tranches (A2-A4). This means that all principal returned to the trust pays the A1 class first; including amortizing principal, refinanced principal and any recoveries from foreclosed properties. This payment priority also means that in the event losses eat through all subordinated tranches, there is a much higher likelihood that the A1 tranche will have already been fully repaid. Once the A1 tranche is paid off, the A2 assumes the beneficial characteristics of the A1 tranche.

### Unique Tranche Risks

The sequential structure also presents unique risks to each tranche. The balloon nature of commercial mortgage loan maturities introduces refinancing risk to tranches that are paid off by the five, seven and ten year balloon loans. This risk is especially present in this market where lenders are increasingly unable or unwilling to lend to a borrower who is facing a loan maturity. The lack of a new issue CMBS market compounds this problem exponentially. When borrowers are unable to refinance, the loan is transferred to the special servicer, who explores options for ultimate repayment. While this exploration continues, the tranche that was supposed to be repaid is receiving interest but no principal from that loan. This loan purgatory, known as extension, can last over two years and can have a substantial total return impact even though principal is well protected.

A quick example will serve as an illustration to this point. GCCFC 2005-GC3 is a 2005 origination deal that has a particularly large A2 tranche that is paid off by five year loans (33% of the deal). The average life of the A2 tranche is listed as 0.5 years with a yield of 11% at the time of analysis. This assumes that all loans pay off at maturity. It is prudent to assume that not all the loans will mature as scheduled. Even those loans that are healthy may have trouble finding a lender willing to commit capital in this market environment. When we run the bond through our extension model, we find the average life extends to 3.1 years and the yield is reduced to 5.9%. That is a dramatic difference in total return prospects for a security whose ultimate principal repayment is not in question. To be clear, this bond is not in default or in the hands of a special servicer. It was chosen purely for illustrative purposes.

As with any model, the inputs are at least as important as the outputs. Regarding extension tests, it is critical to assess the likelihood of extension and/or liquidation of each loan within a transaction – with particular attention to the loans that pay off the tranche in question. Factors to consider include the property's financial performance, rent roll, property market price, growth prospects, size of the loan, the experience of the sponsor and stability of the tenant base. We will alter each loan according to our conservative economic outlook and re-run the cash flows to calculate a new average life and yield at a given price. While most securities look less attractive after this analysis, there are many pockets of value in short highly-rated CMBS, even after dire fundamental inputs are taken into account.

As investors move down the capital structure, the same inputs have different levels of importance on the total return of a tranche. For example, when analyzing a AA tranche, the ultimate repayment of the loan is much more important than the timing of that repayment. In fact, it is common for a short AAA investor to hope for a quick liquidation of a property, so that they can receive the recovered principal back at par. At the same time, the subordinated investors are hoping for a long recovery to maximize the number of interest payments received.

### Conclusion

The commercial real estate market will be fraught with risks for months and years to come. Our skill at analyzing security risk was rewarded during the credit crunch as the positions we held remained robust while fundamentals deteriorated. This same skill will be rewarded again as the risks and rewards shift in 2009 and we are able to find structurally sound CMBS in the face of continued market deterioration. There are opportunities for investors to earn a generous return in the CMBS market as long as both the market fundamentals and the structural idiosyncrasies are taken into account.

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