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The Pitfalls of Aggressive Underwriting
By Madison Capital Investments LLC

The continued reliance on property price appreciation to obtain a positive cash flow is the primary cause for increased defaults of the most recent crop of loans marked for commercial mortgage-backed securities (CMBS). Aggressive underwriting is to blame.

"Experience has taught us that continuously upward-trending rents and real estate values aren't guaranteed," says Zanda Lynn, managing director at Fitch Ratings. "In the overly optimistic view of the market, future corrections or economic fluctuations are not contemplated."

For the past ten years, CMBS defaults have annually averaged over 3.5%, according to Fitch, who defines "default" as 'a payment 60 days or more past due.' They further anticipate about 15% more defaults over the next decade of loans that were finalized in 2007 because of the combined effect of loans based on anticipated values, rather than current values, and from brash underwriting that has enabled borrowers to take on total debt that exceeds their asset values. Some situations have debt service on the outset exceeding existing cash flow.

Researchers at Fitch assert that the adverse side effects in the subprime market should be an alert to investors the dangers of mixing aggressive underwriting with the reliance on a notoriously unstable market. However, Fitch has reviewed cases where existing cash flow had been adjusted to mirror continued rental and market growth.

Some situations, leases that expired past the refinancing date were included in calculations as though they generated higher, market-rate rent; where others, unrented space has been considered rented at market rates.

Fitch has reviewed cash flows, on the hospitality flank, that expect increased revenue just on the market growth that do not possess the continued capital investments necessary to maintain their market position.

"Real estate professionals are structuring loans today with the expectation that cash flow will continue to rise in a commercial real estate market that has already experienced dramatic upward trends," says Eric Rothfeld, senior director at Fitch. "Fitch is seeing the market financing the higher value prematurely based on the expectation that it will occur, but well before it does — or does not — come to exist."

The evidence form the Market is both for and against Fitch's projections, says Mike Straneva, Americas Director of Transaction Real Estate at Ernst & Young. He continues that as cap rates are at historic lows, significant growth through cap-rate compression is not likely.

The results will make refinancing difficult for companies that are highly leveraged and will increase defaults – especially if cap rates increase, Straneva adds. "If your cap rate on an apartment portfolio was 6% when you bought it and now the cap rate is 7.5%, you just had a whole lot of value go out of your property," he says.

Still, commercial real estate basics remain strong across the nation and may be able to support double-digit rent increases, in squeezed market areas like the New York office market, that will truly create a positive revenue flow to help borrowers remain or get back into the black.

"People aren't going to be bailed out by cap rates," Straneva stresses. "On the flip side, there's going to be real rental growth in many property types, and that in turn will cause cash flow to improve and will lower loan-to-value ratios."

Since nearly 70% of new CMBS loans are interest only (IO) or incorporate an IO period, the majority of defaults resulting from the 2007 CMBS issuance may not happen until 2017 when the loans require refinancing, says Lisa Pendergast, Managing Director of CMBS research at RBS Greenwich Capital. Payments on IO loans are easier to handle because they're smaller since the borrower isn't paying on the principal, but when it comes to refinance, they won't have any reduced principle in their back-pocket to aid in their refinancing.

"The irony is that while IO loans will keep term defaults lower, they will work in unison with the very real potential that rates will be higher and property valuations lower (in 2017) to create a higher balloon default rate," says Pendergast.

Source: National Real Estate Investor.com