

**David L. Babson & Company Inc.**  
Investment Management Since 1940

One Memorial Drive, Cambridge, MA 02142  
1500 Main Street, Springfield, MA 01115  
Telephone: 617 225-3800

Friday, May 16, 2003

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## Commercial Real Estate — Finally Entering The Public Financing Arena

*Thomas Zatko*

The key to real estate, and to some extent investing as well, may be location, location, location. But until recently, the investing public couldn't even *find* one whole segment of the real estate sector — commercial properties. Equity investors have been able to buy commercial real estate through limited partnerships and trusts, but fixed

income investors have had few ways to diversify into this area and participate in this large market. That is changing and, in fact, the public capital markets are having a dramatic influence on the historically very private commercial real estate debt market.

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### Background

Prior to the mid-1990s, the commercial real estate business was a private market. Property ownership was regionally focused and few of the mostly private companies and individuals who comprised its investors had a national (and diversified) scope. Lending was dominated by regional banks, insurance companies, and thrifts.

Private ownership meant that there were very few sources of information regarding market rents and occupancy levels, real estate sales prices, and market trends. The lack of information made real estate a highly inefficient, fragmented market — one that offered outsized potential returns to smart investors, but also was subject to dramatic credit cycles.

The real estate recession of the late 1980s and early 1990s caused large losses to both equity and debt investors in commercial real estate. Pre-1986 tax incentives on real estate investments, as well as an overabundance of capital flows into commercial real estate — prompted in part by liberalization of bank regulation — led to overbuilding of all property types in many markets. The result was a large oversupply of space nationwide. Traditional buyers and owners became unable to acquire additional properties because of large losses in their existing portfolios. Debt capital sources were unable or unwilling to provide liquidity to the market.

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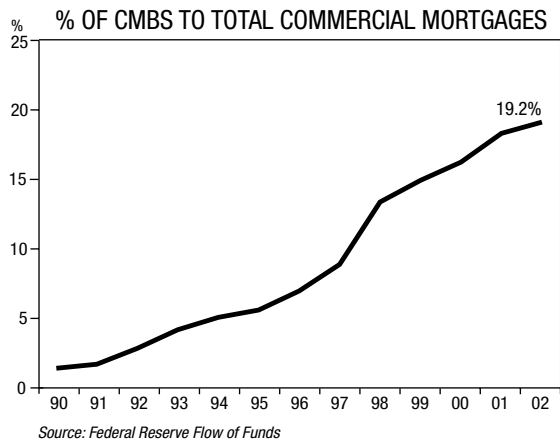
### Development Of The Public Real Estate Market

The early 1990s' lack of traditional sources of capital for the real estate industry set the stage for innovative solutions from non-traditional real estate capital providers. One source that came into its own was Real Estate Investment Trusts (REITs). These are publicly-traded companies that invest in real estate and pass through corporate income to shareholders tax-free as dividends.

REITs entered the market and began buying steeply discounted real estate portfolios using funding from public stock and bond offerings. For individual investors, REITs offered a way to gain access to the commercial real estate market, targeted by property type, or geographic location, or as a diversified portfolio of properties.

Although REITs rose to prominence in the mid-1990s, they had actually come into existence in 1960. Congress, drawing from the mutual fund model, attempted to make commercial real estate investment available to individual investors. At first, REITs were constrained because they were permitted to own, but not manage, real estate. Additionally, they were not allowed to pass through to shareholders the generous pre-1986 tax shelter features (mainly accelerated depreciation) that other vehicles, such as limited partnerships, could.

The REIT sector floundered in the 1970s, as over-leverage, poor corporate governance, and the mismatch of investment characteristics and



**Sample \$1 Billion Multi-Loan CMBS Issue**

Rating	Total Size of Class (Million)	Typical Average Life	Subordination Level	Last Loss	Lowest Risk
AAA	\$810.0	5&10 Year	19%	↑ Last Loss	↓ Lowest Risk
AA, AA-	\$40.0	10 year	15% to 16%		
A, A-	\$40.0	10 year	11% to 12%		
BBB+, BBB	\$40.0	10 year	7% to 9.5%		
BBB-					
BB+, BB,	\$35.0	10 year +	3.5% to 5%		
BB-					
B+, B, B-	\$17.5	10 year +	1.75% to 2.75%	↓ Highest Risk	
Non rated	\$17.5	10 year +	0.0%		

shareholder sophistication created problems. Many were “mortgage REITs,” which invested in real estate debt instruments with complex credit and prepayment characteristics (and attendant risks) that were unfamiliar to their retail investors.

The Tax Reform Act of 1986 gave the group a boost, even as it substantially curtailed the tax shelter aspect of investment in real estate, by allowing REITs to own and manage real estate. Today’s REITs generally enjoy more capable and appropriately-incented management teams, large scale (several REITs are included in the S&P 500 index), and more appropriate capital structures than their pre-

decessors. By agreeing to adhere to set limits on debt levels and other related measures, a majority of REITs have obtained investment-grade credit ratings in order to issue public unsecured debt.

REITs have also focused their strategies on particular property types or geographic locations, and have become widely accepted as an investment vehicle for current yield. By design, REITs pay out the bulk of their earnings in the form of dividends and generally sport generous yields. (The Morgan Stanley REIT Index currently carries a 6.7% dividend yield versus 1.8% for the S&P 500.)

**CMBS**

The real innovation for investors in commercial real estate has come in the fixed income market, with the introduction and rapid acceptance of Commercial Mortgage-Backed Securities (CMBS). These are essentially bonds backed by a pool of mortgage loans on commercial real estate. The process is similar to Fannie Mae and Ginnie Mae pooling home mortgages and issuing securities.

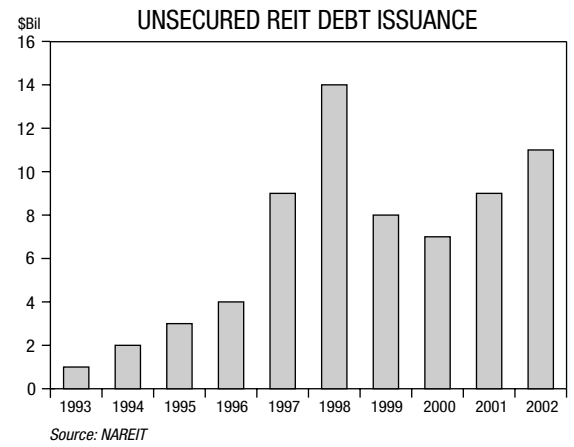
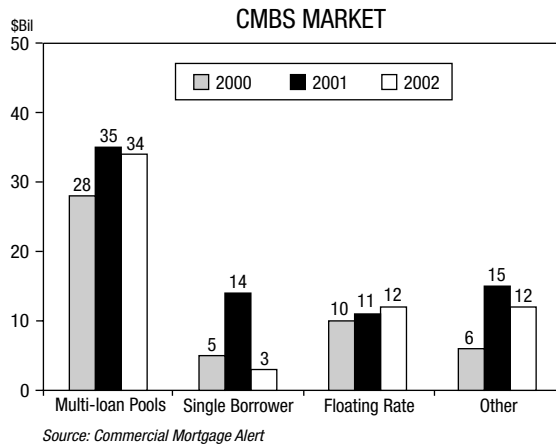
CMBS were born of necessity in the early- to mid-1990s when the Resolution Trust Corporation (RTC), which was tasked with cleaning up the savings & loan mess, pooled non-performing loans from failed lending institutions. To accomplish the pooling of the commercial mortgages, investment banks borrowed established methodology from the residential mortgage-backed securities market. That market had already established a robust mechanism for pooling home mortgages and repackaging them into securities.

Prior to this, a handful of thrifts and life insurance companies had pooled, and subsequently sold, commercial mortgages through Real Estate Mortgage Investment Conduits (REMICs). However, the CMBS market only began in earnest with the RTC’s bailout of the savings & loan companies.

After the success of the RTC offerings, the CMBS market evolved from a liquidation vehicle into a desirable and profitable means of creating a secondary market for newly-issued commercial real estate debt. From the investor standpoint, CMBS offered representation in a diversified pool of commercial mortgages across a wide range of risk and return potential.

CMBS have obviously appealed to investors and mortgage issuers, as they have gained market share in the overall commercial mortgage loan market since their introduction. As can be seen in the left-hand chart above, the percent of outstanding mortgages packaged into CMBS has grown from roughly 3% of the overall commercial mortgage market just 10 years ago to 19% of a \$1.4 trillion dollar market in 2002.

CMBS issues are typically structured as sequential-pay bonds broken into tranches based on their quality rating and maturity. Principal amortization, prepayment penalties, and default recoveries are paid to the outstanding class most senior in credit quality. Losses resulting from defaults on any of the underlying mortgages are absorbed by the lowest-rated remaining class. This structure basically pushes all the credit risk down to the lowest quality level holdings.



A typical CMBS issue has been rated by at least two of the major rating agencies (Fitch, Moody's, and Standard & Poor's), with letter grades ranging from AAA (safest) to non-rated (riskiest). CMBS bonds can carry fixed or floating rates and can be backed by pools of commercial mortgages or by a single mortgage. A typical \$1 billion multi-loan CMBS issue might be structured like the example top right on page 2. Of the various types of CMBS issues, multi-loan pools represent the largest segment of the market. The overall mix of CMBS issues can be seen in the left-hand chart above.

Conduit lenders make up the bulk of the multi-loan market, typically originating commercial mortgage loans expressly for packaging into CMBS pools. The conduits offer highly-efficient and competitive loan execution to the borrower. A potential CMBS issuer aggregates the loans until enough loans are available to package into a pool that will offer adequate diversity by geography and property type.

Once a pool is formed, rating agencies analyze the loans and the proposed structure of the bond issue. They assign ratings and credit enhancement or subordination levels based on the perceived risk of the pool of loans and the issue's structure. Credit enhancement is used in structured financings like CMBS to improve the quality of a bond. Here the form of credit enhancement used is subordination. In simple form, subordination creates a senior/junior structure where the junior class absorbs losses to protect the senior class.

In the example at the top of page 2, the safest portion of the CMBS structure (AAA class) has a 19% credit enhancement. This means the remaining 19% of the entire pool of securities, those ranked below AAA, would absorb all losses before the AAA class is impacted. Conversely, the riskiest portion of the CMBS bond, the non-rated class, has no subordination and is the first bond in the structure to receive losses.

Because the lowest quality segments of the issue – those ranked BB down to “non-rated” status, known collectively as the “B piece” — carry the most risk, they are subject to even greater scrutiny. The buyer of the B piece has first-loss risk and performs a thorough due diligence review of the mortgage loans and underlying properties. The potential reward for the higher risk, of course, is a high yield.

Given the complexity of the cash flows converting rent to mortgage payment to bond payment, a host of service providers are involved in managing and tracking the flow. These include trustees and master and special servicers.

The quality rating and average life of a particular issue determine the yield on CMBS securities. Generally, yields on investment-grade CMBS bonds are based on the swap spread rate plus a premium expressed in basis points to reflect the appropriate risk level of the particular securities. The swap spread, in turn, is the amount in basis points that it costs to exchange a fixed-rate income stream for one with a floating rate.

Non-investment-grade bonds are quoted as a spread over the yield on Treasuries. In a new issue CMBS, yields as of March ranged from 3.75% (the swaps rate plus 40 basis points) for a five-year average life AAA class (safest bond), to 27% for a non-rated class (riskiest bond). The middle of the capital stack, the BBB class, would have had a yield over swaps of +130 basis points or 5.7%.

CMBS represent an excellent way to add diversification to a fixed income portfolio. They allow for investment in the commercial real estate market generally, or in a property type or sector specifically, all with good liquidity and varying risk/return profiles. Because the intermediaries that create CMBS structure them into explicit classes by quality and maturity, CMBS allow participation in these markets at a risk level that is appropriate to a particular investor.

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## REIT Bonds

The other main source of public debt in the real estate area is unsecured REIT debt. These securities are simply corporate bonds issued by REITs. They carry none of the complexity of being associated with mortgages and represent an unsecured claim on the REIT as a company, not on individual assets.

As with CMBS, the market for unsecured REIT debt has grown considerably, as shown in the table at the top right of page 3. Although the REIT debt market continues to grow, it represents only 1.6% of the \$2.17 trillion Lehman U.S. Credit Index.

Most REITs are rated in the BBB+ to BBB- range. Unlike CMBS, where the rating agencies focus on an aggregated pool of loans, the rating on the REIT debt is tied to the overall financial health of the issuer. In addition to the typical financial ratios used in company analysis, the rating agencies focus on qualitative factors such as property, geographic and tenant diversification, quality and depth of management, and ability to adapt to changing market conditions.

REIT debt usually contains covenants to protect the investor. While the covenants may vary slightly for each company, the general intent is to place limits on the debt burden of the company. Typical REIT debt covenants are as follows:

### Covenant

Secured Debt/Total Assets  
Total Debt/Total Assets  
EBITDA/Interest Expense  
Unencumbered Assets/  
Unsecured Debt

### Restriction

less than 40%  
less than 60%  
greater than 1.5X  
greater than 150%

Yield on REIT debt is typically quoted as a spread over the yield on Treasuries. That spread for REIT debt in the Lehman U.S. Credit Index averaged 173 basis points as of March. Individual REIT issue spreads range from 125-265 basis points. These spreads vary because of property sector and geographic concentration, as well as investor perception of the individual REIT's property quality and management team. By contrast, conventional corporate bonds in the Index averaged a 159 basis-point spread through March.

The market for REIT bonds has grown as it has proven an efficient means of providing capital to REITs. The bonds have been well received at new issuance and have exhibited good liquidity in secondary trading. As opposed to CMBS, which represent interest in the mortgages on property itself, REIT bonds provide exposure to the debt of public companies that are established owners and managers of real estate. REIT debt selection can be based on a variety of factors including the rating of the company; the quality, type and location of the underlying properties; the flexibility of the capital structure; and the depth and experience of the management team.

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## Conclusion

The continued growth and acceptance of CMBS and REIT bonds exhibit the increasing influence of the public markets on real estate. Both products are now widely used as a liquid means to add real estate debt to fixed income portfolios. More importantly, the greater involvement of the public capital markets in commercial real estate debt has increased the flow of information, creating both greater efficiency and transparency in this once very private market.

The entrance of the public capital markets into the private domain of commercial real estate was born of necessity. The lack of liquidity and capital during the worst real estate recession in 50 years, a decade ago, brought forth innovative solutions

from non-traditional providers of capital in the real estate business. Over the past decade, public debt vehicles have been refined and now bear the markings of mature investments. Both CMBS and unsecured REIT debt trade in active, liquid secondary markets and are part of recognized investment indices.

Meanwhile, a wide mix of investors is present in both the CMBS and unsecured REIT market. Complex analytical tools as well as detailed market research and surveillance are available from a variety of providers. It is likely that given continued investor demand for these products, the public real estate markets will continue to expand.