

DWIGHT ASSET MANAGEMENT COMPANY LLC

# CMBS Market Update

NOVEMBER 2008

Commercial mortgage-backed securities (CMBS) have been an integral part of our portfolios since we began managing bonds here at Dwight. In over a decade of managing CMBS, we have not suffered a single dollar's worth of principal loss on any one of our holdings. Among the attributes that have attracted us to the sector are stability of cash flows and stability of credit.

**STABILITY OF CASH FLOWS:** Unlike residential mortgage-backed securities (RMBS), CMBS are backed by commercial real estate loans that use lockout provisions and/or prepayment penalties that negate any incentive borrowers may have to prepay their loans. As a result, commercial mortgages are not interest rate sensitive in the way that residential mortgages are. This is among the primary reasons that we have favored CMBS in our portfolios. A market or index allocation to RMBS would result in a significantly negative convexity profile that would increase the prepayment and extension risk on the portfolio. Instead, we tend to substitute that RMBS exposure with an allocation to the more positively convex CMBS sector in order to achieve a more stable and predictable cash flow pattern.

**STABILITY OF CREDIT:** CMBS are collateralized by real assets and have structural protections built into the securities. Every CMBS bond is backed by a static pool of loans secured by commercial properties—shopping centers, office buildings, apartment complexes, and hotels, among others. Typically, the loans are underwritten with loan-to-value ratios in the neighborhood of 70-75%. Furthermore, the loan pools are typically well diversified by property type, geographic location, tenant, and borrower. The overcollateralization also exists at the security level, as senior classes of securities benefit from the subordination of junior classes. At the senior-most level of a CMBS deal, the level of subordination can range from 12% to 30% or more. In many cases, CMBS deals exceed the minimum credit support required by rating agencies to achieve AAA status—and often times by wide margins. These features give the senior bonds credit characteristics that compare favorably to certain unsecured corporate obligations, making the sector a nice complement to a diversified fixed income portfolio.

## RECENT MARKET EVENTS

In recent weeks, credit fundamentals, weak market sentiment, and bad market technicals have all contributed to a truly unbelievable freefall in the prices of CMBS bonds. Amid these themes, there are five main drivers of this extraordinary (and in our view, way overdone) price decline:

**1) There have been a number of negative headlines related to retailers.** Weak retail sales data, sharply declining same-store sales numbers, bleak profit outlooks, and downward-revised forecasts from individual retailers have weighed heavily on consumer sentiment, generating concern about the outlook for retail properties.

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## RECENT MARKET EVENTS, CONT'D

2) **Demand for office space is highly correlated to employment, and recent employment data has been very weak.** Quite simply, fewer jobs translate into fewer cubicles, and an ultimately bleak outlook for office space.

3) **Some over-levered REITs recently warned that their future may be in peril due to a lack of financing in the current credit-constrained lending environment.** This creates a near certainty that some of the REITs' assets will come to market soon—either in a last-ditch attempt to raise cash or in a bankruptcy-induced liquidation. This could exert further downward pressure on property valuations in coming months.

4) **The two largest loans in a recent vintage CMBS deal (JPMCC 08-C1--we do not own it) just became 30 days delinquent.** For some, this raises a red flag about the potential for more large delinquencies in other late-vintage CMBS deals.

5) **Treasury Secretary Hank Paulson changed his mind—again.** Last week, Secretary Paulson announced that he had changed his mind on the Troubled Asset Relief Program (TARP) and would not be buying bonds from banks and securities firms. This caused even more damage to an already significant rift in investor confidence and prompted banks to begin hedging assets that they had previously hoped would be purchased by the program.

## THE IMPACT OF A BIDLESS MARKET

The only way for banks to hedge their long assets, however, is to short something else. As a result, banks have begun aggressively shorting commercial real estate risk through the purchase of protection on the CMBX index in the credit default swap (CDS) market.

Unfortunately, hedging does not come easily these days. For one thing, bankruptcies and consolidations have reduced the number of dealers making markets in CMBX. Furthermore, the hedge fund community, which represented the more active participants in this market, has reined in risk due to heightened price volatility, reduced liquidity, and ongoing redemptions. When five of ten dealers who quote CMBX markets are simultaneously implementing hedging programs without a willing counterparty, a single trade effectively becomes a game of hot-potato in the inter-dealer market, driving spreads 50 to 100 basis points wider at a time.

## IRRATIONAL PRICES

Market technicals have completely overwhelmed fundamentals. Massive supply-demand imbalances have caused market prices to become completely divorced from any and all reasonable valuation metrics. Ten-year super-senior paper has recently traded below 50 cents on the dollar. At this price, these AAA-rated CMBS have a base-case yield of about 20%, and when stress-tested for defaults their yields are even higher. Why? Because recovery on any defaulted loan represents an accelerated repayment of principal at par. If a bond is trading below 50 cents and has 30% credit support, a 100% default rate on the underlying collateral with 50% loan recovery produces an annualized yield to maturity of approximately 50%—not a bad return for a worst-case scenario.

## CONCLUSION: WE ARE STANDING FIRM

Despite the extraordinary events that occurred within the CMBS market over the last few weeks, our belief in the asset class has not wavered. We maintain our conviction in our CMBS holdings based on continued stability of cash flows, credit fundamentals, and structural protections built in through the mechanics of securitization. We continue to have a high-quality bias and favor the more seasoned bonds. While technical factors can certainly cause prices to remain volatile in the near term, we believe that the strong fundamentals of our holdings will be rewarded in the long run.

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