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FEATURE: Public and private CMBS deals mandated; punitive regulations still a major hindrance.

The case for restarting the European primary CMBS market is gaining momentum: deal economics are beginning to make sense, investors are expressing an interest and banks are looking at suitable loans to securitise. But punitive regulatory treatment of CMBS under Solvency II along with fierce competition from other CRE financing sources looks likely to keep a lid on significant issuance for now.

"There is every reason to fix the CMBS market, but at present the possibility is remote," said Peter Cosmetatos, Chief Executive Officer of CREFC Europe. "Even if the economics are beginning to make CMBS look like a more attractive proposal, the odds are stacked against a meaningful recovery."

Approximately €1.2bn of CMBS has been issued year to date. This includes two unrated, single tranche deals from Brookfield: a student housing deal for £215m (Student Finance Plc) and a £101.6m mezzanine loan secured on the CityPoint office building in London (Cleveland Row). Land Securities' legacy securitisation platform issued two new tranches totalling £700m. Meanwhile, another £110.54m deal was also issued secured by office space in the Devonshire Square Estate in London.

New deals – both private and public – are in the pipeline, according to market sources. Whether these deals will be completed is uncertain.

One source cited a recent mandate for a multi-tranche European CMBS. Goldman Sachs is also understood to be actively originating small sized UK regional CRE loans with a view to securitisation.

Other rumoured trades include a UK transaction that may look similar to Griffon Funding CMBS - a €2.43bn true-sale securitisation of 57 commercial real estate loans originated by Barclays Bank. Structured in September 2016, the deal was "overwhelmingly retained", according to a source familiar with the matter.

NPL CMBS are also a possibility: some more demanding assets could form the collateral for future transactions like secondary retail assets or hotel assets, the same source said.

CMBS backed by NPLs have been rumoured for years. The highest profile deal was Bluebonnet, which securitised a €1.34bn loan provided by Citigroup to finance Lone Star's 2006 acquisition of a portfolio of German loans; the bonds were placed in December 2006 and the deal repaid in 2014.

"We can see that our clients want to do deals. Banks like DB and BAML have kept their teams in place, while Societe Generale is keen to re-enter the European CMBS market," a lawyer said.

Investors, too, appear ready to buy new deals: "I would like to see more CMBS in the market," said a UK-based portfolio manager of a global investment management firm. "However, even if prices are reaching a level at which CMBS is more viable, borrowers are reticent to use securitisation, particularly as the loan syndication route is cheaper or easier."

Further factors such as newly implemented risk retention rules from the US and a long rating agency process may also hinder issuance, he said.

Moody's anticipates that a small number of CMBS issuers may test the water in the second half of 2017. "This could be from any European jurisdiction where there is an opportunity to lend at a level where CMBS is viable," said James Belchamber, analyst at Moody's.

Commenting on potential deal structures, Mr. Belchamber said it could be either single or multi-tranche deals, adding that structures would be "whatever works best for the arranger."

Morgan Stanley analysts noted in a recent report that they see CMBS being used to finance higher risk property that domestic banks are reluctant to lend against, such as Matisse Funding in Romania. Matisse Finance was a single tranche transaction in 2016, sold to CPPIB and Cairn, backed by four prime properties.

Starwood Capital, meanwhile, said in a quarterly report that they expect to see further CMBS activity in markets such as Italy and the Netherlands.

"A tightening trend in spreads since the second half of 2016 indicates that levels are reaching a tipping point at which CMBS could once again make sense," said Christian Aufsatz, MD and head of European Structured Finance at DBRS. "However, I don't anticipate a lot of issuance. It would require the right loan being available at the right time. There may be one or two lenders with the right product available."

Punitive regulations

The regulatory capital treatment of CMBS under Solvency II is likely to remain a huge problem for CMBS, particularly as it rules out the participation of insurance companies - traditionally a significant component of the senior CMBS investor base.

For firms adhering to Solvency II's standard model, capital charges for holding a Triple A rated CMBS amount to 12.5% per annum of duration, meaning that a five-year Triple A bond would carry a capital charge of 62.5%. By way of comparison, loans carry charges in the low double digits; owning the property outright carries a capital charge of around 25%.

Over the past two to three years, CREFC Europe has been talking to policy makers both at a Basel and European level. Mr. Cosmetatos said he sees "qualifying" securitisation (such as the EU's "STS" approach) as a sensible proposal, but it would still be hard for any CMBS to meet the criteria for better treatment, he suggested.
"I don't think we'll win that argument, now that the proposal is at the Trilogue stage," he said. "If CMBS is to re-emerge as an asset class, it will most likely be outside of the STS category."

From a policy point of view, the next opportunity for CREFC Europe is the Solvency II review that is due to be concluded by the end of 2018.

"This is an opportunity to look critically at how type 2/type B exposures are treated under Solvency II compared with loans and real estate," said Mr. Cosmetatos. "We need to put forward credible proposals for how and why it should be changed."

According to Iain Balkwill, a partner at Reed Smith, other broad-brush regulator proposals that are not tailored to some of the nuances of individual asset classes, such as CMBS, are another factor responsible for hindering CMBS issuance in Europe.

"While regulations are a positive for CMBS, they have to be correct," he said. "The concentration limit on loans being that no single exposure should comprise more than 1% of the underlying pool does not work in CMBS, for example, particularly as the market standard for CMBS 2.0 has been large loans to single borrowers."

Regional CRE loans

In the near-term, CMBS may have a role to play in a sector of the CRE market where syndication is not effective, i.e. small CRE loans of £5m to £10m.

"While there is plenty of lender competition for trophy CRE loans in big cities, in more regional areas the market is thinner," Mr. Cosmetatos said. "In the UK for example, where there is no local or regional bank system, conduit CMBS would be a natural system for boosting investment in regional CRE markets."

Goldman Sachs is in the process of originating smaller, UK-based regional CRE loans, with a view to securitising the portfolio once it reaches a critical size, according to market sources.
Meanwhile, other banks are being encouraged to revisit CMBS.

"Based on historical pricing volatility there has been a reluctance from investment banks to underwrite CMBS, and they have instead taken the loan syndication route," said Nassar Hussain, managing partner at Brookland. "Although syndication may have given banks a better distribution exit in the past, with the market now more stable it may be a good time to revisit a CMBS exit."

Mr. Hussain pointed to the benefit of agented CMBS deals that do not have to be underwritten by banks. "In such deals the borrower engages a financial advisor or bank and the borrower accesses the market directly," he said. "That's not a bad way to restart the market because through pre-marketing and private placements the banks/financial advisers and borrowers can get comfortable that the bonds can be distributed without the banks/financial advisers taking any principal or underwriting risk."

He added that some banks have tried to distribute CMBS deals that were not right for the market - for example the underlying collateral or structure were too aggressive and that never helps.

"When looking to restart a market such as CMBS, you have to be careful with the types of deals you bring and how generous you are with investors on economic terms such as prepayment penalties."

Private potential

Market participants are expecting a relatively steady flow of single, unrated privately placed CMBS throughout 2017. One source suggested volumes could reach €5bn-€6bn.

In some cases, the CMBS will be a conclusion of a pre-agreed transaction: for example an investor wanting exposure to a specific loan in a bond format. In other cases, existing CMBS bonds are being repackaged into private bond placements, allowing investors of legacy deals to hold on to a particular CRE exposure.

"2017 is a big Legal Final Maturity (LFM) year for pre-crisis CMBS," said a source. "Investors are quite happy to recycle their investment for the right price, particularly as they know the collateral and the properties."

David O'Connor, partner at Mayer Brown commented that market participants are looking at potential deals but for various reasons they have not happened on the public side. "We have been mandated on various transactions but it is hard to tell if these transactions will proceed to marketing - there are a lot of variables," he said. "Going forward, there will probably continue to be more single-tranche, unrated private deals. There could be one-off public CMBS deals - there are one or two potentials in the pipeline. Similarly, if a bank originates a suitably large loan with all the economies of scale for securitising it then they may look to securitise. But CMBS remains a difficult market right now, both in terms of investor interest, pricing and punitive and uncertain regulatory treatment."

Mr Cosmetatos said a real recovery of the European CMBS market is some way off, however, he is convinced that it has an important role to play in the CRE market.

"Killing CMBS through punitive regulation has not protected investors from CRE debt. Now all exposures are at loan level which is less transparent and less liquid," he said. "When the next property crash happens, a generation of loans will be affected, regardless of whether they have been securitised," he added.

Deal specifics

Cleveland Row Finance No.1: the transaction securitises mezzanine notes used to finance the acquisition by Brookfield of the CityPoint tower in London (valued at £557.3m). £101.62m of 8.25% unrated Fixed Rate Notes due 2026 were issued in February. The issuer makes payments on the Notes from interest and principal received in respect of the £101.62m issued by BSREP Citypoint Mezz Limited. No structure credit support will be provided for the Notes. In connection with the Mezzanine Notes, a loan to value ratio is required to be maintained by the Mezzanine Issuer in accordance with the Mezzanine Note Issuance Agreement.

The deal was arranged and managed by Cheyne Capital. The mezzanine note sellers are funds connected to Cheyne. According to the prospectus, the issuer is of the opinion that EU retention provisions do not apply to the issue of the notes. CityPoint was previously securitised in a Morgan Stanley deal (Ulysses ELoC 27).

Deer Funding: £110.54m of unrated Floating Rate Notes due 2019, paying 3mE+245bps, were issued in March. Morgan Stanley Principal Funding Inc acts as sponsor and is the retention holder. The notes receive a proportion of the principal and interest received with respect to its holding of a £116.36m pari passu tranche of a £264m loan (Term Facility A Loan) advanced by Morgan Stanley Bank, as original lender. This Term Facility A Loan is secured by a portfolio of office space in the Devonshire Square Estate, London.

Student Finance: the £215m transaction, described by the leads Barclays, HSBC and RBCCM as senior secured note, priced on 24 February. The transaction is secured over a portfolio of UK student accommodation properties. The borrower is indirectly owned by certain funds managed by affiliates of Brookfield Asset Management Inc. The prospectus notes that the Issuer has considered the applicability of EU risk retention and due diligence requirements to the transaction described in this Prospectus and is of the opinion that the Notes do not constitute an exposure to a "securitisation" for the purposes of such EU risk retention and due diligence requirements and, accordingly, such EU risk retention and due diligence requirements should not apply to investments in the Notes".

Land Securities: Land Securities Capital Markets issued in February £700m of bonds under the company's £6bn secured multi-currency note issuance programme. The £400m Class A12 bonds have an expected maturity of seven years and paying a coupon of 1.974%. The £300m Class A13 bonds have an expected maturity of 12 years and paying a coupon of 2.399%.

At the same time Land Securities Capital Markets Plc launched a bond buyback. It repurchased in cash an aggregate principal amount of Class A3 notes, Class A4 notes and Class A10 notes validly tendered, for an amount equal to £634.684m at a cash cost of £759.1m. No Class A5 notes were accepted.

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