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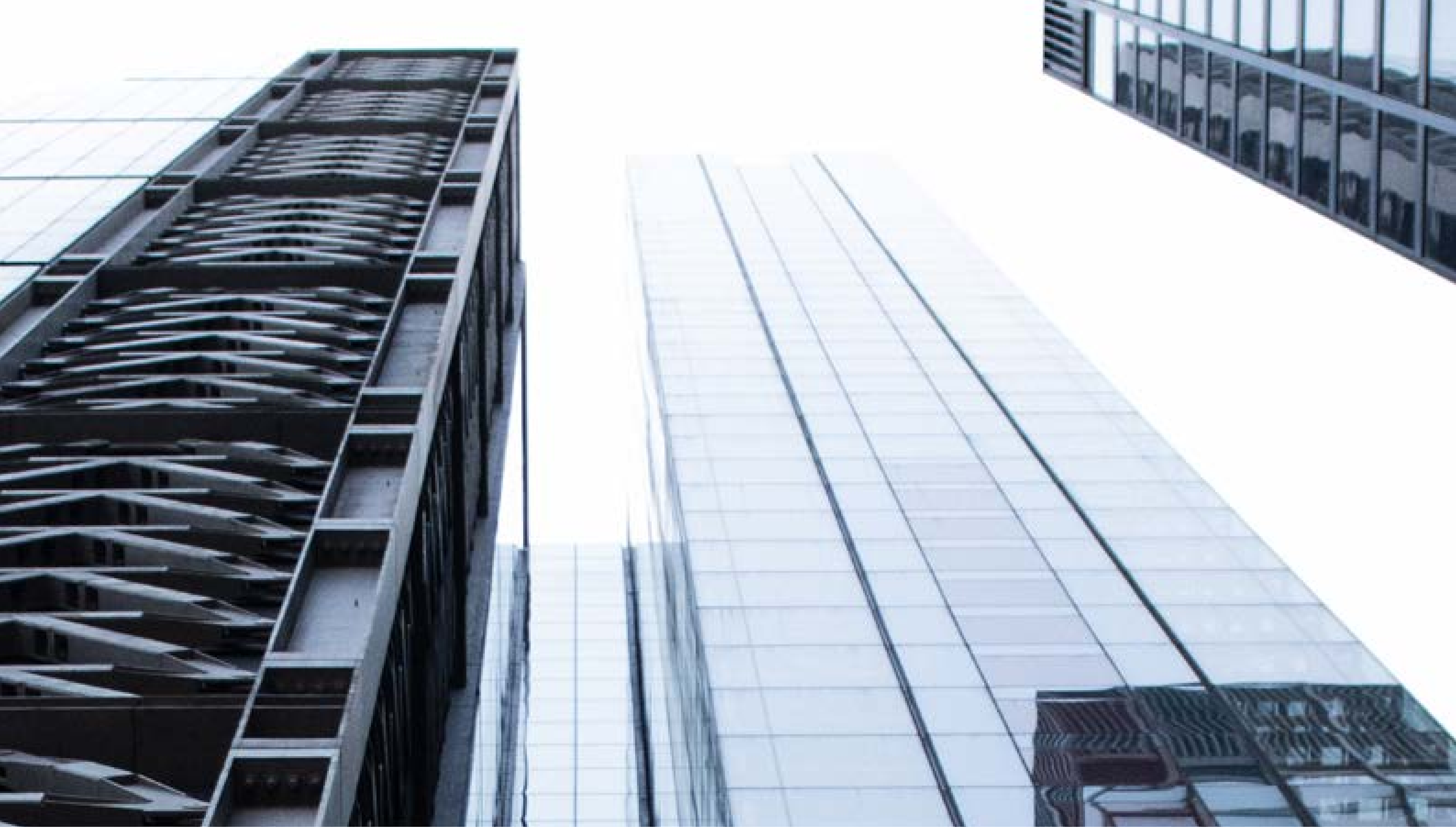

More data can reduce risk in CMBS markets

Why greater disclosure and transparency could help minimise future defaults

Matt Richardson, CEO and Co-Founder, Income Analytics

The commercial-backed mortgage security (CMBS) market faces a number of challenges. Default levels are rising and although the market might be stabilising, higher interest rates and inflation are creating headaches to those who need to refinance.

In a troubled market, it is more important than ever for an investor to understand what they are buying - which in the case of CMBS starts by analysing leases. Until now, the structural challenges within the market have made this extremely difficult. Today, solutions powered by access to large underlying data sets and machine learning can bring a new level of insight.

The difficulties facing the CMBS market

During the last decade property markets were primarily driven by liquidity, instead of supply and demand metrics. It was relatively easy to make money. Property values soared and yields were driven down to record lows. Fiscal policy tightening accompanied by higher interest rates and stubborn inflation means this era is now firmly behind us. Property values have already dropped and we expect further falls in the coming months across almost all markets.

Against this backdrop, we are seeing a rising level of payment delinquency and defaults globally. Blackstone Group's default on a €297.1 million CMBS loan in Q1 2023 is one high-profile example of how tough the market has become. In the US, a Brookfield fund defaulted on a CMBS loan on two LA offices in the same quarter.

A challenge right now is that a lot of loans are coming to maturity. Historically, borrowers capitalised on low rates for long-term loans and advantageous refinancing opportunities. However, climbing rates have created difficulties in loan refinancing, primarily due to unfavourable terms and hedging challenges.

Independent ratings business Scope Ratings expects there will be an increase in refinancing and forced maturity extensions over the next 18 months. This prediction is due to benchmark yields doubling, costly hedging, increased lender control, a liquidity-starved secondary market and overvalued assets potentially facing further devaluations.

According to current data from Trepp, the market leader in CMBS data and analytics, there are €3.06 billion in loans across Europe (excluding delinquent loans or loans in special servicing) that will mature by the end of 2023. These loans will either need to refinance, extend or pay off the balance.

It's not only CMBS loans that will mature. Trepp's data shows that in the US, more than $1.7 trillion commercial real estate loans will mature by 2027 - $270 billion this year. Investors and property owners will be looking to refinance, but in the current market that's far from simple.

Increasing tenant defaults

Behind these defaults lie a high level of tenant insolvencies and bankruptcies. In the UK, the number of insolvencies in Q1 2023 was 18% higher than in Q1 2022 and only just below the level reached in Q2 2022, which was the highest level recorded since the record began in 1960.

In the Netherlands, France and Norway, corporate bankruptcy rates have increased more than 40% in the 12 months ending Q1 2023, according to data from Eurostat and the UK's The Insolvency Service. Across the EU 27, the average increase is 20%.

All this indicates that there is an increased level of risk that tenants who form the basis of CMBS loans may default on their rental obligations. Falling tenant revenue will push yields lower and ultimately lower the value of the property. Managing the risk of tenant income default is therefore a high priority for a landlord.

Systematic problems in CMBS

While the turbulent economy can be blamed, there are systemic failures that put businesses and investors at risk. Simply put, investors don't often look into tenants' individual situations. They usually just look at the overarching bond rating of the CMBS transaction.

It's important to recognise that while these two considerations are interlinked, they do need to be analysed separately. In short, an investor should price the income risk at lease level but the structural and legal risks at the bond level.

Bonds run for several years, during which time many tenants could go bust. The underlying risk is moving, but a CMBS bond rating looks at a single moment at the beginning of the transaction.

Typically, an investor or issuer will only look at the largest five or ten tenants in a property backed by a bond, but CMBS products could cover 3,000 tenants. An investor is exposed to every single tenant within a portfolio.

Often, the largest tenants are blue chip companies that can be fairly reliable. The performance of a CMBS product depends on the tail risk posed by all the other tenants.

The challenge is that when a bond is issued, investors generally don't have access to the granular data on which it is based. They are buying a set of income streams, but have no method to look at the underlying cash flows.

This is particularly the case in Europe. In the US, it is standard to report data on commercial real estate, in terms of transactions and debt. In contrast, Europe is largely a closed book. Lenders don't know what each other is originating. This is partly due to how data is collected and stored across Europe - even addresses have different formats, for example - and how data is not publicly available.

A solution that gives greater transparency

Until now, the way CMBS products are underwritten has been considered good enough. But that's because there hasn't been another way. When markets are smooth, carrying on with how debt products are traditionally underwritten can work out fine.

Today, there is a clear way to reduce the risks present in the CMBS market: look at the underlying lease data. This is the only way to make informed decisions that reduce income risk.

Investors and issuers that leverage solutions from both Trepp and Income Analytics can underwrite issuance with far more granular tenant data. Income Analytics' solution, the INCANS Global Tenant Score, gives a cumulative percentage probability of failure, based on the likelihood of a tenant failing to meet their future rental obligations. The tool uses large scale data processing to analyse the relationship between historic company failures and the factors in the risk model preceding that failure.

The INCANS Global Tenant Score used in junction with data from Trepp gives investors and issuers greater power to accurately predict a tenant's probability of default. Trepp has serviced the CMBS market globally since the market began. The company has modelled every US and European deal and has the market leading cash flow engine, along with a suite of analytics.

The INCANS solution gives a whole new level of granular transparency to investors. It is a step above what has previously been used to underwrite issuance.

Credit reports and bond ratings simply give a snapshot in time, looking historically at how a tenant has performed. They're not fit for purpose in the real estate industry. In contrast, the solution from Income Analytics gives a real-time probability of default based on a wide range of data points.

This solution is not just available to the CMBS market. Anyone who is originating loans or investing in commercial real estate needs to have greater insight into the cashflows securing the debt.

The European CMBS market is showing signs of picking up. During the first half of 2023, there was a significant shift in the evaluation of industrial properties, leading Fitch to adjust the sector's outlook to 'neutral' from the previous 'deteriorating'. Blackstone is currently preparing a £300 million UK CMBS, Last Mile Logistics 2023-1, which will be backed by 37 properties and 161 unique tenants.

Of course, challenges in certain real estate sectors remain. The apparent stabilisation of the industrial sector contrasts with the value correction experienced by the retail and office properties. According to Fitch, retail and office properties continue to show a 'deteriorating' outlook.

If the market is indeed picking up in the industrial sector at least, it will be the investors and issuers armed with accurate, granular data who will make the most of it. Using technology today, a far higher level of transparency is possible. This will lead to a far more efficient market and a far lower level of risk for all involved.

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