PCCP Market Commentary
The Expanding Refinanceability Gap
Second Quarter 2016

As we write our entry for the second quarter of 2016, markets have calmed down a bit. We had an eventful 4th quarter last year, and a wild ride in the first 45 days of the new year. But today, the U.S. public equities market is generally back to positive territory for the year. High-yield debt has marginally recovered and crude oil has marked substantial gains for the year. Real estate prices, as reported by Moody's, fell month over month in February for the first time in six years. We sit in a more volatile and interconnected world. As energy credits suffered and high-yield bonds demanded even wider spreads, subordinate CMBS bonds had to compete as well by offering higher yields, leaving originators of securitized product scrambling to create saleable securities. This volatility led to higher debt pricing and less risk-taking, which affected the refinanceability of maturing loans. We thought this might be a good time to re-examine the situation in real estate debt capital markets, and discuss where we see opportunity for lenders and investors who can see value in a volatile market.

To begin, let's revisit developments in the markets generally. Then we'll take a look at upcoming maturities and the refinanceability of loans in 2016 and 2017.

We believe at least five developments will make 2016 a very interesting year for "stressed" recapitalizations. We think we're a little early for *dis*tress, but the stress in the market is palpable. First, the aforementioned *energy→high-yield→subordinate CMBS bond pricing uncertainty→where's my loan?* chain of logic is having a real effect on the availability of long-term debt for projects that don't meet insurance company standards and don't qualify for Fannie or Freddie financing. Second, U.S. banks increased real estate lending substantially in 2014 and 2015, and now they seem just a little full for new product.[1] Third, Basel III is really keeping the banks that are still in the game pretty risk averse. Fourth, new risk retention rules are going into effect for securitized debt, leaving originators of new loans to figure out who is going to be holding the bag when loans go bad (presumably, someone other than them!). Fifth, rising real estate pricing masked underlying marginal performance on many properties, making it easier to refinance challenging situations. If real estate pricing has flattened out (it's only one month of data, so it is a little early to tell), then properties that have been starved for capital throughout the recession are going to be even harder to refinance.

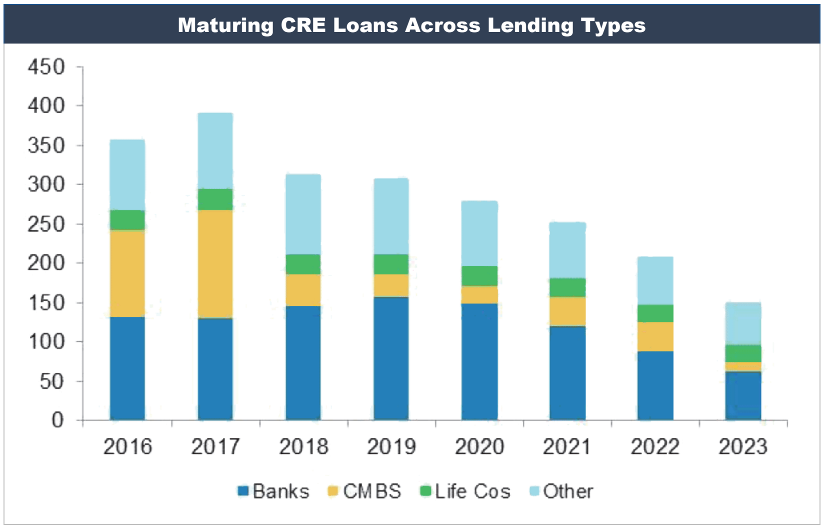
So, if you have a maturing loan, and you have a property that still has a value-add component, what is there to do? We think you are probably going to need a private equity financing solution, or you are going to need a preferred or common equity injection to lower the LTV of your new loan to levels that meet banks' appetites.

If we include all lender types, over $700 billion[2] in loans are scheduled to mature this year and next. Although it was nearly a decade ago, we remember the all-time high of CMBS originations in 2007. Totaling over $220 billion,[3] these loans were issued near the top of the market with lenient underwriting standards and high loan-to-value ratios. Please see the chart at the top of the next page.

[1] Chandan Economics, March 2016
[2] Morgan Stanley, December 2015
[3] Morningstar, February 2016

In the first quarter of 2015, CoStar estimated that 22% of CMBS loans maturing in 2015 were not conventionally refinanceable.[4] Morgan Stanley reported at year end that the actual number was 25%.[5] Morgan Stanley's 2016 forecast is that 25% of maturing CMBS loans are not refinanceable.

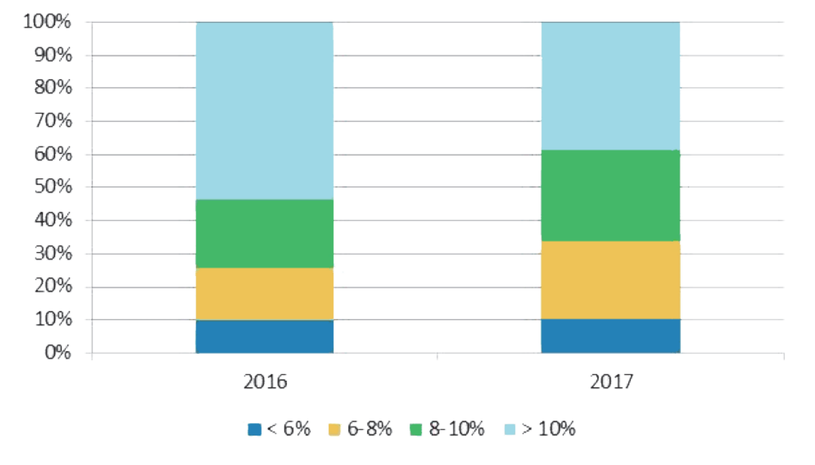
Maturing CRE Loans Across Lending Types



Source: Trepp, Morgan Stanley Research

2017 is even grimmer. Borrowers' capacity to refinance is especially problematic for the CMBS loans with 2005-2007 vintages that have not generated the net cash flow assumptions made at origination. In fact, only 55% of the loans scheduled to mature in 2017 will produce the necessary cash flows to refinance, as reported by Morningstar.[6] This forecast is supported by debt yield profiles. The chart to the left shows debt yields for loans maturing in the next two years. Almost half of the 2016 maturities have debt yields of less than 10%. The figure is over 60% for 2017. To put this in perspective, Morgan Stanley reports that the weighted average debt yield for CMBS loans originated in 2015 is 10.61%. LTV will also be a material constraint. Morningstar's calculation is that more than half of the CMBS loans originated in 2007 have LTVs greater than 80%.[6]

Debt Yield Profiles of Loans Maturing in Next 2 Years



Source: Bloomberg, Morgan Stanley Research

This is all before recent upheaval in the market. We can't predict the future. But what we can say is that if all things stay the same, recapitalizations, rescue capital, stretch senior loans and players with unregulated capital are going to play a material part in reshaping capital stacks over the next two to three years. If any of the factors we mention at the beginning of our newsletter accelerates, it will be very interesting indeed.

William R. Lindsay
wlindsay@pccpllc.com
(310) 414-7868

Greg Eberhardt
geberhardt@pccpllc.com
(310) 414-2004

Steve Chase
schase@pccpllc.com
(646) 308-2101

K.C. Kriegel
kkriegel@pccpllc.com
(646) 308-2102

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[4] Trepp, CoStar Risk Analytics, 1Q15
[5] Morgan Stanley, December 2015
[6] Morningstar, February 2016