Capital Markets
Lender Forum

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Key Trends

- Markets stabilized during Q3 2013, after a sharp widening of rates and spreads in May and June. Lending momentum improved in despite the earlier capital market disruptions.
- Banks had a strong quarter, capturing the highest share of commercial originations among the principal lender types.
- CMBS activity also was resilient. However, new risk retention rules may raise CMBS loan pricing in the coming years.

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RESEARCH CORNER

Real estate capital markets entered Q3 2013 amid a cloud of uncertainty following interest rate hikes in late spring, the prospect of a government shutdown and slowing economic activity. Despite these headwinds, lending and investment sales markets maintained forward momentum during the quarter. Lending by banks and CMBS issuers remained strong, which has brightened our short-term outlook for lending growth as we move towards 2014.

- Lending activity continued to expand during Q3 2013 on the strength of bank and CMBS originations. The CBRE Lending Momentum Index reached 134 in September, up 6.3% from June and 12.6% from September 2012.

- According to Real Capital Analytics, investment sales activity gained momentum during Q3 2013, spurring demand for financing. Total investment sales volume reached $89.7 billion for the quarter, up 26% from year-earlier levels. Retail property transactions, along with several significant portfolio transactions, contributed disproportionately to the large year-over-year increase.

- After a sharp selloff in U.S. Treasuries near the end of Q2 2013, July ushered in a period of relative stability. However, market volatility appeared to increase as market participants closely watched the Federal Reserve for indications of monetary policy changes. Yields on the benchmark 10-year U.S. Treasury began July near 2.5%, and almost reached 3% in early September. By the end of the month, however, yields had settled back down to near 2.6%.

- Despite budget reductions and uncertainty related to the federal government shutdown, the U.S. economy grew 3.6% during Q3 2013. October's employment report was stronger than expected, and included upward revisions to August and September payrolls. Despite the employment gains, there have been concerns that weak consumer confidence has caused spending growth to trend lower over the past several months. Wage growth has also been relatively weak, which contributed to the sluggish spending trend.

- National data on property market fundamental performance was generally mixed during Q3 2013. According to CBRE Econometric Advisors, the industrial sector witnessed its strongest quarterly demand since prior to the recession, which caused the overall national availability rate to drop 30 basis points. Meanwhile, the national office vacancy rate fell 10 basis points during the quarter, the multifamily vacancy rate was unchanged and the retail vacancy rate rose 10 basis points.

- Bank lending was strong in Q3 2013, accounting for more than 35% of the quarter's total commercial loan closing volume. The pick-up in bank lending

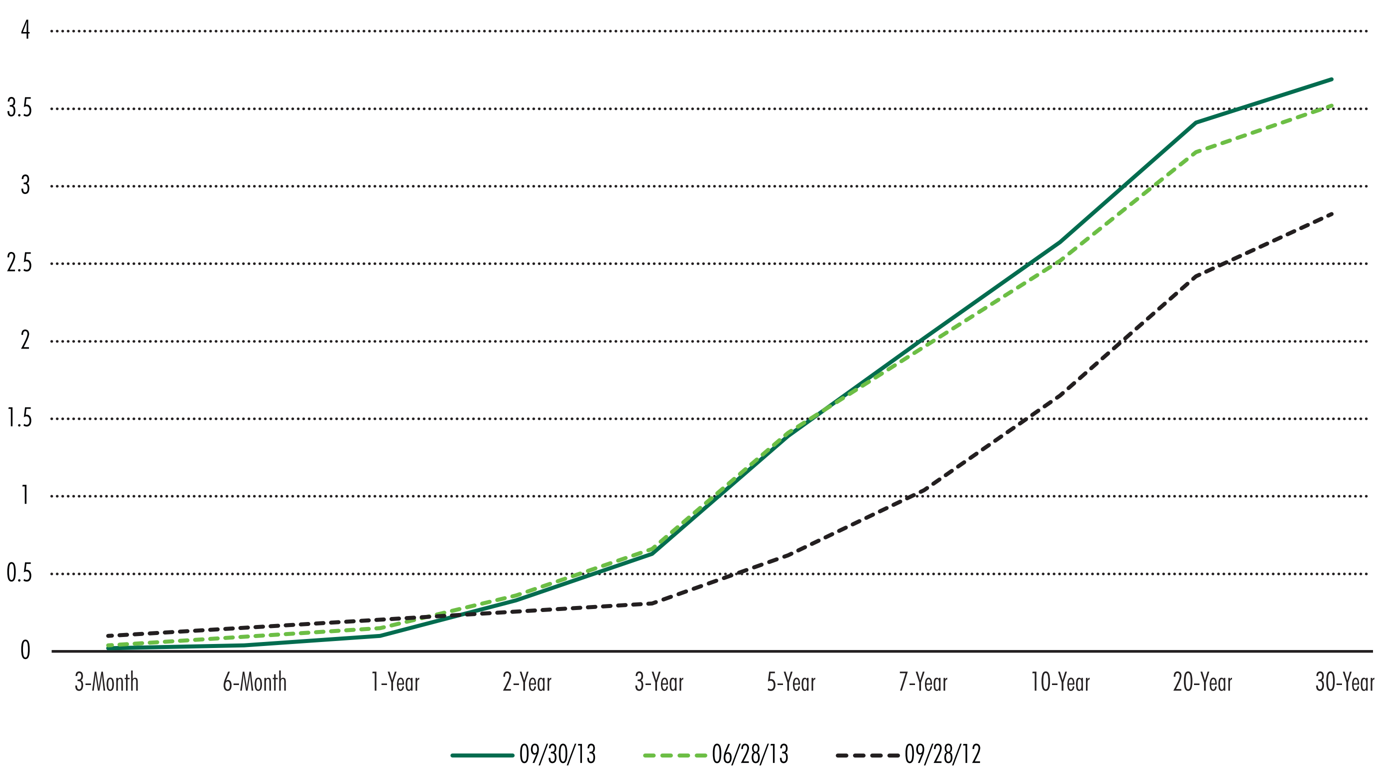
Data as of September 30, 2013

reflected a number of fundamental and market factors. With distressed real estate assets declining and deposits on the rise, banks have refocused their efforts on new commercial loan originations. The recent steepening of the yield curve pushed borrowers to seek lower interest rates on floating and three- to five-year fixed deals, traditionally a strong segment for bank lenders. Value-added funds have been increasingly active in recent quarters, attracted to short-term loans with flexible extension options that match the timing of their strategies. Many lenders have offered floating rate loans without immediate interest rate cap or swap requirements, which has made floating-rate financing attractive relative to similar term fixed-rate financing.

- CMBS lending has been surprisingly resilient in recent months as spreads compressed after a period of turmoil at the end of Q2 2013. As of late October, year-to-date issuance reached $67 billion, almost double the $35 billion pace set during the same period in 2012. However, regulators announced a revised set of risk retention requirements, which could have implications for future pricing and growth. (See analysis in Capital Markets Trends).

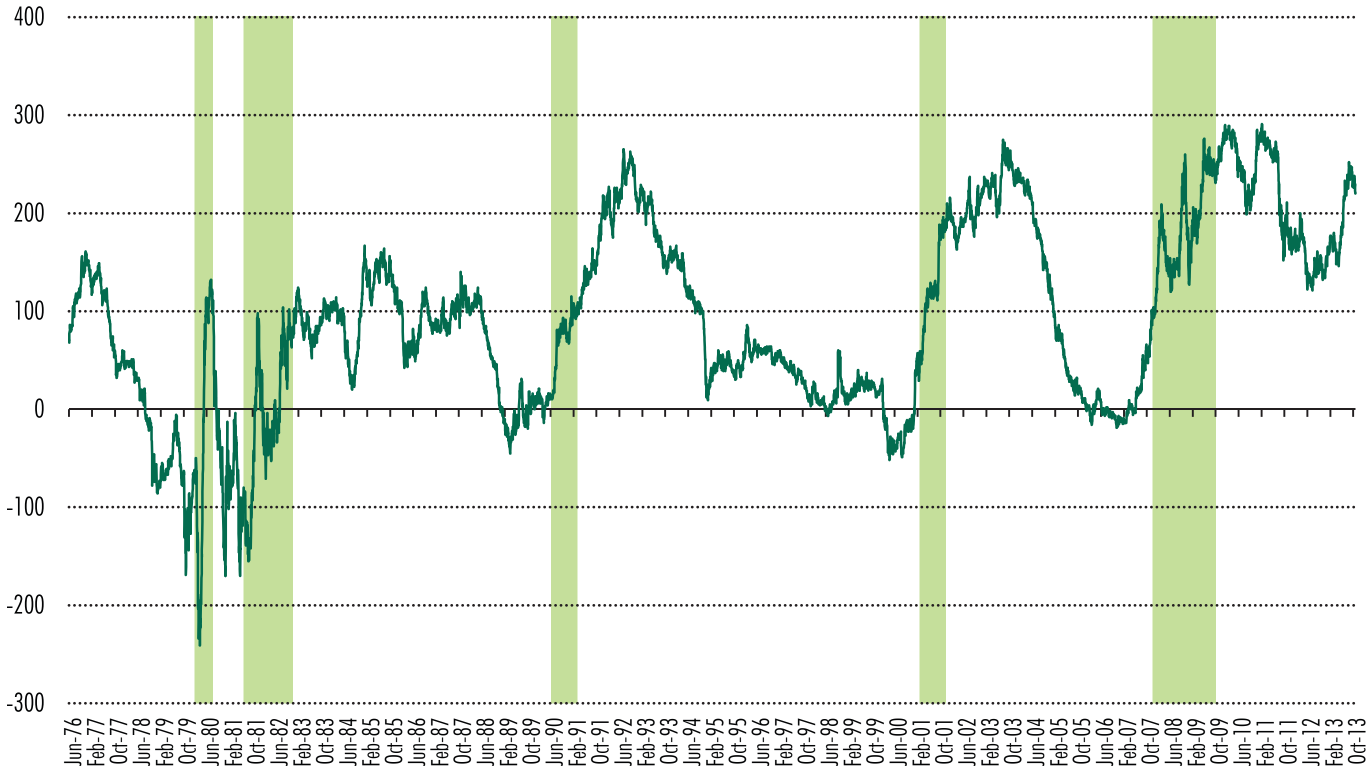
- Agency share of total commercial and multifamily lending volume fell to 32% in September, down from 46% in June. This was likely a result of higher spreads, as well as the FHFA's targeted goal of reducing 2013 Agency origination activity by 10%.

Figure 1: U.S. Treasury Yield Curve Percentage



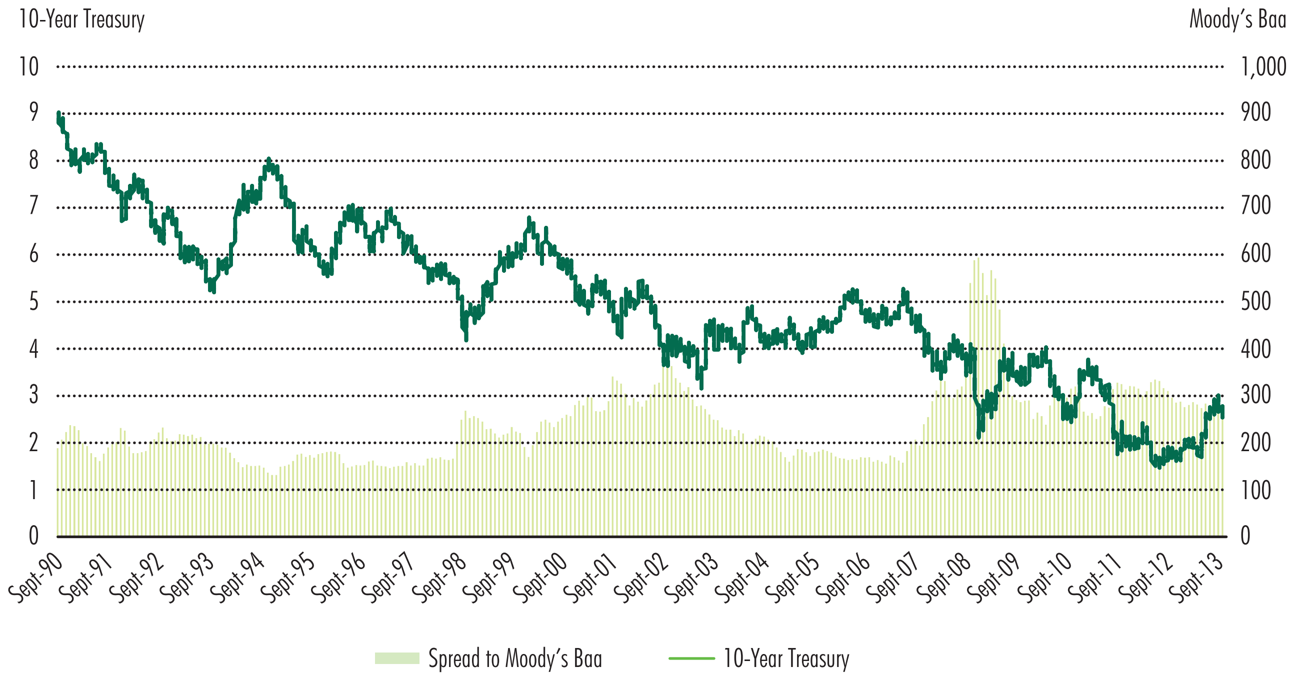
Source: CBRE Research, Q3 2013.

Figure 2: BPS Spread, 10-Year and 2-Year U.S. Treasury Yields



Source: CBRE Research, Q3 2013.

Figure 3: BPS Spread, 10-Year Treasury, Moody's Baa Corporate Bond Index



Source: Moody's Economy.com, Q3 2013.

CAPITAL MARKET TRENDS

Capital markets were relatively calm during Q3 2013, after springtime turmoil pushed up Treasury rates and spreads from lows reached in April and early May. The benchmark 10-year U.S. Treasury began July near 2.5%, and almost hit 3% in early September amid concerns surrounding the Federal Reserve's bond-purchasing program and an impending government shutdown. By the end of the month, however, the benchmark rate had settled back down to around 2.6%. Credit spreads, as measured by Moody's Baa-rated corporate issues, remained fairly stable over the period, at a range of 255 to 283 basis points (bps) over the comparable 10-year U.S. Treasury, settling to 275 bps by the end of the quarter.

CMBS markets recovered and moved ahead during Q3 2013. Spreads on 10-year, AAA-rated new issue bonds compressed nearly 20 bps over the course of the quarter. By late October, spreads had fallen further, approaching swaps greater than 100 bps, a level last recorded in late May as market disruption unfolded. New issuance gained pace during the quarter, with nearly $25 billion in volume closed. As of late October, year-to-date issuance reached $67 billion, almost double the $35 billion pace seen during the same period in 2012.

Markets continued to be on edge regarding the future direction of the Fed's interest rate policy. The nomination of Janet Yellen to succeed Ben Bernanke as Fed chair was seen by many observers to be a continuation of the central bank's "dovish" orientation toward an accommodative monetary policy. In late October, the Federal Open Market Committee, which oversees the Fed's major policy decisions, voted to maintain the $85 billion-a-month bond-buying program. While uncertainty persisted regarding monetary policy, with members of the Committee cautious about the pace of economic growth and recovery in the labor market, many analysts believe that the Fed will begin to taper its bond-buying program by March 2014, with completion by the following September.

While the government shutdown likely caused a temporary reduction in growth and consumer confidence, job growth has been surprisingly favorable. The Labor Department's October payroll employment report indicated an increase of 204,000 jobs, ahead of the 190,000 average monthly gain recorded during the previous 12 months. The October report counted government workers affected by the shutdown as employed. In addition, employment levels for August and September were revised upward by 60,000. However, the unemployment rate hovered at 7.3%, remaining above the Fed's stated 6.5% threshold for the tapering of its bond purchase program.

NEW RISK RETENTION RULES PROPOSED FOR CMBS DEALS

In late August, regulators approved a new set of draft risk retention rules for CMBS securitizations. If originators fail to underwrite commercial mortgages to "qualifying" standards, they will be required to hold 5% of the deal's fair value. Originators may seek to waive risk retention requirements if certain criteria are met. However, it is likely that the majority of loans originated will fail to meet the fairly stringent amortization requirements, which are not currently seen in the market. The originator can satisfy the risk retention requirement by holding a 5% vertical slice of the deal against its regulatory capital, or transferring some of its entire requirement to a qualified B-piece buyer who independently underwrites the loans. B-piece buyers would also be subject to a five-year holding requirement.

The 5% requirement would prompt B-piece buyers to purchase not only below investment grade bonds, but investment grade bonds up to the BBB level. As a result, the changes would likely lead to higher loan pricing, as B-piece buyers would demand higher spreads on these issues to meet yield requirements. The higher loan spreads may make life company and bank deals more competitive over the longer run, and they may have a dampening effect on new issuance activity.

It is likely that regulators will finalize the new rules sometime in late 2013 or early 2014. These rules would likely apply to new CMBS securitizations two years hence.

MARKET OBSERVATIONS

As detailed in the previous Lender Forum, Q2 2013 was best described as one of volatility, with Treasuries and loan spreads rising due to concerns over the tapering of quantitative easing. Fortunately, the markets found more solid footing in Q3 2013, with relative calm taking the place of volatility.

The current environment continues to serve commercial banks particularly well. Many banks can price off a historically low Libor, and many borrowers remain comfortable in allowing their loans to float, at least for a year, if not into the indefinite future. Swaps, forward swaps and caps remain front of mind for borrowers and lenders. We are now starting to see some interest in swaptions. This is understandable as many borrowers believe Libor could remain very low for the short- to intermediate-term, but would like to have the future interest rate protection of the swaption available if needed. Due to the steepening yield curve, some borrowers that would prefer a 10-year loan term are backing down to seven-year and even five-year terms, firmly in the middle of the fairway for many commercial banks. (This is well-presented in Figure 5, "Who's Lending on Commercial Properties?")

CMBS platforms continue to gain market share. We started this year anticipating approximately $70 to $75 billion in CMBS securitizations. The total for 2013 is currently estimated at around $90 billion. Next year, we will see the beginning of the much-anticipated wave of refinancing of 10-year CMBS loans originated between 2004 and 2007. We continue to watch closely for the pronouncements relating to the finalized risk retention rules for CMBS securitizations and expect the new rules to be announced in the next few months.

Life insurance lenders remained active, consistent with their established lending parameters. However, life company market share has fallen from 40% in Q3 2012 to 27% in Q3 2013. The lost market share has come primarily at the hands of the banks. CMBS activity does not seem to be materially impacting life insurance origination at this time. Regardless, many life companies have hit or are close to their allocations for the year. However, several life companies have announced new pools of funds looking to be committed by year's end, with early 2014 loan closings.

The Agencies are operating under a mandated 10% volume reduction in 2013. After an "overcorrection" in early summer, however, Agency volume has picked up, but will likely finish the year inside of the FHFA-mandated guidelines.

As we reflect on 2013, we remain grateful to work with so many wonderful and talented lenders and borrowers. Thank you for your friendship and your role in helping to shape and improve our industry. All the best in 2014.

Brian Stoffers
President, CBRE Debt & Structured Finance
Chief Operating Officer, CBRE Capital Markets

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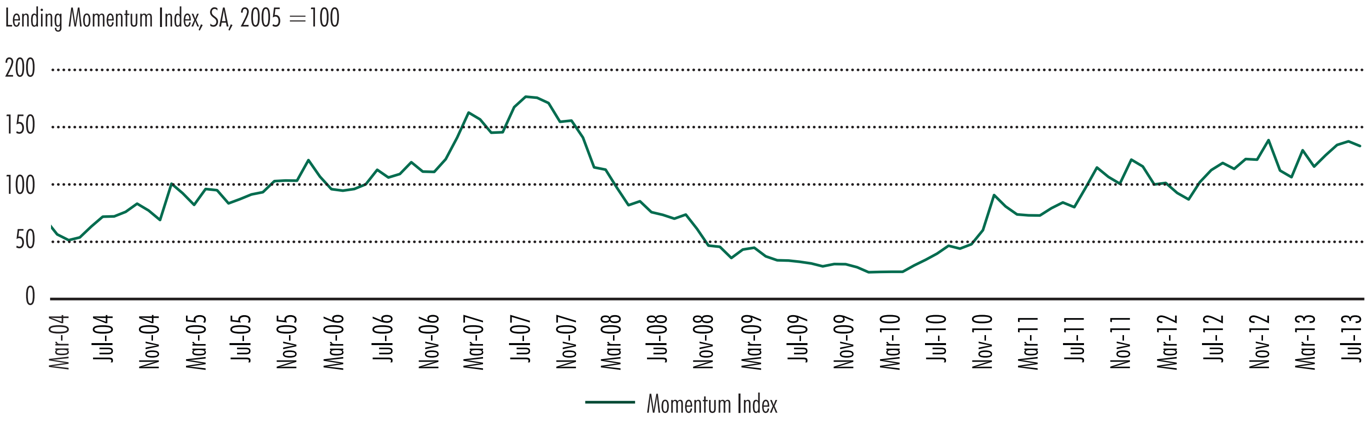
Figure 4. CBRE Lending Momentum Index



Source: CBRE Research, Q3 2013.

The CBRE Lending Momentum Index uses CBRE's proprietary database of loan data to track the momentum of commercial mortgage loan closings. The Index is adjusted for seasonal variation and has a base value of 100, which is equal to the average activity for the entire year of 2005.

To interpret the Index, one has to place it in historical context. The Index peaked at 177 in August 2007 and bottomed out at 23 in February 2010. The way to interpret this change is in absolutes—i.e., there was an 87% decline in lending volume over this 32-month period.

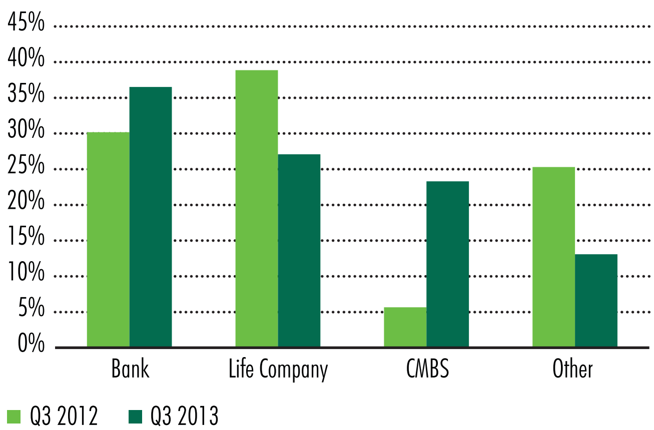
After reaching bottom, lending activity has recovered steadily, with the Index reaching 139 in January 2013. Through the first half of 2013, activity showed a slightly oscillating pattern, ending June at 126. The first half's performance appeared to indicate that the broad, three-year-long recovery was entering a new phase.

During Q3 2013, however, lending momentum improved, with the Index reaching 138 in August, just shy of its January peak. At quarter's end, the Index stood at 134, 12.6% above its year-ago level.

Lending markets were surprisingly strong during Q3 2013 despite the capital markets turmoil that took place in June and July. Since the Index reflects loan closings on deals completed some 30 to 90 days earlier, many had expected that the rise in Treasury rates and loan spreads during Q2 2013 would have had a more negative effect on recent closings.

The share of loans originated by the Agencies dipped during Q3 2013. In September, Agency share of total lending fell for the sixth consecutive month to 31.8%, from 50% in March.

Figure 5. Who's Lending on Commercial Properties?



Source: CBRE Research, Q3 2013.

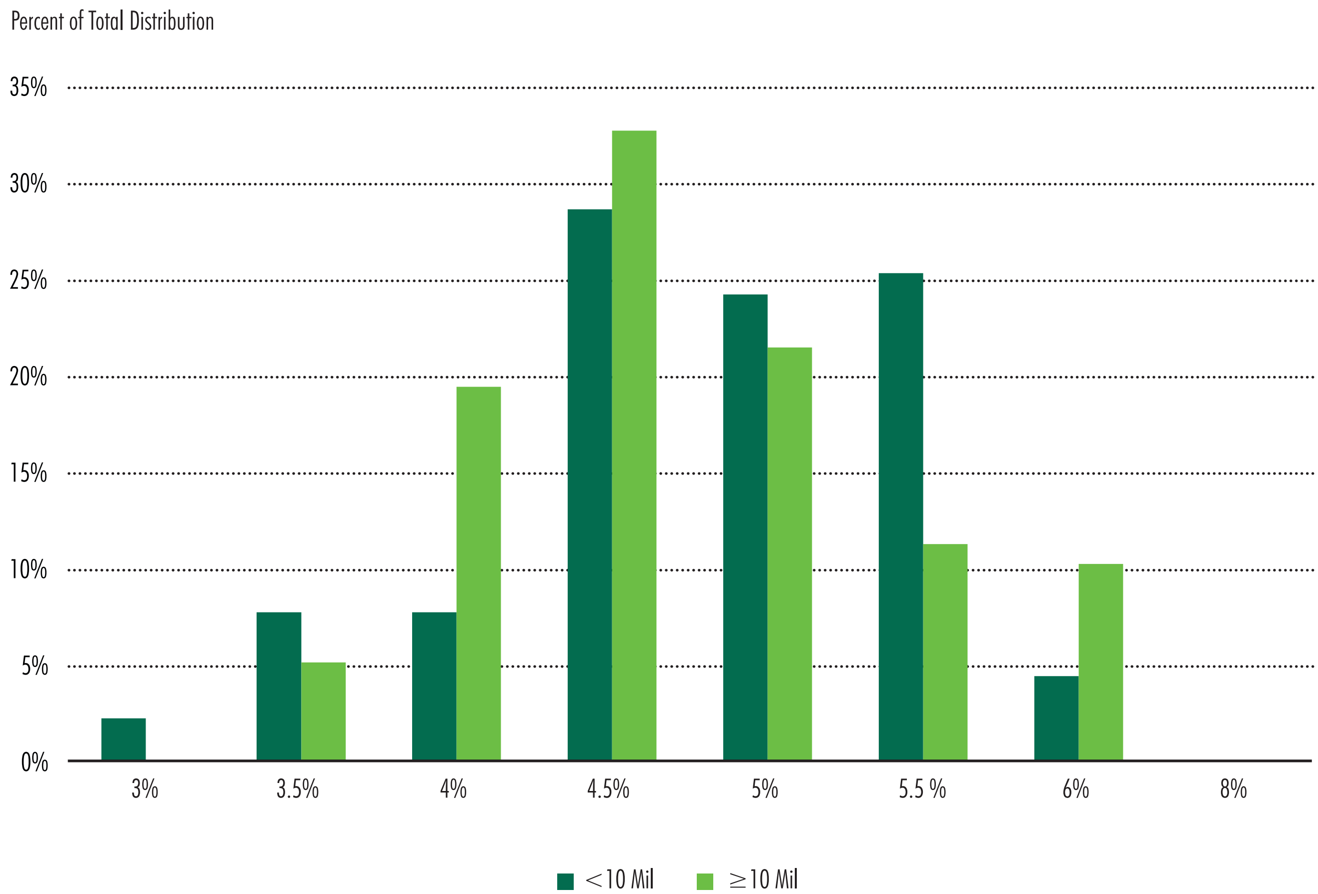
During Q3 2013, banks and life companies remained two of the most active commercial mortgage lenders. Banks remained on a roll during the quarter, capturing 36% of non-Agency originations by volume. By comparison, banks accounted for 30% of the market share in both Q2 2013 and Q3 2012. Meanwhile, CMBS originations remained at healthy levels, as public markets captured 23% of activity in Q3 2013, down slightly from 30% in the prior quarter, but well ahead of year-earlier levels.

With the increasing competitiveness of bank and CMBS conduit lending, life company originations remained under pressure. The share of life company originations slipped to 27% in Q3 2013, down from 30% in Q2 2013 and almost 40% in Q3 2012.

CMBS lenders appeared to continue to take the most market share from the "other" lender category, which includes REITs, private funds and credit companies. The "other" lender category share of commercial lending volume slipped to 13% during Q3 2013, well below the 25% share registered one year earlier.

During Q3 2013, the effect of higher benchmark rates and credit spreads were apparent in the distribution of coupon rates. The majority of overall rates remained low by historic standards. However, the percentage of loans with coupons below 3.5% was 7.4% during Q3 2013, compared with 26% during Q2 2013.

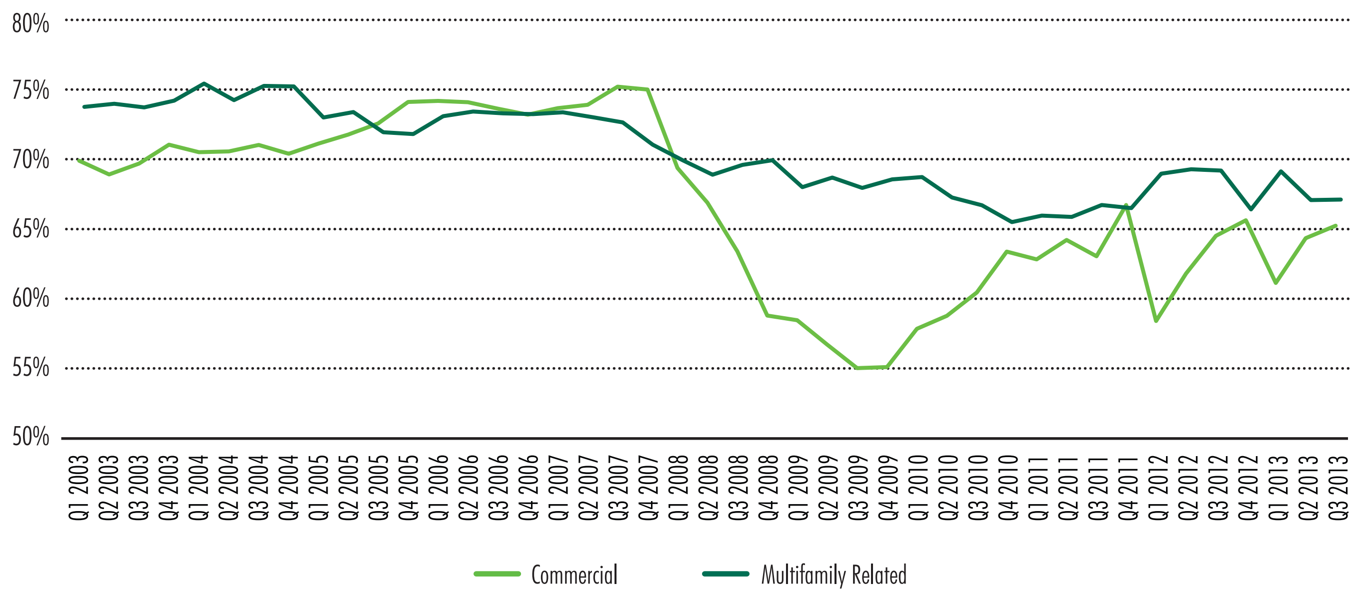
Figure 6. Coupon Rates, July-September 2013*



*Includes both Agency and non-Agency loans

Source: CBRE Research, Q3 2013.

Figure 7. Average Loan-to-Value Ratio*



*This reflects the average LTV for deals with fixed-rate permanent debt.

Source: CBRE Research, Q3 2013.

Coupon rates shifted upwards over the quarter, with 44% of loans carrying a coupon rate between 3.5% and 4.5%. During the previous quarter, the comparable figure was 53%. By contrast, almost half of all loans carried a coupon greater than 4.5% during Q2 2013, compared to 20% during Q3 2013.

During the quarter, commercial and multifamily loan-to-value (LTV) ratios for permanent, fixed-rate loans converged in a pattern similar to that witnessed in Q2 2013. Average LTVs for commercial loans reached 65.3% during Q3 2013, up from an average of 64.4% during Q2 2013. Notably, this was the second highest quarterly average registered since commercial LTVs began to recover from their 55.1% low point in Q3 2009. LTVs reached a peak of 65.3% during Q4 2012.

Meanwhile, average multifamily LTVs remained steady at 67.2% in Q3 2013. Average multifamily LTVs on permanent, fixed-rate loans have remained consistent over the past four years, hovering between 65% and 70%. While multifamily LTVs remain below pre-crisis levels, they remain above average commercial LTVs.

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This report was prepared by the CBRE U.S. Research Team which forms part of CBRE Global Research and Consulting – a network of preeminent researchers and consultants who collaborate to provide real estate market research, econometric forecasting and consulting solutions to real estate investors and occupiers around the globe.

CBRE CAPITAL MARKETS

CBRE Capital Markets combines the company's investment sales, financing and banking businesses into a single, fully-integrated global service offering. As the recognized worldwide leader in the acquisition and disposition of income-producing properties for third-party owners and as a leader in debt and equity financing for all properties, our clients are offered complete capital market solutions everywhere around the globe. Through the first half of 2013, CBRE led the industry with $36.9 billion of investment sales and loan activity nationally*. CBRE ranked as the #1 investment sales firm overall for Q2 2013, according to Real Capital Analytics.

*US investment sales data as reported by RCA. Data does not include CBRE's individual property sales valued at less than $2.5 million.

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