10-YEAR CMBS LOANS: AN ENDANGERED SPECIES?

The competitive threat e-tailers pose to traditional brick-and-mortar retailers is causing lenders to proceed with caution in this sector. The oncoming wave of maturing CMBS loans may be the last.

By Ann Hambly and Steve Banegas

Picture this: It is the year 2027 and you need a new tie for an upcoming ICSC conference. Do you (a) pick up the new catalog you received in the mail recently, thumb through it until you find what you need and then phone in your order; (b) drive to your local mall, walk through all of the stores until you find what you are looking for; or (c) search online for the item and have it shipped to you? Every retail owner, investor and lender today is asking that same question.

Why am I pointing to 2027? That will be the maturity date for a new 10-year CMBS loan originated in 2017, a year when many existing CMBS loans will reach maturity. Will lenders likely recommit to another 10 years of brick-and-mortar retail in 2017?

A Challenging Landscape

Retail store closings continue to make headlines. Family Dollar announced in early April that it plans to close 370 stores after revenue fell 6 percent in the second quarter of fiscal 2014 on a year-over-year basis.

In March, RadioShack announced it would close up to 1,100 poorly performing stores, or roughly 20 percent of the electronic retailer's locations. RadioShack has struggled to find its niche in the modern tech world. Other retailers have announced closures because they are banking on the fact that buyers will more likely resort to Option C — shop online — in 2027.

The experts who keep track of store openings and closings have been forecasting for more than a decade that the day was coming when American retailers would have to pay for building way too many stores. That day of reckoning, some say, has arrived. One retail watcher predicts a "tsunami" of store closings in 2014.

Brian Sozzi, CEO of Belus Capital Advisors, an independent stock market research firm based in New York, made that prediction in January. Shortly thereafter, Staples announced it was shutting 225 of its stores and RadioShack revealed its store closure plans.

Ann Hambly
1st Service Solutions

Alison Paul, a retail and distribution expert at consulting firm Deloitte, stated in January that she expects the coming shakeup will be the biggest change the retail industry has experienced since the 1960s, when the era of big-box stores began.

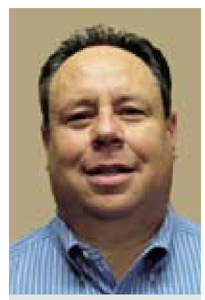
Survival of the Fittest

In a recent CBSNews.com article, titled "A dying breed: The American shopping mall," reporter Mark Strassmann wrote that "it used to be when a sign at the mall said 'Everything Must Go,' it meant a particular store was going out of business. These days it could very likely mean the entire mall is shutting down."

The article recaps the history of America's love of shopping, including 1956 when the nation's first fully enclosed mall opened its doors. Between 1956 and 2005, about 1,500 malls were built — including the Mall of America, one of the world's biggest malls.

It was the golden age of shopping, which lasted until a new golden age came along, courtesy of the Internet.

It is important to point out that not all malls are alike, so the impact of online shopping can vary greatly. There are three main mall categories:



Steve Banegas
1st Service Solutions

• Dominant — A dominant shopping venue typically includes more than 800,000 square feet of leasable area with three or more anchors. These malls typically have high-end retailers like Nordstrom and Bloomingdales.

• Core/Opportunistic — Regional malls in this category typically range from 400,000 to 800,000 square feet of leasable area with a minimum of two anchor tenants. They typically offer a wide selection of stores, a food court and some chain restaurants.

• Distressed — A distressed regional mall is one that has lost one or two of its anchor tenants.

The malls that will likely be closing fall into the distressed or core/opportunistic categories rather than the dominant mall category.

Generational Preferences

The new golden age of retail began as a result of the Internet and is a generational attribute. Many people born before the baby boomers still prefer to either phone in their order after browsing through a newly received catalog, or drive to their local mall and walk through all of the stores until they find what they are looking for.

Baby boomers teeter between driving to the local mall to buy what they are looking for, or search online for the item and have it shipped to them.

Generations X and Y clearly resort to Option C first. Their children may not even think about any other option besides going online to search for the item they want.

Skittish Investors

CMBS investors are cutting back on their appetite for retail, causing CMBS lenders to dial back their originations on retail loans. Predictions are that the total retail loans securitized in 2014 will be the lowest in years.

> Predictions are that retail loans securitized in 2014 will be the lowest amount in years.

Loans on retail properties make up approximately 32 percent of all CMBS debt outstanding as of March 31, according to New York-based Trepp LLC, which closely tracks the industry. Among the five major property types, the retail sector has the second highest percentage of CMBS loans in special servicing. Only the office sector has a higher percentage of loans in special servicing.

Loan Maturities to Spike

There are more than 11,000 CMBS retail loans maturing between now and 2017. Since CMBS loans are typically 10-year term loans, it is safe to assume that these loans were originated in the years 2005-2007, which were the years of highly aggressive underwriting (see loan maturities chart).

Many analysts predict that CMBS loans — regardless of the property type securing the loan — that were originated between the years 2005-2007 will not qualify for refinancing without a significant equity infusion from the owner.

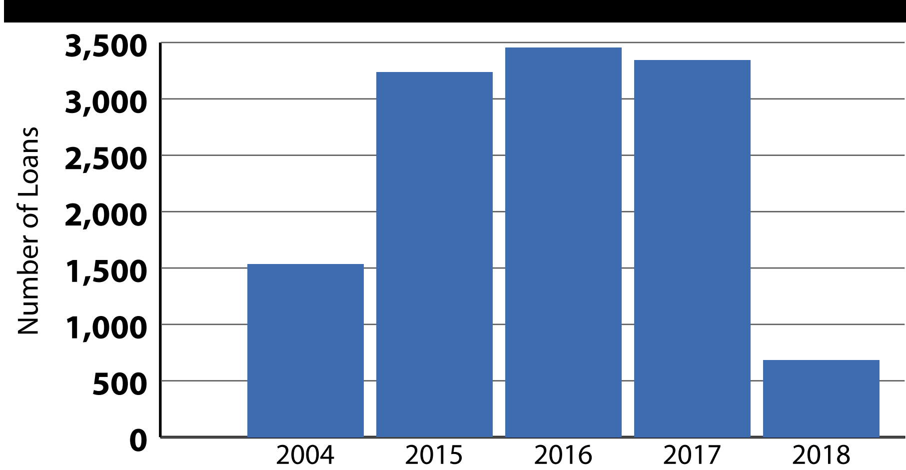
More than 12 percent of the loans maturing in 2015 are over 100 percent loan-to-value. These loans will not qualify for refinancing and most likely will not be paid off. Another 21 percent have loan-to-values between 80 and 100 percent and will likely not be able to be refinanced.

These are the loans originated in 2005, which was the most stringent underwriting year during a period of lax underwriting standards (2005-2007).

When you add the high leverage nature of the upcoming CMBS maturities to the ever-changing dynamics of the new golden age of retail, it is hard to understand how all of these CMBS loans secured by retail properties get paid off.

Ann Hambly is the founder and CEO of 1st Service Solutions, a borrower advocacy firm based in Grapevine, Texas. Steve Banegas is the chief operations officer and chief people officer for the company. To date, 1ST Service Solutions has advocated over $13 billion of CMBS loans on behalf of owners.

Dramatic Growth Ahead for CMBS Loan Retail Maturities



More than 1,500 U.S. CMBS retail loans will reach maturity in 2014 with an aggregate unpaid balance of $11.7 billion. That figure is expected to slightly more than double to 3,236 loans reaching maturity in 2015 with an aggregate unpaid balance of $29.6 billion. The annual number of retail loans reaching maturity is then expected to hold somewhat steady in 2016 and 2017 before dropping off sharply to 684 loans in 2018.

Source: Morningstar