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Unrated issuance
Hilton CMBS unlikely to set a trend

The recent privately-placed Bank of America Large Loan Trust transaction, backed by Hilton Worldwide assets, is believed to be the first unrated CMBS to hit the US market. Only a few unrated deals are expected to follow in its wake, however.

Most traditional CMBS investors are life insurance firms, which are ratings-driven in terms of their investments. This automatically limits the demand side for unrated liabilities, according to Amit Khurana, md at Odeon Capital Group.

He points out that the Hilton CMBS was downsized from US$2.66bn to US$1.56bn, while the yield was increased from 6.5% to 7.5%. "This demonstrates that there is only limited appetite for the deal and that investors have asked for more yield to compensate them for the incremental work that is necessary to analyse it. As traditional investors have been sidelined, the investors looking at this deal will be sophisticated and/or know the hotel sector very well."

Indeed, Khurana likens the approach an investor in the Hilton transaction would have to take in terms of due diligence to that of B-note investors before they buy. "It obviously demands more time and resources than normal, so they probably feel they need to be compensated accordingly."

He adds: "I don't think there will be many unrated deals unless a new metric is developed that provides an alternative to ratings. But this will entail a significant shift away from the traditional model."

In addition, Khurana suggests that the Hilton portfolio is a special case because the assets are well known and Bank of America has an incentive to sell, given that it is seeking to unload the loans from its books. "I think you could only bring an unrated CMBS backed by assets that are well known. The other issue is, of course, economics and whether the portfolio generates enough yield to justify paying a higher coupon."

Anecdotal evidence also points to BoA opting for the unrated route in order to avoid public disclosure of asset performance information.

Nevertheless, Khurana indicates that what BoA has done in terms of structuring the Hilton CMBS could potentially be replicated in the private label student loan ABS sector, for example. "Certain funds could restructure legacy portfolios and place the senior notes with other investors, while retaining the junior notes," he explains. "The limiting factor is whether the assets have enough yield, although this could be created via leverage if necessary."

He says it is a good time to sell legacy assets at present because, from a distressed investment perspective, there isn't enough supply. "Some off-the-run sectors, such as aircraft, are picking up because there is nothing else to invest in. Now is a perfect time to take advantage of a lack of other attractive investments - which is presumably one of the reasons that BoA is coming at this time. However, you still need to have good underlying assets to create interest."

Away from the Hilton CMBS, meanwhile, US conduit issuance appears to be gaining traction, with a handful of deals pricing in recent months. This issuance has gained the moniker of 'CMBS 2.0' as a way of distinguishing it from 2005-2007 vintage deals.

Analysts at Annaly Capital Management reviewed JPMCC 2010-C1 and C2, GSMS 201-C1, COMM 2010-C1 and WFCM 2010-C1 to determine how different the new generation of transactions is. Their first observation is that these deals have a lower average loan count of 33.6, compared to legacy CMBS issuance that contained hundreds of loans.

"Not only are the pools more decipherable due to fewer loans, but investors are given more time to perform their due diligence," the analysts note. "Also, a smaller loan count creates smaller pools versus the legacy pools that averaged US$2bn with some pools topping US$7bn."

Further, while legacy pools reflected debt service coverage and LTVs similar to CMBS 2.0, those ratios included a significant component of pro forma underwriting. Today, debt service coverage is calculated off in-place income with nearly all of the loans containing amortisation from day one and reserves being funded for capital expenditures, according to Annaly. Even so, rating agencies have assigned slightly higher subordination level to triple-A bonds of 17%-18%, compared to the 11%-13% attachment points for legacy CMBS.

Finally, the new transactions contain fewer tranches - generally two triple-A notes supported by five to eight tranches beneath them, compared to legacy transactions that had up to 29 tranches.

In terms of collateral, Annaly estimates that retail, office and industrial securitised loans account for 59%, 19% and 9% respectively of CMBS 2.0 pools, compared to legacy compositions of 30%, 30% and 4% respectively. Additionally, the majority of CMBS 2.0 assets have historically been relative outperformers from a credit perspective.

"The CMBS conduit apparatus has apparently been listening to participants," the Annaly analysts observe. "For the investment grade bond buyers, these transactions almost reflect a 'back to the future' feeling, given their size and collateral characteristics. Time will tell how these assets perform, but at least investors have a better risk profile to assess."

However, Khurana remains unconvinced that CMBS 2.0 is very different to how the sector looked before the financial crisis. "Structures are more conservative and there is more awareness of potential conflicts around, for example, special servicers holding the junior notes - hence the introduction of an operating advisor on some recent CMBS. These issues have to be addressed, but it doesn't mean that a new model has been created. I think the last handful of transactions have been more like 'CMBS 1.5', with some elements having been tinkered with but no fundamental overhaul."

He suggests that if loans are simply being extended rather than refinanced or liquidated, thereby starting with a clean sheet, pre-crisis flaws are unlikely to be completely ironed out. "Some bonds - especially those that were underwritten aggressively at the top of the market on properties that are unlikely to recover in value - will probably remain permanently underwater. I think the market has to fundamentally change before the way CMBS are structured fundamentally changes. It is possible to figure out ways of keeping alive, but at what point is it necessary to face the music?"

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