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Distressed CMBS Loans Now Returning Less Than Half Their Note Value

Declining Property Values Indicate Loss Severities Will Go Higher

The amount of losses on distressed CMBS loans resolved in the past year has jumped 33% to where noteholders are now recovering approximately 43 cents on the dollar. And, say analysts, the losses are expected to continue to mount this year.

The average loss severity rate or the ratio of realized loss to liquidation balance for U.S. commercial mortgaged-backed securities (CMBS) loans resolved with losses in 2009 was 57% compared to the 43% rate in 2008, according to new data from Fitch Ratings. Those losses outpace the cumulative historical average of 37.2%.

"Loss severities are expected to remain above the current cumulative average through 2011," said Fitch managing director Mary MacNeill. "Assets liquidated in the current economic environment will be those not likely to see cash flow improvement from an extension or modification."

"Assets will take longer to resolve as special servicers continue to see high volumes of underperforming loans," added Fitch senior director Richard Carlson. "Continued high inventory and the declining frequency of modifications means there is no relief in sight."

The rationale for seeing continuing increases in losses is relatively simple, explained Xiaojing Li, senior debt analyst for CoStar Group.

"In a 'normal' economic environment, proceeds from a collateral liquidation could fully recover the interest shortfalls, and sometimes even the total outstanding balance in a booming market," Li said. "But in an environment such as today's, when the economy is not fully out of the woods and commercial real estate values are well below the levels from a few years ago, high loss severities are expected to linger, if not deepen."

Evidence for this conclusion was shown in a recent PPR loss severity study Li completed, based on Trepp data on liquidated conduit CMBS loans. Among liquidated loans, 91% of the properties had been reappraised at least once, and 87.5% were appraised at a value lower than their original value at securitization. Thus, Li explained, appraisal reductions are "a fortune cookie of loss severity."

"Property value is the barometer of potential losses for CRE debt," Li said. "In the first quarter of 2010, there were already \$270 million in losses via liquidation. Among the \$17.7 billion in loans newly added to special servicers this year, 7% have already had appraisal reductions, threatening a new wave of losses."

According to Fitch, the largest loan resolution methods for 2009 were real estate owned (REO) dispositions, discounted payoffs (DPO) and note sales. Loans resolved by each of these methods resulted in loss severities greater than the cumulative average.

Fitch expects higher loss severities for all property types this year. Annual loss severities by property type for last year were as follows:

- * Hotel: 81.9%
- * Multifamily: 58%
- * Office: 56.9%

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* Industrial: 48.8% and

* Retail: 48.2%.

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