



CMBS Due Diligence Underwriting: Helping Investors Make Informed Decisions

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The evolution of commercial mortgage-backed securities (CMBS) as a vibrant investment sector has brought many changes to the world of real estate finance. A new and expanding investor base, lower cost of capital for real estate owners, and a discipline to the supply of new buildings are a few of the more notable developments. Less well known is the new application of real estate finance skills known as due diligence underwriting. Due diligence underwriting is focused on collateral credit risk: determining the competitive position of an asset within its market, assessing the quantity and quality of the collateral's cash flow, and determining an asset's ability to generate sufficient cash flow over time to service the mortgage debt.

Collateral credit risk is principally the concern of the below-investment-grade, or B-piece investors. The investment-grade investors assume little or no collateral credit risk by selling this risk to the B-piece. It is essential for investors assuming collateral credit risk to fully understand the collateral and the issues that affect that collateral over time.

In the case of a new bond issue the due diligence underwriter has the unique opportunity to have the first buy-side look at a loan. This independent and objective first look at the collateral is an excellent way to determine what events are taking place at a property and within the market that will impact the collateral's current and future cash flow. How does the due diligence underwriter perform this task so that the investor is able to make informed decisions? Read on for a better understanding of the due diligence underwriting process.

COLLECTING AVAILABLE INFORMATION

The underwriter begins the due diligence process by

accumulating relevant and current information on the collateral to be reviewed. For new issues, the loan file should include the relevant third-party reports, current and historical financial statements, current and historical certified rent rolls, loan terms and structure, borrower information, and the issuer's underwritten executive summary and financial analysis, including a history of the property with the date and amount of the borrower's purchase, and reason for financing.

Often the loan files are not complete. For secondary market transactions the underwriter may only receive information that is available from the master servicer, including property financial statements, rent rolls and structural (escrow) information. In any event, the underwriter must rely on the information available and their own accumulated years of experience assessing real estate properties and their cash flows.

RESEARCH

Next, research must be done to adequately prepare for the site inspection and market tour. The location of the asset, the location of competing properties, and the location of the appraiser's lease comparables are identified. Information on comparable space for lease in the market is available on many Internet sites and can supplement for additional lease comparables. The underwriter will contact local brokers to obtain lease information and market statistics and to gain an understanding of market leasing activity. Published statistics are available on most of the primary and many of the secondary MSAs for macro-economic data, such as demographics, employment history/projections, major industries, employers, etc. This is also true for micro-real estate data, such as vacancy rates for various property types, absorption rates, and market rent trends. For secondary and tertiary markets, the underwriter can research chambers of commerce, local government, and the local brokerage community. Obtaining as much information as possible prior to the site inspection



enables the underwriter to make well-informed observations of the property, the current supply of competitive properties and the potential for future supply.

KICKING THE BRICKS

The site inspection and market tour is the most critical element of the due diligence process. It enables the investor to see, touch and experience the collateral through the due diligence underwriter. Actual tenants in occupancy are checked against the current rent roll. For some properties, such as multifamily or office assets, it may be impractical or impossible to check all tenants due to size or security reasons. The underwriter will inquire about current leasing opportunities to determine current occupancy and asking rental rates.

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An on-site presence allows the underwriter to interview tenant employees, customers and leasing agents for multifamily, hotel, self-storage, and mobile-home parks. These interviews are typically basic: “How is business?” “What happened to the tenant next door?” “Who would you say are your direct competitors?” “Do you know who will anchor that new center across the street?” etc. People will often share a surprising amount of important local market information through friendly, patient, and specific questioning.

The underwriter must also carefully review the physical condition of the property, especially with regard to any immediate needs identified by the engineer. Visibility, accessibility, vehicular and pedestrian traffic flow, landscaping, signage, parking, number of buildings, number of stories, the neighborhood, and surrounding uses are all observed and rated (poor/fair/good/excellent) on an absolute basis as well as relative to competing properties within the market. These elements combine to tell a story of how well the property competes in its submarket.

The underwriter takes a thorough market tour to physically inspect competing properties, lease comparables, current leasing opportunities, and potential future developments. The properties are rated (A, B, C±) to determine the competitive position, which may range from highly competitive to noncompetitive to obsolete. The market tour also helps the underwriter conclude the current level of market rents and market occupancy.

Most often, inspections will confirm the conclusions of the appraiser, the engineers and the original

underwriting. There will likely be some variations in market rent and market vacancy assumptions based on the underwriter’s due diligence. For such assets, the major issue is the competitiveness of the property and the likelihood of the property maintaining its competitive position in the market. In contrast, the underwriter’s conclusions for properties reviewed in a seasoned secondary market transaction are likely to differ from the original underwriting, sometimes significantly, due to events that have taken place at the property and in the market since the loan closed.

Occasionally, the due diligence underwriter concludes something completely different than that of the sell-side production team. The following are examples of information learned during site inspections that led to different and less optimistic conclusions:

- A retail tenant was asked, “How’s business?”
“Great” she replied.
“Oh, sales increasing?”
“No” she said, “They (corporate) are closing this store on Friday.”
“This Friday?” (There are three years remaining on the lease according to the rent roll.)
“Yes—and I’m taking a vacation!”

The tenant represented about half of the first level retail income on this mid-rise multifamily asset. Combined with a market vacancy issue, this created a large variance to the originally underwritten cash flow.

- The appraiser stated there were no competing properties within three miles of the subject self-storage facility. A search on an Internet site revealed six self-storage facilities within a three-mile radius. Upon inspection, three of these were determined to be highly competitive with the subject property.
- A suburban office property located in a secondary MSA just outside a primary MSA had a rent roll showing 92% occupancy by three tenants. Upon inspection, the location was determined to be rural with the closest directly competitive property over five miles away. One of the tenants that occupied 25% of the property had vacated the premises.
- A mixed-use property was not a condominium, as reported in the underwriter’s executive summary. Rather, the taxing municipality had not parceled the living units and the property remained a co-op. Also,

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the restaurant tenant with 50% of the collateral's leaseable area closed for business four days before the site inspection.

- Site inspections on a portfolio of stand-alone retail properties found several vacancies, one fire damaged building, and a tenant constructing a new store less than one mile down the street from the subject collateral.
- The original market rent conclusion for a suburban office in a secondary MSA was approximately 15% higher than the asking rents in the two new office buildings being constructed across the street.

When evaluating a property's competitive position and its ability to generate sustainable cash flow an underwriter's skill and experience are essential.

COMPLETING THE PUZZLE

Back from the road, the underwriter works to complete the collateral review model with all relevant property and market information obtained in the due diligence process. A good model will present the analysis in a concise and efficient format for the investment committee to review and lead to a lively discussion on the collateral and its ability to produce cash flow.

In the model, the financial underwriting flows from the rent roll, which has been verified and adjusted to market. Other sources of revenue are derived from historical performance at the property, with certain non-property specific items, such as interest income, excluded. Operating expenses generally flow from the property's historical performance with some line items being marked to market, including management fee, real estate taxes and, more recently, insurance expense. Capital items, including leasing commissions, tenant improvements and replacement reserves are estimated based on market rates as well as rating agency standards. The resulting underwritten net cash flow is analyzed relative to the collateral's historical net cash flow, the

original underwritten cash flow, and the debt service obligation.

The underwriter concludes the strengths and weaknesses of the collateral and of the loan. Is the property competitive in its market? Is the location and condition a strength or weakness? Does the property have sufficient structure and cash escrows to address the large rollover of tenants in the next several years? Is the property over-leveraged or reasonably leveraged? Does the current market and its trend represent a strength or weakness? Is the borrower well capitalized? Do they have real cash equity in the deal? Has the owner and/or manager shown a willingness to maintain the competitive position of the property? Looking at the big picture—would you like to own this property?

During the investment committee presentation, the underwriter brings the relevant issues to the forefront, presents the photographs taken during the site inspection and market tour, and provides an overview of the financial underwriting. The investor can then analyze the information, challenge assumptions, concur or modify the underwriter's conclusions, and ultimately, make an informed investment decision.

CONCLUSION

Due diligence underwriting evolved as a unique group of investors sought to fully understand the collateral credit risks they were taking by investing in CMBS. Today's B-piece investors wouldn't think of buying below-investment-grade CMBS bonds without first deploying a team of competent due diligence underwriters to collect, inspect, analyze, and report on the collateral at hand. With shrinking subordination levels, downgrades and changing real estate fundamentals, how much collateral credit risk is embedded in your CMBS portfolio? □

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