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CMBS Delinquencies Rise Q1 2009

According to Fitch Ratings, loan defaults for CMBS mortgages jumped in the first quarter 2009. The cumulative default rate rose to 3.29% in the first quarter from 2.7% at year end 2008.

In terms of dollar volume, first quarter 2009 defaults represented \$2.6 billion of loans versus \$3.2 billion of defaults in all of 2008.

Fitch expects CMBS defaults to exceed 5% by year end 2009. Specially serviced loans totaled \$23.7 billion at the end of

the first quarter according to Fitch.

A significant portion of the increase in delinquencies has come from later CMBS vintages that reflected higher leverage and looser underwriting standards.

The trend is expected to increase significantly in the second quarter of 2009 due to the bankruptcy filing by General Growth Properties (GGP). 150 properties that are included in various CMBS

issues are part of GGP's bankruptcy filing.

Similarly, Fitch Ratings CDO delinquency index indicated that CMBS CDO delinquencies increased to 7.8% in April 2009 from 6.5% March. More than 75% of all Fitch-rated CDO's have at least one delinquent loan.

Fitch Ratings has placed 137 classes from 19 CMBS CDO's on Rating Watch Negative due to their implementation of revised criteria announced in late 2008.

B-Notes, Participations, Junior Tranches – Do they have value today?

The commercial real estate financing frenzy that occurred into 2008 led to the proliferation of complex debt instruments including B-Notes, participations and subordinate tranches in highly structured large loan transactions.

These vehicles gave investors a chance to own debt at various levels in the credit stack with generally higher spreads reflecting higher risk in the capital stack.

As the market has weakened, and some of the highly structured loans

are moving closer to default, do these subordinate positions have value?

Each situation is unique and requires a thorough analysis of the underlying collateral, the market as well as a careful reading of the loan documents. Investors in participating and subordinate debt need to know what their rights are and what potential obligations remain in the participation or inter-creditor agreements.

In some cases, it is prudent for the investor to

engage legal counsel to review the relevant documents.

The legal review should summarize the investor's control events, loan cash flow waterfalls, rights in the event of default, outstanding reserves, future funding obligations, etc.

When the loan structure, market, collateral and cash flow are understood, it is possible to reasonably determine a position's value and the potential options available to the investor to maximize the value of their position.



John Saunders, CFA
Principal
McCary Stevens Associates, Inc.

CMBS Due Diligence Underwriting: Helping Investors Make Informed Decisions

In 2003, McCary Stevens Principal John Saunders, CFA, published this article in CMBS World. Given today's climate, the article is even more relevant today for analyzing all types of commercial mortgages. Excerpts from his article are below.

“With downgrades and changing real estate fundamentals, how much collateral credit risk is embedded in your CMBS portfolio?”



The full article is available on-line at:
www.mccarystevens.com/library

The evolution of 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.

The underwriter begins the due diligence process by accumulating relevant and current information on the collateral to be reviewed. 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.

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. The underwriter will contact local brokers to obtain lease information and market statistics and to gain an understanding of market leasing activity.

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.

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?" People will often share a surprising amount of important local market information through friendly, patient, and specific questioning.

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 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 downgrades and changing real estate fundamentals, how much collateral credit risk is embedded in your CMBS portfolio?

CMBS Loss Modeling

CMBS Investors recognize that there will be loan losses over the life of any issue. Traditionally, investment grade buyers used a Constant Default Rate (CDR) analysis while B-Buyers re-underwrote every loan in an issue and assigned specific default assumptions to each loan.

Over time, several “top-down” econometric models were developed for

investment grade buyers. These models provide more time sensitive assumptions but rely heavily on macro economic assumptions.

In an effort to focus loss modeling on the specific real estate asset, McCary Stevens developed a proprietary “Bottom Up” CMBS model. The model considers numerous critical real estate and loan

structural factors that impact loan performance.

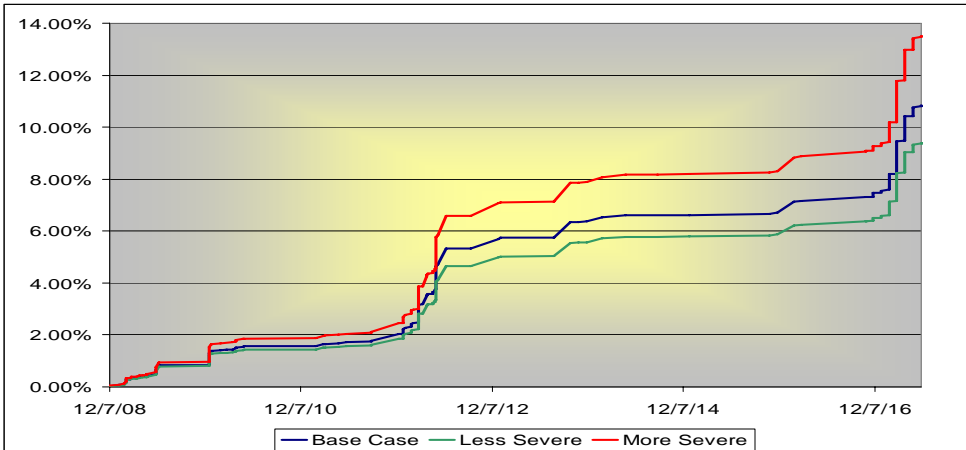
Loan loss assumptions are concluded on each property that can be uploaded into various bond valuation models. It reflects current property performance as well as future default risk events. Each loan receives a unique probability of default, loss severity and timing of the loss.

The timing of the loss for each loan is based on the unique property and loan characteristics for that asset.

By modeling each loan from the “Bottom Up”, a CMBS investor has a comprehensive view of the underlying collateral. The resulting loss projection provides a more detailed insight into the potential critical loss scenarios for each unique CMBS issue.

The “Bottom-Up” loss modeling provides an important complement to the “Top-Down” analysis and allows investors to make better investment decisions.

Sample Bottom Up loss estimates over time for a specific CMBS issue.



CMBS Spreads

CMBS spreads continue to be very wide and have shown very little movement for fixed rate CMBS since Q4 2008.

There has been some tightening of spreads in some of the AAA classes as a result of the recent modification of TALF

financing to longer terms that tend to be found in CMBS issues.

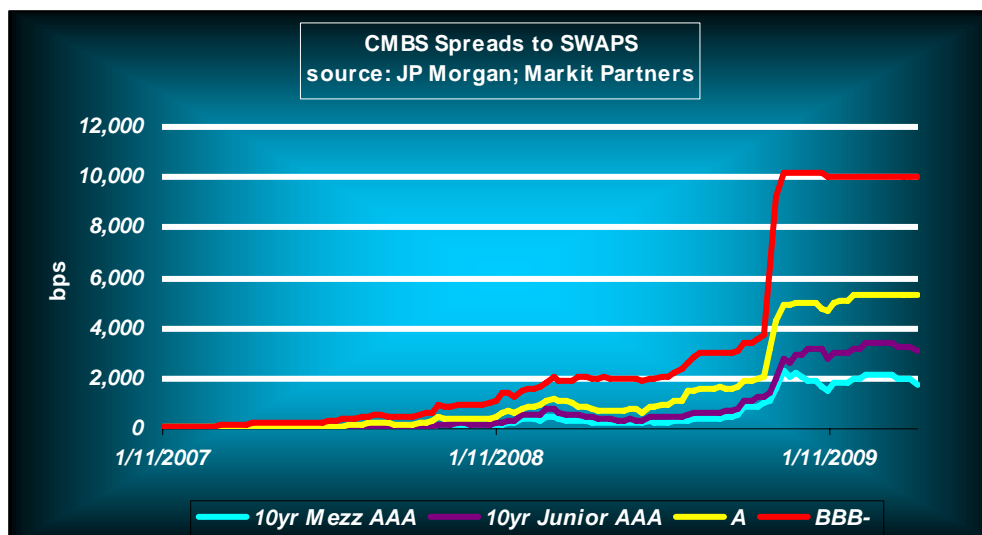
On May 19,2009, it was

announced that certain AAA rated Legacy CMBS assets qualify for TALF.

On May 27, 2009, Standard and Poor’s Ratings Services announced that it was seeking comments on its new CMBS ratings criteria.

Industry sources believe that the new criteria will result in a downgrade to a significant portion of the super-senior AAA bonds that would be eligible for TALF funds.

Junior classes of CMBS, currently not eligible for TALF, remain at close to historically wide spreads.



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Due Diligence since 1993.*

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Recent Assignments

McCary Stevens Associates, Inc. (MSA) is an independent Commercial Mortgage underwriting and consulting firm.

Since inception, MSA has analyzed over \$50 billion in commercial real estate assets for its clients in all major and most secondary markets nationwide.

MSA's clients have included some of the largest financial institutions in the country including: Allied Capital; American Capital; CIBC; CIT; Citigroup; Five Mile Capital; JP Morgan; ING/Clarion Capital; Midland Loan Servicing; Merrill Lynch; RBS Greenwich Capital; Wells Fargo Bank; and, UBS.

MSA has recently completed the following assignments:

- Site inspected, updated local market data and developed a market proforma for over 1,100 properties collateralizing securitized loans in 15 CMBS Issues in a 60 day timeline.
- Reviewed loan files, updated market data, re-underwrote with cash flow projections and presented asset resolution strategies for an \$800+ million nationwide portfolio of first mortgage loans, construction loans, B-Notes and Junior Participation loans.

About McCary Stevens Associates, Inc.

McCary Stevens Associates, Inc. (MSA) has been providing institutional clients a broad range of commercial mortgage underwriting, due diligence and loan advisory services since 1993.

We are experienced and seasoned commercial bank and insurance company trained loan officers with a strong credit culture.

Our services help our clients analyze, invest in, and manage their real estate loans and loan portfolios.

Our services include the following:

- Loan Portfolio Review
- CMBS Bond Analysis
- Loan Portfolio Strategic Planning and Analysis
- Problem Loan Workout
- Executive Loan Review
- REO Management
- Loan Underwriting
- Asset Management