

SPECIAL REPORT

U.S. CMBS: Defeasance Activity Picks Up As Commercial Real Estate Liquidity Improves

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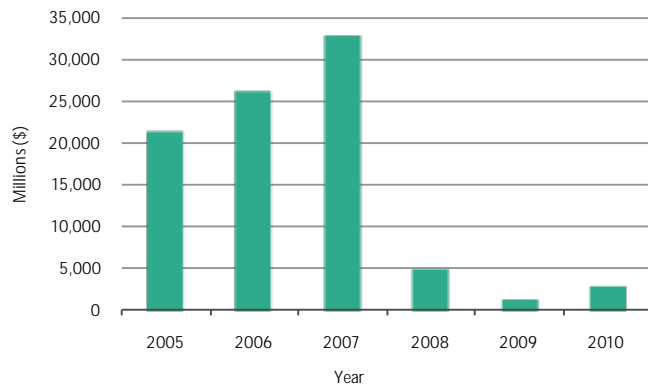
Defeasance activity in 2010 showed a significant pick-up from a depressed level in 2009. Following are the key observations from 2010 defeasance activity:

- » Defeasance of CMBS loans in 2010 was more than double that of 2009 --\$2.8 billion in 2010 compared to \$1.3 billion in 2009.
- » By aggregate loan balance, multifamily represented the largest share of defeased loans, at 39%. This is consistent with the multi-family sector benefitting both from improved fundamentals and additional financing options due to the activities of the GSE's.
- » The ten largest defeased loans totaled \$1.2 billion or 42% of 2010 defeasance volume. Most notable was defeasance of the \$468 million loan secured by 111 Eighth Avenue in Manhattan, which by itself accounted for 17% of 2010 activity.
- » Consistent with recent valuation trends, vintages prior to 2005 are proportionately over-represented in defeasance while vintages from 2005 through 2008 are under-represented.
- » By aggregate loan balance, 81% of the loans that were defeased in 2010 had three years or less of remaining term. By loan count, the comparable number was 93%.
- » Defeasance continues to be a positive credit factor in seasoned pools but has a very limited impact on recent vintage deals given their low levels of defeasance activity and high levels of interest shortfalls.

Figure 1 indicates defeasance activity from 2005, the first significant year for defeasance, through 2010.¹

FIGURE 1

Annual Defeasance Activity



While current levels of defeasance are low in comparison with 2005 through 2007, the recent pick-up is a sign of improved real estate fundamentals, investment sales and lending activity. Defeasance is typically done in connection with a property sale or refinancing and generally occurs only when there is sufficient value appreciation to justify the transaction costs involved in the defeasance process.²

Defeasance by Property Type

Loans originally secured by multifamily properties represent the largest share of 2010 defeasance activity by aggregate balance, at 39%, followed by office and retail, at 32% and 14%, respectively. When defeasance is viewed by number of loans rather than by balance, multifamily still represents the largest share, at 47%, followed by retail and office, at 23% and 16% respectively (see Figure 2).

FIGURE 2

2010 Defeasance by Property Type



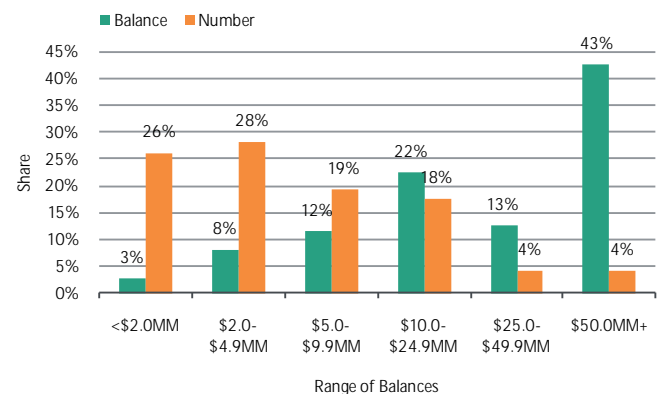
The distribution of defeasance by property type can vary over time due to changes in investor appetite, liquidity and financing opportunities. It is not surprising that multifamily represents the largest share currently, as many multifamily markets are experiencing improved fundamentals. In addition, this sector currently has more financing options than others due to the lending activities of Freddie Mac and Fannie Mae.

Defeasance by Loan Size

Approximately 55% of the loans that defeased in 2010 had balances less than \$5.0 million. These loans, however, only represented 11% of the aggregate defeasance balance. On the other hand, while only 4% of the defeased loans were \$50.0 million or larger, these larger loans represented 43% of the aggregate defeasance balance (see Figure 3).

FIGURE 3

2010 Defeasance by Loan Size



The largest defeased loan was secured by 111 Eighth Avenue, an office building in New York City, which accounts for approximately 17% of the year's activity. The property was purchased by Google for approximately \$1.9 billion, roughly four times the defeased balance. It is not surprising that the two largest defeased loans were represented by office buildings located in New York City and Washington, D.C. Office property values in these two markets have snapped back sharply within the past year, with gains of 32.9% and 20.7%, respectively.³ The ten largest defeased loans accounted for approximately 42% of overall volume (see Figure 4).

FIGURE 4

Top 10 Loans Defeased In 2010

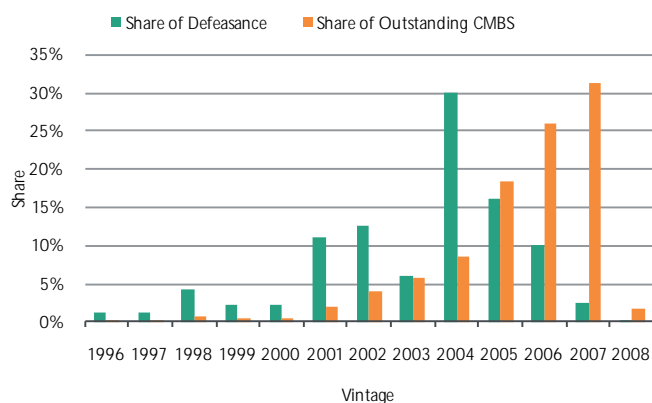
Property Name	City, State	Property Type	Vintage	Balance at Defeasance (\$)
111 Eighth Avenue	New York, NY	OF	2004	467,947,417
1111 Penn. Avenue	Washington, DC	OF	2004	122,000,000
Summit at Warner Center	Woodland Hills, CA	MF	2005	120,000,000
W New York - Union Square	New York, NY	HT	2006	115,000,000
The Hilton Minneapolis	Minneapolis, MN	HT	2006	83,000,000
Cinemark	Various	RT	1998	61,014,549
180 N. LaSalle	Chicago, IL	OF	2004	60,739,229
River Ranch Apartments	Canyon Country, CA	MF	2005	57,000,000
The Terrace Apartments	Santa Clara, CA	MF	2005	55,200,000
Orsini Apartments	Los Angeles, CA	MF	2006	50,000,000

Defeasance by Vintage

Figure 5 shows the share of defeased loans by vintage, based on aggregate balance, compared to the share that each vintage represents of the entire conduit/fusion CMBS universe. It illustrates that defeasance represents a disproportionate share of the 1996 through 2004 vintages, which either benefited from appreciation or less value loss than more recent vintages. Notably the two vintages that represent the largest share of the current outstanding CMBS balance, 2006 and 2007, are significantly under-represented. This is due in large part to their position at the apex of the recent valuation peak.

FIGURE 5

2010 Defeasance Compared to Current Vintage Balance

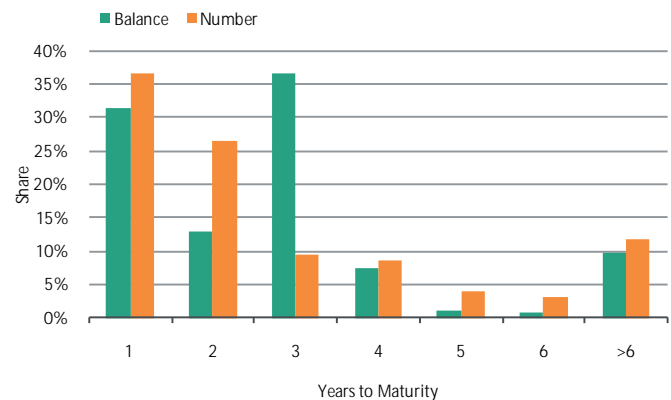


Defeasance by Years to Maturity

By aggregate balance, 81% of the loans that defeased in 2010 had three years or less of remaining loan term compared to just 19% that had five years or more remaining on their loan terms (see Figure 6). By loan count, 93% of the loans that defeased in 2010 had three years or less of remaining loan term compared to 7% with five or more years. The willingness of a borrower to defease a loan is generally related to the ability to recoup the cost of defeasance from a sale or refinancing of a property. The majority of loans that defeased with four or more years to maturity were originated prior to 2004. The properties securing those loans benefited from property appreciation over an extensive time period.

FIGURE 6

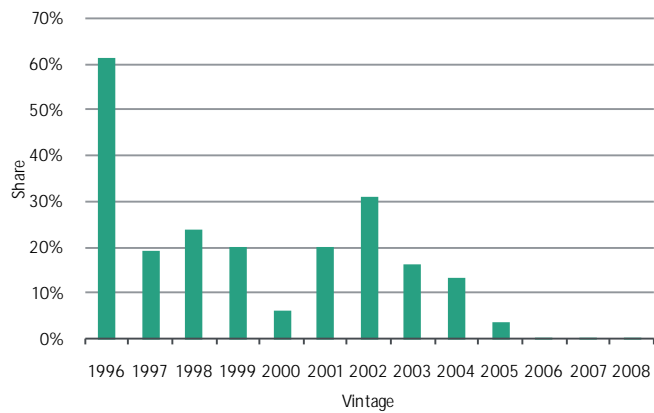
2010 Defeased Loans by Years to Maturity



Impact of Defeasance on CMBS Credit

Defeasance remains an important factor in CMBS credit because it dramatically reduces the risk of potential loss of principal and interest associated with real estate assets by substituting Aaa-rated US government securities for the real estate collateral. However, the amount of defeasance, and hence the benefit to CMBS credit, varies significantly by deal and vintage. While over 30% of the 2002 vintage is defeased, a significant boost to credit, less than 2% of the 2005-2008 vintages is defeased (see Figure 7). Even though many early vintage deals have significant defeasance, which provides protection to the top classes against principal loss, these classes may still be impacted by interest shortfalls from specially serviced loans.⁴ Classes that are entirely protected from principal loss due to defeasance may still be subject to ratings migration due to interest shortfalls.

FIGURE 7

Cumulative Defeasance by Vintage (Moody's Rated Deals)

Related Research

For a more detailed explanation of Moody's approach to this type of transaction as well as similar transactions please refer to the following reports:

Special Reports:

- » [U.S. CMBS: Strong Property Appreciation Fuels Defeasance, March 2007 \(SF94356\)](#)
- » [U.S. CMBS 2007 Defeasance Activity Sets New Record Despite Midyear Slowdown, March 2008 \(SF125196\)](#)
- » [US CMBS and CRE CDO Surveillance Review: Q2 2010 August 2010 \(SF215204\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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- ¹ Data for this study was provided by advisory firms involved in the defeasance process, including AST, Bank of America, Chatham Financial, Commercial Defeasance, Trimont Real Estate Advisors, Waterstone Capital Advisors and Wells Fargo.
 - ² Defeasance allows a borrower to substitute the real estate collateral securing a mortgage loan with a portfolio of U.S. Government securities sufficient to satisfy all debt service payments, including the balloon payment upon maturity. The mortgage loan remains in the trust, the real estate that originally served as collateral for the loan is released and the certificate holders receive an uninterrupted Aaa payment stream from the defeased mortgage loan.
 - ³ Moody's Special Report, "Moody's/REAL Commercial Property Price Indices, March 2011", published March 22, 2011.
 - ⁴ Interest shortfalls occur when there is insufficient interest available to pay 100% of the interest due on all the certificates. Interest shortfalls are caused by special servicing fees, including workout and liquidation fees, appraisal subordinate entitlement reductions (ASERs), loan modifications, extraordinary trust expenses and non-advancing by the master servicer based on a determination of non-recoverability.

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