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REAL ESTATE FINANCE AFTER THE RECESSION

The Future of Real Estate Financing: What to Expect After the Crash

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Speculation about the form commercial real estate financing will take when the current disastrous economic conditions start to reverse themselves is running rampant throughout the real estate community.

Will there be a commercial mortgage-backed securities (CMBS) market and, if so, what form will it take? How will borrowers cope with loan maturities in light of impending new underwriting standards? Will mezzanine lending still be viable? These are some of the questions that will be faced in the next year or two that will establish the future course of real estate lending for many years.

The purpose of this brief overview is to help set some of the potential framework that may take shape in the coming months. Fortunately, the cause of the severe downturn of the real estate market, unlike previous years, was not over-supply. With the possible exception of the home building industry, which acquired raw land at a record pace without regard to the potential future market, the remainder of commercial real estate was built based on reasonable estimates of the marketplace assuming that there would be no catastrophic and sudden decline in the economy.

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However, today over-supply exists because of the poor health of the end users of real estate rather than a glut of buildings on the market that had no potentiality for occupancy. For example, retail facilities were built anticipating the typical growth of merchants based on a predictable increase in markets, population, and sales. The retail developer could not anticipate that many occupants of the facilities would fail—or find themselves on the brink of failure—or that they would not grow due to the lack of consumer spending power.

The World of CMBS. Presently, there is essentially no market for CMBS. There are some pools where the top AAA-rated tranche can be purchased to yield the investor as much as 15 percent on its investment. Despite the fact that reasoned analysis would determine there is no risk of non-payment at that level of the tranche, investors are scarce.

In order to restore confidence in this form of investment, the following will have to be present:

1. Regulation of the Rating Agencies. In the lead-up to the crash, the rating agencies were not accountable for their actions in analyzing the underwriting of individual loans and the pools in which the loans were placed. Even though the rating agencies over the last several years warned the lending community that they believed underwriting standards had deteriorated, pools continued to be rated with little regard to those issues. More stringent federal standards imposed on the rating agencies, as well as increased mandatory self-

regulation, is a strong possibility. Increased due diligence on the underwriting by the rating agencies will help cure some of the poor underwriting standards.

2. Retention of Sponsor Ownership. Toward the end of the most recent cycle, the most conspicuous absence from the CMBS process was ownership by any real entity with a true economic interest in the loans and pools that comprised the backbone of the CMBS investments. Sales of interest to collateralized debt obligation (CDO) pools and divestiture of true economic interests to warehouse lenders meant the B piece holders no longer had an economic interest in the underlying assets. It appears likely that real economic interest will be required of the first loss holder of the issued securities.

3. REMIC Amendments. It is impossible to predict whether new forms of securities will be developed. Of great interest is the fact that presently there are not significant numbers of commercial loan foreclosures. The greatest opportunity for the default scenario appears to be present when the current pool of loans mature and face new underwriting standards (to be discussed below). The best way to abate some of this risk would be to implement statutory and regulatory revisions to the Real Estate Mortgage Investment Conduit (REMIC) rules of the Internal Revenue Code. Although there is some movement afoot to amend the regulations to permit more flexibility in servicing CMBS pools, there does not appear to be any traction to amend the Code itself to permit, for example, the infusion of new capital into the capital stack. Without some relief along this line, if the maturity default risk becomes too onerous, commercial mortgage-backed securities may decline significantly in future value.

Maturity Defaults: De-leveraging. When loans mature over the next several years, in the absence of adequate capital many of the transactions at maturity will not be refinanced without an equity infusion. The tightening of underwriting standards that will require financing on real prospects rather than developer pro-forma analysis—coupled with lower loan-to-value standards—may result in refinancing proceeds that are insufficient to pay off existing debt. One of the most obvious defects with lending toward the end of the most recent cycle was that there was little reality to the income stream being financed and lenders were accepting as fact that which could not be achieved.

The options when dealing with a relationship lender provide much more flexibility than those presented by a CMBS special servicer. The relationship lender has unlimited ability (although perhaps not the desire) to grant extensions, permit new secondary financing, or become an active player in the process. The CMBS servicer is restricted from many of these options by the REMIC rules and the servicing standards of the pooling and servicing agreement to which the trustee and the servicers are parties. The REMIC rules permit limited extensions and interest rate relief in the event of a default or imminent threat of a default but never permit new money to be added to the investment. The servicing standard may well require an analysis that will not permit interest rate relief or extensions but will mandate foreclosure as the remedy.

In the case of either the relationship lender or the CMBS servicer, a maturity default will most probably require a full refinancing. Since the underwriting will require significant additional funds, the best opportunities are to admit new investors by way of mezzanine financing, preferred equity, real equity, or a second mortgage. In any of those cases, the requested return for the new investor will be very similar to that which the promoter developer demanded of equity investors when the old cycle was at its peak: the promote or an increase in return over the amount of money invested.

Let us assume that an existing $20 million five-year loan was approved in 2003 at an 80 percent loan-to-value ratio providing a value of $25 million. At maturity, while the rent roll had a marginal improvement, the new underwriting loan-to-value ratio became 60 percent. The final loan amount available on this imaginary transaction is $17.5 million leaving a $2.5 million gap. No other first lender is willing to cover the spread.

The developer will be forced to seek an additional equity infusion in one of the forms set forth above. The new provider of funds will likely seek a high coupon rate and may well seek a kicker. This example of a ''reverse promote''—a kicker to the investor rather than to the sponsor—may become the price for the first loan bail-out.

De-leveraging is simply the replacement of debt with equity, which will be the most effective cure for the inability of matured loans to be refinanced in full as a result of strict underwriting standards, renewed review of the reality of loan assumptions, and drastically reduced loan-to-value ratios.

Secondary Financing. A number of lenders are creating second mortgage funds that will make available capital in the form of second mortgages to alleviate the shortfall described in the previous section. The advent of CMBS made the second mortgage an endangered species and, where the means of financing was a rated security, as extinct as the famed dodo bird. The requirements of CMBS eliminated the use of the second mortgage because the rating agencies would not permit an impediment to exist in the foreclosure scenario. The second lender, despite any inter-creditor agreement between the senior lender and the second lender, had too much clout in a foreclosure proceeding. This could result in material delay in the realization of collateral, which required the rating agency to ultimately downgrade the security.

As a surrogate, the mezzanine loan or preferred equity structure was developed. The senior loan position was unencumbered by any additional lien at the property level and was replaced by encumbrances on the ownership interests that were thought to not effectively compete with the senior lender in either the foreclosure scenario or bankruptcy scenario.

However, many lenders did not and do not feel as secure holding a lien on ownership. Having a junior lien at the property level, at least in the minds of certain lenders, provides more palpable comfort.

It is likely that new capital infusions will be made only with second mortgages. The question remains as to whether the CMBS market can handle the situation. Given that a real track record of interaction between senior lenders and mezzanine lenders has not yet developed and that the bankruptcy courts have not weighed in with any material rulings, the ''mezz'' lender could well turn out to be as much a impediment as a second mortgage holder.

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Conclusion. The world of real estate financing is due to undergo some radical changes and revaluation by the lending community. Ten years from now, the world may well retreat to the ''happy days'' of the last 10 years as lenders and borrowers forget the present debacle. However, over the short or intermediate term, the new world will impose strict discipline on borrowers and lenders alike, which will result in many new looks at the real estate financing landscape.

One last important word. In the CMBS world, the attitude by special servicers toward borrower defaults is worth significant attention. Although the special servicer has limited flexibility, the exercise of that flexibility is easier when the default scenarios are infrequent and sporadic and when they constitute a small percentage of any loan pool. The special servicer is mandated to act in the best interest of the bondholders. The special servicer should also act in a prudent manner with respect to its responsibility and liability to the parties it serves. If there are many defaults in any particular pool, it will be important to observe whether the special servicer is taking an extremely conservative position with borrowers or whether the special servicer treats each loan on a case-by-case basis. To a great degree, the depth and power of the present downturn will depend on the viewpoint of many the special servicers that minister to the existing CMBS pools.