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Northeast retail defeasance activity remains steady, as the economy continues to improve

August 21, 2014 - Retail

As the economy continues to improve in the current low interest rate environment it is generating greater lending activity in the commercial real estate market. Subsequently, as lending improves it drives commercial real estate sales and refinance transactions. These trends, in turn, are also generating a larger number of defeasance transactions in CMBS loans as borrowers take advantage of the opportunity to refinance their loan or sell the property.

Defeasance is the process through which a borrower is released from the obligations associated with its debt through the purchase of a portfolio of high quality bonds, typically U.S. Treasuries. This portfolio serves as replacement collateral to secure the CMBS loan and generates the cash flows required to meet the future loan payments. By far the largest potential cost of defeasance is the price of the replacement collateral over the outstanding principal balance of the loan, often referred to as the "defeasance premium."

The defeasance process allows a borrower to get released from a CMBS loan when the borrower is either selling the property or refinancing the loan. The process is typically coordinated by a defeasance consultant that coordinates with the various parties such as the servicer, servicer's counsel, verification accountant, securities broker/dealer, securities custodian, rating agencies, title company, and the successor borrower. The process is complex and often times the parties have competing interests.

According to Bloomberg, through the first six months of 2014 approximately 500 CMBS loans totaling $6.5 billion were defeased, which is up slightly compared to 2013's defeasance volume at mid-year. Of that, approximately 100 loans totaling $850 million were retail property types. Drilling down further in the retail data, 15 loans representing 15% were located in the northeast states, where 60% were un-anchored retail and 40% were anchored. The data also reveals the average defeased retail loan in the northeast was $14 million, with a 5.6% loan rate, and 13 months remaining on the loan. The northeast states with the most defeasance activity were New York, Massachusetts, and New Jersey, respectively. The largest northeast retail loan to be defeased so far this year was a $105 million loan on the Herald Center at 1311 Broadway in NYC that had a 6.06% interest rate with 17 months remaining on the loan. On a recent defeasance transaction we handled, the owner of a retail portfolio refinanced their CMBS loan and absorbed an 18% defeasance premium with approximately 3 years remaining in order to take lock in at a low rate for another 10 year term.

Looking ahead, there are approximately 200 CMBS loans (representing 2.7 billion) with retail properties located in the northeast that are coming due over the next 24 months. Regardless of what interest rates do over this period, it will be a busy time for commercial real estate professionals as owners decide whether to refinance or sell as this wave of CMBS retail loans come due.

As CMBS lending continues to rebound, more retail property owners are choosing conduit loans for the new financing. Although most of the energy is spent negotiating price and proceeds, it is also important for owners to spend time negotiating the defeasance section of their loan documents. Just changing a couple of words can mean several hundred thousand dollars in savings to an owner. For example, make sure the "borrower" retains the right to designate the successor borrower, rather than the "lender." This will ensure the borrower has the opportunity to participate in any residual value economics generated by the Successor Borrower. Also, it is important to request the ability to buy Agency securities such as Fannie and Freddie bonds rather than only U.S. Treasuries. Since Agency securities can be cheaper than U.S. Treasuries, it may not cost as much to buy the defeasance portfolio if you are permitted to buy Agencies as well.

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