nerej
1963 CELEBRATING 55 YEARS

Understanding debt and the new real estate trade

March 11, 2009 - Financial Digest

A deflationary cycle inevitably yields valuation decreases that wreak havoc on debt stacks. Consequently, across real estate assets as a whole, we are now witnessing valuations that are lower than outstanding indebtedness.

When debt exceeds equity, positions within the debt stack will trade. However, current debt structures are more complex. During the previous recessionary cycle, debt purchases largely amounted to whole loans. Loan syndication demonstrated the full extent of complexity. In contrast, according to the CEO and president of the Federal Reserve Bank of Atlanta, $2.5 trillion of commercial real estate loans are held in CMBS vehicles. In CMBS, loans are pooled in a trust, and the trust issues securities in tranches that create a descending order of payment with respect to the loan assets held by the trust. A variety of combinations can appear within a CMBS pool. Loans might be paired within loan groups. The loan itself might be split into an A-Note that is within the CMBS pool and a B-Note that is outside the CMBS pool, but has significant control and purchase rights with respect to the loan in the event of default. The B-Note, might not consist of one single note, but several notes in a senior-subordinate structure. The debt could include mezzanine financing. Finally, the asset-backed securities created by CMBS might be further securitized into a CDO structure, which in turn issued debt securities.

The complexity of interlocking structured vehicles creates issues for asset acquisition. First, there is a sourcing issue. Many of the positions are traded through trading desks as opposed to normal real estate trading channels. Furthermore, holders of debt securities that might otherwise be incentivized to trade those positions may be prevented from doing so due to countervailing considerations, such as mark-to-market accounting.

Certain key considerations are front and center in connection with CRE debt acquisition. First, one must understand the motivations of the seller. If a seller is looking at obtaining capital in exchange for a debt security position, it is doing so in a depressed market. Since many of the holders of debt positions are institutions with regulatory capital and mark-to-market accounting requirements, structuring the acquisition in a manner that accounts for these concerns might permit a transaction to occur where otherwise an insurmountable obstacle to deal consummation exists. On the buy side, invested capital will certainly have hurdle returns that are part of the investment. Verification of the ability to achieve that return in an uncertain market is a necessary predicate to capital's entry into a transaction.

Second, understanding the rights associated with a particular debt security is critical to the analysis. Generally, the first loss tranche in CMBS pools, referred to as the "controlling class," enjoys the right to select the special servicer and has a subordinated purchase option with respect to defaulted assets in the CMBS pool. If a note within a CMBS pool is subject to an A-B note structure, then the B-note within that structure might include key rights, such as the ability to control foreclosures and workouts and the ability to purchase the A-note upon default. Any purchase of debt securities should be accompanied by a thorough analysis of the rights and characteristics of the securities.

At its heart, the purchase of debt is a valuation analysis. The bundle of rights associated with debt securities and the underlying collateral value must justify the price paid for the debt. Purchasing debt positions at a discount to par in and of itself does not guarantee a return on capital. Any debt purchase must be made in conjunction with thorough diligence and a well-defined strategy in mind.

Jonathan Black is a partner in Brown Rudnick's structured finance group, Boston, Mass.