

## THE TECHNOLOGY OF THE DEAL

By Ericka Morphy

**IN THE CURRENT YIELD-RICH,** margin-tight and subordination-shrunk environment, it is not that difficult to find examples of lenders pushing the debt-structure envelope.

Just ask Doug Hercher, managing director of Sonnenblick-Goldman Co. in Manhattan. The real estate banking firm, he reports, recently received proposals from a few securitized lenders for a deal that included an “earn-up” feature, which in essence allows the loan amount to be resized if the numbers improve prior to securitization. “I have never seen this kind of feature

Newark. “Borrowers are looking to have it all. They want to retain options and want a low cost of capital. The market has never been more favorable for allowing that.”

That has been clear for some time. But what does this mean for the investors structuring these deals? At first glance, it would seem the commercial real estate market’s frothiness is rife with potential pitfalls for debt players. But at the same time, there are other dynamics in the works that are mitigating some of the excesses in underwriting.

that are then sold to other investors capable of bearing the risk. This has been the trend of the past 24 months. But in the past six months, new innovations in deal structures, or deal technology, as some refer to it, has pushed this paradigm to a new level.

“On the debt side, there is a willingness to push the boundaries on what kind of deals people do,” Hercher says, such as the “earnout” feature he recently encountered on a floating-rate transaction.

For the moment, only a few investment banks, such as Deutsche

## AS STRUCTURES BECOME INCREASINGLY COMPLEX, PUTTING TOGETHER A DEBT TRANSACTION TODAY INVOLVES LESS ART AND MORE SCIENCE

before in a CMBS structure,” he says.

Or Rick Gallitto, executive director of Tremont Realty Capital in Boston, who says his firm just completed financing for a condo development in which the borrower put up less than 2% of the \$20-million project cost.

Or Michael Maidman, president of New York City based Townhouse Management Co., who tells of a recent CMBS deal where the lenders approved a preferred equity loan in advance, leaving the servicer with little to say in the matter.

“For borrowers, it is a Burger King world in terms of having it your way,” says David Durning, managing director of Prudential Mortgage Capital Co. of

“More investors are discovering they can play in alternative parts of the market,” says Bruce Cohen, CEO of Cohen Capital, formerly the investment arm of Chicago’s Cohen Financial, LP. “They are able to invest in different parts of the risk profile and different places on the time horizon.”

This movement, which started with CMBS, is spreading to other areas of the debt marketplace, adds Cohen. “Mezzanine financing is being provided in all shapes and sizes,” he says.

The bottom line is that investors can be leveraged higher than ever before, in large part because they are able to turn around and cut up these sometimes-risky loans into alternative instruments

Bank, RBC Greenwich Capital and Eurohypo, are willing to consider such a structure, relates Hercher.

An earn-out feature is available in the time between the point the lender makes the loan and then securitizes it. During that time, if the performance of the property improves, the lender will increase the amount of the loan proceeds by recutting the deal based on a previously agreed upon calculation. “Historically, once you write a loan that will be securitized, it is locked,” he explains. “If the performance picks up significantly, the borrower can’t go back and get more money.”

The kicker was that the borrower turned down the offer because it didn’t

think the additional proceeds were worth the trouble. “He didn’t need the leverage,” Hercher says.

Such stories cause some to worry that underwriting is growing dangerously lax. Various reports from Standard & Poor’s, Moody’s Investors Service and Fitch Ratings relate that underwriting and origination standards have loosened as companies compete for the better deals. Flexibility is also the watchword in the treatment of “non-economic” issues such as guarantees and grace periods. Little is required of borrowers these days, in terms of putting up their own equity as well as taking responsibility and tenant improvements, according to the experts.

Anecdotal evidence of all this abounds. Tremont Realty Capital’s aforementioned condo deal is backed by the Atlantica Condominiums in Revere, MA. The total development cost for the 83-unit project was approximately \$20 million. The funding package consisted of a \$15.5-million senior construction loan and a mezzanine/equity investment of \$4.1 million. The project’s developer is Crescent Beach LLC.

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**Rick Gallitto  
Tremont Realty Capital**

“The developer got into the deal for a little less than 2% of the total capital stack,” Gallitto says. The asset is projected to sell out at \$27 million, “so he made several million bucks from a \$400,000 investment.”

Then there is Maidman, who tells of a CMBS structure where the borrower negotiated a set of preferred equity papers, in essence receiving secondary financing over which the servicer had little discretion to deny.

“The borrower and the originator wrote it in and attached an inter-creditor agreement,” he reports. The document

allowed the borrower to obtain up to, but not exceed, an 85% LTV and a 115% debt service coverage.

Rarely do servicers permit second mortgagers, much less a pledge of equity interest, Maidman says. “By putting this in the original papers, the service has little discretion to say no.”

Even some established deal structures have been bothering the pundits of late, including interest-only loans and balloon-balance financing.

Interest-only loans, for example, are still very susceptible to early defaults, and it is still a large loan, such as a default can have a disastrous effect on yield. In general, investors like to see borrowers put equity into a property because it provides them with more of an incentive to hold onto the asset and stay current on debt service. Increasingly, though, the length of these loans is growing and the market still finds investors willing to carry the risk. “It used to be you could only get these loans for a year,” Maidman says. “Now three years is the norm and five years isn’t unheard of.”

Hercher notes that the market has also entered a new paradigm in mezzanine and subordinate loan pricing. “We have executed a couple of deals recently at spreads that reflect very aggressive pricing from lenders providing non-investment-grade proceeds.”

The pricing of this piece, the more speculative part of the loan, has gotten tighter over the past 12 months, he says, and that is what has been driving spreads around.

On the other side, lenders and originators counter the market, even in the space of a year, has become more efficient, able to obtain and process more accurate information on loan performance. No one has returned to the excesses of previous cycles, such as 100% financings. “There is greater transparency in the capital markets,” Hercher says. “Lenders have become more disciplined about the way they use financing.”

Some say, as one example, that the current popularity of interest-only strips is due to recalculated and now more accurate assumptions on prepayment and default speeds.

“Capital has gotten much smarter and investors know where they want to play,” says Tom MacManus, president and CEO of North American operations at GMAC Commercial Mortgage Corp. of Horsham, PA.

And increasingly, they have a greater ability to pick and choose the risk they want to carry. For example, a lender can issue a \$100-million loan on its balance sheet, rated entirely BBB. Or it can take that same loan, carve it onto separate tranches and resell those tranches through a commercial real estate collateralized debt obligation to a new category of investor.



Tremont Realty Capital arranged a funding package that consisted of a \$15.5-million senior construction loan and a mezzanine/equity piece of \$4.1 million for the Atlantica Condominiums in Revere, MA. The 82-unit project, a development of Crescent Beach LLC, has a total cost of \$20 million.

As it happens, such a structure—a CDO comprised of B-piece loans and come mezzanine debt—came to market in 2004. Another followed soon after and others, according to observers, are currently pending.

The first such deal occurred in July when Capital Trust executed a CDO comprised of B-notes and mezzanine loans, called CDO I. Later in October, Arch Capital completed a similar transaction, albeit structured with slightly higher-rated credits.

The Capital Trust transaction originated around a portfolio of assets—40 floating-rate B notes and one mezzanine loan—purchased from GMACCM, with an aggregate principal balance of \$251 million, according to Capital Trust. The New York City-based firm added \$74 million of similar collateral to that portfolio, thus creating an overall collateral pool of \$321 million. Simultaneous with the purchase of GMACCM’s assets, Capital Trust executed the CDO, which held \$253

million of floating-rate CDO obligations rated AAA through BBB. Capital Trust retained the subordinate investment-grade classes of debt and equity.

Since that transaction, Capital Trust CEO John Klopp has said he expects to complete another, similarly structured CDO that pushes higher into the capital structure and includes more fixed-rate assets.

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Prudential Mortgage Capital

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It was a unique transaction in that Capital Trust pushed the limits of CDO technology, as Klopp calls it. The firm needed a critical mass of assets, which it accomplished via the purchase of GMACCM’s portfolio. It also needed a certain level of flexibility. Since floating-rate B notes normally have an expected life of two-and-a-half years, Capital Trust wanted the ability to replace the assets in the financing structure once the initial collateral was paid off. Thus, the deal also included a four-year reinvestment period with pre-negotiated criteria outlined by the rating agencies, relates the firm.

According to MacManus, it was also a win-win transaction for GMACCM, which, he says, will likely continue to take advantage of similar structures as the Capital Trust CDO.

“We want to maintain our investing relationships and deliver products to those players, while maintaining appropriate liquidity,” MacManus says. “At the end of the day, it all benefits the borrower, rather than having inefficient whole loan structures.”

However, there are risks involved, to which investors must pay attention, particularly if they are used to rules governing the way losses on collateral move up and down the capital structure,

reports Fitch Ratings. Over-collateralization and interest-coverage tests, for example, might prove to be a stumbling block, states Fitch, depending on the stresses imposed and how the OC triggers are set.

Dan Smith, senior vice president of GE Real Estate’s North America debt group, says that in general B-piece buyers are playing it smart. “They are being selective and sophisticated. It is a larger universe for them now,” he says.

Investment issues that B-piece buyers tend to focus on, he says, are collateral specific. “Deals that have specific credit concerns with an anchor tenant, for instance. Smaller tertiary markets also give investors concerns.” In short, he says, the market for B-piece investment is competitive, but more in terms of price than on collateral quality.

Similar examples can be found on the other end of the risk spectrum. For example, a Goldman Sachs/RBS Greenwich Capital transaction that priced last spring held seven different AAA tranches—enough vehicles, in other words, to meet conservative investors’ needs. Other than that, it was fairly routine deal with a mix of office and retail properties.

A more dramatic example was provided by the successful issuance of the super-subordinated, or “super senior,” AAA conduit offerings that priced in the last week of October. By providing additional credit enhancement, these structures catered to those investors concerned that AAA subordination of CMBS deals, which can range from 10% to 12%, is not sufficient.

Super seniors create a senior AAA class and a junior AAA class with the subordination of the senior note at 20%. The first was a \$1.1-billion issue from Credit Suisse First Boston that priced in October, followed by an amended Merrill Lynch-led conduit and a Merrill/Bank of America deal.

“These had a profound impact on pricing,” Prudential’s Durning says. There was an investor class “that wanted a bond-like instrument made up of real estate but not a lot of risk. All of a sudden the market made that part of the capital stack available” at a reasonable price, he says.

The super seniors are just one data point of the larger overall story, Durning says. “Besides the ongoing securitization of economic interest in real estate, there is also the ongoing blurring of the capital stack,” he adds.

Lenders, in many cases, are remaking themselves over to be de facto one-stop shops, combining mezzanine loans with fixed-and floating-rate loans and other permutations that result in a far more complicated structure- and at lower cost to borrowers too.

Thomas M. Alperin, partner and president of National Development, a Lower Falls, MA-based firm, notes that many lenders are providing vehicles that not only price senior debt in the 65% LTV range in most cases, but also provide options that can additionally finance up to 85% to 90% of the project with mezzanine or junior debt. “The blended yield on those returns on a combined basis is often far less expensive than raising equity for projects,” he says.

He recently worked with Cohen Capital to finance a 400,000-sf warehouse facility for a fast-food retailer along those lines. Cohen provided 80% debt financing, only a partial amount of which was structured on recourse.

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Cohen Financial LP

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“It enabled us to minimize the amount of capital we invested in the project. An 80% loan-to-cost is probably higher than we would have accomplished with senior debt financing and with less recourse on the transaction,” he says.

Jay J. Eisner, a partner of LEM Mezzanine LLC in Philadelphia, tells of a recent mezzanine transaction the firm closed that had a total mezzanine piece valued between \$18 million and \$19

million. It included 18 properties in Texas and Florida. "We closed it with a senior lender, so there was new senior financing put on at the same time," he says.

LEM, Eisner says, will invest as long as 10 years, which it did in that case. "The senior loans totaled \$230 million, but they were individual loans, not one large first mortgage, which is important to us because we don't like being behind one large piece of debt."

In general, Eisner says, the mezzanine landscape is very competitive. There is a lot of competition from equity, and that is a result of the amount of liquidity in the real estate market. Our challenge is to sift through the deals to find ones we think are appropriate on a risk-adjusted return basis."

That competition has not stopped new firms from entering the market, Cohen says. "There is a whole new slew of mezzanine funds out there with different strategies.

"Some are making long-term mezzanine loans behind CMBS, some are doing mezzanine loans based on value-added strategies, such as building or renovating. Some are focusing in the large market and some in the middle market," he continues.

Motivations for borrowers are equally as diverse, says Shawn Rosenthal, director and general counsel of Ackman-Ziff- Real Estate Group in New York City. "Often borrowers use mezzanine debt in situations where they think they can create some value, increase the income of the asset and thus pay back the mezzanine financing quickly."

He tells of one deal in which the client was buying a large piece of real estate that needed to be rezoned from industrial status to residential. "The upside was dramatic, and the client did not want to share it with a partner. So we arranged for a loan that was up to 85% of the cost to acquire the land as well as carry it for three years in order to go through the rezoning."

If the rezoning did not go through, the loan would have been more than 100% of the value of the property. "The client needed to be certain that the rezoning was going to happen,

otherwise there would have been significant downside."

No matter how robust, some things in the market never change. ♦