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Debt Service Coverage Ratio "Cushions" as Loan Risk Premiums With Implications for Commercial Real Estate Bankruptcy Outcomes: Examination of the General Growth Properties Reorganization Experience

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This article discusses the reorganization process of General Growth Properties which provides insight into the mechanics of a successful bankruptcy that achieved acceptance from creditors through emphasis on cash flow issues measured and monitored by debt service coverage ratios.

Comparisons are drawn between commercial real estate performing loan originations and disclosures contained within the General Growth Properties reorganization plan that relate to the topic of debt service coverage ratios. Risk premiums are calibrated for performing loans according to debt service coverage ratio ("DSCR") categories, resulting interest rate spreads on loans can be deemed "risk premiums" that result from varying levels of debt service coverage cushions. The debt service coverage ratio concept was extensively employed by General Growth Properties ("GGP") to measure cash flow adequacy under a wide variety of circumstances and is being used as an ongoing compliance feature for the GGP Newco. The reorganization process of GGP provides insight into the mechanics of a successful bankruptcy that achieved acceptance from creditors through emphasis on cash flow issues measured and monitored by debt service coverage ratios.

Debt Service Coverage Ratio Significance

Debt service coverage ratios are utilized to assist in the evaluation of risk, price loan products and provide underwriting guidance. Debt service coverage ratios are frequently contained within loan documentation and can be considered as a type of negative covenant. Many of the GGP modified loan agreements state that if a 1.20 debt service coverage ratio is not maintained then this "event" triggers implementation of a restrictive cash management regime. Flexibility of debt ser-

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vice coverage ratio analysis as a financial concept is heralded by the wide diversity of situations where it is effectively employed beyond negative covenants. Debt service coverage ratios, however, are only as good as the assumptions that they are premised upon, so lease rate, occupancy, operating expenses and net operating income are key inputs. Some of the dynamics that can be modeled include various "what if" situations, such as changes in operating expenses, rental rates, absorption, net operating income, with cash flow implications as indicated by corresponding DSCR changes. Additionally, income comparisons to debt service requirements are relative measures of cash flow adequacy, in that a given level of net operating income productivity will result in a range of debt service coverage ratios dependent upon interest rates, amortization and loan structure.

GGP Newco modified loan agreements revealed that certain loans feature accelerated amortization or principal reductions at specified dates. Creditors can monitor cash flow adequacy upon increases in scheduled loan amortization utilizing DSCR, in contrast with an alternate mechanism of having loan constants as fixed assumptions in the modified loan agreements. Overall, most debt service coverage ratios for the GGP shopping centers are above the frequently specified "minimum" standard of 1.20. Some GGP loan modifications included pro forma leasing assumptions, expected economic results stemming from filling vacant shopping center spaces or "dark anchor" spaces. Pro forma expectations were addressed in some instances with "stepped" DSCR provisions, where during an initial post-modification period perhaps a 1.10 DSCR is sufficient as a minimum threshold, then subsequently increasing to 1.20 or greater.

Debt service coverage ratios have an added dimension in that they provide important evidence regarding the speculative nature of real estate investments, with low DSCR investments usually considered to be highly speculative. Low debt service coverage ratio investments tend to have higher loan default risk, consequently there is added concern for these types of loans and greater scrutiny of loan to value issues is common. Debt service coverage and real estate valuation concepts are independent analyses, yet theoretically both valuation and debt service coverage ratio analysis utilize net operating income as computational variables in differing capacities. Performing loan originations indicate that low debt service coverage ratio investments attract financing at higher interest rates even by well capitalized publicly traded borrowers, as indicated by the REMCO study.

The REMCO Study of Performing Loans

Findings from an ongoing REMCO analysis of over $40 billion of commercial real estate loans to public borrowers since the heightening of the credit crisis in September 2008, indicates that the larger the cash flow "cushion" available to cover debt service, the lower the negotiated interest rates for those performing loans. High DSCR loans to public borrowers may be regarded as a benchmark for the assessment of risk in other commercial real estate applications, including bankruptcy.

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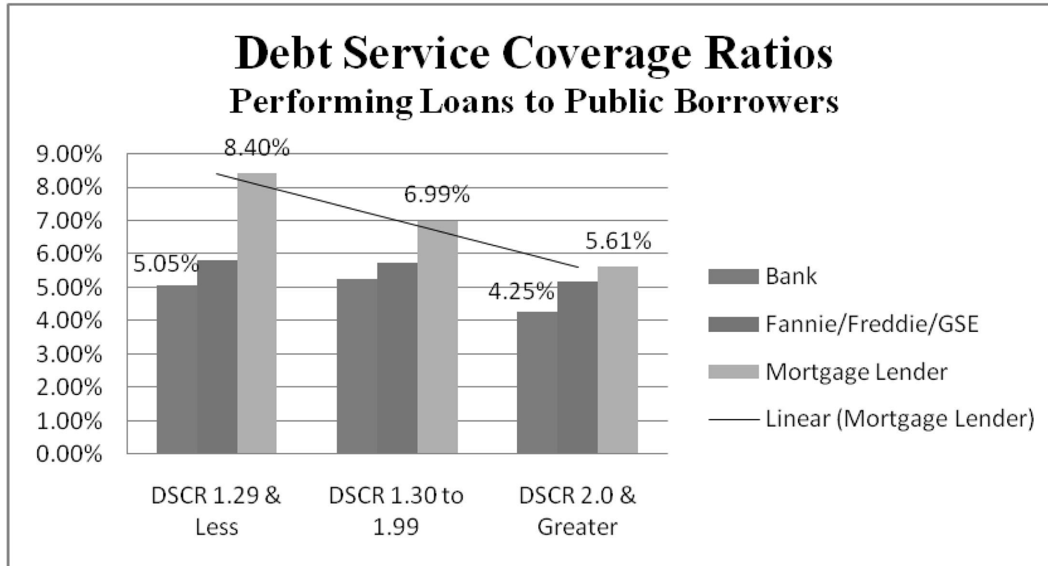

Data provided by Termzsheets.com

The REMCO study found that risk premiums for low DSCR cushions are substantial. Amongst mortgage lenders, interest rate risk premiums are 141 basis points between loans with low debt service coverage ratios compared to moderate debt service coverage ratios. For purposes of the study, loans with DSCR of 1.29 and less are considered low values, DSCR within the range of 1.30 to 1.99 are moderate and high debt service coverage cushions have a value of 2.00 or greater. High DSCR loans resulted in an additional 138 basis point reduction of interest rates by mortgage lenders. Total risk premiums for performing commercial real estate loans average 279 basis points in the REMCO study, providing benchmark comparisons between loans with varying levels of DSCR.

An inverse relationship exists between interest rates on performing commercial real estate loans when correlated with debt service coverage ratios that is observable for all types of lenders including banks, government sponsored entities ("GSE"), and mortgage lenders. Debt service coverage ratio patterns for performing loans, however, do vary by type of real estate lender profiled. The least interest rate variance according to DSCR is observable for loans provided by government sponsored entities, which make few loans at DSCR levels less than 1.10, and few loans with DSCR levels above 1.80. The typical GSE loan product analyzed by REMCO had an interest rate of 5.67 percent, was partially amortizing, with multifamily property serving as collateral for the loan and a debt service coverage ratio of 1.25.

Bank loan terms tend to be interest only, thereby avoiding the debt service burden of amortization, making bank loans highly attractive financing alternatives for a wide variety of DSCR sensitive borrowers and property types. Also, bank derived interest rates on average are lower than comparable rates charged by mortgage companies. Consequently, bank loans can result in higher debt service coverage ratios for a given level of property net operating income, compared to similar loans from mortgage lenders. Bank

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loans are subject to renewal more frequently due to shorter loan maturities which generates a level of renegotiation uncertainty and increases many loan transaction costs that can be substantial, such as lender fees, particularly for long term hold properties. Bank customers accept the risk of variable interest rate financing, usually pegged to LIBOR Indexes. Variable interest rate risk is frequently managed through “swap” arrangements for fixed interest rate contracts which entail paying fees for this hedging service, increasing the effective interest rate for the loan. Bank loans for high DSCR properties averaged 4.25 percent interest in the REMCO study. Bank interest rates for high DSCR loans were 136 basis points lower than corresponding loan products from mortgage lenders and 91 basis points lower than similarly positioned government sponsored entity loans. Loans provided by banks may also include significant covenant protection for the lender. Bank loans may have the flexibility that comes with secured credit line features, and for large loans of this nature the credit risk is frequently spread amongst a consortium of lenders.

Mortgage lenders fund a wider range of property types than GSE’s and tend to accept broader variance of DSCR. Mortgage lenders generally make longer term loans, with maturities ranging from five to 10 years, charge higher interest rates than banks or GSE’s and typically structure loans with partial amortization. Many loans originated by mortgage lenders have low DSCR levels, less than 1.29, with 8.40 percent the average interest rate for these types of loans, higher by 130 basis points than the average interest rate of 7.10 percent for all loans originated by mortgage companies. REMCO found an interest rate spread of 279 basis points between high and low debt service coverage loans provided by mortgage lenders, a spread significant enough to have capital structure implications for borrowers.

General Growth Properties Reorganization

Healthy cash flow is characteristic of the GGP portfolio, consisting of over one hundred regional shopping centers with geographic diversification. The principal financial weaknesses of General Growth Properties that precipitated the largest real estate bankruptcy reorganization in history were loan maturities, too many highly complex loans maturing within the same general time frame. Many GGP loans became securitized financial products, bundled with other real estate loans then rated and sold according to tranche as bond-like instruments to the investing public with little forethought devoted to loan renewal procedures, other than containing provisions for the appointment of special servicers. Literally, the only viable alternative for negotiating maturity extensions on dozens of these CMBS loans with diverse ownership was to take the company through bankruptcy.

The Augusta Mall provides an interesting case study for illustration purposes. It is a regional shopping center serving a large rural market area that is centered upon Augusta, Georgia, approximately 150 miles east of Atlanta along Interstate 20. The Augusta Mall example is characteristic of a subset of low DSCR loan situations resolved by the GGP bankruptcy, which does not negate the fact that many GGP properties have high debt service coverage ratios. A $175 million loan was originated by Eurohypo, AG then sold by JP Morgan Chase Commercial Mortgage Securities Corp. along with 215 other loans totaling $5.3 billion as series JMPCC 2007-LDP10 to the commercial mortgage pass-

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through certificate market ("CMBS"). Series JMPCC 2007-LDP10 has 35 tranches with credit ratings ranging from AAA to CCC, Augusta Mall was the sixth largest loan in the pool according to a January 2010 Fitch-Ratings study. Retail loans represent 26.2 percent of the total series collateral, while the 15 largest loans in the pool constitute 42.5 percent of the total loan balance.

It was reported by the CMBS servicer that Augusta Mall was 86.4 percent occupied and cash flow prior to reorganization had been declining from a 1.48 DSCR at the time of loan issuance to 1.19 at year end 2008, which was lower than the average 1.38 DSCR for the top 15 loans in the pool. The reorganized Augusta Mall loan has a seven year maturity at an unchanged 5.48 percent interest rate. The original loan agreement provided for interest only terms, but the reorganized loan added debt service burden of 25 year amortization, so the reorganized debt service coverage ratio may be less than 1.00. If the debt service ratio does not improve within 12 months the loan could be subject to "lock box" style cash management provisions of the modified loan agreement. GGP did not have to reduce the outstanding principal balance even though the loan had a low DSCR and a "stressed" loan to value of 136.3 percent, according to FitchRatings. The reorganized Augusta Mall loan has a favorable interest rate compared to the averages for low DSCR performing loans, much lower than the 8.40 percent average mortgage company rate and only slightly higher than the average 5.00 percent bank loan rate. The reorganized loan will be guaranteed by the GGP Newco entity that has been invigorated with $6.5 billion of fresh equity from Fairholme Capital Management LLC and Brookfield Asset Management, Incorporated.

DSCR Implications for Bankruptcy Outcomes

Knowledge of the lenders involved with a creditors committee, their underwriting criteria and acceptable terms for performing loans and DSCR, represent important intelligence that may be useful for negotiation purposes. Besides loan maturity situations, another frequent cause of insolvencies are portfolio imbalances, too much highly speculative property with low debt service coverage ratios for the income being generated. Cash flow may be insufficient even though the properties may have considerable value in excess of the loan amounts, a situation seemingly tailor made for an effective bankruptcy. Some properties may have literally non-existent debt service coverage ratios, a direct consequence of highly speculative investments. Low to very low debt service coverage ratios are a major contributing factor to insolvency. Newco reorganizations involving multiple asset rollups for a new parent entity can utilize debt service coverage ratios as a potential guide to achieve sustainability in the mix of assets, business combinations and equity infusions, thereby potentially resolving some of the economic problems that contributed to the insolvency. Plans that contain "one modification fits all lenders" type of proposals pose special challenges, particularly if a diversity of lender types are represented on the creditor committee.

Successful negotiated outcomes strike economic balances amongst outstanding loan principal, amortization schedules, adequacy of debt service and creditor compensation for acceptance of particular loan risks. DSCR is a useful technique for analysis of economic issues underlying problem loans, providing guidance to the pricing of modified loan

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proposals. DSCR consideration can compare proposed loan modifications to those associated with the normal acceptance of risk for performing loan originations. While real estate companies involved with bankruptcy protection represent divergent business situations, Newco reorganizations can quantify cash flow using property specific debt service coverage ratios to demonstrate adequacy, as was recently proven by General Growth Properties through their successful renegotiation of many CMBS loans. Debt service coverage ratios permitted GGP to deal with their lenders from a greater position of strength and thereby facilitated creditor agreement, the key challenge for many real estate bankruptcies. Plans of reorganization may be evaluated with respect to DSCR implications, and may achieve a higher probability of bankruptcy emergence as a result.

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