Optimizing New Generation CMBS with Mezzanine Financing

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The author says that mezzanine loans are filling voids in the credit markets for lower than investment grade credit, tranches that ordinarily would have been previously sold as a lower rated portion of a collateralized mortgage backed security.

The Royal Bank of Scotland PLC ("RBS") made headlines during the second quarter of 2010 by issuing a collateralized mortgage backed security ("CMBS") using commercial real estate assets as security, the first such issue in over two years since the heightening of the credit crisis and the fall of Lehman Brothers. The issue was relatively small, less than $300 million and focused upon single tenant properties 100 percent occupied by credit tenants. Absent were non-investment grade tranches which previously were routinely incorporated into CMBS, consequently mezzanine financing was relied upon to complete the credit offering for the borrowers. RBS proved that there is a market for high quality commercial real estate loans, even within a generally avoidant credit environment.

This comparative analysis focuses upon financial parameters that are shaping new generation CMBS and provides some suggestions for optimization of this financing technique. Particularly, two transactions designed to be included within a CMBS are profiled, loans made to two different true borrowers for different purposes. The first loan portfolio is termed the "Private" borrower example and highlights many of the issues associated with effective use of CMBS for refinancing purposes. The second portfolio is labeled the "IPO" example, and illustrates CMBS financing for new acquisitions within the contemporary business environment. Both sets of loans had similar structures, portfolios of properties financed by CMBS along with separate mezzanine loans for each collateral property. The loans involved similar commercial real estate collateral, 100 percent occupied single tenant retail properties and both sets of loans were originated during the same month, April, 2010. The "Private" portfolio of properties was acquired during 2004–2005, while the "IPO" featured 2009–2010 asset acquisitions. IPO acquisition loans involved 14.5 percent mezzanine participation while the Private borrower refinance loans required a 31.0 percent mezzanine piece. The CMBS issue for the IPO was rated investment grade for 53 percent of the net operating income generated by properties financed, while the Private borrower was rated investment grade for 48 percent of NOI.

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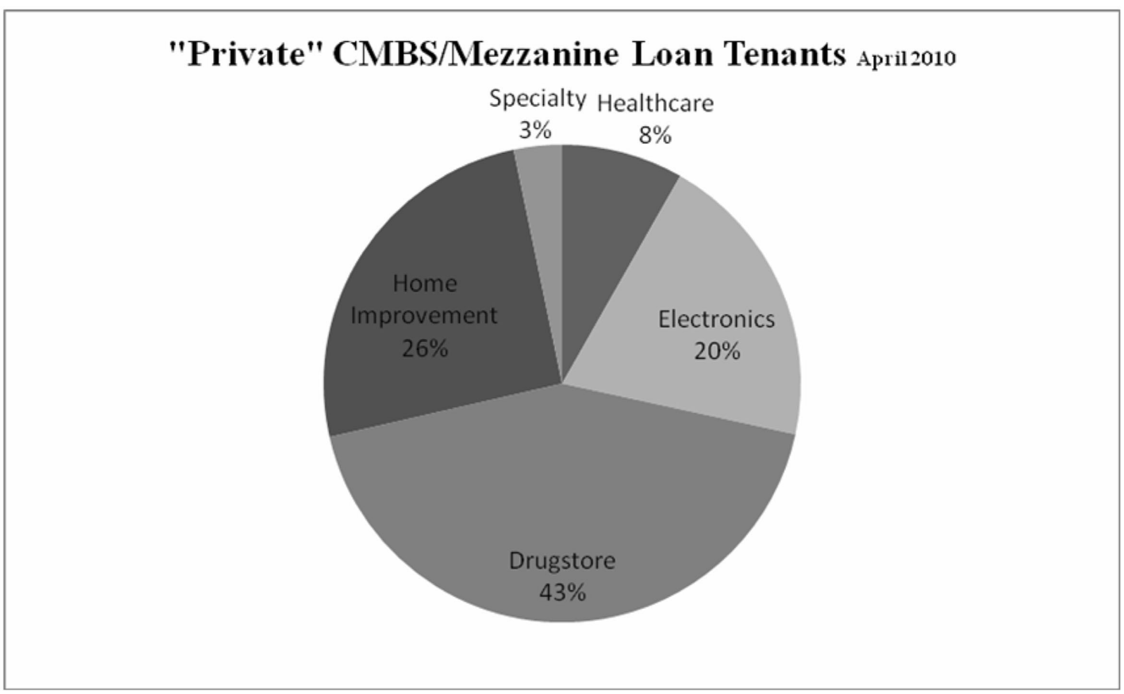
The "Private" Borrower

A $51.6 million CMBS/mezzanine loan transaction closed in April 2010 to refinance a portfolio of loans originally made in 2005 that had an outstanding maturing balance of $50.7 million. Even though the 2010 loan amounts were higher in aggregate than the 2005 loan principal balances, these loans could not accurately be described as "cash out" refinancing given the transaction costs, but the new CMBS/mezzanine loans stand in stark contrast to mortgage refinancing with substantial "paydown" requirements that have become prevalent for many commercial real estate financial transactions.

The Private borrower formed in 2004 and was capitalized primarily by a single $100 million private placement that occurred in September 2005. Common stock was issued at this time "in reliance upon exemptions from the registration requirements of the Securities Act and state securities laws" so consequently the stock is not listed on any national securities exchange. Dividend procedures for this borrower provide for a return of and on investment, so stockholder equity as of the time of the CMBS/mezzanine loans had declined to approximately $70 million.

CMBS/mezzanine collateral consisted of 22 total properties, entirely retail properties with complete occupancy by single tenants, geographically dispersed throughout eleven states, occupied by eight different triple net lessees, including well known brands such as Best Buy, CVS, Lowe's, Rite Aid and Walgreens. Loan collateral represents 594,000 square feet of rentable building area, 57.4 percent of the total owned by the company. Only one tenant was of credit concern such that loan documentation established a special reserve fund, triggered by gross revenue dropping below a certain threshold as determined by SEC filings for this tenant.



All secured assets of the Private borrower were acquired between 2004 and 2005 and had a rolled up book value before depreciation of $87.3 million. The total loan to book ratio was 59.1 percent for the combined CMBS/mezzanine loans, with the CMBS portion of the loans at 40.8 percent of total book value. The debt yield ratio computed to 12.2 percent on the entire financed portfolio, an increasingly popular measure for lenders to utilize in the evaluation of risk, while the overall rate of return for this seasoned portfolio was 7.23 percent at origination. CMBS and mezzanine loans all had similar five year maturities, with payments partially amortized and a blended fixed interest rate of 7.14 percent, slightly less than the overall return rate.

The 4.24 percent interest rate on the CMBS portion of the Private borrower refinance loan obligations was 175 basis points ("BP") above the treasury security yield of similar maturity. A total of 69 percent of the combined credit was represented by the CMBS issue, $35.6 million of the loan balance. Annual debt service on the entire loan portfolio for this borrower is $4.18 million compared to net property income of approximately $6.3 million. The debt service coverage ratio for the combined CMBS/mezzanine financing was 1.51 to 1.00. $2.098 million is required to annually service the CMBS debt and the debt service coverage ratio for the CMBS piece was almost exactly 3.00 to 1.00. Debt yield ratios for the secured properties ranged from 14.5 percent to 24.0 percent for the CMBS component, with an average of 17.7 percent.

The mezzanine loans provided to this borrower bear interest at 13.0 percent, with the CMBS loans encumbering the identical assets as the mezzanine loans. The lowest tranche in the mezzanine loan still represents a credit at no more than 60 percent of book value, with the rents provided from the same credit tenants under long term lease obligations. Mezzanine debt yield rates are high since remaining property net income after CMBS debt service relative to mezzanine loan balances averaged 26.2 percent. Mezzanine debt yield was variable on a property by property basis, ranging from 19.1 percent on a relatively more heavily encumbered property located in Houston, TX, to 40.3 percent for a lightly encumbered drug store located in Tennessee. The total mezzanine piece of the refinancing requires the borrower to service $16.025 million of debt with payments of $2.156 million annually. After CMBS debt service, $4.2 million of property generated net income remained at the time of loan origination to service the mezzanine debt, providing a significant level of debt service coverage "cushion". In the aggregate for the Private borrower refinancing, the mezzanine loans require a higher level of total debt service than the CMBS loan components, even though the mezzanine loan was less than one third of the entire credit, 31 percent of the total mortgage commitment.

The "IPO" Borrower

The "IPO" borrower is engaged in implementing a similar business plan to that of the Private borrower, owning and operating 100 percent leased single tenant properties. The "IPO" is a significantly larger company compared to the Private borrower, formation occurred in 2008 and the initial public offering is in the final stages of completion, currently capitalized at over $1.3 billion. The IPO may "go public" eventually but at the time of the CMBS financing the company had not elected to do so. The IPO borrowed $74.9 million from the same CMBS lender and a different mezzanine lender as the Private borrower. Mortgage refinancing issues were not of concern to the IPO borrower since the properties were funded at the time of acquisition by the equity issue. A total of 32 separate loans were made to the IPO, three loans of which were distinct pools of properties.

	"Private" Borrower	"IPO" Borrower
Total Loan Amount	$51,600,000	$74,900,000
Total Blended Interest Rate	7.140%	5.29%
Total Annual Debt Service	$4,185,000	$5,094,348
CMBS Loan Portion	$35,600,000	$64,800,000
% CMBS	69.0%	86.5%
CMBS Interest Rate	4.236%	4.209%
CMBS Annual Debt Service	$2,098,000	$3,806,664
Mezzanine Loan	$16,000,000	$10,100,000
Mezzanine Interest Rate	13.000%	12.250%
Mezzanine Annual Debt Service	$2,156,000	$1,287,684
Collateral Properties	22	32
Collateral Sq. Footage	594,444	827,321
Operating Expense Ratio	2.7%	1.9%
Net Operating Income	$6,308,000	$10,937,340
Investment Grade NOI %	48%	53%
Collateral Book Value	$87,300,000	$132,032,000
Overall Return Rate	7.23%	8.28%
Collateral Acquisition	2004–2005	2009–2010
Debt Yield Rate	12.2%	14.6%
Total Debt Service Coverage Ratio	1.51	2.15
CMBS Debt Service Coverage Ratio	3.01	2.87
Loan to Book Ratio	59.1%	56.7%
Equity Return Rates	1.5% to 4.0%	3.0% to 6.0%

Data provided by Termzsheets.com

Subtle differences between the two loan portfolios contributed to major differences in debt service levels. The IPO properties generate an overall return rate relative to their 2009–2010 purchase price basis of 8.28 percent, 105 basis points higher than the 2004–2005 portfolio. The interest rate for the IPO on the mezzanine debt was .75 percent less than the mezzanine debt for the Private borrower. The level of non-reimbursed expenses from triple net leases was higher for the Private borrower by .8 percent of income. Additionally, there were some differences in the geographic composition of the two portfolios. The CMBS portion of the IPO loan had a 48.6 percent loan to acquisition cost ratio for the 2009–2010 vintage properties, compared to 40.8 percent for the Private borrower. Greater income per dollar of investment generates more debt service coverage with sufficiency to support a higher percentage of CMBS loan balance relative to the total credit. Greater overall return rates when combined with higher overall percentage of investment grade rated NOI, produced a financing result for the IPO borrower of 86.5 percent CMBS eligible loans. Consequently, mezzanine loan participation was only13.5 percent in the total credit provided to the IPO, compared to 31.0 percent mezzanine debt for the Private borrower with the 2004–2005 acquisition date portfolio of properties.

Optimizing New Generation CMBS

The IPO borrower achieved "better than market" terms from the CMBS offering in comparison to products available in the commercial mortgage markets, paying a blended interest rate of 5.29 percent. As the Private borrower experience illustrates, refinancing commercial real estate presents special challenges due to investment parameters driven by far different credit conditions that existed previously, successful refinancing remains a challenge in today's credit environment. Finance terms carry implications for future income potential available to owners of real estate and influence investment strategies.

Recent CMBS/mezzanine loan transactions selected for evaluation reveal consistency among debt yield and debt service coverage ratio benchmarks for the CMBS portion of the loans. Percentage of investment grade rated net operating income drives the proportion of the credit eligible for financing with CMBS and thus determines the varying need for mezzanine financing components. Loan collateral consisting of single occupancy credit tenant properties with long term leases are relatively straightforward with an apparent advantage for approaching contemporary credit markets. Saleable loans have conservative leverage ratios, good overall rates of return and high debt service coverage ratios. AAA rated CMBS loan criteria, as indicated by the two portfolios of loans analyzed, have debt service coverage ratios within a range of 2.87 to 3.01 times the debt burden.

Mezzanine loans are filling voids in the credit markets for lower than investment grade credit, tranches that ordinarily would have been previously sold as a lower rated portion of the CMBS. CMBS loans with various levels of mezzanine participation have implications that are not purely economic. Mezzanine loans often carry guarantees that may not be required with traditional mortgage debt, and there is a growing trend in the industry for defaults on mezzanine loans to result in foreclosure of ownership interests. The CMBS loans indicate that only the best properties with the strongest cash flow and the best tenants will be considered investment grade. Portions of the credit that are rated non-investment grade constitute expensive financing so inclusion of specific properties should be scrutinized for marginal contributions to enhancement of the investment grade rating. CMBS loans representing lower levels of loan commitment with higher percentages of investment grade NOI may produce superior financial results for borrowers than the converse of larger loan commitments at lower investment grade ratings, providing standard commercial mortgage products can be accessed elsewhere.

While decisions to pursue financing in the capital markets may be driven by a desire to diversify sources or to establish relationships with larger pools of capital, the key to achieving low rate financing via new generation CMBS is to optimize the portion of the loans considered investment grade, while accommodating the necessary mezzanine piece. The mezzanine debt percentage contained within CMBS financing has significant implications for financial outcomes associated with property ownership, returns paid for some mezzanine loans are significant enough to warrant extensive debt versus equity substitution investigations. For situations where blended loan interest rates become set nearly equal to the overall rate of return for collateral properties, particularly when loan terms include partial amortization, borrowers are likely to be holding properties at relatively low equity return rates. Equity return rates are under pressure due not only to increasing costs of financing but also operational issues concerning vacancies and lease concessions. Successful financing that maintains sustainable long term equity return rates is a critical issue for the future performance of commercial real estate and the return of CMBS may foster this goal under the right circumstances.