



CMBS 2.0 and the new rules for mezzanine debt

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The good news making the rounds of the commercial real estate marketplace this year is the long awaited return of CMBS. According to Real Capital Analytics, approximately \$10 billion of new CMBS originations took place in the first quarter of 2011, more than all originations in 2010 combined. In January, predictions for the year ranged between \$20 billion and \$40 billion, and at this pace, there's a chance that CMBS may exceed those targets. According to Bruce Cohen, CEO of Wrightwood Capital, "CMBS's new activity is just one part of an overall return of liquidity to commercial real estate that is very encouraging. A healthy level of securitized lending, along with the steadily increasing debt availability from insurance companies, banks, Fannie Mae and Freddie Mac is all essential for sustained growth. This is all setting the stage for an eventual recovery of real estate fundamentals and the economy at large."

As the market continues to stabilize and competition heats up in the best core markets, a growing number of CMBS originators have had to look for transactions beyond the Class "A" properties in core markets dominated by institutional investors hungry for the safest of investments. According to the CoStar Group, approximately 85% of CMBS originations in the second half of 2010 was outside of the most popular markets – and that trend seems to have continued – all helping to extend recovery further and deeper in the market.

Constrained as CMBS is at the moment by a shortage of enthusiastic "B" piece securities buyers, and continued concerns about job creation in the US, rental rates and absorption, this originations growth presages better times. But as CMBS begins to grow again, visions of past years' excesses haunt lenders, investors and borrowers alike. There is a clear need to learn from past mistakes and create a more sustainable approach to securitization. With each new loan written, originators, investors and rating agencies are trying to create a stronger, better CMBS: a CMBS 2.0.

So, what does CMBS 2.0 look like? According to Bruce,

"At this point, we're not seeing too many changes in CMBS underwriting, deal structuring and servicing. CMBS 2.0 looks a lot like CMBS 1.0 – and no one should look for underwriting discipline from CMBS originations. One thing we do see, however, is that there's less traunching taking place and more wariness about subordinated capital, particularly mezzanine debt."

After the recent recession, there is quite a bit of incentive to restrict the rights of a mezzanine lender. Insurance companies and some banks just don't want another debt capital holder to stand between them and the principal. In those cases, mezzanine debt is strictly off-limits. CMBS originations, however, have so far been somewhat open to mezzanine debt, but not without some caveats and the devil is in the details.

According to Jason Choulochas, managing director of investments for Wrightwood Capital, "The rules for mezzanine debt are getting tougher. Even though pricing, sizing and underwriting have remained somewhat the same, closing the deal has become more difficult. The good news is: you can still combine mezzanine debt with CMBS first mortgages. The bad news, however, is this: it's going to be a bit tougher to pull off. The rules have changed."

How have the rules changed? Christine Fitzgerald, a partner with the law firm Katten Muchin Rosenman LLP, sees one of the primary changes centered around requirements for potential foreclosure of a mezzanine loan. "Before, the originating mezzanine lender was typically automatically qualified to foreclose upon its loan. Now, CMBS is trying to contractually obligate mezzanine lenders to meet certain financial requirements in order to do so, including requiring a foreclosing mezzanine lender to provide a replacement guarantor meeting specified financial tests, or requiring the foreclosing mezzanine lender itself to meet the "qualified transferee" financial tests at the time of the foreclosure before it will be permitted to foreclose."

Christine continued, "This, in effect, puts the mezzanine



lender at risk that it will not be able to realize on its collateral at the time of a mezzanine borrower's default, and potentially limits the pool of qualified mezzanine lenders. The mezzanine lender has to be able to meet certain financial requirements, including certain total assets under management and capital/statutory surplus tests, at the time of foreclosure. If, during a bad time in the market, the mezzanine lender is unable to meet those requirements, it may potentially no longer have foreclosure rights, in effect losing its primary remedy."

Jason added, "We've only seen a small number of deals so far, and we are all adapting to a new version of CMBS as we go. It is likely that we will see further changes as well."

Bruce commented, "I'm glad that CMBS participants are re-examining their process and trying to build a more sustainable model for securitized debt. But so far there doesn't seem to be a lot of meaningful change. While the elimination of complicated structures and multiple classes of securitizations will mitigate some of the tranch warfare that took place on the large structured transactions, it won't mitigate poor underwriting, poor borrower selection or poor business plans. Disallowing a third party to foreclose doesn't materially protect an investor from lax underwriting – although it may make a bad situation slightly less bad. I hope that rating agencies and investors will continue to focus on underwriting discipline, even as the market pushes for a return to less rigorous practices."

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