

Real Estate Capital Markets Update – May 5, 2007

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The following is a special edition of ULI's Real Estate Capital Markets Update in which we define and discuss Commercial Real Estate Collateralized Debt Obligations, the "new, new" thing in the corporate and real estate capital markets.

"What is a commercial real estate (CRE) collateralized debt obligation (CDO)? And why should you care?" You should care because CRE CDOs are the "new, new" thing in corporate and real estate finance and they have begun to "migrate" from investing solely in "finished product" (existing debt obligations originated by others) to "creators" of new debt obligations, i.e., they are beginning to originate and underwrite loans, and you may soon find yourself either negotiating a term sheet with one of these hybrid lenders before too long or with one of these entities owning your existing loan.

A commercial real estate collateralized debt obligation is a special purpose investment vehicle created to finance the purchase, ownership, and management of a wide array of real estate denominated (as well as other) debt obligations including, but not limited to: various tranches (or slices) of commercial mortgage-backed securities (CMBS); bonds of publicly-traded real estate investment trusts and real estate operating companies; real estate whole loans as well as participations (shares of) whole loans; credit tenant loans; B-notes and mezzanine debt secured primarily by the entity owning the property (but sometimes directly by the real estate); and even construction loans.

Where did the idea for CRE CDOs come from? We think that recent increases in the levels of subordinated financing available in the market, combined with the amount of capital looking for higher yield producing investments, provided the "jet" fuel necessary to drive the creation and growth of financial exotica such as CRE CDOs. Once started, CRE CDOs took off, driven by the performance of the real estate industry during the past several years including: improving market and property sector fundamentals; strong financial returns; very few, if any, mistakes or miss-cues (such as governance and compensation scandals or overbuilding); and attractive risk-adjusted yields and spreads as compared to alternative debt investments.

"What makes CRE CDOs attractive to investors? And who buys this paper?"

CRE CDOs are purchased primarily by the same investors who purchase CMBS including: financial institutions; money managers; hedge funds; and insurance companies—just your typical group of institutional investors and money managers searching for yield and willing to take increased risk to get it. According to an analysis published by JPMorgan, financial institutions and money managers account for more than 50% of all purchases of CRE CDOs.

Investing in CRE CDOs offers investors a series of benefits including increased diversification and liquidity as compared to all but the largest CMBS or commercial real estate whole loan portfolios. For example, an average CMBS transaction may include as

many as 150 commercial and multifamily real estate loans as its underlying collateral. On the other hand, a CRE CDO that purchases tranches of multiple CMBS offerings may be invested in literally thousands of loans, thereby gaining increased diversification in terms of property type, property location, transaction originator, and borrower.

CRE CDOs come in two “lifecycle” investment structures: static lifecycle and managed lifecycle. The difference between the two structures is that in the CRE CDO with a static lifecycle, the original portfolio chosen by the fund manager remains “static” or unchanged during the entire lifecycle of the CRE CDO (say 7 to 10 years). In the managed CRE CDO, the portfolio is actively managed via sales and re-investment of sales proceeds for a period of 5+/- years before it is allowed to run off in an orderly way. The following time line, adapted from a similar chart in a recent publication by JPMorgan, illustrates the differences between a static and a managed CRE CDO:

Static CRE CDO Lifecycle		Managed CRE CDO Lifecycle	
Time Period	Event	Time Period	Event
9-12 Months	Warehouse period during which time CRE loans are accumulated; transaction priced	9-12 Months	Warehouse Period during which time CRE loans are accumulated; transaction priced
At end of 12 th month	Deal closes with asset pool 100% “Ramped” (or fully invested)	At end of 12 th month	Deal closes 70% to 90% “Ramped” (or fully invested)
7-10 Years	“Run-Off” or liquidation period	3-9 Months	Remaining proceeds of offering invested; asset pool 100% “Ramped”
		5 Years	Revolving period during which time reinvestment of asset sale proceeds allowed
		2-3 Years	“Run-Off” or liquidation period

Source: JPMorgan.

CRE CDOs are not required to operate under the same rules as REMICs (real estate mortgage investment conduits) which is the traditional structure utilized to own portfolios of commercial mortgage-backed securities. This allows the investment manager of the CDO increased flexibility in terms of the assets it can invest in, re-investment periods, leverage, etc., as well as greater latitude in dealing with a borrower who defaults on a mortgage loan as compared to a CMBS loan where all defaults are handled on a formulaic basis by the special servicer.

As one would expect with any new financial product, there are some questions swirling around relating to CRE CDOs. We believe the two primary ones are as follows:

The first deals with the real estate underwriting and real estate investment experience and expertise of the persons managing investment pools investing in CRE CDOs. It has been proffered that some of these persons are relatively new to the real estate industry and are investing without the benefit of fully understanding the “bricks and sticks” and markets underlying each individual asset in the portfolio. It is all well and good to invest in the higher rated tranches of a pool of CMBS which is both homogenous as well as highly liquid without being a real estate expert as you have the B-piece (lower rated tranche)

buyers doing considerable due diligence. This is known as the “don’t have dirty fingernails” postulate. Performance to date has shown that the stratification (division) of CMBS portfolios into multiple tranches combined with the diversification provided under the current CMBS structures has spread the risk of payment of current interest and repayment of investment sufficiently—so far—for all, but the lowest rated, tranches. The potential issue with CRE CDOs is that some appear to be relying more on transaction structure and dispersion of risk through diversification as their primary protection against potential defaults as they are not lenders by tradition, practice, or training.

A second question relates to the structure of CRE CDO investment pools. CRE CDOs invest in a wide array of real estate assets, each having own credit profile (as well as credit rating). In an attempt to achieve both diversification and increased yield, some portion of these investments must involve lower “credit” rated securities. Once purchased, the securities and loans are combined for cash flow purposes with the resulting cash flow “sliced, diced, and priced” to create an efficient investment transaction comprised on numerous tranches diversified as to credit rating. The problem in some people’s minds is that some portion of what went into the hopper was lower rated securities whose repayment is subordinated to numerous higher rated tranches and that their use as collateral in structuring a new investment transaction which then has higher rated tranches is effectively piling “leverage on leverage”, and that some aspects of the structural protection provided by the sequential payment structure of the CRE CDO, may be subject to question. Only time and investment performance will answer these questions.

It is our intention to continue to report on the progress of CRE CDOs and their impact on the real estate industry and real estate capital markets. Please address your questions, comments, and suggestions to blank@uli.org