A Case Property Services Publication Q1 2015

RESTRUCTURING QUARTERLY

THE UNDERWRITING AND RATING AGENCY ISSUE

In this Issue:

CASE
DISTRESS . CMBS . LOAN WORKOUTS

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From the desk of **Shlomo Chopp**
Managing Partner, Case Property Services

Dear Reader,

The first quarter of the year has been pretty eventful. CMBS originations are continuing with gusto and while we are seeing some increased distress, the worst is yet to come. For CASE, the first quarter has brought welcome changes and additions. We have relocated to new offices in Downtown Manhattan and are proud to welcome David Balaj to our team. David will serve as a Director and Project Manager- his bio is included on page 2.

Providing workout solutions for distressed assets puts us in the unique position of seeing the less glamorous side of real estate finance. Unfortunately, we are already seeing distressed CMBS 2.0 loans and it is pretty obvious that as an industry we have not learned from our past mistakes.

This issue of Restructuring Quarterly focuses on underwriting practices and rating agency methodologies. For the most part, the credit ratings analyses of CMBS trusts are proverbially skin deep. So long as an originator is careful not to raise any red flags, it would be possible to finance and securitize fundamentally flawed properties. Sort of like a "don't ask don't tell" policy- and that is plain wrong.

To be fair, I'm sure that many of our concerns and ideas have been broached by the agencies themselves- with significant push back. The ideas outlined in "What Underwriting Standards?" (page 4) are costly and would require an overhaul of the system. Some of the ideas would get the mortgage brokerage community up in arms; however, what is more important than the recovery and full repayment of the entire balance of each and every loan? If it costs a bit more, that is the downside of borrowing non-recourse money at relatively high leverage. Without reform, the industry is a ticking time bomb. Keep on losing their money, and Investors will flee.

As always, feel free to reach out with any questions or comments at schopp@caseps.com

Best regards,

For all **media inquiries**, please contact mediarelations@caseps.com.

Sub-par due-diligence threatens the future of CMBS lending.

Often, "collateral gone bad" could have been avoided.

Rating agencies find themselves in a fiduciary position to protect Joe and Jane Main Street's retirement nest egg (via pension plan investments) from being squandered by an originator or bond investor more concerned about fees than security.

The theory of CMBS is that by pooling multiple loans in a trust, and then slicing the cash flows into various levels of rated tranches, even if multiple properties decline somewhat in value, there would still be sufficient cash flow to provide the returns to the various tranches commensurate with their credit levels. The intent is good, but in practice, concerns are abound. While legacy CMBS declined at greater levels than anticipated, most believe that this is almost entirely due to an overall market meltdown, and to a great extent that is correct. However, many of the instigating causes still remain. Like super high valuations, a lack of proper regulated due diligence, and the belief that all risks can be offset with minimal dollars and so-called credit enhancements. On a blended basis, yes, these offsets may help mitigate the risk somewhat, however, on a loan by loan basis, they are far from adequate. Sometimes risky loans must be excluded from a trust. What may be underwritten as a potential minor hiccup can cause a chain of events that would ultimately devalue the asset below underwritten levels. Furthermore, if originators, underwriters and rating agencies are not fully aware of, or ignore the potential risks involved with each underlying asset, mistakes can occur that can cause unnecessary losses.

On March 5th 2015, Sarah Mulholland of Bloomberg quoted a Nomura Holdings estimate that "$16 billion in property debt that has been sold to investors as securities is vulnerable to default after crude prices plunged, posing risks for the economies of U.S. cities and towns built around the boom." With a simple Google search we were able to uncover that the "all-in," breakeven cost for U.S. hydraulic shale is $65 per barrel, according to a study by Rystad Energy and Morgan Stanley Commodity Research. Was this fact ignored? Or were there credit enhancements? Last we checked a CMBS trust cannot buy hedges on oil prices- what else would hedge against such a massive exposure?

We have not reviewed all pre-sale reports of these loans to understand what warnings were given and how the cash flows were "tranched." However, one thing is for certain- all the slicing and dicing in the world cannot add value to properties that make up a modern ghost town. Hopefully, oil recovers sufficiently over the long term to support these properties, but this is merely one example of the underlying flaws in the process. When you start with a basis that is too peachy, it is hard to create a realistic stress scenario. Remarkably, investors have returned to the CMBS market. However, the process is still broken and unless it is fixed, and soon, investors will be forced to flee CMBS investments for good. □

CPS News:

David Balaj joins CPS as Director and Project Manager.

Mr. Balaj has 20 years of real estate investment, underwriting and debt structuring experience involving over $15 billion in commercial real estate transactions.

After graduating from Fordham University's finance program in 1992, David started his career as a property and asset manager overseeing residential and retail assets in the New York City area. Capitalizing on his extensive problem solving, and operational expertise, he obtained his Masters degree from the NYU School of Real Estate, and landed a position with SL Green Realty Corp. (NYSE "SLG").

At SLG Mr. Balaj was initially an analyst under the now President and CEO of the company. During his tenure at SLG, David was eventually promoted to Senior Vice President in the Investments group working on acquisitions, dispositions and joint venture asset management. One particular aspect of the position, was the asset management and/or workout of loans held in SLG's structured finance platform totaling an amount in excess of $1 Billion.

Since 2011, David Balaj has provided financial and operational consulting services to private investors, as well as advising high net worth individuals in executing acquisitions, dispositions, and debt financing instruments structures.

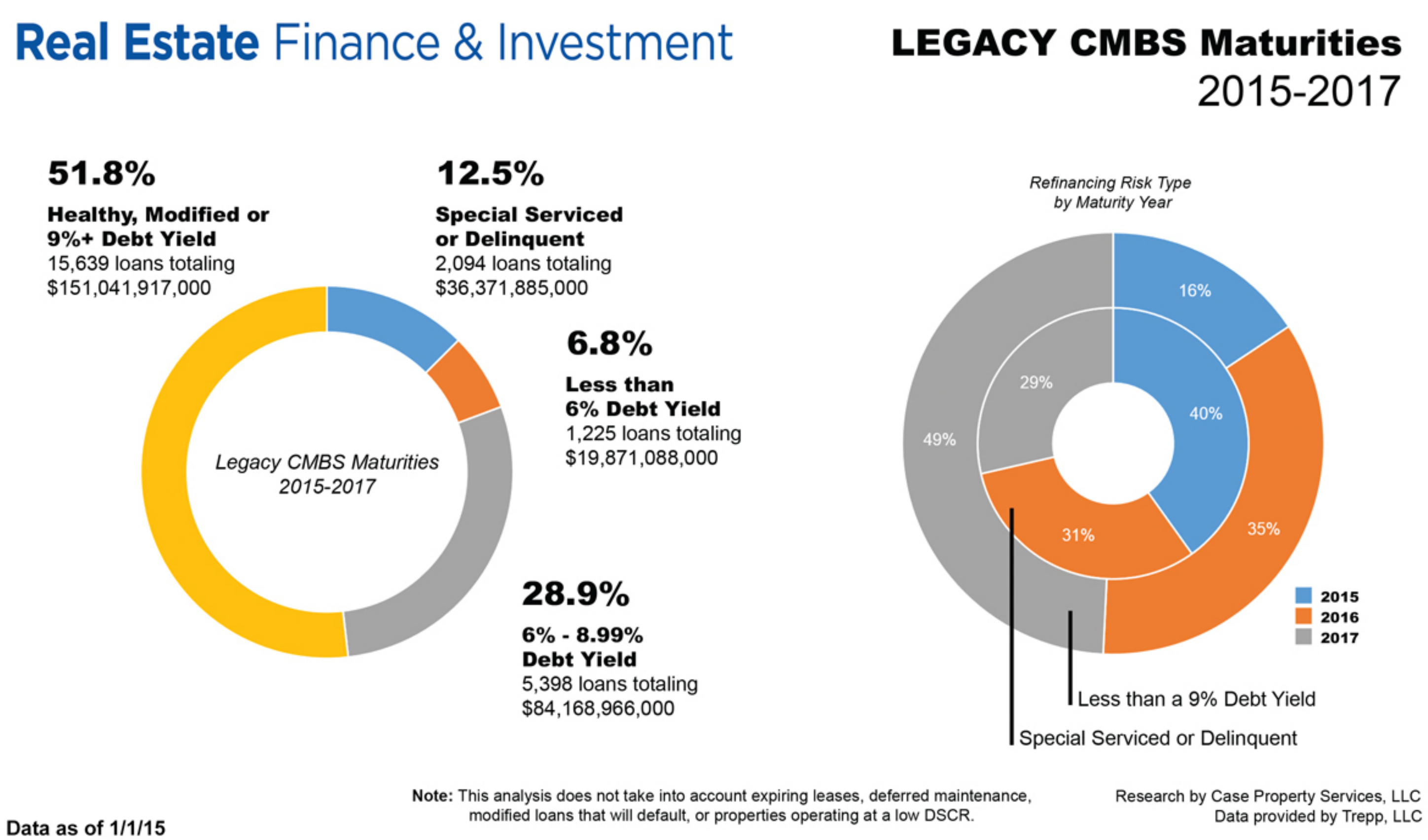
As Director and Workout Project Manager with our firm, David will lead a team executing highly specialized workout solutions for CPS clientele. David can be reached at (646) 412-5888 or dbalaj@caseps.com. □

The LTV's are just too high.

Is CMBS debt actually Mezzanine debt at first mortgage rates?

A novice commercial real estate finance intern can tell you that loan proceeds are intended to be less than an assets value in order to allow for value depreciation and property level financial disruption, to establish a risk premium. In working out distressed loans, it has become readily apparent that the risk premium is not nearly large enough. In our experience, it has become more and more difficult for a lender to execute a foreclosure. Borrower's and their attorney's have become very creative in defending even the most open and shut cases. It is relatively easy to create significant leverage in a courtroom setting. This stems from judges not being familiar with CMBS structures, new case law, or loan documents drafted by attorneys who while working for even white shoe law firms, are woefully inadequate.

Ultimately, lenders usually succeed due to the simple fact that the money is owed – but at a cost. More than the massive legal bills, loans mired in contentious litigation suffer massive property value declines. The properties stagnate like a rudderless ship with no direction, and lose countless opportunities to the competition. When the industry refuses to acknowledge inherent risk in many properties, this is but one reason why the LTV's are just too high. □



What Underwriting Standards?

Establishing a set of underwriting standards rather than relying on less scientific stress tests.

Multiple news articles and rating agency commentaries have decried the decline of underwriting standards. This must be a misnomer. With no real standardized underwriting methods, how can they be declining? The reality is that lenders have become investors - both literally and figuratively. Literally, lenders are short term investors in CMBS debt flipped into a trust. Figuratively, the mindset is to focus on profits, so long as they can tolerate the risk- because "hey, we're selling it anyways." Can you imagine what the lenders of yesteryear would think of this?

The process is broken. Loan originators find themselves in the enviable position of a fox guarding the henhouse. Very simply, if they choose to ignore underlying asset issues, provided that the rating agencies do not pick up on it, they can churn out deals and make significant profits flipping them to CMBS trusts. As a result of our working out distressed loans, we find ourselves in a unique position to recommend changes to the industry and hopefully spur the establishment of standardized underwriting protocols. While rating agencies only view their responsibility as commentary driven, they are at times blindly relied upon by investors. They sit in a position to effectuate change in the industry, and in our opinion have a duty to do so.

VALUE THE CASH FLOW- NOT THE TRANSACTION DATA

When determining property values based on transaction data, one is relying on "over-payer" data points, as property sales are almost always the result of a "bidding process." A better indication of value may be the median bid amount, but that information is never tracked. Using historical or stressed cap rates is a good start, but they often have little basis in the current reality- and at times are even too harsh. Stressing trust level cash flow, or even general loan cash flows provides for a shaky foundation. For proper analytics, one must go to the source- the tenant cash flow of each and every lease representing 20% or more of a single loan should be analyzed. The following are just several factors that utilizing readily available rating agency data (after all they do rate corporate bonds), can help determine the credit certainty of each tenant's lease cash flow. A similar metric is found in retail real estate, this is known as health ratios - the percentage of retail sales allocated to real estate occupancy costs. A restaurant would have a different acceptable health ratio as compared to a discounter.

CORPORATE LEVEL ANALYSIS:

Often tenants are required to provide periodic financial statements, in addition to those provided at the commencement of the lease. Analyzing a tenant's financial standing, credit profile, profitability and stability can at times help inform realistic cash flow stress levels.

INDUSTRY LEVEL ANALYSIS:

What is the short, medium and long term prospects for the industry? (i.e. retail and its impact by on-line stores)

MARKET WORKFORCE AND MUNICIPAL ANALYSIS:

How will the business environment affect the tenants on a long term basis? Each community and municipality should have its own risk factor, adding to the stress test formula.

USE OF SPACE ANALYSIS:

It is necessary to understand the tenant's industry specific utilization of leased space. If it underutilizes the space, while leasing at market rates, it stands to reason that this tenant's occupancy costs exceed those of its competitors. As a result its lease cash flows must be stressed to account for a possible future rent reduction request.

Furthermore, with retail assets, if an anchor tenant leases risky space (oversaturating a market for competitive reasons or embarking on a new store concept that may not succeed etc.), there is a risk that they may go dark triggering reduced rental proceeds from the shop space due to potential co-tenancy clauses. With proper diligence, such risks can be quantified- with the cash flow stressed accordingly.

THE ORIGINATOR / UNDERWRITER RELATIONSHIP

Loan originators should be required to farm out the underwriting and due diligence process to qualified third party underwriters overseen by and periodically audited by the rating agencies internal review personnel. There must be a clear separation between the "sales guy," the due diligence team, and the committee rubber stamping the deal. There has to be incentivized motivation to uncover issues, not just to push deals to generate fees.

FORMULATE APPRAISAL GUIDELINES

We recently saw an appraisal on a 30% vacant building that grossed up the vacancy at market rates, and then took a loss factor of only 7%. It would surprise the average real estate professional to learn that maneuvers similar to (although many times not as egregious) this are all too commonplace. It is time for rating agencies to insist on its own set of appraisal guidelines.

LOAN DILIGENCE DATABASE

Once a loan is denied, or even if it is closed, a complete due diligence file should be entered into an online databank that can be accessed by competing lenders and or bond buyers. This way the diligence monies spent by the originator (and passed through to the trusts) will be well spent in preventing another lender from making a bad loan- now or in the future.

INVESTIGATIVE TEAM

Each third party underwriter must retain the services of an investigative team. If the NFL can do it for draft choices before they risk millions of dollars, so too should CMBS lenders. The team should learn all that it can about each borrower and property, including researching on the ground initiatives and the like (such as traffic pattern change proposals, or zoning changes being lobbied for- and we're referencing those that aren't available in public documents).

Some of these concepts can be viewed as taking competition out of the marketplace. This is wholly untrue. The differentiation between lenders will stand solely on the non-securitized risk an individual lender is willing to carry on its books as a B-Note or Mezzanine loan - not pawn off on unsuspecting investors. When working off of a set of data with little gray area, determining property values and tenant risks comes down to simple math. ☐