

CMBS LOAN WORKOUTS

# Options & Strategies

*By Shawn Hill*

CMBS  
D E B T





**A**s a result of the post-recession economy, more borrowers continue to struggle to meet their loan obligations, oftentimes through no fault of their own. As a firm that arranges debt and equity financing for commercial real estate investments nationwide, with an emphasis on self-storage, The BSC Group has witnessed many different types of transactions face a myriad of difficulties over the past several years.

Consider that between 2000 and 2004 a total 18 banks failed in the United States, with none occurring in the period between 2005 and 2006. In contrast, 393 banks failed since the recession began in 2007. This exceptional collapse led to government intervention and a virtual realignment of the entire banking system. For almost two full years there was a credit freeze, whereby almost no debt lending occurred and capital was extremely difficult to obtain for all sectors of business, including but by no means limited to commercial real estate. During this time period, the amount of CMBS loans in default went from approximately under 1 percent in 2007 of total loans outstanding, to over 9 percent, totaling almost \$60 billion of loans as of August 2011 according to Trepp, LLC.

In the commercial real estate world and in many ways the banking system as a whole, the heart of the matter relates to leverage, or more specifically too much leverage. According to Moody's/REAL Commercial Property Price Index, commercial real estate values dropped 40 percent from their peak in 2007 in the face of this recession. Considering that it is not uncommon for commercial real estate assets to be purchased with a 75/25 debt to equity ratio, one does not need to be a mathematical genius to figure out that in light of post-recession valuations, assets may be worth less than the outstanding debt amount.

There are currently more than \$60 billion of securitized loans in some stage of actual default. If one assumes that there is a similar amount of defaulted portfolio loans, the sum adds up to approximately \$120 billion of defaulted loans in the commercial real estate market. Many industry experts estimate that the amount may be even greater.

In addition, the number of maturing Commercial Mortgage Backed Securities ("CMBS") loans in the "near" term is astounding—more than \$400 billion between now and 2017! By adding the life company, bank and GSE products that are maturing, the number doubles and an estimated two-thirds of those will not qualify for refinancing at an amount required to pay-off the existing debt.

Borrowers faced with a problem loan are definitely not alone, and all is not lost since. There are options. The problems being faced today are not singular; rather they are systemic and most, if not all, lenders are facing the same situation with other borrowers and assets in their portfolio of real estate loans. The silver lining is that depending on the type of debt you have, your options may be better than you think, and if you are a borrower with non-recourse CMBS debt, your options may not be bad at all.

**Understanding CMBS**

Commercial Mortgage Backed Securities (CMBS) are a type of security backed by mortgages on commercial real estate. In a CMBS transaction, the lender (often referred to as a conduit) originates loans for the express purpose of packaging

them with other loans of various sizes, property types, and locations in order to sell the pool of loans as bonds. Specifically, once a critical mass of loans is achieved by the conduit, ownership of these loans is transferred to a legal trust, through the use of a specially created tax entity known as the Real Estate Mortgage Investment Conduit (REMIC). The trust then issues a series of bonds that vary in yield, duration and payment priority. This process is referred to as securitization, which by its very definition is the process of taking an illiquid asset, or group of assets, and through financial engineering, transforming them into securities.

The process of creating a CMBS transaction, while seamless to the borrower, is complex and occurs after the origination of their loan. Owing to the nuances of the process and the rules that govern REMIC transactions, however, it is critical that borrowers maintain some understanding of the CMBS process, particularly if they plan on negotiating the workout of a distressed asset that is contained in a securitized CMBS transaction.

**Understanding The Lenders (Non-Re) Course Of Action**

CMBS loans are non-recourse loans secured by real property, for which the borrower is not personally liable, other than specific acts spelled out in the loan documents, commonly referred to as the "carve outs." As such, if a borrower defaults on a non-recourse loan obligation, the lender's recovery is generally limited to the loan collateral and the lender typically does not hold the right to pursue

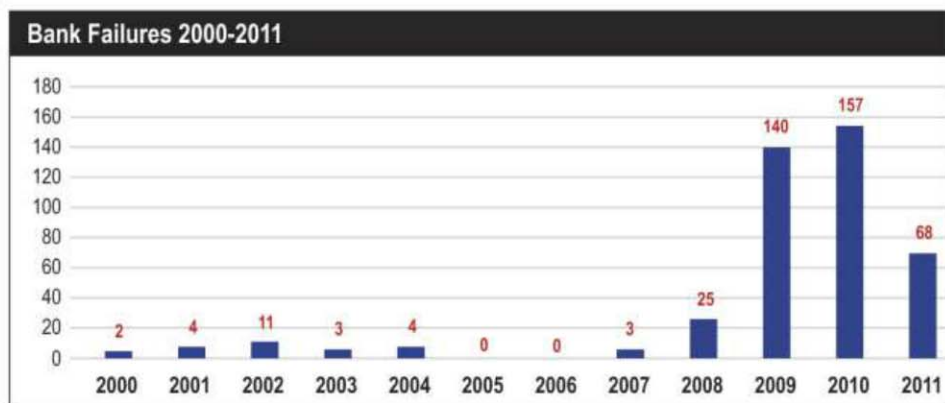
remedies other than repossessing the collateral securing the loan. In the event that the collateral value is not sufficient to cover the outstanding loan balance, the difference between the value of the collateral and the loan value would become a loss for the lender.

Therefore, if a borrower defaults on his non-recourse self-storage loan, the lender can foreclose on the self-storage asset. If the asset is no longer worth the value of the debt, the lender is not entitled to pursue a deficiency judgment against the borrower for the difference in value.

**CMBS Politics**

A number of players are involved in the process of originating and administering a CMBS securitization. The borrower's day-to-day contact on securitized loans for routine matters such as questions about payments, property taxes, insurance and other daily matters is referred to as the primary or master servicer, which may or may not be the original Lender. Regardless, the approval authority required on specialized matters such as loan assumptions, modifications, and restructures typically does not fall under the jurisdiction of the day to day loan servicer. This role is handled by the "special" servicer.

Many investors who buy CMBS bonds do so for the yield and the perceived risk/return relative to other alternative investments, and not necessarily for the real estate itself. In a CMBS transaction, the lowest rated bond holders are called the controlling class certificate holders, and this party has the authority to appoint the special servicer.



So, why is a special servicer important to the borrower? Well, if everything was going as planned with the asset, then more than likely the borrower would never need to know the name of the special servicer! However, in the event that a borrower wanted to sell property encumbered by CMBS debt and to have a new buyer assume the loan, the special servicer would ultimately approve the transaction. Furthermore, if a property is not performing as originally planned and therefore is in need of restructure options, the special servicer is the one who approves these requests.

If you need to restructure a CMBS loan, it is critically important to understand the objective of special servicers. Since they represent the lowest rated bond holder (also known as the "first loss position"), this class will suffer the first loss on the loan. The special servicer has a fiduciary duty to make decisions that will be in the best interest of all the classes of bonds.

Therefore, the most important question to the special servicer is "will the losses to all bond holders ultimately be less if I foreclose and sell the property, or if I negotiate an alternative arrangement with the current borrower?"

Perhaps the most challenging and ironic aspect of a CMBS workout is that the borrower cannot speak directly to the special servicer until after they have actually defaulted, or until they can prove to the master servicer that a default will be imminent without some relief in payments or other alternative strategy.

**Initiating the Process**

The first step in a CMBS loan workout is to notify the master servicer of the situation. As discussed, the master servicer does not possess the authority to discuss a restructure or modification with the borrower; in fact, in a workout situation, his only role is to transfer you to the special

servicer for those discussions if (1) you are currently in default, or (2) they firmly believe that you will eventually go into default in the near future.

In order to qualify for a loan modification or restructure plan on a CMBS loan, the borrowers must be able to demonstrate that the current cash flow from the property is not adequate to support the current debt service payment. It is not enough to simply have a property that has declined in value to a point where the loan balance is higher than the value of the property. In the event that the cash flow is less than the debt service payment, and once the master servicer has made that determination, in their sole discretion, they will then transfer your loan to the special servicer, who may then be willing to consider a restructure or payment modification.

**CMBS Workout Options**

It is somewhat ironic that the very REMIC

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rules that do not allow a restructure or significant modification of a loan do allow the special servicer to do whatever is in the best interest of the bond holders once a loan has been declared in default or imminent default. Therefore, once a loan has been transferred to the special servicer, any restructure or modification that is in the best interest of the bond holders can be considered. For borrowers facing a CMBS loan workout with their special servicer, there are a variety of options that the master servicer may deem to be acceptable, depending on the specific situation and circumstance.

### Payment Modification

The most common type of restructure is one that results in a slight modification of the payment so that the current income from the property will be adequate to support the new payment. Typically the current mortgage payment consists of more than just principal and interest, and includes other escrows for taxes and insurance and replacement reserves. So long as the current cash flow from the property is sufficient to support a payment that consists of some of the components of the previous payment (i.e. modification to interest only), then it is possible that the payment can be modified for a period of time so that the income from the property now satisfies the new modified payment.

### Interest Rate Reduction

If a payment modification, as described above, is not sufficient relief given the property's current cash flow, it is possible that the interest rate can be lowered for a period of time, as long as the property can then cover operating expenses and debt service at the lower rate.

### Principal Balance Reduction

The most difficult type of a modification to achieve is a principal balance reduction, which can only be considered in two instances: (1) the property cash flow will not support any other type of payment modification (i.e. interest only, lowered interest rate, etc.); or (2) the borrower is willing to share the 'pain.' Remember

## CMBS Workout Options

- Payment Modification
- Interest Rate Reduction
- Principal Balance Reduction
- A/B Split Note
- Discounted Payoff
- Note Sale
- Short Sale
- Maturity Date Extensions

that the special servicer is almost always the entity that will absorb the principal reduction loss. In exchange for granting a principal reduction, the special servicer will typically require the borrower to contribute capital to help offset the total amount of principal being reduced.

### A/B Split Note

In lieu of outright forgiving some of the principal and incurring a loss today, it might be preferable to split the note into two parts—an A and a B. The A note will essentially equal the amount of debt the property's cash flow will support today. The B note will be the difference between the original note amount and the A note amount. The B note will typically not accrue interest and will essentially be due upon final payoff of the debt at the original or extended maturity. The key benefits of the A/B split note is that (1) it does not require the special servicer to actually incur a loss today; (2) it allows the special servicer to potentially recoup its entire original debt; and (3) the borrower does not have a tax consequence as a result of the debt forgiveness unless and until there is an actual loss in the future at the original or extended maturity date.

### Discounted Payoff

In some cases, the special servicer

may entertain a discounted payoff. The instances when the discounted payoff can be considered are (1) the borrower has the means to pay the loan off at a discounted amount; and (2) the current as-is value of the property is significantly less than the current debt amount; and (3) it is not anticipated that the value of the property will ever allow for a complete pay-off of the debt during the term of the loan. Typically all three of these circumstances must be present to even consider a discounted pay-off; although some special servicers have seemed to prefer to accept a discounted pay-off lately as a way to eliminate any future exposure on the asset.

### Note Sale

Since a discounted payoff has potential tax consequences to the borrower at the time of payoff, another method of accomplishing the same objective as stated above is for the borrower to actually purchase the Mortgage Note from the lender. The borrower is then in control of the Note and subsequent actions on the Note.

### Short Sale

When a borrower is interested in 'handing back the keys' but has a potentially interested buyer of the property, the borrower may want to consider a short sale. A short sale occurs when the new buyer assumes the existing debt and the special servicer agrees to write the debt down to the price of the sale. The benefit for the existing borrower is (1) no negative credit results from handing back a property; (2) potential negotiation on the tax consequences of debt forgiveness; and (3) overall greater control in the negotiation versus handing the property back to the "lender."

### Maturity Date Extensions

If you happen to be one of the many borrowers with an upcoming maturing loan, the special servicer is the party with the authority to approve an extension of your CMBS loan. It is important to remember that the special servicers are really only interested in speaking to borrowers under


two scenarios: (1) the loan is actually in default; or (2) a near term default on the loan is eminent. Borrowers with an approaching maturity date that cannot pay-off their loans are qualified because those loans will default on the maturity date. This is known as a maturity default.

Until late 2008, most special servicers would not even grant an extension of a maturity date at all. As the capital markets completely dried up during the recession however, it became abundantly clear that borrowers had no other options, and therefore the special servicers had no choice but to foreclose on an otherwise good borrower, or offer some sort of extension. As a result, the special servicers started to grant extensions on a regular basis which is sensible and clearly a better option for everyone involved.

For borrowers who need an extension of the maturity date, the first thing to do is alert the master servicer of the issue. It is important to be able to demonstrate to the master servicer that despite best efforts there were no lenders in today's market willing to refinance the current loan, and proof of these efforts will be required. Upon verification of the facts the master servicer should then transfer the loan to the special servicer, so meaningful discussions about a possible extension can commence.

Theoretically all of this should happen well before the maturity date so that the loan never actually goes into default. However, given the overwhelming amount of loans being transferred to the special servicers at present, it is not always a practicality. While some special

servicers will begin these discussions with borrowers as much as 90 days before the maturity date, others will not have any discussions with borrowers until the maturity date is looming. The length, cost, and amount of pain involved to obtain the extension is largely dependent on the particular special servicer involved.

We recommend you work closely with your financial partners or a qualified advisor to determine the best-case scenario for your situation. 



Based in Chicago, Shawn Hill is a principal at The BSC Group, where he provides mortgage brokerage, financial consulting, and loan-workout solutions to self-storage real estate owners nationwide.

### Analyzing Several Lenders' Proposals

#### Lender #1 Loan Quotes as per 2/13/11 Loan Apps

	Swap Rate (basis pts)	Years	Spread (basis pts)	Interest Rate	Actual Loan Constant	Loan Constant Required	Debt Service	Loan Amt Requested	Accepted NOI	Debt Service Coverage	Min DSC Required	Cash Flow Yield (1)	CFY Required	Cap Rate	Fair Mkt Value	Loan to Value	Max LT Allowed
Property A	249	5	315	5.64%	6.89%	6.98%	447,850	6,500,000	764,000	1.71	1.30	11.8%	12.0%	7.50%	10,186,667	64%	62%
	375	10	231	6.06%	7.31%	7.23%	475,150	6,500,000	764,000	1.61	1.30	11.8%	12.0%	7.50%	10,186,667	64%	62%
Property B	249	5	330	5.79%	7.03%	7.05%	393,680	5,600,000	672,000	1.71	1.30	12.0%	11.9%	8.00%	8,400,000	67%	68%
	375	10	241	6.16%	7.33%	7.26%	410,480	5,600,000	672,000	1.64	1.30	12.0%	11.9%	8.00%	8,400,000	67%	68%
Property C	249	5	306	5.55%	7.03%	7.43%	379,620	5,400,000	692,000	1.82	1.30	12.8%	11.5%	7.50%	9,226,667	59%	59%
	375	10	225	6.00%	7.33%	7.16%	395,820	5,400,000	692,000	1.75	1.30	12.8%	11.5%	7.50%	9,226,667	59%	59%

Notes  
(1) Cash flow yield is NOI divided by loan amt

#### Lender #2 Loan Quotes - 2/10/11 -

	Swap Rate (basis pts)	Years	Spread (basis pts)	Interest Rate	Actual Loan Constant	Loan Constant Required	Debt Service	Loan Amt Requested	Accepted NOI	Debt Service Coverage	Min DSC Required	Cash Flow Yield	CFY Required	Cap Rate	Fair Mkt Value	Loan to Value	Max LTV Allowed
Property A	260	5	315	5.75%	7.00%	none	455,000	6,500,000	688,457	1.51	1.45	10.6%	10.5%	7.50%	9,179,427	71%	75%
	386	10	230	6.16%	7.41%	none	481,650	6,500,000	688,457	1.43	1.45	10.6%	10.5%	7.50%	9,179,427	71%	75%
Property B	260	5	315	5.75%	7.00%	none	392,000	5,600,000	673,090	1.72	1.55	12.0%	12.0%	8.00%	8,413,625	67%	75%
	386	10	220	6.06%	7.31%	none	409,360	5,600,000	673,090	1.64	1.55	12.0%	12.0%	8.00%	8,413,625	67%	75%
Property C	260	5	295	5.55%	6.80%	none	367,200	5,400,000	694,920	1.89	1.65	12.9%	12.5%	7.50%	9,265,600	58%	70%
	386	10	220	6.06%	7.31%	none	394,740	5,400,000	694,920	1.76	1.65	12.9%	12.5%	7.50%	9,265,600	58%	70%

Notes  
(1) Cash flow yield is NOI divided by loan amt