MEZZANINE FINANCING AND MORTGAGE SECURITIZATION ISSUES: 2000

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I.

MEZZANINE FINANCING

A.

Definition of Mezzanine Lending

"The term "mezzanine" was borrowed from the Wall Street markets, in which debt is characterized by the perceived quality of the underlying credit and traded in separate markets according to the risk inclinations of different classes of investors. Debt classified according to credit quality is deemed to be "investment grade" on the high end and 'high yield' (or 'junk') instruments on the low end. Debt which carries the highest risk is the equivalent of equity. The market for debt between the extremes of investment grade and equity was broadly referred to as the 'mezzanine' market. This market attracted investors who were not regulated institutions required to hold only investments grade securities, but who were also unwilling to speculate in the highest risk equity investment instruments."

K.C. McDaniel, "Intercreditor Issues in Mezzanine Lending", SD04 ALI-ABA 501, 503 (1998)

Advantage of Mezzanine Debt to Borrower

For the borrower, mezzanine loans afford a means of extracting value from appreciated assets without having to refinance mortgage debt with a prepayment premium.

B.

Mezzanine Financing: Corporate Debt (Non-Real Estate)

Mezzanine financing refers to an investment provided to a company that is already providing and selling a product or service for the purpose of helping the company achieve a critical objective (such as increasing inventories to accomplish greater sales) that will enable it to go public.

Mezzanine financing is typically undertaken when it promises to decrease the company's overall cost of financing by helping the company attract a better price for its shares in a later public offering. Sometimes it is undertaken because the market for public offerings is so poor that going public is not a viable alternative.

A theory espoused by many underwriters and investment bankers is that there are important psychological break points in initial public offerings, below which the company's stock will not attract institutional investors and other important investors. Without their interest, the theory goes, the stock will have fewer potential buyers and will obtain a lower price.

Sometimes a mezzanine financing can move a company into a position in which its stock will attract a significantly larger audience and a healthier price. By accepting mezzanine financing, management hopes to make its stock more appealing to investors and to decrease the company's overall cost of financing by making its first round of public financing significantly less costly. A large increase in the price the public is willing to pay for a company's stock means the company will have to issue fewer shares to raise funds than it would if its shares supported a lower market value.

The critical factors in determining a viable price of a company's stock are the size of the company, its earnings history, its prospects for continued and dramatic growth, and the price-earnings ratio its shares can command.

C.

Standard & Poor's Definition of a Special Purpose Entity

An SPE is an entity which is unlikely to become insolvent as a result of its own activities and which is adequately insulated from the consequences of any related party's insolvency.

D.

Standard & Poor’s Overview of SPE Criteria

Standard & Poor’s SPE criteria can be divided up into four fundamental categories:

1. Items intended to prohibit the SPE from incurring liabilities:

    - Limitation on Purpose
    - Limitation on Indebtedness
    - Prohibition on liquidation, consolidation, merger, etc.

2. Items intended to insulate the SPE from liabilities of third parties:

    - Separateness covenants
    - Nonconsolidation opinions

3. Items intended to protect the SPE from dissolution risk

    - Prohibition on dissolution
    - Special-purpose bankruptcy-remote equity owner (e.g., general partners and SPE members)

3. Items intended to protect the solvent SPE from filing a bankruptcy petition:

    - Independent director

E.

Substantive Consolidation

"Substantive Consolidation" is an equitable remedy in which a court may combine the assets and liabilities of two or more separate and distinct legal entities in a common fund as if the assets and liabilities belonged to a single entity. *See In re Stop & Go Co. of America, Inc.*, 49 B.R. 743 (Bankr. D.Mass 1985).

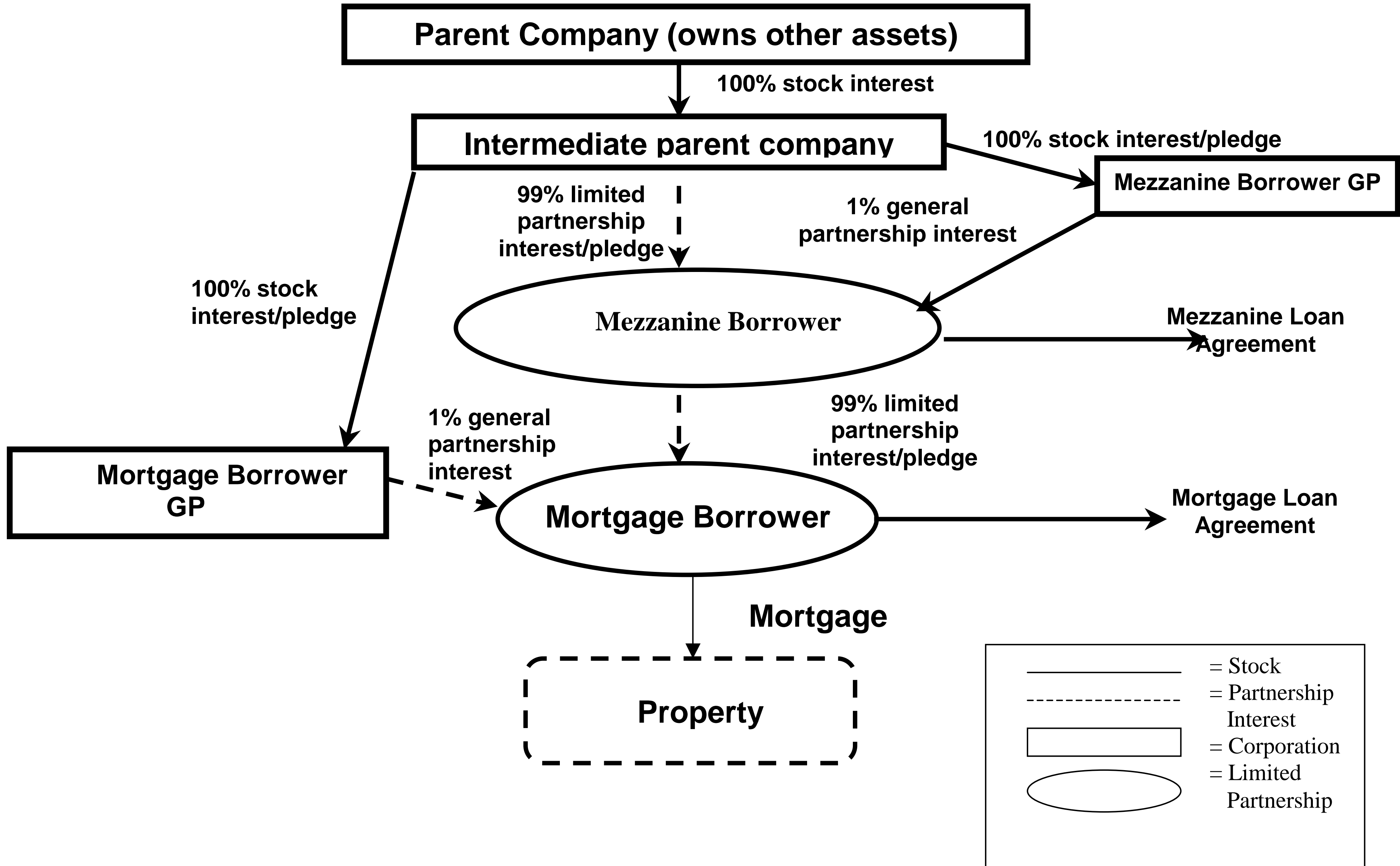
The power of a court to substantively consolidate related cases falls within the general equitable powers Bankruptcy Code § 105, which states that "the court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105 (a). *See F.D.I.C. v. Colonial Realty Co.*, 966 P. 2d57, 59 (2d Cir. 1992).

Substantive consolidation is an extraordinary remedy, and there is a presumption against its use. *See In re DRW Property Co.*, 54 B.R. 489, 494 (Bankr. N.D. Tax 1985).

There are generally two critical issues; (1) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity when extending credit, and (2) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors. *See Union Savings Bank v. Augie/Restive Baking Co., Ltd., (In re Augie/Restive Baking Co., Ltd.*), 860 8.2d 515, 518-20 (2nd Cir. 1988)

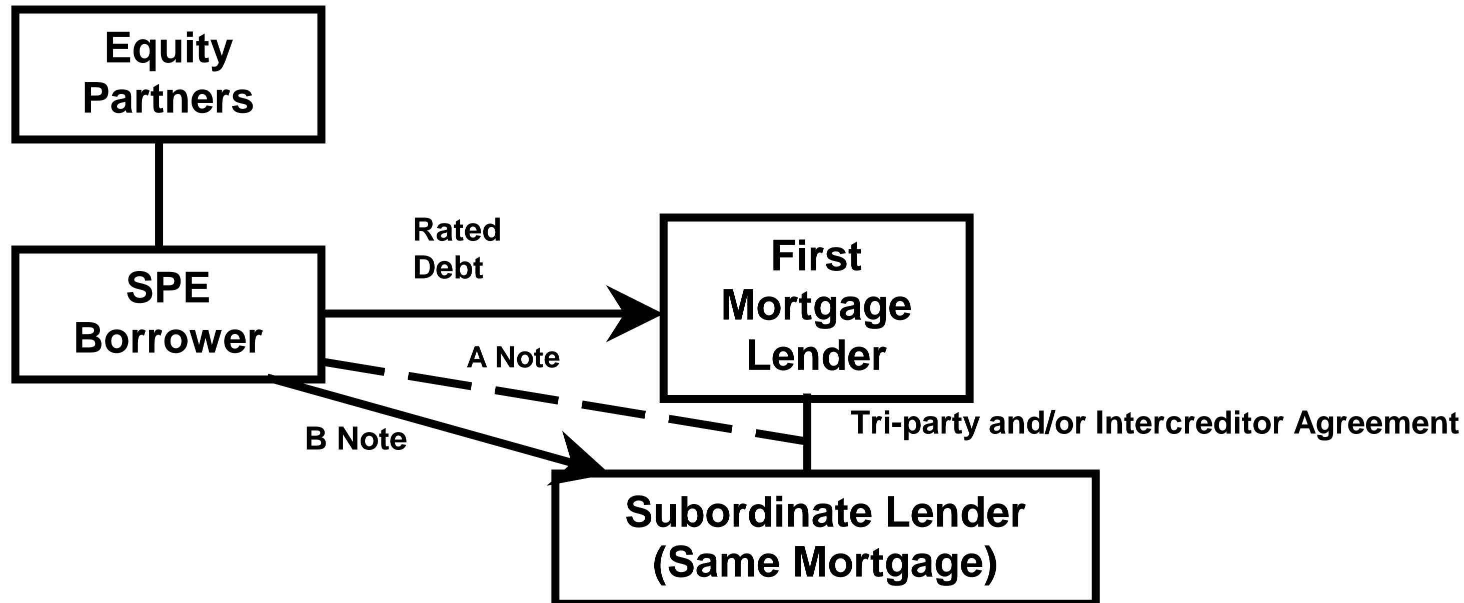
F.

Structure for Mortgage Loan and Mezzanine Loan



G.

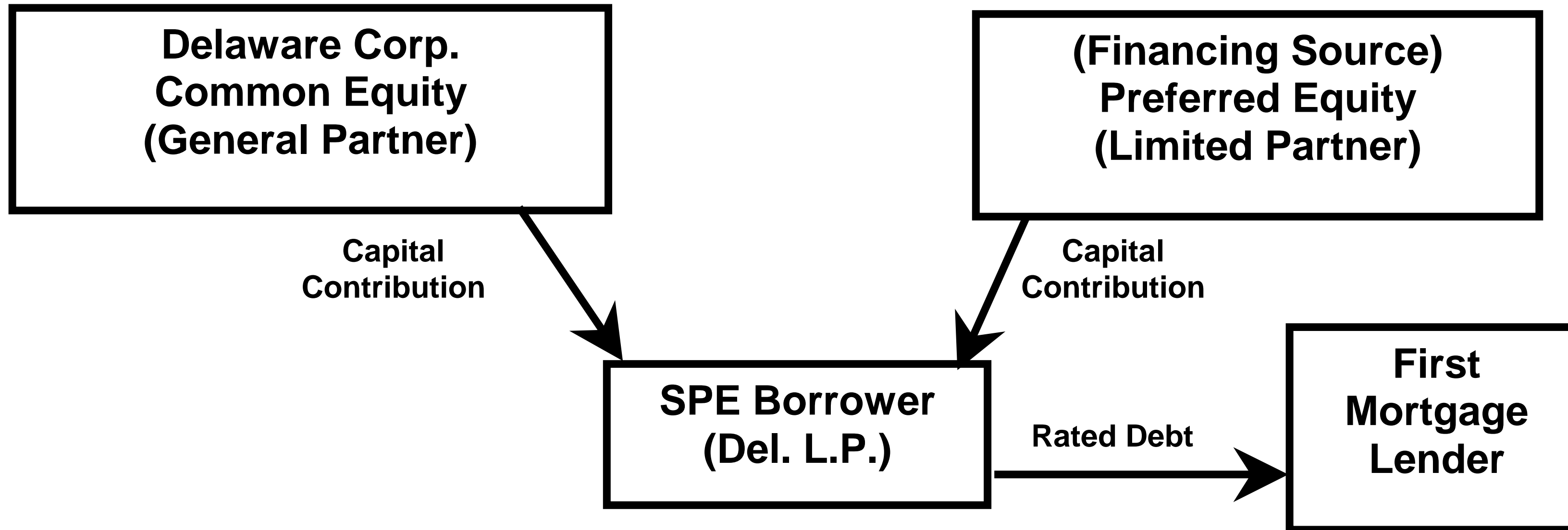
Mezzanine Financing Structure: A – B Notes



1) Subordinate debt is kept outside the securitization (although it may be syndicated or participated)
2) This structure will have a greater negative effect on the credit of the senior debt than preferred equity or mezzanine debt, but less than that of a second mortgage.
3) Both notes are secured by a single mortgage to the A lender, with the A - B lender relationship set forth in tri-party or intercreditor agreement.
4) Loan agreement contains “mini-waterfall” for allocation of cash flow between lenders
5) B note does not represent debt separate from that of senior A loan deposited into the trust
6) A note can only be refinanced together with the junior loan
7) Owner of B note usually has very few rights
8) “Event” risk is higher, but risk of loss on senior loan is lower
9) Senior debt has same default probability as entire loan (senior plus junior debt), since A and B notes are part of one financing

H.

Mezzanine Financing Structure: Preferred Equity



1) Preferred equity receives "excess cash flow" only after payment of taxes, insurance, capital reserves, tenant improvements, debt service, operating expenses, extraordinary capital and other unexpected expenses.
2) Aggregate amount of preferred equity and senior debt cannot exceed 80% of property FMV.
3) Limitation on transfer: no withdrawal, qualification or downgrade of senior debt rating
4) Control rights (e.g., refinancing) will not be permitted unless they benefit both senior debt and preferred equity (e.g., replacement of property manager).
5) Preferred equity retains "excess cash flow" until equity investment, plus negotiated return, is repaid.

II.

SECURITIZATION

A.

CMBS (Securitization)

- Commercial Mortgage Backed Securitization (CMBS) grew from $4.8 billion in 1990 to $78.4 billion in 1998.

- For decade of 90’s total issuance was $300 billion.

- Securitized vehicles in 1998 surpassed insurance companies to become the second largest holders of commercial mortgages, doubling their market share in just 3 years.

- CMBS issuance leveled off in 1999, at $67 billion (of which approximately 19% was international).

- Estimate (Moody’s) of domestic issuance levels - $50-55 billion, a 20% decline from 1999. Issuance level may even be as low as $45 billion in 2000.

- Global CMBS volume for 1 Q 2000: $13.2 billion, down 30% from $18.7 billion 1 Q 1999. U.S. volume dropped from $16.7 billion to $8.2 billion.

- Sharp drop in U.S. issuance and sharp increase in international issuance.

- U.S. market is showing signs of maturation.

- Increasing demand for property is moderated by role of capital markets.

- Affirmations in ratings, and low, but rising, delinquent rates (S&P).

- Typical borrower is unwilling to lock into higher interest rates and instead is opting for short-term, floating-rate financing.

- Decreasing level of issuance due to:

    1. Already high level of financing from 1997-1999, severely limiting new financing.

    2. Lower volume of commercial mortgage origination from 1989-1992 means less refinancing opportunities. (Commercial mortgages customarily have 10-year terms).

    3. Bond markets significantly impacted by rising interest and treasury rates (creating a financing disincentive). Interest rates are higher by approximately 200 basis points than in 1999.

    4. Substantial decline in REIT acquisitions.

- The number of conduit lenders should continue to decline, because of lack of demand and volume. Banks will continue to be dominant players. Conduit lenders (mostly banks) will originate more than twice as many loans as insurance companies in 2000.

- Internet web sites make origination, due diligence and trading faster and cheaper.

- Transparency increases. This end trend toward standardization is a positive development for the CMBS market.

- International Services

  - Electronic payments (Japan, Australia)
  - "Approved Servicer"
  - Australia – no deductions

- Since 1974, federal legislation has limited pension fund investments in mortgage-backed securities to "prudent and safe" investments, i.e., those rated "AAA". Lower-rated securities were deemed too risky, but that has now changed. New federal rules, which are expected to become effective before the end of 2000, will permit pension funds (which currently have approximately $6.5 trillion of assets) to invest in asset- and mortgage-backed securities rated as low as "BB-." These investments consist of pools of residential and commercial mortgages, and automobile, manufactured housing and home-equity loans (estimated to have a market value of more than $100 billion). As a result of newly granted permission to invest in these lower-rated securities, pension funds stand to earn as much as 2.5 percent more than similarly rated corporate bonds that they are currently permitted to invest in. The rationale for the change is that these lower rated securities now have an established track record as relatively safe investments and are at least as safe as the lower-rated corporate bonds that pension funds currently invest in. *See* Bloomberg Business News, 8/23/2000; Institutional Real Estate Newsline, 8/28/2000, at p. 4.

B.

Standard & Poor's Commercial Property Analysis

"We rely upon real estate fundamentals (location, occupancy, competition, local market conditions, etc.) at the property level. The underlying properties in any transaction become the primary focal point of our analysis and the rating process. The cash flows of these properties are analyzed to determine ongoing viability and to establish Standard & Poor's adjusted loan-to-value (LTV) ratios and debt service coverage ratios (DSCR)."

Several considerations are incorporated into each property analysis. These considerations include many of the qualitative aspects of the analysis, such as competition, economic projections, demographic changes, occupancy trends, design features that may result in functional obsolescence of the asset, and other factors that may affect a property's performance over time and possibly impair its value."

C.

Factors Considered by Rating Agencies When Making Adjustments to Ratings of Senior Debt Based on Presence of Subordinate Debt

1. The form of the subordinate debt, and the rights of the borrower and the holder of the subordinate debt under the loan documents and in a bankruptcy proceeding.

2. The total debt on the property, including senior and junior debt, and the size of the junior debt relative to the senior debt.

3. The identity of the borrower and subordinate lender and their expertise in property operations.

4. Portfolio effects in the case of pooled senior debt.

General Rule: All subordinate debt has some adverse effect on the credit of the senior debt. Even when fully subordinated, junior debt increases the likelihood of default on the senior debt and, in some cases, increases the severity of loss on the senior debt when a default occurs.

As the amount of the senior debt on the property increases, the ratings on the senior debt will fall; on the other hand the greater the amount of subordinate financing, the greater the default probability and, possibly, severity of loss on the senior debt. This risk may be partially offset if the holder of the subordinate debt is highly rated, or has particular expertise with specialized properties, e.g., nursing homes or hotels. The following factors are relevant in this analysis: the type of property involved; the creditworthiness and expertise of the subordinate lender; the degree of control that can be exercised by the subordinate lender; the circumstances under which the subordinate lender may exercise that control; and restrictions on the transfer of the subordinate debt.

The following is a list of subordinate structures, in terms of smallest to largest negative impact on senior debt:

1. Preferred equity.

2. Mezzanine debt.

3. Participation interest.

4. A-B note structure.

5. Second mortgage.

See **Table 1** attached hereto

Table 1 (Moody's)

Approximate Impact of Form and Amount of Subordinate Debt on Senior Debt [1,2,3]

		Smallest Impact on Senior Debt **Aaa** Tranche			Largest Impact on Senior Debt **Aaa** Tranche		
	Senior/Sub Split (LTV)	45/10	45/20	55/10	65/10	65/25	
	Aaa Component 4		45	45	43	40	40
	Form of Subordinate Debt						
Smallest Impact on Senior Debt	Preferred Equity	0-0.5	0.25-1.25	0.25-1.25	0.5-1.5	1.5-2.5	
Aaa Tranche	Mezzanine Debt	0-0.5	0.25-1.25	0.25-1.25	0.5-1.5	1.5-2.5	
	Participation Interest	0.5-1.5	1-2	1.5-2.5	2-3	3-4	
Largest Impact on Senior Debt **Aaa**	A-B Note Structure	0.5-1.5	1-2	1.5-2.5	2-3	3-4	
Tranche	Second Mortgage	1.5-2.5	2-3	2-3	2.5-3	4-5	

1 The adjustments shown in Table 1 compensate for both the existence of additional debt (subordinate to the senior piece) and the form of that subordinate debt, The impact is shown in terms of the percentage point reduction in Moody's **Aaa** tranche [from the base Level accordance with Moody's large loan analysis (with reference debt only *to the* senior*)*. For example,if a 65% LTV whole loan (with no subordinate debt) has a **Aaa** tranche of 40% LTV, a 65/25 A-B financing would have a **Aaa** tranche of about 36-37% (40% minus an Table 1 of 3-4% due to presence of subordinate debt in the form of an A-B note structure).

2 The results in this table assume that the junior debt is appropriately subordinated to the senior debt,

3 For any given loan, the credit effects shown in this table may be adjusted by Moody's to account for the particular facts and circumstances involved. This table is therefore best viewed as an illustration of the approximate scope of the adjustments made by Moody's and the relative effects as between the various forms and amounts of subordinate debt.

4 This is the approximate **Aaa** component of the senior debt (as a percent of property value), assuming no subordinate debt.

D.

Emergence of A-B Structures

"For those transactions that are being brought to market, a greater number of them are also incorporating innovative technologies, like the A/B and the non-sequential pay structures. The market is also seeing more credit enhancement through sureties, guarantees, and LOCs."

Kim Diamond, *Domestic CMBS Market Evolving and Innovating*, Standard & Poor's, CMBS Quarterly Insights; Changing with the Times, April 26, 2000.

E.

Credit Ratings

Credit ratings are an independent opinion of an issuer's long-term fundamental credit quality. They are an evaluation of the agency's opinion as to the capacity of an issuer to make timely payments of its rated debt obligations. Credit ratings principally relate to probability of default and not recovery potential.

The respective seniority of various categories of debt security by an issuer will be reflected in different credit ratings. This differentiation will reflect creditors' preferential situation or priority with regard to access to the issuers' cash flow. This differentiation is defined as "notching".

With respect to securitized mortgage loans, the rating agency provides underwriting standards for individual loans and provides debt ratings for the bonds issued, so that the senior interests in the pool can be sold as rated debt with an attendant lower interest rate. It is this lower interest on the rated portions of the loan that makes the whole process work and allows the originator to offer financing that is usually at better rates than typical insurance-company or pension-fund loans.

Crucial to the development of an effective securitization market in commercial real estate has been the ability of disinterested third parties to review the underwriting methodologies of the originator, the characteristics of the loan and the property itself and the structure of the proposed pool, and assign a standardized rating to each class of securities to be issued. With these ratings, public investors can rely on the risk assessment of a credible independent source and make comparisons between different debt instruments.

Ratings are assessments of credit risk. They are used to gauge credit quality and make investment decisions. A credit rating is not a recommendation to purchase, sell, or hold a particular security. The rating performs the isolated function of credit risk evaluation, which is only one element of the entire investment decision-making process. Ratings by one or more nationally recognized rating agencies- "opinions on the credit quality of the securities offered to investors" –are invariably required in order to sell asset-backed securities in the public markets. Additionally, many financial institutions and investment funds that purchase asset-backed securities in the private markets require ratings in order to satisfy either applicable regulatory requirements, investment guidelines, covenant restrictions or internal policies.

F.

Effect of Subordinate Debt on Ratings

“ The subordinate debt increases the likelihood that the senior debt will experience a payment default. The owner has less equity in the property and less incentive to create and maintain value. There is a smaller cash flow buffer to cover expenses and a greater likelihood of diminution in value as a result of deferred maintenance. Also, the borrower may divert resources and tenants to other buildings with lower leverage.”

“The subordinate lender may have substantially greater financial and personnel resources that the borrower, in which case the preferred equity lender’s ability to quickly gain control over the property may have a positive impact on the credit of the senior piece.”

- Expert management and oversight during loan term may *increase* recovery on senior debt.

- For example, specialty properties (nursing homes, hotels), where business operations are large part of property value.

- Moody’s examines

    1. Type of property

    2. Creditworthiness and expertise of subordinate lender

    3. Degree of control it can exercise

    4. Circumstances under which it can exercise control

    5. Restrictions on transfer

But may undercut standstill; judgement on benefit is subjective.