

Collateral damage

Managers of real estate mezzanine funds are finding renewed opportunities as collateralized debt obligation financings take a hit. By Robin Marriott

August 9, 2007. The date will be etched in financial history as the day that the credit crunch truly arrived.

The reasons why the US Federal Reserve and the European Central Bank tried to prop up lending markets with injections of \$12 billion and €98 billion, respectively, are well documented. The collapse of the subprime market suddenly turned the entire lending environment into a very different animal compared to what it was before.

In an instant, the more highly leveraged real estate debt lenders were forced to park their business, and worse, some found themselves under duress.

Even before the subprime market blew up, there was concern about those involved in collateralized debt obligation strategies – real estate debt investors using CDOs as a form of financing for their own investment strategies. The financing method had become popular for its potential to levitate returns given the way debt was being so cheaply priced by the market.

Now, given that buyers of CDOs have largely disappeared, those CDO-financed real estate debt investors are facing an uncomfortable time. With no buyers in town, some businesses have to consider turning to alternatives such as warehouse lenders to finance future acquisitions of debt. The concern in doing so is that they are open to margin calls at any time and, as a consequence, need to keep lines of adequate liquidity available to meet them.

CDO woes

JER Investors Trust, a public REIT in the US that mainly invests in commercial mortgage backed securities, is one of those facing the music. Though it has been at pains to point out to spooked shareholders that it has no exposure to subprime property and has no delinquencies in its commercial property loan and assets portfolio, it faces two pressing issues: First, how will it grow the business if it cannot use the CDO route, and second, with \$293 million in debt subject to margin calls, how will it provision to meet any such calls, which have been rising in recent months?

In a conference call with analysts on August 8—one day before the Fed propped up lending markets—Mark Weiss, president of JER's REIT, responded to the first question: "I think

the answer is you have to be cautious and opportunistic." When asked if the company will borrow further from warehouse lenders, he said: "If the CDO market, which is limited today, doesn't come back in spades, we will evaluate all opportunities to finance real estate assets."

Opportunities

Any collateral damage—to borrow a military term—to JER Investors Trust and other CDO lenders is unfortunate. In the case of JER, which operates a successful series of private equity real estate funds starting during the S&L debacle, its debt investments have grown significantly and, save for one hiccup in Florida, it has invested in successful deals based on sound underlying commercial real estate underwriting principles.

To be fair, the group says it has not downgraded a previously announced target to add around \$800 million of acquisitions to its portfolio in 2007. However, it is clear that the outlook may not be as rosy for investors in CDOs compared with private equity-backed mezzanine and high yielding debt funds which avoided the CDO route, such as Apollo Real Estate Financial Corporation, Lehman Brothers Real Estate Mezzanine Partners and TriLyn's TriLyn-Investcorp Mezzanine Partners I, a \$100-million fund closed in January this year.

Mark Antoncic, founder and managing principal at TriLyn, says he and the funds' partners, Investcorp and Bank of Scotland, viewed the rapid expansion of CDO financing product as a "potential train wreck."

"As a result of some over-zealous and lax underwriting, coupled with significant global liquidity and willing borrowers, the product got ahead of itself and risk was mispriced," he says.

Though Antoncic views the CDO "technology" as being a sound, long-lasting financing vehicle, the partners in his fund decided last year not to pursue the CDO route but to wait for the market to settle and correct itself, which it is now doing.

"We made the conscious decision to pursue sound, fundamental balance sheet investing, with the intent to utilize a CDO, or alike, in the future as an appropriate financing vehicle versus an arbitrage play. We were not going to allow the CDO securitization markets dictate our investment judgment. Others who pursued the opposite strategy now find themselves



Wildauer: From a buyers market to a lenders market



Robert: supply and demand is at equilibrium

victim to the unpredictable markets.”

Funds like TriLyn have suddenly found that the room hitherto full of rivals is virtually empty. Prior to the crunch, it was the CDOs who were enjoying a banquet of deals on racy terms that had little to do with the underlying real estate collateral and more to do with the credit rating of the paper. Real estate borrowers were getting very cheap debt from the CDOs on

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terms that TriLyn and others were finding hard to rationalize.

Now the situation has reversed. Real estate borrowers that might have gone to CDOs are now calling up equity investors. Some of the borrowers are in distress. For one thing, it is getting more expensive to borrow on deals committed to. Some borrowers who executed a term sheet with a lender prior to the crunch might not have got a firm commitment and their loan is either being delayed or scrapped altogether. In this environment, they are turning to mezzanine providers and these are able to pick and choose the tastiest opportunities being

brought to them on a platter. Though such funds are seeing their fair share of deals they do not want to do, there are improved chances to structure deals they do want to underwrite at wider spreads.

“It has turned from a borrowers market into a lenders market,” confirms Bradford Wildauer, partner at Apollo. Apollo’s new fund, which targets mid-teen returns according to an investor and launched in 2006 as a follow up to Apollo-GMAC Real Estate Mezzanine, was previously losing out on deals to the CDO lenders. As a result, it was becoming disappointed by its transaction rate.

“We didn’t close as many transactions in the second quarter having seen credit quality and terms become tenuous in the first quarter and we decided to take a cautious approach,” says Wildauer. “That has turned out to be a good decision.”

He points out that that the current situation has hit borrowers indiscriminately – even the principal underwriters in the £12-billion takeover of British high street pharmacy Boots by one of the most renowned private equity firms, Kohlberg Kravis Roberts, has yet to syndicate £6 billion of debt used to finance the acquisition.

“This is a credit situation,” Wildauer says. “It has not come in response to problems of the underlying asset collateral in

the commercial real estate, the underlying fundamentals of which continue to be healthy in most markets.”

Both sides now

With TriLyn and Investcorp launching their next real estate mezzanine fund, LEM Real Estate Mezzanine Fund II recently closing and Lehman Brothers said to be planning its next vehicle in the space, the timing of current debt market turbulence seems fortuitous.

No one knows how long this will go on for. Certainly, some real estate pros believe a backlog of debt will not be cleared before the end of the year. In the meantime, unless the crisis in confidence in that area and the wider loss of nerve in financial markets globally contaminates the real estate sector, the mezz funds should perform well.

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At the moment, hardly any of the reasons why investors have been committing equity to new fund launches have vanished.

Improving property fundamentals driven by economic recovery and rising interest rates which generally lead to an increase in acquisition costs and can lead to distress for some leveraged owners of real estate, have created a favorable environment for real estate debt vehicles. In addition, there is an expectation that the US market for commercial real estate debt will grow significantly annually. It was worth \$2.4 trillion in 2005.

These factors were highlighted by the Pennsylvania Public School Employees' Retirement System (PSERS) in April 2006 when it was considering investments in two funds, LEM Real Estate Mezzanine Fund II and Apollo Real Estate Finance Corporation. It committed to both. In relation to Apollo, it pointed out that the firm started off purchasing portfolios of assets taken over and sold by the Resolution Trust Corporation and that as a “value-added’ lender it could retain more stringent credit controls and still achieve higher returns.”

That a private equity real estate firm should want to invest in both parts of the capital structure, debt and equity, should come as no surprise. If a firm has a core competency as a principal investor and developer, then it is well-placed to supple-

ment the main business with higher yielding debt investments.

That said, the main question now must be whether real estate fundamentals will stay in tact.

The future

“One of the issues is the broader macro economy and financial factors that impact real estate,” said Yon Cho, co head of Lehman Brothers Real Estate Mezzanine Partners in New York. “The disruption is not something that is going to recover in the near term. But, the sophistication of the real estate borrowers, and given that real estate is much more of a short-term trading asset class, means the mezzanine component can only expand going forward. Long-term, there is going to be continued opportunity in the mezzanine component of real estate.”

When Joseph E Roberts, founder of JER Roberts, was asked during that recent second quarter earnings conference call for JER Investors Trust how he characterized the market, the 36-year veteran of commercial real estate said periods of market turbulence are to be expected. “While we can’t control market conditions, we can control what our company does,” he said. “So we will continue to run our busi-

ness and we will maintain strong underwriting and capital discipline and focus on credit analysis of our collateral.”

He also described how the market today is very different to what it was in the late 1980s and early 1990s when there was a huge demand/supply imbalance of real estate. He recalled how people in Houston were saying they had enough space to satisfy projected demand for the next 20 years. There was oversupply in almost every market and in 1991 there was virtually no credit available except for smaller recourse loans on commercial property.

“Today, I would say that supply and demand is largely at equilibrium. None of the assets we are financing are troubled assets,” he told analysts.

As private equity real estate holds its breath for signs of a widespread meltdown, in the meantime investors in the space are enjoying a more favorable market.

“We view the current market correction as healthy,” says TriLyn’s Antonic. “It should bring back prudent underwriting standards and appropriate risk-adjusted returns. These are markets in which new platforms are created and expanded and where sound fundamentals are rewarded. We are in the early innings in an extra-inning game.” □