

**EMERGING TRENDS IN  
COMMERCIAL REAL ESTATE FINANCE**

*Real Estate Conduits*

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Presented by:

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## **Speaker Biography**

**BRIAN S. ANDREWS** is a Vice President in the Commercial Mortgage Capital group of Hibernia National Bank in New Orleans, Louisiana. Mr. Andrews is a Loan Placement Specialist working to assist borrowers in the placement of real estate properties in the permanent market through several vehicles, including real estate mortgage conduits. Prior to joining the Commercial Mortgage Capital group, Mr. Andrews was a real estate portfolio lender for Hibernia in Baton Rouge, where his loans included a participation in the construction financing for the Mall of Louisiana.

Mr. Andrews earned his MBA from Tulane University in 1982 and his Bachelors Degree in Finance from Louisiana State University in Baton Rouge in 1980.

# *Outline*

1. Introduction
  - a) Commercial real estate finance is alive and well in Baton Rouge for 1999 and the foreseeable future. Conduit financing will make up a large sector of the permanent funds offered.
  - b) Because of time constraints, this discussion will be limited to conduit financing and will not address commercial bank lending, insurance companies, governmental and quasi-governmental loan programs, tax credit issues, or other means of permanent financing, except as they relate or compare to conduit financing.
  
2. What is a conduit loan?
  - a) Ordinary, long term loan secured by commercial real estate
  - b) Loans that are bundled together with other loans to secure bonds which are sold in the market.
  - c) Underwriting and structure have to conform with the guidelines established by the agencies that rate the bonds.
  
3. Characteristics of Conduit Loans vs. Commercial Bank Loans
  - a) What conduits offer that commercial banks usually do not
    - i) Lower interest rates
    - ii) Interest rates are fixed for 10 years or more
    - iii) Amortization periods are longer, generally 25 to 30 years
    - iv) Non-recourse except for standard industry carveouts
  - b) What conduits prohibit/require that commercial banks can usually work around
    - i) Subordinate loans are not allowed
    - ii) Prepayment is locked out for 3 to 4 years, then subject to defeasance
    - iii) No additional funds can be advanced once the loan is made
    - iv) With the exception of some single tenant, credit lease programs, loan amounts are based on the current level of cash flow (ie – no credit is given for future increases in lease rates, even those stated in the existing lease)
    - v) All landlord obligations must be reserved for (ie – taxes, insurance, repairs and replacements, tenant improvements, leasing commissions)
  
4. When is a conduit loan the appropriate financing vehicle?
  - a) When the cash flow stream is stable and will remain stable for the term of the loan
  - b) When the owner does not intend to sell the property, except through an assumption of the conduit loan
  - c) When the owner does not intend to pay off the debt early with other funds.
  - d) When the proceeds from the loan are the maximum amount that the owner wants from the property

5. Determining the Loan Amount or “Sizing” the Loan
  - a) Debt Service Coverage Ratio
  - b) Loan to Value
  - c) Required Equity
  - d) Underwriting standards
  
6. Loan programs based on property types
  - a) Each property type has its own program and is subject to unique underwriting standards.
  - b) Apartments and anchored retail are the darlings, but interest still depends on the local market.
  - c) Limited service hotels are somewhat out of favor
  
7. Pricing issues – Recent Trends
  - a) There is a disconnect between how Treasuries move and how Corporate Bonds move. Conduit loans are priced over Treasuries, but the bonds must be sold in the open markets and compete against Corporate bonds which do not necessarily move in the same ways.
  - b) Treasuries have responded to international issues (ie Russia in the summer of 1998)
  - c) More volatility results in wider spreads
  
8. Reserves required for Landlord obligations (Bi-product of non-recourse loans)
  - a) Taxes and insurance
  - b) Tenant improvements
  - c) Leasing commissions
  - d) Repairs and replacements
  
9. National financing views about Louisiana and Baton Rouge
  - a) Historical default and loss information
  - b) Lack of familiarity with our markets
  - c) Concern about laws
  - d) Some good news ...
  
10. What can the owner do to assist the conduit lender?
  - a) Provide complete financial disclosure
    - i) Temporary tax abatements
    - ii) Extraordinary or non-recurring income and expense items
  - b) “Tell the Story”
  - c) Assist with compilation of market data
  - d) Project photographs
  - e) Get the proper help in making the loan application

## ***Sample Multi-Family Mortgage Program***

**Eligible Property Types:** Conventional A and B/C multifamily apartment projects, including rent subsidized, student and military impacted housing.

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse, balloon loans with amortization schedules ranging from 25-30 years, based upon property condition and age. 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by multi-family apartments on fee simple land.

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Please refer to the Conduit quote Matrix.

**Debt Service Coverage:** Minimum of 1.20 times depending upon property type, age, physical condition, location and market condition.

**Loan to Value:** Up to 80%

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Permitted under certain limited conditions.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Affordable Housing Tax Credit Program ("LIHTC")***

**Eligible Property Types:** New construction multifamily apartment projects which are eligible to receive tax credits under Section 42 of the Internal Revenue Service Code.

**LOAN PARAMETERS**

**Loan Types:** 15 year fully amortizing fixed rate, non-recourse loans.

**Security:** First mortgages secured by multifamily apartment projects on fee simple land.

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Please refer to the Conduit quote Matrix.

**Debt Service Coverage:** Minimum of 1.15 times for new construction projects, based upon 100% units set-aside for the LIHTC program;

**Loan to Value:** Up to 85% of the value based upon restricted rents (excluding value of the tax credits).

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Permitted under certain limited conditions.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Anchored Retail Mortgage Program***

**Eligible Properties:** Anchored strip centers

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 30 years; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing retail shopping centers on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.25 times depending on property type, age, physical condition, lease terms of tenants, location and construction.

**Loan to Value:** Up to 75%.

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Retail Mortgage Program***

**Eligible Properties:** Unanchored strip centers

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 30 years; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing retail shopping centers on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.30 times depending on property type, age, physical condition, lease terms of tenants, location and construction.

**Loan to Value:** Up to 75%.

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Freestanding Retail Mortgage Program***

**Eligible Properties:** Freestanding retail buildings including sub-investment grade tenants.

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 30 years; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing retail shopping centers on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.25 times depending on property type, age, physical condition, lease terms of tenants, location and construction.

**Loan to Value:** Up to 75%.

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Outlet Center Mortgage Program***

**Eligible Properties:** Factory outlet centers

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 25 years; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing centers on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.40 times depending on property type, age, physical condition, lease terms of tenants, location and construction.

**Loan to Value:** Up to 70%.

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Industrial Mortgage Program***

**Eligible Properties:** Multi- and single tenant bulk warehouse, light industrial, and multi-tenant flex space

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 30 years for warehouse and 25 years for others; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing industrial properties on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.25 to 1.35 times depending on property type, age, physical condition, credit and lease terms of tenants, location and construction.

**Loan to Value:** Up to 75% warehouse; 70% flex.

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Office Mortgage Program***

**Eligible Properties:** Class “B” and “C” suburban and urban, multi-tenant office properties

**LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 25 years; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing office buildings on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.25 to 1.30 times depending on property type, age, physical condition, credit and lease terms of tenants, location and market condition.

**Loan to Value:** Up to 75%.

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender’s consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Hotel Mortgage Program***

**Eligible Properties:** Flagged, limited service hotels with greater than 50 rooms. Full service hotels with greater than 100 rooms.

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 25 years; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing flagged limited service hotels on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.50 times on full service; 1.60 times on limited service depending upon property type, age, physical condition, location and market condition. Full service must exceed 1.10 times excluding net food and beverage income.

**Loan to Value:** Up to 70% on full service; up to 65% on limited service.

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Self Storage Mortgage Program***

**Eligible Properties:** Self storage and mini-storage facilities containing a minimum of 50 units

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 25 years; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing self storage facilities on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.30 times depending on property type, age, physical condition, location and market condition.

**Loan to Value:** Up to 70%.

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Mobile Home Park Mortgage Program***

**Eligible Properties:** Class “A” and “B” mobile home parks with a minimum of 50 spaces

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 30 years; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing mobile home parks on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.20 times depending on property type, age, physical condition, location and market condition.

**Loan to Value:** Up to 80%.

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender’s consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## ***Sample Healthcare Mortgage Program***

**Eligible Properties:** Congregate care, assisted living and nursing home facilities.

### **LOAN PARAMETERS**

**Loan Types:** 10 year fixed rate, non-recourse balloon loans with amortization schedules up to 30 years; 7 year terms considered on a case-by-case basis with a pricing adjustment.

**Security:** First mortgages secured by existing senior living facilities on fee simple land (leasehold mortgage loans available on an exception basis)

**Principal Amount Range:** \$2 million and higher.

**Interest Rate:** Based on a spread over the 10 year Treasury

**Debt Service Coverage:** Minimum of 1.25 to 1.40 times depending on property type, age, physical condition, credit and lease terms of tenants, location and market condition.

**Loan to Value:** Up to 75% for congregate care; 75% for assisted living; 70% nursing home

**Prepayment:** No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter

**Recourse:** Non-recourse except for standard industry carve-outs

**Assumability:** Allowed with Lender's consent and a 1.0% fee.

**Rate Lock:** The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)

**Secondary Financing:** Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.

**Application Fee:** \$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.

**Origination Fee:** Typically 1.0%

## *Sample Net Lease Financing Program - Investment Grade*

**Product Type:** Mortgages secured primarily by free-standing real estate tenanted by “Investment Grade Tenants”

**Property Types:** Retail, warehouse/distribution, corporate office and medical office

**Property Location:** National

### **LOAN PARAMETERS**

**Lease:** NNN, NN and bond leases. Lessee must be responsible for real estate taxes, insurance and utilities. If not provided for in the lease, Lessee will be required to carry Business Interruption Insurance and All-Risk Insurance

**Security:** First mortgages secured by existing office buildings on fee simple land (leasehold mortgage loans available on an exception basis)

**Loan Size:** \$1,000,000 to \$15,000,000

**Loan Terms:** Typically co-terminus with the lease term

**Amortization:** Self-amortizing to the loan term. Longer amortization terms will be considered on a case-by-case basis.

**Pricing:** Fixed rate based on a spread over Treasuries. Spreads are determined based on the quality of the tenant and the strength of the lease.

**Loan to Value:** Up to 100% of Loan-to-Leased Fee or 130% of Loan-to-Dark Value

**Debt Service Coverage:** 1.003x to 1.05x depending on the type of lease

**Structural Reserves:** A reserve of \$0.15 psf to \$0.30 psf will be established depending on Landlord’s structural repair obligations.

**Other Reserves:** Required if the Landlord has Latent Defect, Common Area Maintenance, or similar obligations.

**Escrows:** Required if real estate taxes and insurance if Tenant is not responsible for direct payment.

**NOI:** The NOI will be calculated based on the Base Rent less any expense flow throughs not defined in the Lease.

<b>Prepayment:</b>	No prepayment permitted during the first 4 years of the Loan; subject to Defeasance thereafter
<b>Recourse:</b>	Non-recourse except for standard industry carve-outs
<b>Assumability:</b>	Allowed with Lender's consent and a 1.0% fee.
<b>Rate Lock:</b>	The coupon rate will be locked 1 or 2 days prior to closing unless a forward rate lock is requested (additional fee)
<b>Bond Lease Insurance:</b>	Required where Tenant can terminate for Casualty & Condemnation
<b>Residual Value Insurance:</b>	Required if the amortization is longer than the loan term.
<b>Tax Plat:</b>	Separate tax parcel required.
<b>Secondary Financing:</b>	Generally prohibited; may be permitted under certain limited conditions on a case-by-case basis.
<b>Application Fee:</b>	\$5,000 non-refundable Inspection/Loan Processing Fee payable to Lender with the Loan Application.
<b>Origination Fee:</b>	Typically 1.0%

## **CHECKLIST FOR CMBS DEALS**

Source: COMMERCIAL REAL ESTATE QUARTERLY

Analysis of CMBS should be done at three levels, the real estate, the loans, and the deal structure. Buyers of senior classes should naturally spend less time on the real estate analysis and more time on deal structural issues, whereas junior class buyers need to understand the real estate issues, and their rights in a default situation.

### A. Real Estate Analysis for CMBS

- Who is the borrower? What is the borrower's credit history? What is the borrower's business?
- What is his motivation? How much has the borrower invested in the property? All of these questions are important even though the deal is structured through a bankruptcy remote entity, because quality borrowers make for a better deal.
- Is there a single borrower or are there multiple borrowers? Is there Borrower concentration? All else equal, senior bond buyers should prefer multi-borrower deals. (Diversification can also be achieved at the portfolio level.)
- How many properties are in the deal? What is the property concentration? All else equal, all classes should prefer many properties if the loans are cross-collateralized and cross defaulted. Senior classes should always prefer a multi-property deal even if the loans are not crossed. Junior buyers will have to do more homework for deals backed by many non-crossed properties.
- Who is the property manager? What is the relationship between the property manager and the borrower? If they are unrelated, are there long term management contracts? Can management be replaced by the servicer if income drops or for other causes?
- Can the properties be transferred to a new owner without rating agency approval?
- Where are the properties located? Are there any significant geographic concentrations? Geographic region? urban, suburban, rural?
- What type of properties are involved? Different types of properties have different types of risks.
- Is the property type popular or is it considered a "trophy property"? If so, it may be overpriced, thus giving less protection to bondholders than indicated by LTV even using current appraisals.
- Tenant diversification/concentration? Overexposure to a particular tenant in an office building or retail property can pose a significant risk or may be a good thing depending on the tenant's credit quality.
- What is the occupancy? What is historical occupancy? Are tenants current?
- Who did the appraisal? Was it a third party? When was the appraisal done? What method was used? Were audited financials used? Are financials available for the past several years? Were projections used? What is the stabilized income? Current income? Last several years income? (Analyze the value and coverage based on the minimum of these.)
- Does the property have seasonal variation in income and occupancy? Are there percentage rents? This could be helpful in periods of inflation. Which expenses are the responsibility of the tenants?
- Local market considerations: Supply/Demand, Barriers to entry, zoning restrictions, local demographics and economics, exposure to regulation.
- Capital Expenditure Reserves: How much is being set aside? Who is verifying this? This is particularly critical for balloon loans, since the greatest risk of commercial mortgages is the ability to refinance. If the property is not maintained, it is unlikely that the borrower will be able to roll over the debt.
- Age and condition of property. Of course, age alone is not a sufficient indicator. Some older properties may be fully renovated and updated, whereas some newer properties may have been improperly maintained, and suffer from technological obsolescence.
- Lease expiration schedule. This needs to be examined in light of whether in-place leases are above or below market. Schedule needs to be compared to loan maturity.
- Engineering reports and environmental studies must be done, and any suggested reserves set aside.
- Is the insurance adequate? To whom are the proceeds payable?
- Is the income paid into a lock box which pays taxes, insurance, and debt service before the owner gets paid?

**B. Mortgage Analysis**

- Is the loan fixed rate or floating rate? What is the maturity? If it is floating, what is the index? Is there a cap? Who provides the cap? If the mortgage has a balloon, does the cap extend if there is a balloon default?
- Is the loan a bullet, balloon, or fully amortizing? If it is a balloon, what is the amortization period?
- What is the day count basis for interest payments?
- When were the loans originated? Who did the underwriting? Were the loans from institutions taken over by RTC? Were the loans purchased from an institution's portfolio? (Could suffer from anti-selection bias.)
- If the loans are not new, are they performing? Current? Do they have a good payment history?
- What is the reason for the loan? Is it a refinancing? A rollover? Is it a cashout loan? Bridge loan? Development? Is it an acquisition by a new owner?
- Is the loan secured by a first mortgage on the property? Are there any second mortgages? Are second mortgages permitted?
- What is DSCR using appropriately adjusted NOI? If properties are not cross collateralized/cross defaulted then DSCR must be considered individually for each loan, and not as a weighted average.
- Is the borrower required to submit updated financials on an ongoing basis? What is the frequency? Are they required to be audited?
- What is the LTV? How is it computed?
- What are the events of default? What happens when a default occurs?
- Is the loan assumable? This can be a positive or negative. From a credit standpoint, one has to be careful that the new borrower is at least of equal quality. On the other hand from a prepayment standpoint, if assumability is not permitted, then if the owner wants to sell the property, the loan has to get prepaid which could be detrimental to the bond holders.
- Are prepayments permitted? Are partial prepayments allowed? Can prepayments take place on any day other than a payment date? Is there a penalty? What is the nature of the penalty? Is it a yield maintenance penalty? Is there spread maintenance? Does the penalty make the investor whole? Is the penalty a fixed or declining percentage of the amount prepaid? Does the penalty apply to the entire term during which prepayment is allowed or is there a free period?
- Can any terms of the loan be modified?
- Can the servicer extend the maturity of the loan? What conditions must be satisfied in order for this to happen? Can the senior classes prevent this? Is there a default rate that is applicable? Is all excess income trapped to be used to pay down principal?

**C. Deal and bond analysis**

- What are the expected maturities of the bond classes? What is the certainty of the expected average lives?
- Is the coupon fixed or floating? Is it a weighted-average coupon?
- What is the payment priority? What are the subordination levels?
- In the case of voluntary prepayments, how is the principal allocated? How are the prepayment penalties computed and allocated for each class?
- Is the class private or public? Is the class ERISA eligible? Is it SMMEA eligible? How will the NAIC treat the class for RBC?
- What is the size of the deal? What is the size of the class?
- Is the class a strip? How is it protected from prepaids? From where is it stripped? Is it stripped at the whole loan level?

## *Defeasance*

### *What is defeasance?*

Defeasance is a prepayment mechanism whereby borrowers can retrieve their properties from the bond pools and replace them with Treasury instruments.

### *Why is it such a big issue with Lenders?*

The Lenders must be able to bundle their loans up, pledge them against newly created bonds, and sell those bonds in the market. The Bondholders are expecting a stable cash flow stream on the bonds and do not want to endure prepayments, which interrupt the cash flow stream.

### *How does it work?*

Assume the following hotel loan characteristics:

- \$5,000,000 beginning balance
- a 25-year amortization
- 10-year balloon payment
- Pricing at a spread of 295 basis points over the 10-year Treasury. Using a Treasury rate of 5.17%, we will have an all-in rate of 8.12% (the actual interest rate basis will be 365 days over a 360 day year, but for illustration I will use a 360/360 basis so we can easily calculate our figures using an HP-12C or similar software).

The result of these assumptions will be a loan that generates 120 monthly payments of **\$38,989.12** and a balloon balance payment of **\$4,050,428.36**.

If the Borrower needs to sell the property (other than through an assumption of the debt), the Borrower needs to replace the cash flow stream from the property with US Treasury obligations that generate the same cash flow. For our example, assume the following:

- We have made all scheduled payments on the loan and want to pay it off after 36 months. At that time, the balance of the loan will be \$4,790,628.63.
- More importantly, there will be 84 more monthly payments (7 years) and the balloon payment due under the loan.
- Assume that the 7-year Treasury rate is 5.17% (to make things easy, I am using the same 10-year that we used at the making of the loan).

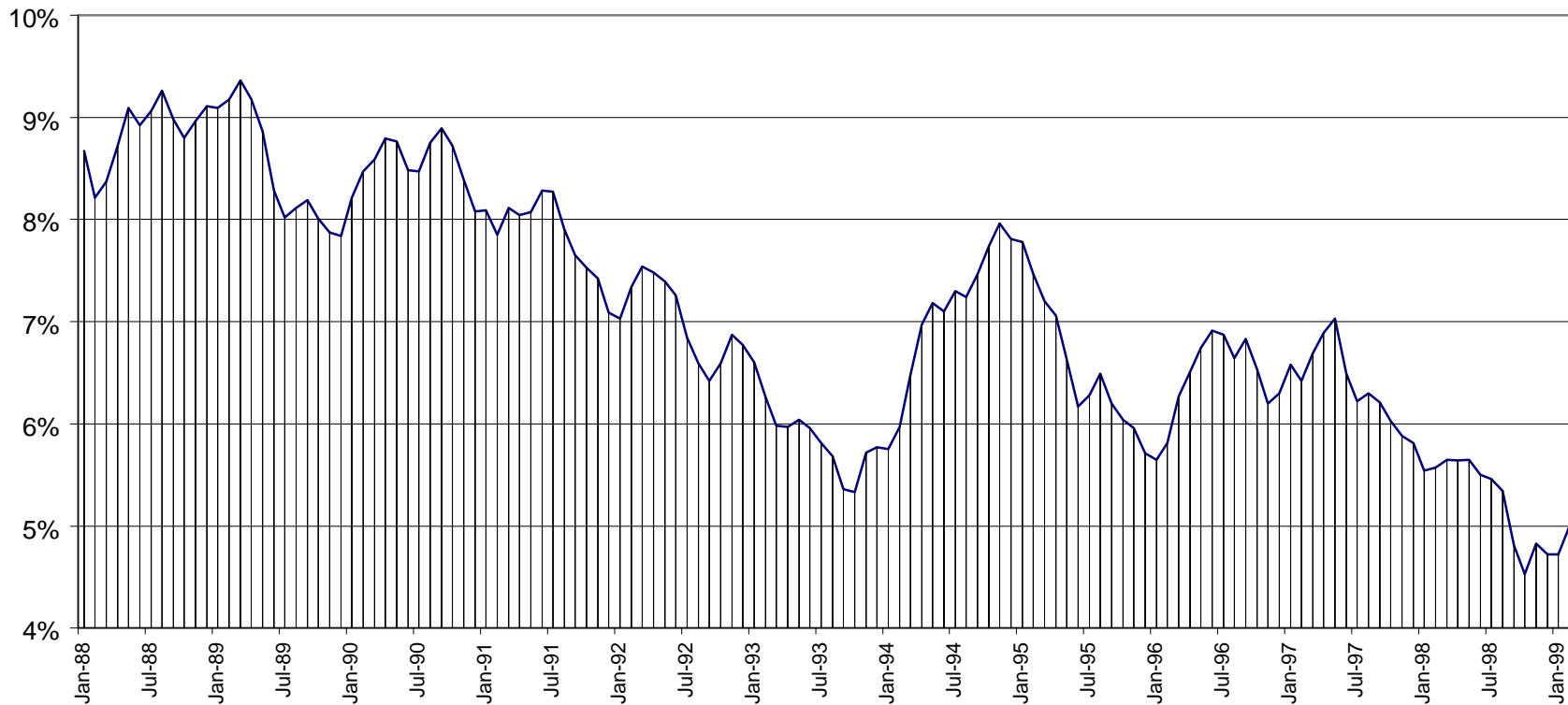
To replace the cash flow from the property, we need to purchase a US Treasury obligation (or series of obligations) at the prevailing average interest rate of 5.17% that will yield 84 monthly payments of \$38,989.12 and one balloon payment of \$4,050,628.63. **Plugging this information into a calculator returns a present value of \$5,565,739.66, which is the amount of the Treasury obligation(s) required.**

***What does it cost?***

In addition to the transaction costs (legal, accounting, etc.), the cost of the defeasance to the borrower is the difference between the required Treasury obligations and balance at defeasance. In our example, this is the difference between the \$5,565,739.66 in required Treasuries and the \$4,790,628.63 balance due at defeasance, or **\$775,111.15**. This amount is **16.2%** of the loan amount at defeasance. This difference will decrease as we get closer to the maturity date and/or if Treasury rates are increasing, and will increase if the Treasury rates are falling.

# 10 Year Treasury Rates

Average Monthly Rates  
January 1988 through February 1999

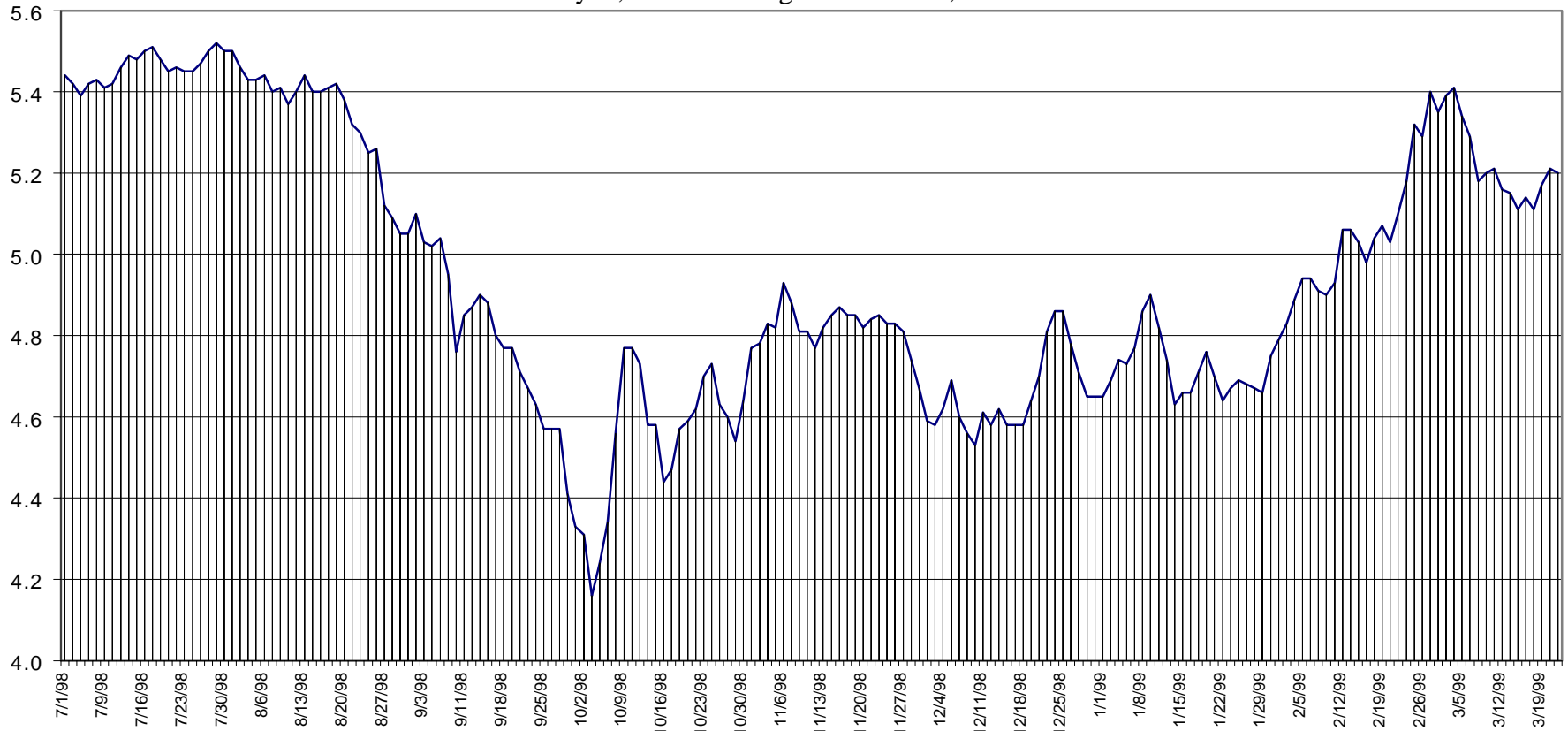


Source: Bloomberg

# 10 Year Treasury Rates

Daily Closing Rates

July 1, 1998 through March 23, 1999



Source: Bloomberg