CMBS LOAN MATURITIES CAN BE LIKE A FALLING KNIFE

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Underwater commercial real estate loans are putting senior bondholders, even some pension funds, at risk.

By Ann Hambly

According to Webster's dictionary, a "falling knife" is a slang phrase for a security in which the current price or value has dropped significantly in a short period of time, or where the shares of a company become worthless.

Investopedia describes a "falling knife" as an investor buying into a market with a lot of downward momentum — a stock that drops precipitously as the equity ownership is reduced to nothing.

The commercial mortgage-backed securities (CMBS) industry is facing a falling knife scenario today. Over $350 billion in CMBS loans will mature over the next three years. In many cases, the outstanding loan balance exceeds the value of the property. That's commonly referred to as an underwater commercial real estate loan.

The property type and geographic location may vary, but the general circumstances are similar. What follows is a hypothetical example that reflects what's occurring in the trenches today.

The property is a 122,000 square-foot office building in a sunny city in Arizona. In 2007, the borrower, Sentient LLC, went to his friendly lender, On The Move, and secured a new 10-year, interest-only loan for $12 million. After all, the property was worth well over $15 million at that time. It was 100 percent occupied and the major tenant was Legal Tender, a large bank. Legal Tender had a lease expiring at the end of 2017.

Unbeknownst to Sentient, On The Move put its loan in a commercial mortgage-backed securities (CMBS) pool. Consequently, the ultimate owner of Sentient's loan was a large pool of bondholders that would remain unknown to Sentient. On The Move would no longer be able to help Sentient with any future requests the borrower might have on its loan because it no longer owned the loan.

Delaying the Inevitable

When the market crashed in 2008, Sentient got lucky and managed to escape unscathed, mainly due to the long-term lease in place with Legal Tender that included above-market rents. However, the problem will hit when Legal Tender leaves or renegotiates its lease at expiration.

The real problem is the CMBS platform is not set up to incentivize servicers to be proactive in this manner. The servicers making the decisions are more incentivized to wait until an event — such at the tenant moving out — is imminent.

In 2011, Sentient needed to get a lease modified. Since the lease modification required lender approval, Sentient went to its originator at On The Move to discuss. Of course, On The Move informed Sentient there was nothing that it could do as the loan was now in a CMBS pool. After many months and much frustration, Sentient learned about the approval process in a CMBS transaction. By early 2015, Sentient begins to sweat, knowing it won't be able to pay off the loan at the maturity date, which is two months after the lease expiration of Legal Tender. No lender is willing to give Sentient a new loan that is sufficient to pay off the existing loan, given the decline in rental rates and the uncertainty in Legal Tender's lease.

Tough Choices for Borrower

Sentient also knows by now that a CMBS special servicer will not be as understanding as a friendly banker might be. So, Sentient considers its options.

If Legal Tender decides to stay in the building, it will require a rent reduction, perhaps as much as 25 percent, to reflect market rates. Remember that Legal Tender has been paying above-market rents since it signed the lease in 2005. Many other tenants in the building have already received rent reductions and concessions to get their rents in line with market rates.

If Sentient requests a loan extension, it will also need to ask the special servicer for a payment modification. Even then, the principal balance at the extended maturity date will likely be higher than the value of the property. The days of pretend and extend are over, so this option likely will not make sense.

If Legal Tender vacates, there will be no way to pay off the loan because the value of the property will be significantly less than the loan at that point. There will not be enough income to pay the loan during an extension period, if Legal Tender vacates its space.

A Catch-22 situation

Sentient quickly concludes there aren't any great options and it would be best to talk with the special servicer now to see what course of action it would prefer. After all, it would be best to address the situation while Legal Tender is in place rather than wait until immediately before the maturity date and the expiration of Legal Tender's lease.

The problem with a CMBS loan though is that the borrower is prohibited from simply picking up the phone to discuss the matter with the special servicer. While the special servicer is the only party in a CMBS pool that can address the situation, it only gets involved when a loan has actually been transferred to the special servicer.

While the loan is performing, the loan is the responsibility of the master servicer. The master servicer's role is primarily to manage the flow of payments and information between all the parties in the CMBS pool.

And for a loan to be transferred from the master servicer to the special servicer, the loan has to either be in default or there has to be a real threat of an imminent (near-term) default.

In this case, the loan is not in default and the only threat of default is at maturity; meaning the default is not imminent. So, how does a borrower address this situation proactively? That is the question many commercial real estate professionals are currently trying to figure out.

The CMBS structure makes it difficult for the players involved to be proactive and attempt to catch these falling knives early on. Yet, being proactive will most often result in minimizing losses for the CMBS trust in the long run.

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The party at risk of catching the falling knife is the senior bondholders, often the pension funds, who are probably unaware the knife is even falling. Surely the retiree who is living off the pension funds is unaware of this impending danger.

If the special servicer were to bring a loan into special servicing when the problem is initially identified so everyone can address the problem while all parties (tenant and borrower included) are in place, and a reasonable solution can be achieved, the losses would be greatly curtailed and in some cases, possibly eliminated.

The real problem is the CMBS platform is not set up to incentivize servicers to be proactive in this manner. The servicers making the decisions are more incentivized to wait until an event — such at the tenant moving out — is imminent.

While the structure of the CMBS trust makes it difficult to resolve some of these issues, we can't stand idly by and watch the knife fall. If we do nothing, it will slice through the highest-rated bondholders, typically pension funds, in many pools.

I personally believe that we need to huddle up and figure out a way to catch these falling knives as high up in the air as we can to avoid as much blood loss as possible for the unsuspecting bondholders.

Ann Hambly is founder and CEO of 1st Service Solutions based in Grapevine, Texas. Launched in 2005, the firm is the first-ever CMBS borrower advocate. Its purpose is to help guide property owners through the complex maze of CMBS financing.