A Complex Process Made Simple

By Erika Morphy

Commercial Defeasance, headed up by (from left) COO John R. Hosmer, CEO Robert J. Finlay and managing director Josh Cohen, states that it handles 95% of all commercial defeasance deals in the US.

LAST OCTOBER, WITH LITTLE fanfare or formality, what is believed to be the largest defeasance transaction to date closed. It had a principal balance of $700 million and had to be coordinated across five different servicers. Outside of its size, though, it was a very routine transaction. In fact, the number of players was the only significant challenge to closing, says one participant. Stewarding that many parties with their accompanying documentation requirements and attorneys through the closing process on a single day was akin to herding cats.

According to industry statistics, some $6 billion worth of commercial mortgage loans in CMBS pools were defeased last year. In essence, defeasance is a process for collateral substitution. Borrowers replace the real estate collateral with qualified government securities that are timed to be redeemed when the principal and interest payments and/or the balloon payment are due. In other words, the debt still exists, but the mortgage is released, which permits the borrower to sell or refinance the property.

It is a simple concept, but in reality it can be a very messy process given the number of players involved, which, depending on the deal, can be as many as 25. To navigate a defeasance to completion, borrower issues, rating agency approvals, title company paperwork, not to mention structuring the securities, all must be properly attended to.

"Defeasance is probably 80% process," says Robert J. Finlay, founder and CEO of Commercial Defeasance LLC, a leading player in this emerging industry. The Charlotte, NC-based firm's 20 or so staffers work off of an established checklist as they bring transactions to fruition.

Not long ago, defeasance was both cumbersome and rarely used. Indeed, the aforementioned $700-million transaction shepherded to conclusion by Commercial Defeasance would have been inconceivable 10 years ago, according to Finlay.

Despite the fact that originators such as Nomura had been incorporating defeasance into its CMBS loans since at least 1995, "by 2000, as few as two to five deals had actually been done," Finlay says. "At that time, the entire market had a very negative perception of defeasance, and there wasn't any one firm that you could approach to manage the process."

And what began as a disgruntled former client's demand for assistance with a defeasance resulted in the creation of the company, says Finlay, whose career includes stints with Lehman Brothers, Credit Suisse First Boston and Deutsche Bank. He recalls receiving a call one day in early 2000 from a borrower he worked with while at an investment bank that wanted help defeasing a loan Finlay helped to structure.

At first Finlay, who had never been confronted with such a request, assumed it would be a relatively easy matter. But when he called the servicer, it became clear that it was not.

"The servicer's response was that it was too expensive and in reality the loan was never meant to be repaid," the CEO remembers. "At that point, the borrower told me I had two choices. He said, 'Either figure out how to get this done or get ready to be deposed because I am going to sue your former employer for putting me in this loan.' "

It was then, Finlay says, that he realized there were likely other borrowers out there experiencing the same set of problems.

Around the same time that Commercial Defeasance was launched, CMBS volumes started to gain significant critical mass. "The growing numbers generated in 1997 and 1998 were definitely key to the development of defeasance as an industry," says the firm's chief operating officer, John R. Hosmer Jr.

WITH MORE THAN 1,000 DEALS ON ITS BOOKS, THIS FIRM, ONE OF THE FIRST TO SPECIALIZE IN DEFEASANCE, IS CLEARLY A MARKET LEADER

"Every year, the CMBS industry adds $50 billion to $90 billion in new issuance. Therefore, the number of potentially defeased loans also increases yearly."

The next few years are looking good for another leap forward, he adds. That is because the $15.7 billion of CMBS loans originated in 1995, which are now maturing and dropping out of the eligible defeasance pool, are being replaced with some $93 billion of debt expected to be originated this year. "Just in terms of sheer numbers, defeasance will affect more borrowers than it ever has in the past," Hosmer says. He estimates there is a pipeline of $500 billion that will include defeasance in some form this year.

Then there is the fact that defeasance costs are usually less in a rising rate environment, given the relative costs of US Treasury securities. However, its optimal use is in a low interest rate environment, when borrowers are able to replace collateral with a lower coupon loan, the executives relate. With rates slowly rising, borrowers are scrambling to optimally position themselves and defeasance is one way to do so.

According to the experts at Commercial Defeasance, a typical defeasance transaction will cost between $50,000 to $60,000.

The fixed costs include the standard pre-established fees of the ratings agencies, servicers, securities intermediary and defeasance consultant. Generally over the life of a loan, borrowers can save two to three times the defeasance penalty, according to the firm's calculations. So, for every dollar you spend on a defeasance, it's reasonable to expect to save between $2 and $3.

With more than 1,000 transactions under its belt, it can arguably be said that Commercial Defeasance established and defined today's defeasance processes. Back in 2001, Finlay served on the Commercial Mortgage Securities Association's defeasance subcommittee, which established a standardized template for documentation.

"We are considered the industry leader not only because we have completed the most loans, but also–even our competitors will agree–because we have helped to standardize the defeasance process," Finlay says.

The firm's deal volume has also risen steadily over the years, Finlay adds. It completed 70 deals in 2002, 200 in 2003 and 550 in 2004. And Commercial Defeasance continues to push the envelope, he maintains. "We were the first to do a Canadian defeasance, the first to do a franchise defeasance and the first to do a defeasance using a synthetic GIC (guaranteed investment contract). We stay ahead of the industry. That is why we represent 95% of defeasances in the country."

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ROBERT J. FINLAY
FOUNDER AND CEO

The Canadian defeasance happened in 2001. Again, the company had to start from scratch. "A lot of the structures we have in the United States, particularly REMIC, were not applicable in Canada," Finlay explains. Essentially, he says, the firm had to create its own structure. It also had to develop the necessary relationships to buy Canadian and Provincial bonds. Since then, the firm has done between five to 10 Canadian defeasances.

In 2003, Commercial Defeasance found itself with 67 franchise loans that needed to be processed over the December holiday season. "We got a call from a large institutional client that needed to get this transaction done before the end of the year. The problem was that the loans all had different cash flows and different payment structures. It took us close to a week to get the cash flows and securities in place," he recalls.

Another benchmark Finlay likes to point to is a recent synthetic GIC. A loan supporting a large office building in New York City was being defeased but the note had irregular payments associated with it. The company was not able to get sufficient pricing from the bond market to structure the deal. So it instead convinced the servicer to change the language in the document to allow the use of a Fannie Mae bond. "We went to Fannie Mae and asked them to create a one-off security for us."

The constant theme in most of these anecdotes is the relationships Commercial Defeasance has formed. Indeed, that is usually the first attribute that clients cite when asked about their experiences with the company.

"They have relationships throughout the industry that have proven to be invaluable," says Andrew S. Levine, general counsel for Manhattan-based office REIT SL Green Realty Corp. Levine has used Commercial Defeasance for a handful of transactions, including one currently under way.

Mark Isaacson, CFO of the Laramar Group of Chicago, tells of how Commercial Defeasance recently closed a very complicated transaction involving five properties and five separate loans from a common lender with a book value of $60 million. "It was one of the largest deals I had ever done," he says. "We were acquiring and refinancing properties and bringing in a new equity partner–and it all was scheduled to close on same day."

In the end, the deal came down to the wire. Laramar Group wound up purchasing the securities on the same day it settled the transaction, instead of the standard two to three days prior to closing.

"It was gut wrenching, but they were able to manage all the players and came through for us," Isaacson says.

These relationships will buttress the firm as more companies enter the business.

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CHIEF OPERATING OFFICER

Some originators are making a play for defeasance market share. SGL's Levine, for instance, says he is being pitched by Wachovia for the firm's business. He says he doubts he'll make the switch though.

"Everyone knows Commercial Defeasance," Levine maintains. "We could probably get the same work done cheaper by a new entrant, but it is not worth the pennies we would save."

That assessment, however, may be subject to change depending on monetary and macro-economic factors. The loan SGL is currently defeasing makes sense right now, Levine says. "The interest rates on the existing loans are sufficiently high that by defeasing it, the cost of that premium–even with the defeasance premium associated with it–on a present value basis is less than what the current market interest rates are."

But as interest rates rise, the spread between the rate at which the initial loan was booked and what it would currently cost, or what a borrower currently can save, will decline.

At that point, would Levine consider the lower prices of newer entrants in the market? Absolutely, he says.

Yet Finlay is not too worried about the increasing competition. Borrowers will always weigh such cost-benefit analyses, he says. But Commercial Defeasance has something the others do not. "No one else has the expertise that we do," he states. ◆

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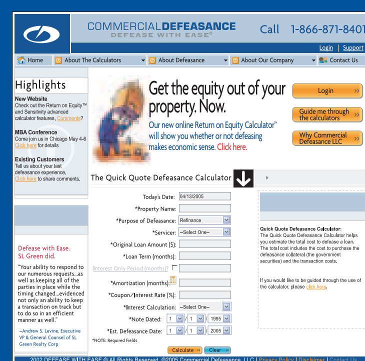

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