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Why the Checkout Line to defease is lengthening

By Matt Hudgins

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When Matrix Capital Partners purchased two Cincinnati apartment complexes in 1998, the company locked in mortgages at modest interest rates of 7% and 8% for 10 years via securitized deals. But that was before the 10-year Treasury yield began tumbling to near historical lows, registering a paltry 3.3% in June of 2003 and rising to only 4.2% in the early months of 2005.

During that stretch, the value of Matrix Capital's two properties rose dramatically. One apartment complex increased 41%, from $2.7 million to $3.8 million, while the value of the other climbed 37%, from $5.9 million to $8.1 million.

Sensing an opportunity, Ed Johnson, president and CEO of Matrix Capital based in Loveland, Ohio, wanted to pay off the existing loans in order to take on even more debt financing on the same assets and plow the additional loan proceeds into new acquisitions.

But Matrix Capital was in a bind. It couldn't prepay without a severe penalty because regular payments on loans tied to commercial mortgage-backed securities (CMBS) are promised to bondholders for the full, original term of the loan.

Through a complex process known as defeasance, Matrix was able to exit its loans and refinance the properties at interest rates just above 5%. Defeasance is the exchange of one type of collateral, such as real estate, for another, such as municipal or government bonds.

Technically, the loans remain in place while principal and interest from the bonds replace income from the original assets so disbursements to CMBS investors continue unaffected. The significance of defeasance for a borrower is that it removes a lender's lien on the real estate, freeing up the asset for new financing or resale.

A defeasance clause is common to 90% of all CMBS loans. Nearly all loans offering defeasance as an option originated in 1998 or later, and most carry a 10-year term that matures in 2008 or later.

Low-cost alternative

Whereas defeasance is the substitution of collateral, yield maintenance is the actual payoff of an existing loan and is generally more costly because there is always a minimum prepayment penalty of at least 1% of the loan balance.

The defeasance process generally takes 30 days, and can cost the borrower an average of $50,000 to $60,000 in fees per transaction. Still, many borrowers believe that the ability to exit a loan early is worth the cost.

In the case of Matrix Capital, the company decided to bite the defeasance bullet early this year rather than wait to refinance until its loans expire in 2008, when interest rates are expected to be higher than they are today. In February, Matrix Capital contacted Commercial Defeasance, based in Charlotte, N.C. Two months later, Matrix Capital had defeased its loans.

“One of the difficulties with these 1998 (CMBS) loans is you have a lot of equity trapped that you can't access,” Johnson says. “Now that we've completed the defeasance and refinanced the loans to pull out the (increased) capital, we can reinvest for a higher return on investment.”

Johnson projects income from the refinanced properties will recover his defeasance costs within three years. “And since we plan to buy more properties with the cash we pulled out, we're going to get an incremental rate of return from that capital that will result in a faster payback. It will take that three-year payback down to one year,” Johnson says.

Market drivers

Defeasance volume is growing by leaps and bounds, but the industry is dominated by a handful of specialists. Transaction volume at Commercial Defeasance, which processed $5.5 billion of the total $6 billion of CMBS loans defeased in 2004, has grown dramatically from six deals in 2000 to 177 in 2003 and 550 last year.

Wachovia, a relative newcomer to this market niche, predicts that of the $22 billion in CMBS loans eligible for defeasance in its portfolio, 30% will be defeased either by Wachovia or an outside provider this year. That's a dramatic increase from the 9% defeasance rate among Wachovia's eligible loans last year.

Skyrocketing property values are the biggest engine driving defeasance in 2005. The flood of capital pouring into commercial real estate has outstripped supply in recent years, with the resulting competition to acquire properties exerting upward pressure on sale prices and property values in general.

Owners are capitalizing on that increased value by either selling or refinancing with new and larger loans. But most CMBS borrowers can't join the party without defeasing their loans.

Interest-rate game

The portfolio of securities in a defeasance must generate a revenue stream sufficient to pay the regular principal and interest payments owed on the original loan.

If yields are lower than the original loan's interest payments to bondholders at the time of purchase, the borrower must buy more securities to generate the required revenue stream. Conversely, when yields are high, the borrower will require fewer bonds in the portfolio and benefit by a reduced cost.

The more properties appreciate in value, the more attractive defeasance becomes for borrowers. For example, Chris Simms, owner of GMC Property Management, recently completed the defeasance of two loans that totaled $12.25 million on an apartment complex in Jacksonville, Fla.

Because the appraised value had increased from $16 million to $21 million since the loans were originated in 2000, Simms was able to borrow $16 million against the property to refinance.

Even though it cost GMC Property Management $14.5 million to buy the securities required for the collateral substitution, plus approximately $100,000 in transaction costs to defease the two loans, Simms' company cleared about $1.4 million in additional loan proceeds.

What's more, the refinancing lowered the interest rate on the property from 8.6% to 5.8%. “After we paid all costs, we put $500,000 into an escrow to upgrade the properties and put $900,000 in our pockets,” Simms says.

Incentive to act now

With long-term interest rates expected to climb, those borrowers who entered into CMBS deals in the late 1990s at interest rates of 7% to 9% are understandably interested in refinancing at today's relatively low rates.

Case in point: A Tishman Speyer Properties partnership defeased a $1.2 billion loan on New York's Rockefeller Center earlier this year in order to refinance with a 20-year, interest-only loan at an undisclosed, fixed interest rate.

Watt Commercial Properties, with headquarters in Santa Monica, Calif., cites both equity gains and attractive interest rates for refinancing as its motivation to complete three defeasance transactions announced in February.

Initially, Watt opted to hire Commercial Defeasance to structure a $3.18 million defeasance transaction for a 132,129 sq. ft. retail center in Santa Monica. After learning the process and potential benefits, however, the company retained Commercial Defeasance to defease two more loans — the $5.76 million loan on Watt's corporate headquarters, followed by a $4.35 million defeasance on another retail property.

Impact of rising rates

Clearly, defeasance is gaining attention from CMBS borrowers while low interest rates and high property values provide strong incentives to sell or refinance, but such favorable market conditions won't last forever.

The Mortgage Bankers Association projects the 10-year Treasury yield will reach 4.9% by year's end, with a 5.2% rate in 2006.

Then comes a tougher question: Will there be an incentive to defease loans in a rising interest-rate environment? Defeasance counselors say yes, because defeasance is less expensive when the bonds required for the substitution of collateral are less expensive, and because increased bond yields mean fewer bonds are required to meet the original loan's payment obligations.

“It's really a win-win,” says Lisa Traylor, director and head of the defeasance team in Wachovia's commercial real estate servicing unit. “If current Treasury yields increase beyond the loan's original interest rate, then the securities are actually going to be cheaper and you're going to be able to pay off your loan at a discount.”

High expectations

An increase in defeasance volume is almost certain with CMBS issuance that is on pace to break another record in 2005. Volume hit $32.7 billion during the first quarter, a 72% increase from the same period a year ago. “If origination volume is up, then defeasance has to be up as well, because defeasance is the only option for the majority of CMBS borrowers to get out of existing loans and reinvest in the market,” Traylor says.

Even some borrowers with relatively new loans at Wachovia have inquired about defeasance options. Tax laws that regulate issuers of CMBS prohibit defeasance during the first two years of a CMBS loan.

Wachovia has some borrowers ready to defease the minute their loans meet that two-year requirement, according to Traylor.

Back in Cincinnati, Matrix Capital's chief executive believes that his company timed its defeasances well to refinance at low interest rates, and he predicts those who wait too long will find themselves waiting in line to defease. “I'm ahead of the curve,” Johnson says. “This year, if rates do start to inch up, you're going to have a lot of people running to the exit to refinance their 1998 securitized loans.”

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