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Commercial Real Estate Restructuring Revolution

Strategies, Tranche Warfare, and Prospects for Recovery

Stephen B. Meister

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To my wife and partner, Melissa, who endured many weekends and several holidays with a husband in absentia so that this book could be written.

Preface

Owners of office and apartment buildings, and retail and hotel properties, draw upon both consumers and businesses as their customers. The businesses that occupy our office buildings and book our hotels, and our retailers, in turn, depend largely upon consumers, whose spending accounts for over 70 percent of our gross domestic product. One way or the other, commercial real estate is dependent upon consumers.

The financial health of U.S. consumers was decimated by the bursting of the housing bubble, while American businesses, particularly small businesses, were ravaged by the abrupt curtailment of credit following on its heels. The credit freeze itself was triggered by the subprime mortgage crisis.

To understand where our commercial real estate markets are headed, we must gauge the health *and future prospects* of U.S. consumers. This, in turn, requires an understanding of the subprime mortgage crisis, the building and bursting of the U.S. housing bubble, and where the housing sector is headed—matters covered in Chapters 1 and 2. Consumer purchasing power and sentiment are largely driven by the relative health of the housing and equities markets.

During the first half of the 20th century, the U.S. home ownership rate hovered in a tight range—roughly 45 to 48 percent. After the end of World War II, however, the percentage of home ownership began a steady climb, reaching 55 percent in 1950 and from there up to 66.2 percent at the turn of the millennium. By 2004–2005, the U.S. home ownership rate had skyrocketed to 69 percent.

The stunning post–World War II increase in U.S. home ownership rates—going from about 47 percent to 69 percent (representing a 47 percent increase in the home ownership rate)—was not brought about by laissez-faire market forces, but rather by aggressive government intervention designed and driven by a liberal vanguard so blinded by the political correctness of marching toward the American Dream for America's minorities that they could not foresee the devastating consequences to both the supposed beneficiaries of their intervention, as well as to all other Americans (and really, people the world over). Regrettably, however, good intentions are not enough; as Oscar Wilde said, "All bad poetry springs from genuine feeling." And as the late neoconservative publisher, Irving Kristol, added, "The same can be said for bad politics."

Empowered by the powerful influence of Congress over the government-sponsored enterprises and the corrupt influence of mortgage lenders like Angelo Mozilo's Countrywide Financial over Congress and Fannie and Freddie; assisted by mortgage originators, who, courtesy of Wall Street's securitization prowess, retained no stake in the loans they originated and therefore no reason to underwrite them soundly, and the appraisers they controlled; aided and abetted by an oligopoly of credit raters who, protected by our government from the pressures of free-market competition, had fallen asleep at the switch; and enabled by the swollen supply of cheap and easy money put into place in the years preceding the bursting of the housing bubble by the Greenspan Fed, there was no stopping the mainstream-media-praised racial lending quotas established under our affordable home ownership mandate. The results, given the scale of the U.S. housing market, were nothing less than cataclysmic.

Trillions of dollars were loaned to homebuyers who put little or no money down on homes they purchased, and to existing homeowners who used their appreciating homes like ATM machines by taking ever larger cash-out refinancing loans. In both cases, the borrowers lacked the income and other assets necessary to repay those loans.

A massive housing bubble resulted from trillions of dollars in government-subsidized and mandated affordable housing loans. That bubble began imploding in 2006, as unfit borrowers, many of whom were granted loans well beyond their means to repay, started defaulting in droves.

In order to comprehend the impact of the collapse of the housing markets on commercial real estate ("CRE"), Chapter 3 traces the history of the CRE capital markets, so that the reader has an understanding of the required structures and concepts before delving into more detailed aspects of CRE financing in later chapters. I explain the composition of modern complex CRE debt stacks, including securitized mortgage loans and junior loans, now known as mezzanine loans, and recurring issues such as maturity defaults, value declines, and extension rights.

At the end of 2008, nominal investments in U.S. commercial real estate totaled $6.4 trillion, composed of $2.9 trillion of equity investments and $3.5 trillion in debt. CRE assets are held by a diverse group of investors—individual entrepreneurs, including multigenerational "real estate families," publicly traded and private real estate investment trusts (REITS), real estate private equity firms, hedge funds, banks and savings and loan associations, privately held real estate holding companies, publicly traded and private businesses, not-for-profit corporations, foreign, federal, state and local governments, and a whole plethora of foreign investors, including foreign individuals, banks, and sovereign wealth funds.

In Chapter 4, I address CRE values, which are a function of both underlying fundamentals and the yields demanded by CRE investors—capitalization (cap) rates. This chapter explains why increases in market cap rates, more than eroding market fundamentals, are responsible for CRE value reductions. A corollary of this observation is that once rental and vacancy rates return to their prerecession levels, CRE values will likely still lie behind their prerecession levels due to increased cap rates.

In Chapter 5, I describe a process that began unfolding in the last two quarters of 2009 and that will continue to unfold for the next five to eight years, as several hundreds of billions of dollars of CRE loans mature annually in that period. While lender reactions have varied—even within the participants owning a single loan—one consistent lender-driven theme has already emerged: putting off the day of reckoning until a better market arrives.

The deferral of lender loss-taking can take different forms. Where the real property is encumbered by a single mortgage loan (i.e., there are no mezzanine loans or junior lenders), the decision about what to do at maturity—from the lender side—is simplified in that one lender makes that decision, at least where that single mortgage loan is not owned by multiple participants or securitized. In such a case, assuming the loan is partly underwater (i.e., the loan balance exceeds the property value), the lender has essentially four options:

1. Sell the loan at a discount to a third party.

2. Take a discounted payoff (DPO) from the borrower (or sell the loan to a borrower affiliate at a discount, the economic equivalent of a DPO).

3. Take back the property either by way of a deed in lieu of foreclosure or through the prosecution of foreclosure proceeding (whether judicial or nonjudicial).

4. Enter into a modification and extension of the loan with the borrower, usually involving three elements—an increase in term, an increase in interest rate, and a cash payment from the borrower, some of which may be applied to reduce the principal balance of the loan and the balance of which may be held as reserves for future costs not otherwise fundable from property cash flow.

In Chapter 6, I discuss the intramural battles among lenders in complex debt stacks, colloquially referred to as “tranche warfare.” As CRE debt maturities and payment defaults hit on individual properties or portfolios encumbered by commercial mortgage-backed securities (CMBS) or whole mortgage loans coupled with hierarchical mezzanine debt stacks, tranche warfare has erupted between subordinate and senior lenders, as well as between lenders and borrowers.

No better example of the “tranche warfare” phenomenon is presented than by what happened on David Lichtenstein’s massive 2007 Extended Stay Hotels acquisition. In June of 2007, developer David Lichtenstein purchased for $8 billion the more than 75,000-unit Extended Stay Hotel (ESH) portfolio—an enormous portfolio of some 683 extended stay hotel properties located in 44 states and Canada—from Blackstone (not to be confused with BlackRock, the co-investor in Peter Cooper Village/Stuyvesant Town). Blackstone had purchased the ESH portfolio (then 475 hotel properties) for less than $2 billion in March 2004, three years before it sold the expanded 683-hotel chain to Lichtenstein. In 2004, the ESH portfolio traded for $4.2 million per hotel property while just three years later it traded for $11.7 million per hotel property—a nearly threefold price increase in just three years. The Bank of America and the other original lenders attempted to take the hotel properties back from Lichtenstein in a “transfer-in-lieu-of-UCC-foreclosure” transaction that would have wiped out $2.6 billion in junior mezzanine lenders. I represented one of these mezzanine lenders and obtained a temporary restraining order blocking that transaction. As a result, Lichtenstein put the entire portfolio into bankruptcy. Eventually, Centerbridge, Paulson and Blackstone bought the portfolio out of bankruptcy for $3.88 billion—about $5.7 million per hotel property.

As the CRE crisis has deepened, a host of hedge funds, real estate private equity investors, publicly traded and private REITs, and foreign and domestic investors have sought to buy distressed commercial real estate. Unfortunately, the distressed CRE owner is rarely in a position, alone, to convey title at a market price. Given the 40–60 percent decline in CRE values since the height of the market, and the far greater leverage levels offered in the frothy refinancing markets CRE investors tapped into during the 2003–2008 period, it is a rare CRE asset that is not leveraged beyond its current value. As a result, CRE investors must resort to indirect methods of acquiring commercial real properties—buying a “loan to own” or a short-sale by the deed holder with the consent of the lenders. I discuss these acquisition strategies in Chapter 7.

CRE investors anxious to acquire overleveraged properties have taken to purchasing either at or below par, depending on the situation, one or more mortgages or mezzanine loans encumbering the target property and thereafter foreclosing against the collateral. In states where mortgage foreclosures must take the form of court proceedings, strategic buyers of “loans to own” will often purchase both the first mortgage and senior mezzanine loan, so they can avail themselves of the streamlined (nonjudicial) UCC foreclosure proceeding available to the foreclosing mezzanine lender. The trick is identifying and buying the loan or participation in the control position.

Once a lender, whether the whole loan owner itself or the servicer for a CMBS loan, determines that the loan is underwater—that the CRE asset has a market value less than the balance due on the loan—a series of obvious economic motivations set in. These economic motivations have spawned two recurring themes in lender-borrower conflicts: funding cessations and extension fights. I discuss both these trends in Chapter 8.

For one thing, the lender does not want to get in any deeper—it does not want to advance any more money. Second, if the property is income-producing, the lender is loathe to allow net cash flow (even after debt service) to leak to junior stakeholders (whether junior mezzanine lenders or equity participants in the borrower). Such excess net cash flow, from the perspective of the senior lender, ought to be applied toward reduction of the principal balance of the senior loan—thereby reducing the senior lender’s eventual loss—instead of going to any subordinate stakeholder. However, typical loan documents do not permit the senior lender (prior to maturity, including an extended maturity date) to trap all net cash flow available after servicing the senior debt interest, provided the borrower is not in default.

I discuss key bankruptcy considerations for CRE assets in Chapter 9. Bankruptcy filings are infrequent, relatively speaking, for commercial real estate. For one thing, the vast majority of CRE assets are held by single-purpose entities (SPEs). These SPEs generally do not directly employ management or building personnel, who, more often, are employed by a separate management company, even if that management company is controlled by the same principals who own the SPE. In consequence, the majority of CRE-owning SPEs are not operating companies in the true sense of that term, but rather are dedicated legal vehicles for maintaining CRE ownership in an isolated format, offering protection (via liability immunization) to the SPE’s equity holders and their other assets (including other CRE assets).

As a result, commercial real estate–owning SPEs are not well suited to classic bankruptcy reorganization, which contemplates a leaner going concern exiting the bankruptcy process, though bankruptcy reorganization can be used to force the deleveraging of an overleveraged CRE asset through a cram down (debt restructuring).

There are, of course, exceptions to this generalization. CRE assets held by public and private real estate investment trusts and hotel chains, for example, do present true operating companies capable of benefiting from the bankruptcy reorganization process. Recent examples of CRE-based going concerns that have entered the bankruptcy process include Extended Stay Hotels and shopping mall giant General Growth Properties. In addition, while debt cram downs sometimes do occur within the context of Chapter 11 reorganization, the ubiquitous nonrecourse carve-out guaranty—making a principal, fund, or holding company liable for the loan in the event of a bankruptcy filing—make such cram downs relatively rare.

The multifamily sector, discussed in Chapter 10, presents unique considerations not affecting other CRE asset classes. First, multifamily lending is the only category of CRE asset lending supported by government-subsidized loans—multifamily properties are financed by Fannie Mae and Freddie Mac. Second, the multifamily sector is the only CRE asset class subject to price controls, the most severe restriction on the free market possible, short of a government takeover. For these two reasons, the multifamily sector presents both risks and benefits not found in other CRE asset classes.

According to its website, “Fannie Mae provides multifamily financing for affordable and market-rate rental housing. We operate nationally, in all multifamily markets and under all economic conditions. Every day, Fannie Mae delivers economical, flexible, and tailored financing for investors. In 2008 Fannie Mae invested over $35.5 billion in the multifamily affordable housing market. Eighty-nine percent of the homes and rental housing financed by Fannie Mae lenders are affordable to families at or below the median income of their communities.” Likewise, Freddie Mac boasts that its “multifamily division supports the acquisition, refinance, rehabilitation and construction of apartment communities across America."

Fannie and Freddie dominated the multifamily lending market in 2009. According to the Co-Star Group, a commercial real estate information company, Fannie Mae and Freddie Mac overwhelmed private-sector multifamily financing in 2009: "The two federal government sponsored entities financed 81% of multifamily activity based on Freddie Mac's accounting. Their combined activity totaled $36.4 billion. Fannie Mae, through its lender and housing partners, provided $19.8 billion in debt financing for the multifamily rental housing market in 2009."

While the vast majority of the approximately 17 million rental apartments in the United States are priced by the free market, some major U.S. cities (like New York, the District of Columbia, and San Francisco), as well as some smaller towns in New York, California, New Jersey, and Maryland, have chosen to fix rents through rent control laws. Few legislative efforts in our history have proved as misguided or resulted in more damage than our rent control laws, though it remains to be seen whether Obamacare gives rent control a run for its money on the worst-legislative-idea-ever list.

Oddly enough, universal condemnation of rent control has been advanced by economists on both the right (Nobel Prize winners Milton Friedman and Friedrich Hayek, for example) and on the left (Nobel laureate Gunnar Myrdal, an architect of the Swedish Labor Party's welfare state). In fact, Myrdal said, "Rent control has in certain Western countries constituted, maybe, the worst example of poor planning by governments lacking courage and vision." Another Swedish socialist and economist, Assar Lindbeck, bluntly put it that "in many cases rent control appears to be the most efficient technique presently known to destroy a city—except for bombing."

As with any price control, rent control—by mandating prices below the level dictated by a free market—inevitably creates a shortage of the price-controlled commodity—here housing. Said differently, in a price-coordinated or free market economy, suppliers furnish more of a given commodity as the price goes up while buyers do the reverse—buy more as prices go down. The market price, always in a state of flux, tentatively sets where buyers' and sellers' desires are optimized, resulting in the most efficient allocation of scarce resources (with alternative uses) possible.

Since the core function of any economic system is the allocation of scarce resources with alternative competing uses, housing (a commodity like any other) must nevertheless be allocated—only with price control, the market can no longer perform that function. In a rent-controlled housing market, cronyism, succession rights, gamesmanship, and luck replace price as the resource allocator. In the end, no serious economist quarrels with the notion that rent control results in a reduction in both the quality and quantity of housing, and to boot creates crushing inequities to market newcomers.

In New York City, for example, while rent control laws have kept rents down for a fortunate few—long-standing in-place tenants—it has increased the rents for others—themselves often low-income renters—and on balance have driven rents up on average. By protecting in-place tenants, older (often dilapidated) tenement buildings from the turn of-the-century dot the city's streetscape. They would have been replaced with new, larger apartment buildings absent rent control laws. The result has been a constriction in the city's housing supply. Prices of free-market apartments are driven up and new entrants to the market are forced into overcrowded conditions (often three or four roommates per apartment), while older rent-stabilized empty nesters whose children have grown up and moved out continue to hoard three- and four-bedroom below-market rent-controlled units.

No place is more notorious than New York City for the cronyism infecting the allocation of below-market rent-controlled apartments. Stories about the wealthy elite occupying vastly below-market rent-regulated apartments abound. Actors Mia Farrow and Dick Cavett, for example, held rent-regulated apartments in New York City.

As for cronyism, nothing can match Congressman Charles Rangel's four rent-stabilized apartments in Harlem's Lenox Terrace. Imagine a public servant hoarding four different below-market rent-regulated apartments in a city with the lowest vacancy rates and greatest housing shortage of any major U.S. city. That's what rent control enables.

In 2007, Rangel paid about $4,000 per month for all four apartments, easily half the market rate, and one of them was located on a different floor than the others and used solely as an office, even though rent-stabilized apartments in New York City must be used solely as primary residences. Worse, Rangel took a homestead tax break on his Washington, D.C. house during the same years he occupied his four Manhattan rent-stabilized apartments, thus simultaneously claiming a primary residence in two different cities (while he was the chief tax-law writer).

In Chapter 11, I explain how government inflicts us with a disease and then rushes to our aid with a supposed cure. The "affordable housing crisis" was really brought about by earlier misguided governmental actions. Regrettably, the cures the government has offered in response to the disease of its own making are even worse than the disease itself.

Named after the 18th-century Baron Munchausen, the psychological disorder Munchausen syndrome describes someone who intentionally harms himself in order to gain medical attention and sympathy. In a different form of this awful syndrome—called Munchausen by proxy—the afflicted individual, a parent, secretly harms his or her child, so that the child is hospitalized and treated, thereby achieving the clandestine object of the mentally ill parent—self-aggrandizement for his or her excellent caregiving. In extreme cases, afflicted parents have poisoned their children in order to be lavished with praise for their ensuing dedication to the care and welfare of the poisoned child.

Munchausen by proxy offers an instructive analogy to various governmental actions. Examples abound in which government initially takes some action that causes great harm to society and then later responds with some (supposed) legislative “cure” for the societal ill brought about by the original ill-advised governmental intervention. Though the examples are legion, for our purposes, a good starting place is the congressional reaction to the so-called affordable home ownership crisis—a situation that, though hardly qualifying as a crisis at all, was brought about largely by earlier misguided governmental actions.

Land cost is a very substantial component cost of all housing—be it multifamily rental housing or individual homes. Laws and regulations reducing the yield of land—the square footage of gross building area that may be built upon a lot (whether by bulk or zoning restrictions or overlaying conservation restrictions, which curtail building footprints)—drive the price of housing up. So do rent control laws, because they inhibit the demolition and redevelopment of more efficient housing accommodations.

This inability to see the true long-term costs of governmental policies and who bears them is one of the greatest shortcomings of our political system. Although, in Chapter 11, I use Nantucket as a handy example, this story repeats itself in thousands of communities throughout the United States. In fact, wherever housing is exorbitantly priced, development-thwarting (and/or rent control) regulations are likely to be found. While affluent communities from Puget Sound to Nantucket concern themselves with recreating endangered habitats for earthworms and other species of "special concern," without regard to the costs imposed by that effort, I tend to doubt these lowly creatures generated as much concern among those in charge of inner city planning in the Detroit neighborhoods about to be bulldozed.

In this way local governments throughout the United States created pockets where home ownership (and for that matter, rental housing as well) was no longer affordable. They did this by taxing home buyers and using the proceeds to buy and place undeveloped lands in permanent protected trust and by enacting a labyrinth of common sense-defying zoning restrictions and conservation rules, many of which became powerful weapons in the hands of "Not-In-My-Back-Yard" neighbors or not-for-profit collectives funded by NIMBY neighbors.

Our federal government then came to the rescue—governmental Munchausen by proxy—via forced lending to low down-payment minority buyers (the Community Reinvestment Act) and explicit quotas on Fannie and Freddie buying those low down-payment mortgage loans. Local government created the affordability crisis—the disease—and our federal government came to the rescue with the cure—subprime mortgage loans. Unfortunately, the cure turned out to be far worse than the disease.

This analysis raises a critical threshold question—should government concern itself (at all) with the form of ownership of its citizens' housing? Said differently, isn't the proper role of government ensuring the decency and quality of housing and not whether it is owned by the housed citizen or the landlord? Governments have a place making sure their citizens' housing accommodations are safe, well equipped, sanitary, heated, perhaps air conditioned in some areas, and free of vermin and pests, but why should our government concern itself with a citizen’s decision whether to own or rent housing?

In Chapter 12, I discuss the Obama administration’s efforts to combat the housing crisis and why they have been worse than tragic failures—they have only compounded the crisis, as the White House insists on printing more and more subprime paper. The administration’s efforts at financial reform are really nothing more than a power grab and do little to mitigate the risks of a repeat crisis. In order to get “reform” passed without even mentioning the real culprits—Fannie and Freddie—Obama waged and won a propaganda war against business.

The Obama administration’s multiple past attempts to fix housing have been both frighteningly expensive and miserable failures. First, through his Home Affordable Modification Program (HAMP), Obama tried to pay both delinquent homeowners and their banks to modify defaulted loans—an attempt to stop foreclosures (and the resulting resetting of housing prices). It failed miserably.

Next—call it HAMP 2.0—Obama tried to pay the banks holding second mortgages—the piggyback home equity lines—thinking they were getting in the way of the modifications. That failed too.

He attacked the demand side of the equation as well, hoping to stimulate buying—only at the lower end, of course—in an apparent realization that his attempts to stop foreclosures would not work. Through the First Time Home Buyer’s tax credit, we ended up paying $8,000 apiece to 1.5 million people who would have bought homes anyway, borrowing sales from the future, inviting billions in taxpayer fraud, and chasing out of the market middle and upper price bracket buyers who waited in the wings, astutely fearful of a double dip in housing prices once the unsustainable government supports fell away.

It all failed. We got 10 percent of the 4 million modifications Obama promised us; handouts to first-time homebuyers resulted in billions of dollars being paid to those who would have eventually bought houses anyway; and foreclosures, while delayed, continued to stack up in the legal pipeline. Housing prices will remain flat for years, or, more likely, double dip in foreclosure-rich regions, as the foreclosed homes finally hit the market.

Meanwhile, to stimulate demand for purchases and refinancings, we've pumped $1.4 trillion into the mortgage market (through Fed and Treasury purchases of mortgage-backed securities), taking rates to the lowest level in decades. Yet neither has occurred in a meaningful way: Middle- and upper-market buyers continue to wait in the wings for the bottom that has yet to come, while overleveraged homeowners found themselves unable to refinance.

In Obama's desperate last-ditch effort to help housing—call it ObamaHome 5.0—instead of subsidizing delinquent homeowners, this program benefits homeowners who are underwater on their mortgages but continue to pay.

Obama has subsidized upper-income homeowners (folks owing mortgage balances up to $729,750) by paying their banks if they reduce the principal balance to 97.5 percent of the home's value and payments to "affordable" levels—31 percent of the homeowners' income. For homeowners who owe second mortgage loans, the balance need only be reduced to 115 percent of the home's value. Obama will pay billions of taxpayer dollars to the principal-forgiving banks—from 10 to 21 cents per dollar of principal forgiven, depending upon the overall percentage of principal forgiven.

Even so, banks would never take the principal hit, unless they were getting cashed out on the unforgiven principal balance. After all, the redefault rate on Obama's prior modifications has been abysmal. And the amounts at stake