

Ten Ways to Structure Deals So They Don't Blow Up

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The major reasons why deals blow up even after being fully underwritten is inextricably tied to how well the originator and the underwriter understand the requirements of rating agencies and B-piece buyers. Unlike portfolio lenders who buy and hold real estate debt for their own account, a

commercial mortgage-backed securities (CMBS) loan underwriter is more concerned about what bond investors on Wall Street want, how they perceive the credit risk in the deal and the marketability of the loan. In a securitized transaction, the key to structuring and making deals is understanding both the property and the credit risk requirements of the rating agencies and B-piece buyers, and the "hot buttons" of your own internal Loan Committee.

The purpose of this article is to save originators and underwriters some time by identifying potential issues early so that good deals are sorted from the bad. We recognize that almost every deal underwritten today has some "hair" on it and has risks that need to be mitigated. We believe a majority of the deals in your pipeline can be securitized if they are carefully underwritten and if your borrower is creditworthy and flexible

Here is a summary of the top ten pitfalls to avoid when structuring deals:

1. Month-to-Month Tenants affects the duration and durability of the income stream and inflates the property's net operating income (NOI). Since this income can disappear at any time, it shouldn't be given any credit when underwritten. For example, in a recently submitted \$8.5 million dollar Washington, D.C. strip shopping center transaction, the month-to-month tenants were included in the appraised value as if they were "regular" tenants. Therefore, at first blush it appeared as if the center was 92% occupied and all of the tenants were paying base rent and expense reimbursements. In reality, the property was only 72% leased and the borrower had been trying to get the tenants to renew. The borrower even indicated that the leases would be signed within a week or two. Unfortunately, it didn't happen. In the end it turned out that several of the

tenants had been month-to-month tenants for 1-2 years but yet were still paying their rent on time each month. This deal never made it to Loan Committee. It should be noted (and some consideration should be given to the fact) that the month-to-month tenants had been paying rent on a month-to-month basis for several years and had below-market rents, which indicates a willingness and ability to stay and continue to pay rent. The loan could be underwritten with guarantees and a strong debt service coverage ratio (DSCR), but would be better placed with a portfolio lender and not in a securitized pool for Wall Street.

2. Double Counting Revenues creates an inaccurate picture of the gross effective rent, and increases NOI and DSCR. Therefore, the underwritten amount should be checked by reviewing the leases and examining the prior three years of actual reimbursements to uncover any potential double counting. For example, in a Dallas office building submission, expense reimbursements were being double counted. The borrower "accidentally" added together the base rents and expense reimbursements, and then inadvertently the mortgage broker analyst added back the reimbursements again, making the gross potential rent approximately 20% higher than it should have been. The deal still worked, but much more time was spent recalculating all of the reimbursements for each tenant. The lesson learned here is to call the borrowers accountant early in the process to clarify any numbers that appear to be unreasonable.

3. "As Is" and "As Stabilized" Values contained within the appraisal report are an often overlooked part of an underwriting analysis that need to be understood. Most appraisal engagements require these two values to be explained and described in the letter of transmittal. However, in about 30% of the appraisal reports submitted, the "as is" and the "as stabilized" values are not broken out separately or completed properly in the report. The "as is" value is based on the actual current occupancy and income, and the "as stabilized" value is when the property reaches its long-term occupancy. These values should be different if the property is not currently stabilized. The report should contain a detailed explanation as to how these two different numbers were reconciled into a final conclusion of value. An incorrect value causes an obvious problem in calculating the loan



to value (LTV) ratio, which can create delays and frustration in trying to make sense of the deal and whether it meets your underwriting criteria.

4. **Bankruptcy** of a major tenant should be an immediate red flag to any underwriter, rating agency or B-piece buyer. This is an obvious issue that shouldn't surface late in the process, but sometimes does. For example, after spending a week underwriting a deal and completing the tenant credit and background checks, we discovered that one of the major tenants in the building had changed its name and was now part of a new organization that was still struggling financially. In addition, on inspection of the major tenant's space it was found that they only actually occupied 25% of their leased space and there was little business activity. Unfortunately, there were too many issues and concerns surrounding the transaction to continue underwriting the deal. We returned the check and application to the borrower.
5. **Residential Tenants Living in an Office Building** can create legal and zoning use problems in underwriting a loan. For example, a midtown south New York City office building had been a residential use from 1975–1995. The engineering report found that two residential tenants (totaling 2,500 square feet of space) were still paying rent and wouldn't vacate the premises. These were rent stabilized tenants, who had been in the building for the past 20 years and claimed the space as their primary residence. In attempting to underwrite and mitigate this risk, we had to insure there was a clean certificate of occupancy and that the insurance company for the property would pay off in the event of a fire. In order to insure that none of these issues would create a problem, a condition of the loan closing was that the borrower had to buy the residential tenants out of their leases.
6. **Single Tenanted Buildings** can be a huge problem for lenders if the tenant goes bankrupt. If the tenant defaults on their loan, the costs could be significant, with typically 12 months of marketing time to release the space and \$20 per square foot for tenant improvements and leasing commissions to be paid. For example, a technology company in Seattle, with a billion dollar net worth but little real income, occupied more than 60% of a building. Our Loan Committee was concerned and wouldn't approve the deal unless it was possible to convert the building to multi-tenanted use. However, the Committee felt that some of the risk was mitigated by the fact that the tenant was paying 40% below market rent and that the lease for this space continued for an additional 15 years. In the end, there still was a considerable amount of risk that had to be mitigated, which was accomplished by having the borrower post a Letter of Credit to cover the re-tenanting costs for the space.

7. **Deal Disconnects.** There is sometimes a disconnect between the originator's perception of what deals can get done and what B-piece buyers or the rating agencies want the loans to look like. If the deal is an out-of-favor property type that is not securitizable, it is more efficient to discuss it with the originator before starting to underwrite it. For example, the property types that B-piece buyers typically don't like are car washes, fitness centers, bars, or entertainment centers. These uses, along with nursing homes, storage facilities and cinemas, are "red flags" that need to be addressed before an application is taken and underwriting begins. Although transactions like these may have reasonable DSCRs and relatively low LTVs, they are difficult to sell to B-piece buyers and are probably better placed with a portfolio lender.

8. **No Continuous Operation Clause** in a retail strip center or shopping mall can create additional underwriting and default risk. Small stores are often unable to continue operations if the anchor tenant leaves the center. Therefore, in underwriting a center it is critical to ensure that the retail tenants don't go dark. For example, an Atlanta shopping center loan died at the last minute at the Loan Committee because the lease on the anchor tenant, a large supermarket chain, did not have a continuous operations clause and the tenant would not sign one. Ultimately the deal was approved, but only after the borrower agreed to guarantee the loan.

9. **Parent Company Consolidates All Its Leases into One Space.** When the parent company of your major tenant announces plans to consolidate all of its office space into one central location, it usually means your building's major tenant will not be renewing its lease when it expires. This dramatically increases the risk of a default and foreclosure if the risk is not properly managed and mitigated.

Here is a real example of this situation that required a lot of underwriting and structuring to ensure that it would make it through Committee. We received an underwriting package on a New York City office building where the major tenants' parent company had just signed a 15-year lease in a nearby building for 350,000 square feet. By making calls to brokers active in the market, we discovered the major tenant's parent company was planning to consolidate all of its subsidiaries into the new space within the next two years. In order to ascertain whether the tenant would vacate the space, we contacted the parent company and found out that there was a strong probability that the tenant would not renew its lease when it expired in two years. In addition, we checked the cash flow assumptions and found that the renewal probability for this tenant was 75%. We reduced the renewal probability to 50% and recalculated the appraised value.



In order to make sure that the deal made it through the Committee, we mitigated the renewal risk by setting up a reserve for future tenant improvements, leasing commissions and 12 months of assumed downtime. The reserve was to be established at closing with monthly set-asides, which would build up over two years until the required amount was reached. If the tenant renewed its lease, the funds would be returned to the borrower. This deal structure mitigated the renewal risk and was quickly approved by the Committee.

10. **Letters of Credit** are frequently required when there is a risk of default during the life of the loan. For example, a San Francisco office building on the wrong side of Market Street had a major tenant's lease expiring in four years. The loan originator structured the deal so that a letter of credit would be put in place in four years to cover the costs involving renewing the major tenants space. If the tenant didn't renew its lease in four years, the borrower would be responsible for making and paying for all necessary tenant improvements, leasing commissions and 12 months of downtime. However, the loan was not going to get approval from the Loan Committee unless the tenant posted the letter of credit immediately rather than in four years. The rationale for this was that in four years the borrower might not be as financially secure. Therefore, by posting the letter of credit now, there is a much lower probability of a future default.

Each of the above underwriting risks and issues can be managed or mitigated. There are many ways to avoid underwriting issues. For example, as soon as a deal is signed up, run it by the originator and a senior underwriter to make sure it passes the "smell test." This will save everyone a great deal of time and money. In addition, once this advance work is complete, it is easy to address and focus the third-party vendors on the critical issues that need to be resolved immediately. Without an ahead of time "smell test" an underwriter can spend a week or two of work on a deal that still has many outstanding issues. By performing a thorough up-front analysis, you can ask the right questions, get the right answers, manage the borrower's expectations and manage your time more efficiently underwriting deals that close.

CONCLUSION

We have outlined ten ways to structure and underwrite your deals to make sure they don't blow up. As an underwriter, your job is to identify the issues and find a way to manage and mitigate the risks. From experience, we have found that most individual issues can be underwritten and mitigated. However, there is a "multiplier effect" on the level of risk in a deal if collectively there are four or five smaller issues that need to be addressed. In this situation, the deal can still

be done, but much more preparation time may be required before it goes to the Loan Committee.

The key to working smart and avoiding deals that don't close is to spend as much time as possible understanding rating agency issues, what the B-piece buyers like and don't like, and identifying the risks before you start underwriting the deal. It takes discipline to do it this way, but if more time were spent flushing out the underwriting risks, it would make all of our jobs easier. Once the issues are identified, speak to your mortgage originator or correspondent. If there aren't compelling reasons or ways to mitigate the risks, then speak to members of your Investment Committee to see if a creative solution can be found to resuscitate the deal.


In conclusion, analyze the deal beforehand and communicate your findings quickly with the originator, mortgage correspondent and borrower to find a way to make the deal work. Understand the criteria, the likes and dislikes of the rating agencies and the B-piece buyers, and you will have a better chance of mitigating the issues and getting the deal approved. □

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