❖ High Yield Debt: Expanding Opportunities for Investors

Brian DiDonato

President

GMAC Institutional Advisors

Opportunities for institutional investors to gain exposure to high yield real estate debt investments have advanced with growth of the securitized loan market. Institutional investors can now target a specific risk/return dynamic, engaging investment managers to achieve their goals. This paper examines collateral associated with real estate debt investment and strategies utilized by managers to achieve high yield returns.

Before the advent of core real estate funds, value-add vehicles and REIT mutual funds, insurers dominated institutional real estate markets, focusing their investments on commercial mortgages. Mortgage cash flows matched up well against their long-term policy liabilities. In fact, until the early 1970s, institutional activity largely concentrated on lending, not equity ownership. Since entering the real estate arena, pension funds traditionally have signaled disinterest in whole loan commercial mortgages—it is easier to command reliable fixed income returns in the bond markets than deal with illiquid loan portfolios, and if loans go bad you end up owning troubled real estate. Since markets were established for mortgage securities in the early 1990s, the once-simple world of mortgage lending (a first mortgage secured by property equity) has become highly segmented, specialized, and sophisticated. Now loans can be divided into tranches, segmented by risk, pooled, securitized, and sold off to a variety of investors with a variety of risk tolerances. Institutional investors have warmed to CMBS slowly—it was only in 2000 that the U.S. Labor Department gave the green light to ERISA plans to invest in investment grade bonds. Most institutions invest in investment grade CMBS through diversified fixed-income funds rather than stand-alone CMBS products or separate accounts. (See Exhibit 1, next page.)

Today, debt-related real estate investments and funds have begun to capture greater attention as yield hungry investors search for higher income-oriented returns in real estate markets. This flood of capital, in part propelled by low interest rates and corresponding low returns in fixed income investment alternatives, has compressed property cap rates despite space markets with only slowly recovering supply/demand fundamentals. Credit markets exhibit the most liquidity and the tightest credit premiums in more than a decade. Default and delinquency rates, meanwhile, continue to stand near all-time lows, highlighting a dearth of distressed selling for opportunistic investors to capture bargains. U.S. buyers continue to face a reality of either paying up for income-oriented returns or looking offshore, particularly in Asia, to target outsized performance with inevitably higher risk.

@ 2006 Institute for Fiduciary Education

Exhibit 1
Evolving Capital Structure

Traditional
1st Mortgage
Equity

Early Stage
A Note
Mezzanine
Equity

Current
A Note
AAA/ BBB CMBS
B-note
BB+/ B
Mezz
B-/Unrated
Preferred Equity
Equity

But high yield debt investments, secured by U.S. real estate, using leverage and hedging strategies can achieve value added to opportunistic returns. These investments comprise three major categories—high yield CMBS, high yield whole loans/B-notes, and mezzanine loans. Currently, leverage on high yield CMBS, whole loans and B-note investments made available through collateralized debt obligation (CDO) financing can achieve returns in the 13% to 20% range. Mezzanine loans can achieve similar yields.

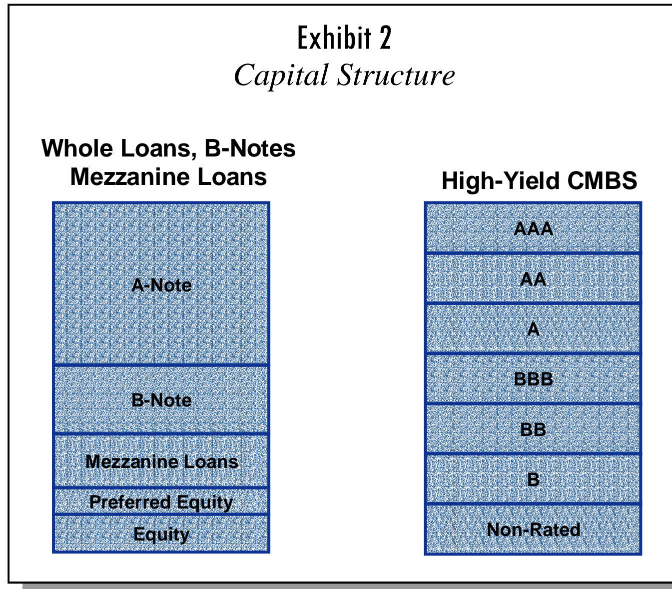
Capital stack collateral

Sustained strong real estate performance over the past decade has encouraged a trend to increasingly complex, high loan-to-value financings and interest-only loans. These financings provide substantial opportunities both in securitized pools and large single asset offerings for segmenting capital positions and spreading risk. The typical real estate capital stack and its various segments can range from the first mortgage-senior note position or comparable AAA to BBB- investment grade CMBS; through B-notes or CMBS B pieces (BB+ to B) and mezzanine debt or B- to unrated CMBS; to real estate equity. (See Exhibit 2, next page.) High yield debt investors have typically focused on the B-note/B-piece and mezzanine debt/unrated CMBS segments. In the current market, investment managers also can target transitional or bridge first mortgage loans to achieve high yield returns through ever-evolving structured finance vehicles.

High Yield CMBS/B pieces

Until 2003, the evolving B-piece CMBS market was dominated by a small group of investors who exerted considerable control over offerings, kicking out undesirable loans from pools and exerting considerable pressure on mortgage underwriters to adhere to their standards. With defaults and delinquencies near record lows, B-piece players were able to capture opportunistic yields without suffering any significant losses. Outsized returns garnered in B-piece investments attracted significant numbers of new entrants to the market. This wellspring of demand substantially reduced spreads, limited buyers' ability to drive credit quality of the underlying mortgage pool, and compressed returns. As a result, B-note yields became more desirable on a risk-adjusted basis than B-piece

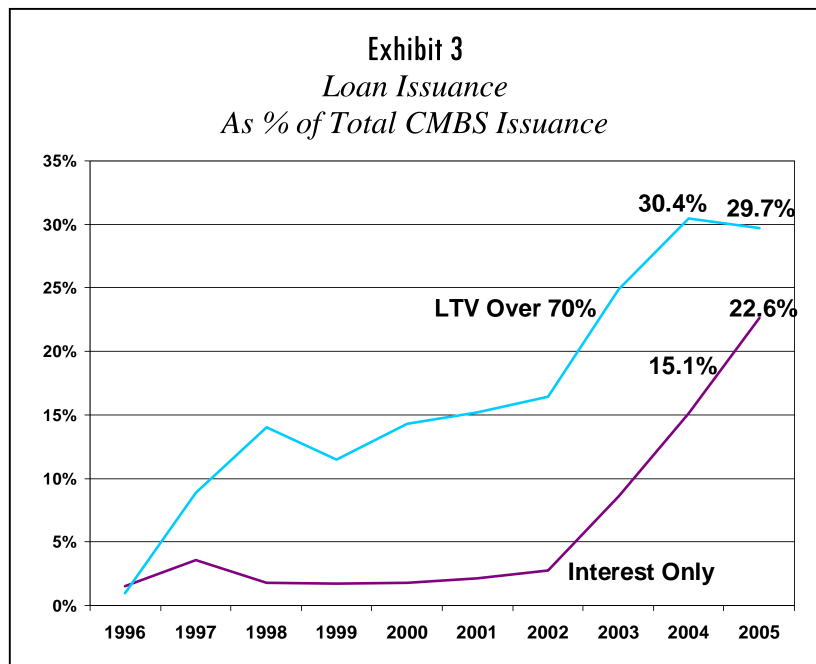
@ 2006 Institute for Fiduciary Education



securities, although B-notes have also experienced spread compression recently. Today credit fundamentals have deteriorated associated with underlying collateral and CMBS subordination—apparent in higher loan to values and interest-only loans, making loans riskier and creating aggressive capital structures in securitizations. (See Exhibit 3, this page, and Exhibit 4, next page.) At present, nominal yields for B pieces range between 7% and 10%.

High yield whole loans/B-notes

High yield whole loans represent short term (three-year floating rate) bridge loans on transitional properties typically on single assets or on small portfolios of assets. B-notes are second loan positions often in large single assets, sandwiched between traditional first mortgages (A notes) and mezzanine debt. Since whole loans and B-notes are components of a single asset financing structure, investors have the ability to



Source: Realpoint research, GMAC Institutional Advisors

@ 2006 Institute for Fiduciary Education

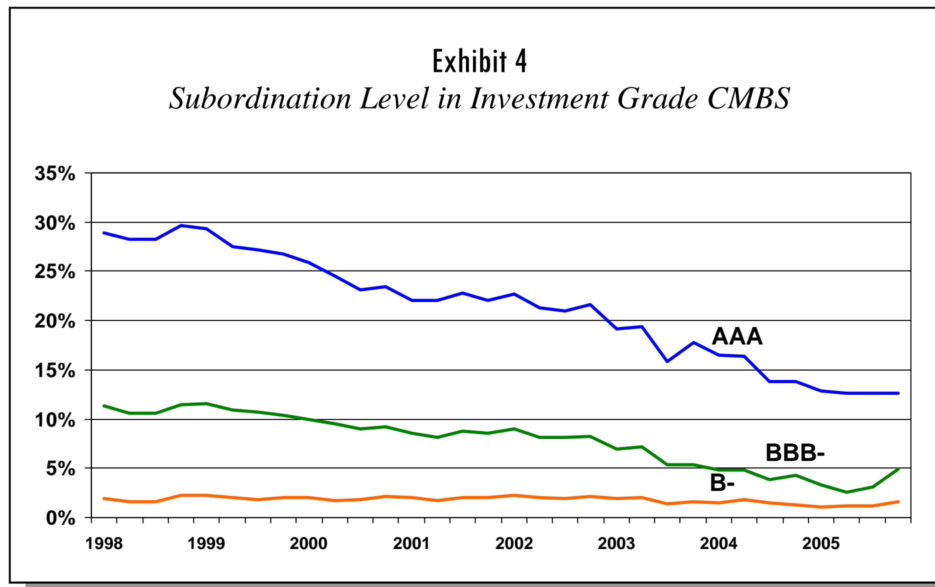


Exhibit 4
Subordination Level in Investment Grade CMBS

Source: Realpoint research, GMAC Institutional Advisors

underwrite the credit of a specific property fully. Individual B-notes obviously do not capture the diversification benefits of B-piece securitizations where investment analysis down to the property level is more generic and summary in nature. Well underwritten whole loans and B-notes can avoid losses where any given bad loan in a securitized pool can wipe out small pieces of the capital structure.

Mezzanine loans

While bridge loan/B-note spreads today typically register from 150 to 300 basis points above underlying collateral, spreads on Mezzanine Debt can range from 300 to 650 basis points, recognizing their most junior debt position in the capital stack. Mezzanine loans are typically secured by pledges of ownership interests and made on properties in transition with lease-up issues, management changes, and repositioning needs. These loans traditionally have had maximum five-year terms, but some lenders now extend to 10 years. Mezzanine investors in certain cases can gain better spreads than core real estate investors with more downside protection in the capital structure than equity owners, who are dependent on appreciation for enhanced returns. Any sale or refinancing offers the opportunity for mezz investors to exit. Like real estate equity funds, mezzanine debt funds can offer geographic and asset type diversification. Mezzanine loan quality can vary among the types of buyers/originators. Wall Street investment funds are primarily retail buyers not originators. So-called loan-to-own investors look to take equity control of properties by structuring terms that borrowers will have difficulty meeting over time. Financial company originators control financial terms and structures of mezzanine loans to greater advantage since they are positioned to finance properties across the entire capital stack.

Non-performing / sub-performing loans

These loans can also provide excellent opportunities for attaining enhanced returns. The early 1990s real estate depression and S&L crisis was the last opportunity for investors to take advantage of widespread lender red ink in the U.S. Since those RTC days, when pools of loan defaults could be bought for cents on the dollar, U.S. property markets recovered and low interest rates helped owners through the 2001-2003 period of soft tenant demand. Depending on interest rate movements and demand fundamentals, U.S. default rates likely will

@ 2006 Institute for Fiduciary Education

increase at some point, but the current domestic non-performing loan market is constrained with limited numbers of distressed loans trading at 80 to 90 cents of par. At present, some foreign markets—Japan, China, Germany, and Mexico—offer debt asset managers the chance to acquire distressed properties, renovate and release them, and cash out at high yields if and when markets turn more favorable.

Generating higher yields

Although various B-piece and B-note structures as well as mezzanine debt can provide enhanced returns for investors, financing these assets through securitizations and fund level leverage can achieve higher yields. B-piece, B-note, and mezzanine loan cash flows can be securitized in collateralized debt obligations (CDOs) and REMICS, creating residual pieces of high yielding equity and providing upwards of seven to one leverage. Pools of higher risk mezzanine loans typically are financed with two-to-one leverage. (See Exhibit 5.)

CDOs

Introduced to real estate markets in the late 1990s by Wall Street bankers, CDOs continue the rapid evolution and growth in the debt securities markets which started with mainstream CMBS offerings less than 15 years ago. CDO structuring has evolved from leveraging static pools of fixed rate investment grade and subordinate CMBS, REIT paper, and some residential mortgage securities to an efficient financing source for pools of short-term B-notes and mezzanine debt. More recently, CDO structures allow for financing whole loans. (See Exhibit 6, next page.) In addition to the basic food group investments—multifamily, office, industrial, and retail—CDO structures can finance a range of real estate assets including healthcare, hospitality, and senior housing.

CDO bonds issue multiple classes of debt, tranched by loss threshold and timing of repayment. Investment managers using CDO structures can potentially turbo-charge performance on B-notes, B-pieces, whole loans and other forms of debt by leveraging underlying collateral value, increasing returns on typical whole loans and B-notes above 15%. Currently, high yield whole loans offer the best risk-adjusted pricing today compared to B-pieces and B-notes. CDO structures allow cherry picking and leveraging these better protected A-loan positions into returns ranging into the mid teens. CDOs are inherently

Exhibit 5
Investment Volatility Matrix

	Nominal Yield	Leverage Available	Leveraged Yield
High Yield Whole Loans B-Notes	LIBOR + 150 to 300	7 to 1	15% - 18%
High Yield CMBS	7% - 10%	4 to 1	15% - 20%
Mezzanine Loans	LIBOR + 300 to 650	2 to 1	14% - 20%

Source: GMAC Institutional Advisors

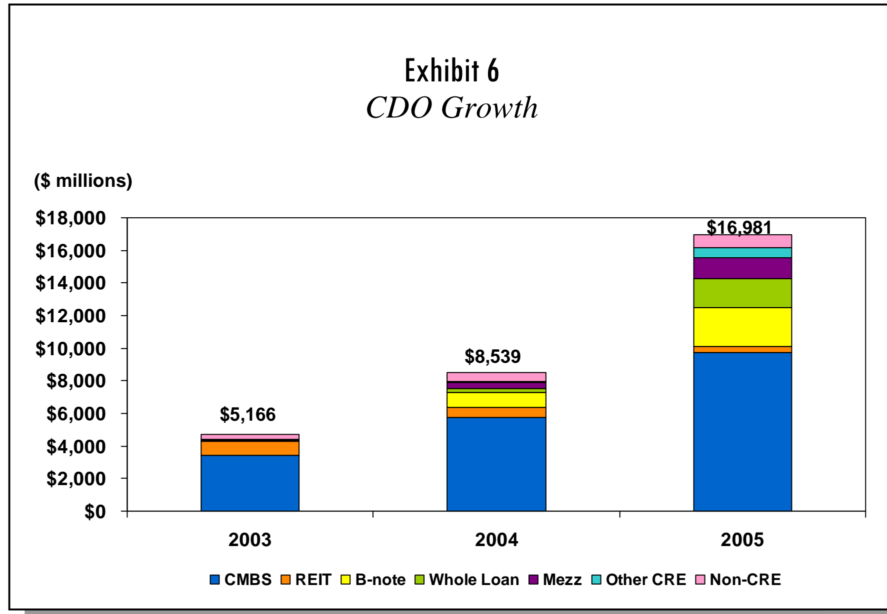


Exhibit 6
CDO Growth

Source: Credit Suisse First Boston and Commercial Real Estate Direct

diversified, pooling various debt tranches from 100 properties or more.

Risks

Real estate market shifts, property valuation declines, and refinancing risk obviously shadow debt investments. Lowered vacancy rates in office and industrial markets, sustained consumer confidence, and improving wage growth should help enhance property revenue streams and support debt service coverage. Widespread delinquencies and defaults could compromise returns, but pooled investments offer diversification benefits and credit agency analysis helps evaluate risk. CDOs lock in term financing as of origination so widening spreads will benefit returns, while tightening spreads will reduce yields. Properties leveraged with low interest rate mortgages face greater challenges in refinancing their debt the higher interest rates rise.

High Yield Debt Funds

The proliferation of various debt instruments and tranches combined with CDO enhancements has led to new high yield debt funds, which investment managers can diversify broadly across the spectrum of subordinations, asset types, credit risks, and locations. Current capital markets are tailored for funds that concentrate in CDO portfolios of whole loans and B-notes; stand alone mezzanine loans and B-notes on large assets which can provide return premiums from their structural complexity; and CDO equity, the below BBB tranches of CDO bonds. These funds can comprise investments in hundreds of properties with considerably greater diversification than typical equity real estate vehicles as well as superior loss protection than traditional commingled property pools. CDO leveraging, meanwhile, can enhance returns well above expected equity returns given the current cap rate compression environment. If spreads widen again for B-pieces or market dislocation spurs defaults and workouts, these investments would become ripe for high-yield debt funds.

Investment managers are sensitive to pension fund needs and look to create investment fund structures that limit exposure to unrelated business taxable income (UBTI), ERISA restrictions, and other potentially thorny issues, which have limited institutional appetites in high yield debt markets.

@ 2006 Institute for Fiduciary Education

The introduction of new high yield real estate debt vehicles offers institutional investors the opportunity to capture higher returns than have been available recently in U.S. property markets. For now, the challenge for investment managers is to select investments which meet disciplined underwriting and credit risk criteria in highly competitive debt markets that have narrowed spreads on underlying collateral.

Brian has a B.A., Mechanical Engineering, Villanova University; and an M.B.A., Finance, New York University, Stern School of Business. Brian was also an Aerospace Engineering Officer in the United States Navy

---

This research paper is published solely for information purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or derivative. The Material is not to be construed as providing investment services in any state, country or jurisdiction. GMAC Institutional Advisors (Institutional Advisors), its affiliates and subsidiaries and/or their officers and employees may have positions in securities or companies referenced in the paper and may, as principal or agent, buy from or sell to clients. From time to time, the firm, its affiliates and subsidiaries and/or their officers and employees may have a corporate finance relationship or perform other services for companies mentioned in the paper. Opinions expressed herein may differ from the opinions expressed by other divisions of Institutional Advisors, its affiliates and subsidiaries.

This research paper has no regard to the specific investment objectives, financial situation and particular needs of any specific recipient of the Material and investments discussed may not be suitable for all investors. Investors should seek financial advice regarding suitability of investing in any securities or following any investment strategies discussed in the paper. Past performance is not indicative of future returns. Certain assumptions may have been made in preparing this paper that has resulted in certain returns detailed herein and any changes thereto may have a material impact on any returns detailed. No representation is made that any returns detailed here in will be achieved. If an investment is denominated in a currency other than the investor's currency, changes in the rate of exchange may have an adverse effect on the value, price or income.