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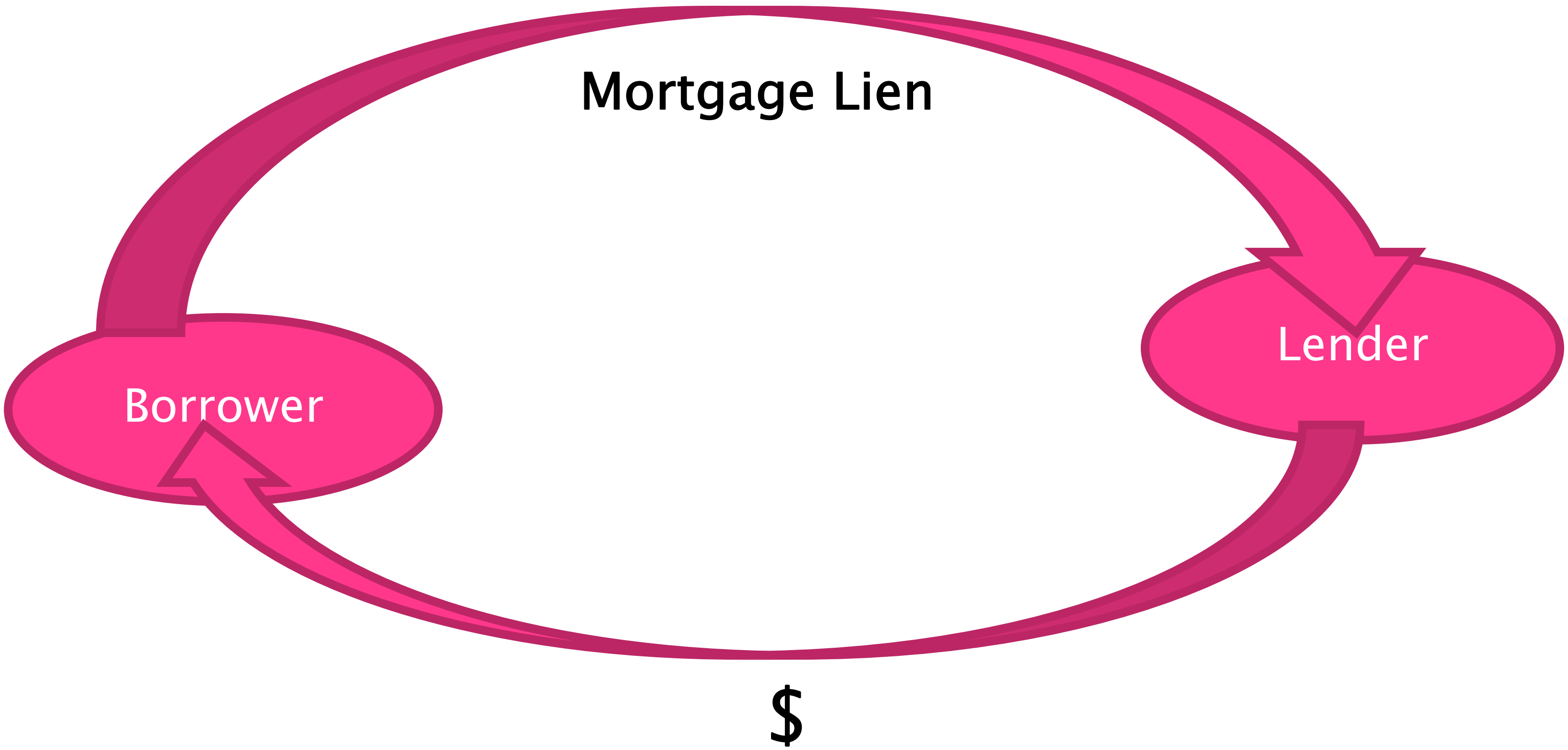
October 29. 2009

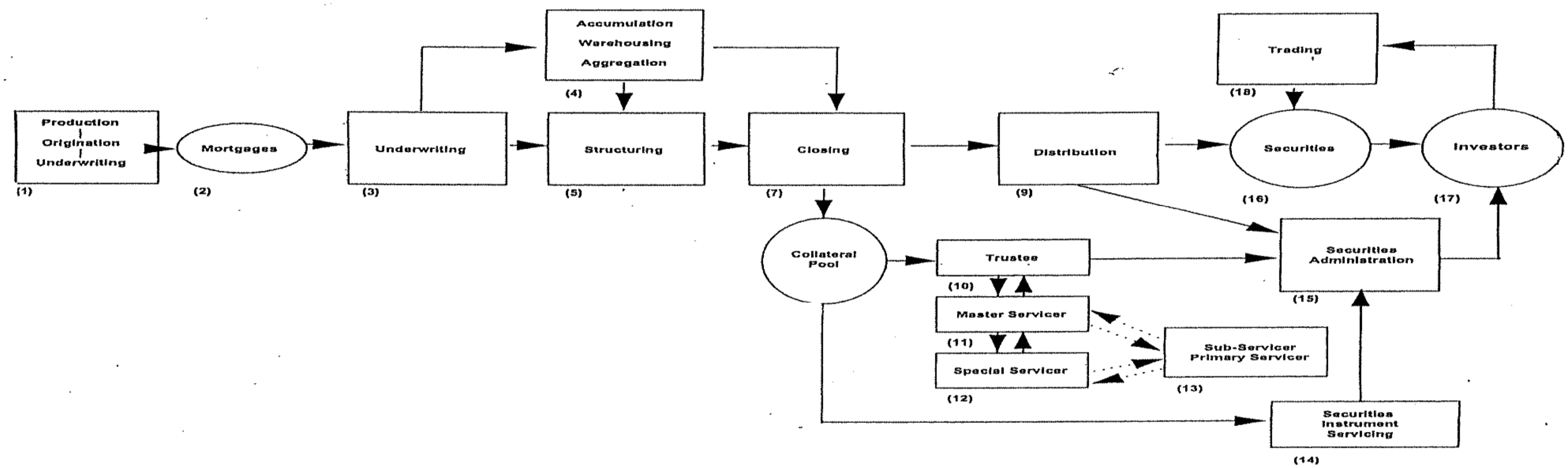
Basics of Debt Financing

Making Sense of Today's Market

Illustration of Portfolio Loan



CMBS Structure (simplified)



Providers of Debt to CRE

- Clearly defined and concentrated risk in a single property, based on local market knowledge.
- Instant information on property and market changes.
- Frequent and direct contact with borrower.
- Control of resolution of on-going issues.

Portfolio/Balance Sheet Lenders

- Investor (bondholder) has no direct borrower contact.
- Collateral is a diversified pool of loans – no market or asset type concentration.
- Pool performance information is delayed and second-hand.
- Reliance on third parties for problem resolution.
- Risk/return a function of place in the CMBS capital stack.

Public Capital Markets: CMBS

The CMBS Process

1. Commercial mortgage loans originated by multiple lenders.
2. Loans aggregated into a REMIC (Real Estate Mortgage Investment Conduit) pool, that then becomes the owner of the loans and issuers of bonds. REMICs are pass-through entities granted tax exempt status by legislation.

3. In anticipation of selling bonds (tranches) collateralized by the pool of loans, a collaborative effort takes place to determine
   - **the assets** that constitute the pool and
   - **the tranche sizes** (“sizing”). The parties to this “collaboration” are:
     - **the issuer** of the bonds
     - **the rating agencies** and
     - **the purchasers of the “first loss” bonds**

Rating the Bonds

4. After review of <u>each loan</u> in the collateral pool, and assigning each loan an **"expected loss"***, the rating agencies assign ratings to each bond (tranch).
   a. Most CMBS securitizations are rated by two agencies.
   b. A very few rated by three agencies.
   c. No securitization is rated by only one rating agency.

- *** Next two slides**

Expected Loss

- Using the historic data of the performance of fixed-rate loans held by insurance companies in 1990-1994 recession, each pooled loan is determined to have
  - A "Default Probability" based on property type, LTV and DSCR, and measured as a percent, and
  - A "Loss Severity" measured as a percent of principal when the loan defaults
  - "Expected Loss" is the product of default probability and loss severity

Expected Loss Example

- If a 70% LTV hotel loan has a default probability of 25%, and,
- If it were to default it would have a loss of 30% of principal (Loss Severity)
- Then the loan would have an "expected loss" of
  - 25% x 30% = 7.5%

- *Each loan in the pool is assigned an expected loss -- even if the expected loss is zero*

5. The tranched bonds then publicly sold (investment grade) and privately placed (below investment grade).

Where's the profit in this??

The Rationale of CMBS

- The **arbitrage** between
  - The blended rate of the collateral pool of mortgage loans and
  - The blended rate of the bonds issued against the collateral pool.

Lumpy to granular

- Concept:
  - A pool of loans in the aggregate amount of $2 billion has a <u>blended interest rate of 6.75%.</u>
  - Since a pool of "lumpy" mortgage assets has been converted into <u>rated marketable securities</u> (Value added by Wall Street!), the bonds generated by the pool have a <u>blended interest rate of 5.75%</u>, and . . .
  - The arbitrage is monetized as a separate bond!

Lumpy to granular = profit

- $2 billion of loans at 6.75% = $135mm of annual interest.
- $2 billion of bonds at 5.75% = $115mm of annual interest
- The difference of $20mm of annual interest is sold as an 'Interest Only' (IO) bond

- Price of the IO is the P/V of the steam of cash flow depends on a number of factors
  - If buyer of IO uses a 6% discount rate, the "value" of the IO is $147,000,000.

Monetized arbitrage:

$2,147,200,000	of bonds generated by
2,000,000,000	of mortgage loans.
$ 147,200,000	gross profit

INITIAL PRICINGS

ML-CFC Commercial Mortgage Trust, 2007-6

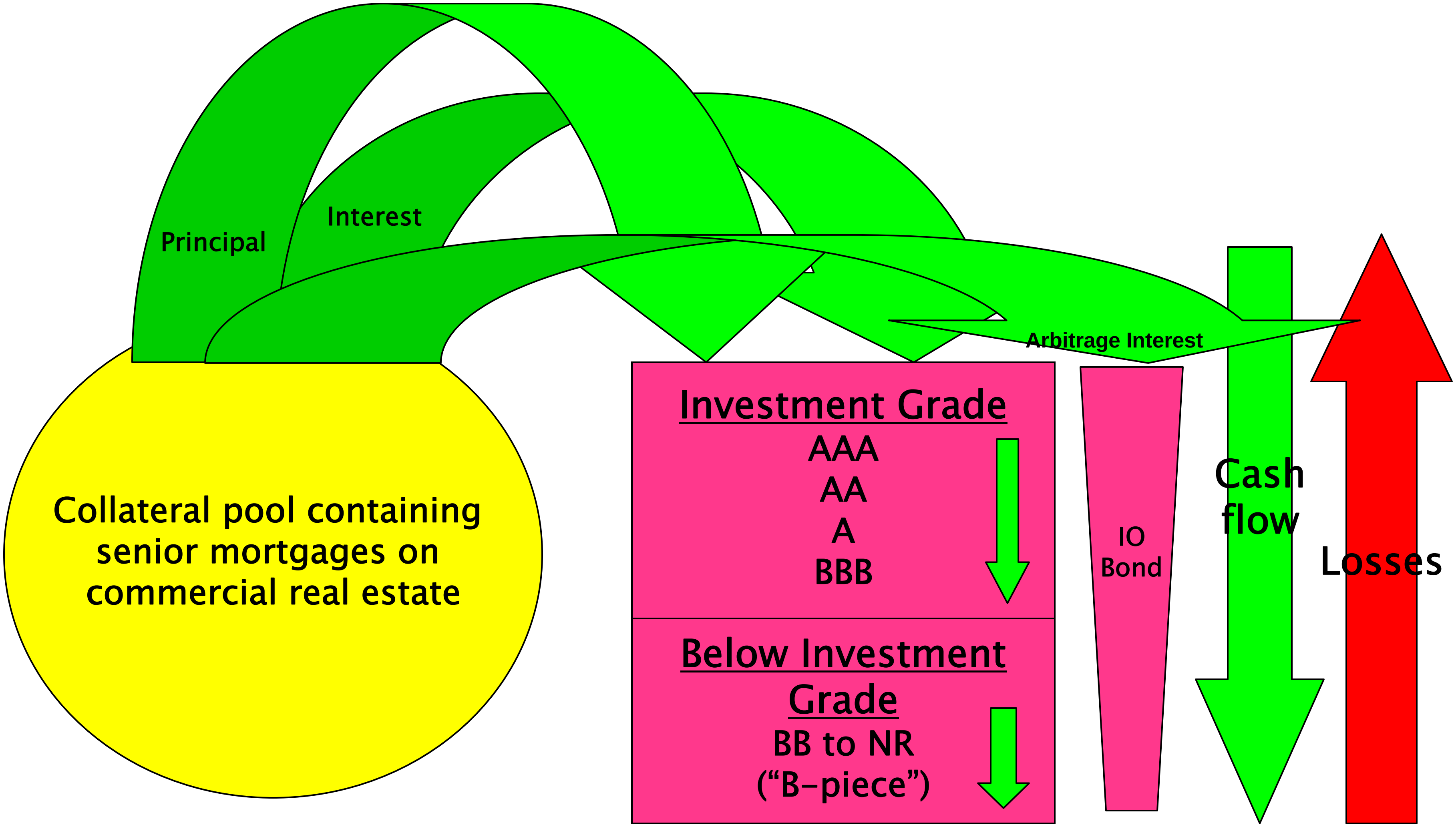
Pricing date:	March 30
Closing date:	April 12
Amount:	$2,145.9 million
Seller/borrowers:	Merrill Lynch, Countrywide
Lead managers:	Merrill Lynch, Countrywide
Co-managers:	Credit Suisse, Morgan Stanley
Master servicers:	Wells Fargo, Wachovia
Special servicers:	LNR Partners, CWCapital Asset Management
Trustee:	LaSalle Bank
Offering type:	SEC-registered

Property types: Retail (48%), multi-family (16.8%), office (16.3%), industrial (6.9%), hotel (6.6%), self-storage (2.6%), mixed-use (2%), manufactured housing (0.7%) and other (0.1%).
Concentrations: Florida (15.3%), California (13.6%) and New York (13.4%).
Loan contributors: Merrill (64%) and Countrywide (36%).
Largest loans: A $223.4 million loan to Morgan Stanley Real Estate Fund 5 and Kitson-Evergreen on eight Florida shopping centers encompassing 1.3 million sf; a $202.3 million portion of a $3 billion loan to Tishman Speyer and BlackRock Realty Advisors on the 11,227-unit Peter Cooper Village and Stuyvesant Town apartment complexes in Manhattan; a $150 million loan to Westfield America on the 1.6 million-sf Westfield Southpark mall in Strongsville, Ohio; the $84.7 million senior portion of a $91.7 million loan to Blackpoint Partners on six Puerto Rico shopping centers encompassing 855,000 sf; a $72 million loan to Beacon Capital Partners on the 280,000-sf International Place office building in Arlington, Va.; a $63.6 million loan to Steuart Investment on 10 industrial properties, encompassing 984,000 sf, in Virginia and Maryland; and a $59.4 million loan to Morgan Stanley Real Estate 5 and Kitson-Evergreen on two Florida shopping centers encompassing 208,000 sf.
B-Piece buyer: American Capital Strategies.
Notes: Merrill and Countrywide securitized large loans and conduit mortgages that they had originated. **CMA code:** 20070027.

Class	Amount ($Mil)	Rating (Moody's)	Rating (Fitch)	Subord. (%)	Coupon (%)	Dollar Price	Yield (%)	Maturity (Date)	Avg. Life (Years)	Spread (bp)	Note Type
A-1	27.682	Aaa	AAA	30.00	5.175	100.249	5.060	3/12/51	2.64	S+10	Fixed
A-1A	364.360	Aaa	AAA	30.00				3/12/51	9.03		Fixed
A-2	170.430	Aaa	AAA	30.00	5.331	100.548	5.221	3/12/51	4.85	S+24	Fixed
A-2FL	150.000	Aaa	AAA	30.00	L+14	100.00		3/12/51	4.85	L+14	Floating
A-3	60.689	Aaa	AAA	30.00	5.420	100.546	5.360	3/12/51	7.26	S+29	Fixed
A-4	728.987	Aaa	AAA	30.00	5.485	100.549	5.452	3/12/51	9.84	S+29	Fixed
A-M	214.593	Aaa	AAA	20.00	5.526	100.545	5.495	3/12/51	9.92	S+33	Fixed
A-J	107.403	Aaa	AAA	11.50	5.556	100.548	5.525	3/12/51	9.92	S+36	Fixed
A-JFL	75.000	Aaa	AAA	11.50	L+27	100.000		3/12/51	9.92	L+27	Floating
B	42.919	Aa2	AA	9.50	5.635	100.549	5.605	3/12/51	9.92	S+44	Fixed
C	16.094	Aa3	AA-	8.75	5.674	100.546	5.645	3/12/51	9.92	S+48	Fixed
D	34.872	A2	A	7.13	5.714	100.547	5.685	3/12/51	9.92	S+52	Fixed
E	18.776	A3	A-	6.25	5.866	100.548	5.785	3/12/51	9.92	S+62	Fixed
F	24.142	Baa1	BBB+	5.13	5.770	97.718	6.217	3/12/51	9.98	S+105	Fixed
G	24.142	Baa2	BBB	4.00	5.770	95.590	6.518	3/12/51	10.00	S+135	Fixed
H	26.824	Baa3	BBB-	2.75	5.770	92.512	6.968	3/12/51	10.00	S+180	Fixed
J	5.365	Ba1	BB+	2.50				3/12/51	10.00		Fixed
K	5.365	Ba2	BB	2.25				3/12/51	10.00		Fixed
L	5.364	Ba3	BB-	2.00				3/12/51	10.00		Fixed
M	5.365	B1	B+	1.75				3/12/51	10.00		Fixed
N	5.365	B2	B	1.50				3/12/51	10.00		Fixed
P	5.365	B3	B-	1.25				3/12/51	10.00		Fixed
Q	26.824	NR	NR	0.00				3/12/51	10.78		Fixed
X(IO)	2,145.926*	Aaa	AAA		0.297	2.412	6.008	3/12/51	8.84	T+140	Fixed

*Notional amount

IO Bond



Sequential-Pay Structure

6. **Pooled loans are then serviced by a <u>Master Servicer</u> who**

- **<u>collects</u> principal and interest and disburses to bondholders**
- **<u>collects</u> escrows for taxes and insurance**
- **<u>collects</u> escrows for capital expenses**
- **<u>collects</u> escrows for re-leasing roll-over space**
- **<u>disburses</u> escrows as needed**
- **<u>collects</u> and analyzes rent rolls, operating statements, budgets, etc.**
- **conducts periodic <u>inspections</u> of property**
- **<u>approves</u> leases where required by loan documents**
- **<u>executes</u> Subordination/Non-Disturbance Agreements (SNDA)**

People who are special

- Upon the default of a pooled loan, the administration of a loan is transferred from Master Servicer to Special Servicer, who acts to maximize the loan recovery on a net present value basis for the benefit of the bondholders.

“B-Piece Buyer”

1. The most junior tranches are referred to, collectively, as the “B-piece”, or the “First Loss” position.
2. The investor buying these junior bonds is the **“B-piece buyer”.**
3. The B-piece buyer is designated in the **Pooling and Servicing Agreement as** the **“Controlling Class”** of the securitization, and as such, <u>**has the right to be, or the right to select**</u>, the pool’s **Special Servicer.**

B-piece

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*Notional amount

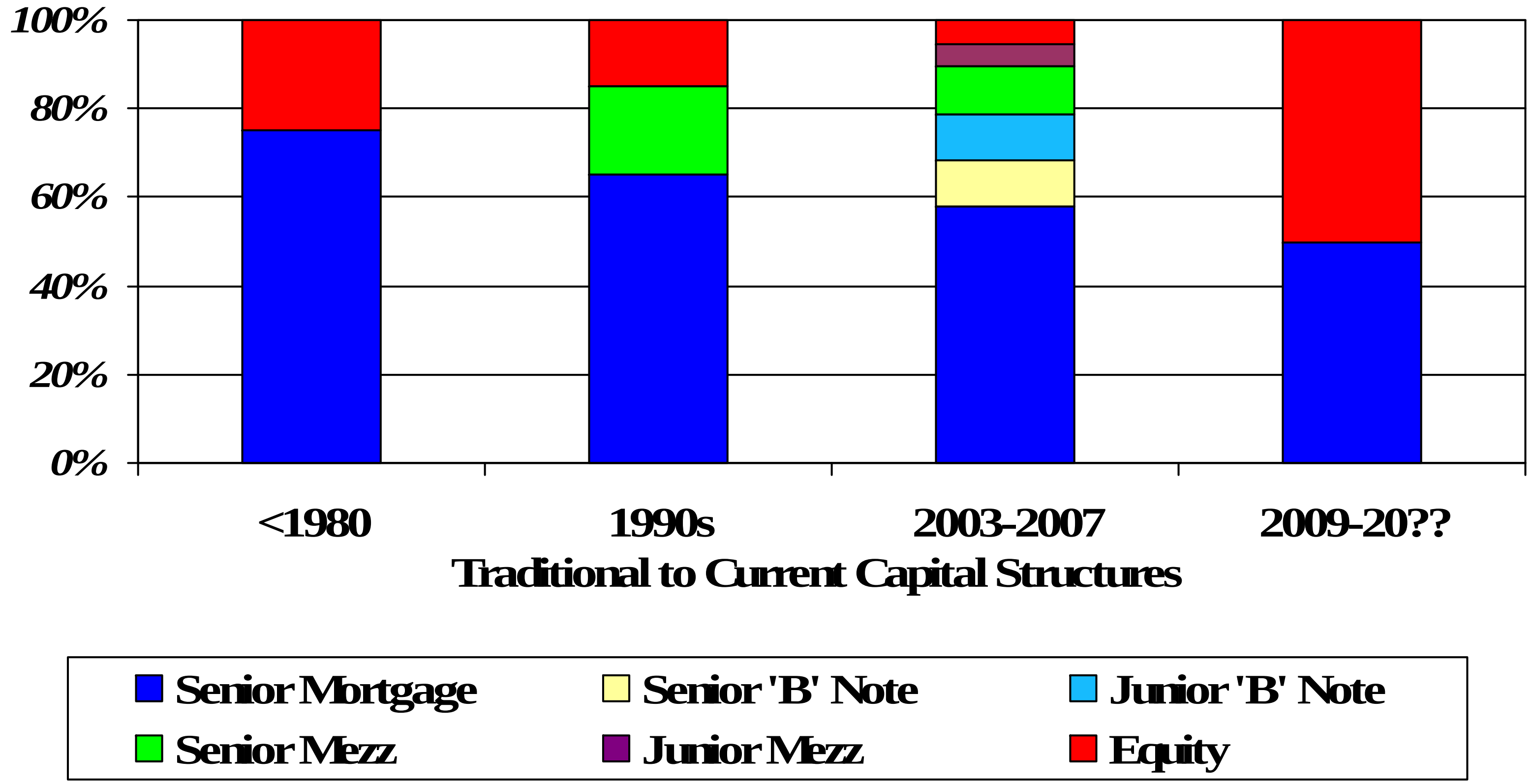
Mezzanine Financing

A Generic Term

Mezzanine Financing

- B-Note: the junior portion of an A/B note structured senior mortgage loan. A-note into the pool; B-Note goes “elsewhere”.
- Mezzanine loan: loan secured by borrower’s equity – not a lien on the property. Mezz lender’s right evidenced in Intercreditor Agreement with senior mortgage lender. Mezz loan can be in at inception of senior loan, or anticipatory.
- Preferred Equity: not a loan; equity return

Evolving Capital Stacks of Property Finance



CMBS Watchlist

Bloomberg, July 2009

- One-fifth of all CMBS loans by balance (12,853 loans with a balance of $158.6 billion), are on master servicer watchlists.
- The chief reason that they failed certain objective financial tests, primarily DSC levels.
- Loans originated in 2006 and 2007 account for an overwhelming share – nearly 65 percent – of the volume on watchlists.

CMBS Loans on Watchlist		
Year	Balance ($mln)	% of Total on Watch
2003	6,731.46	4.24
2004	10,819.24	6.82
2005	20,552.42	12.96
2006	47,736.99	30.09
2007	55,290.66	34.85
2008	122.93	0.08

EXHIBIT 1: CMBS DELINQUENCY

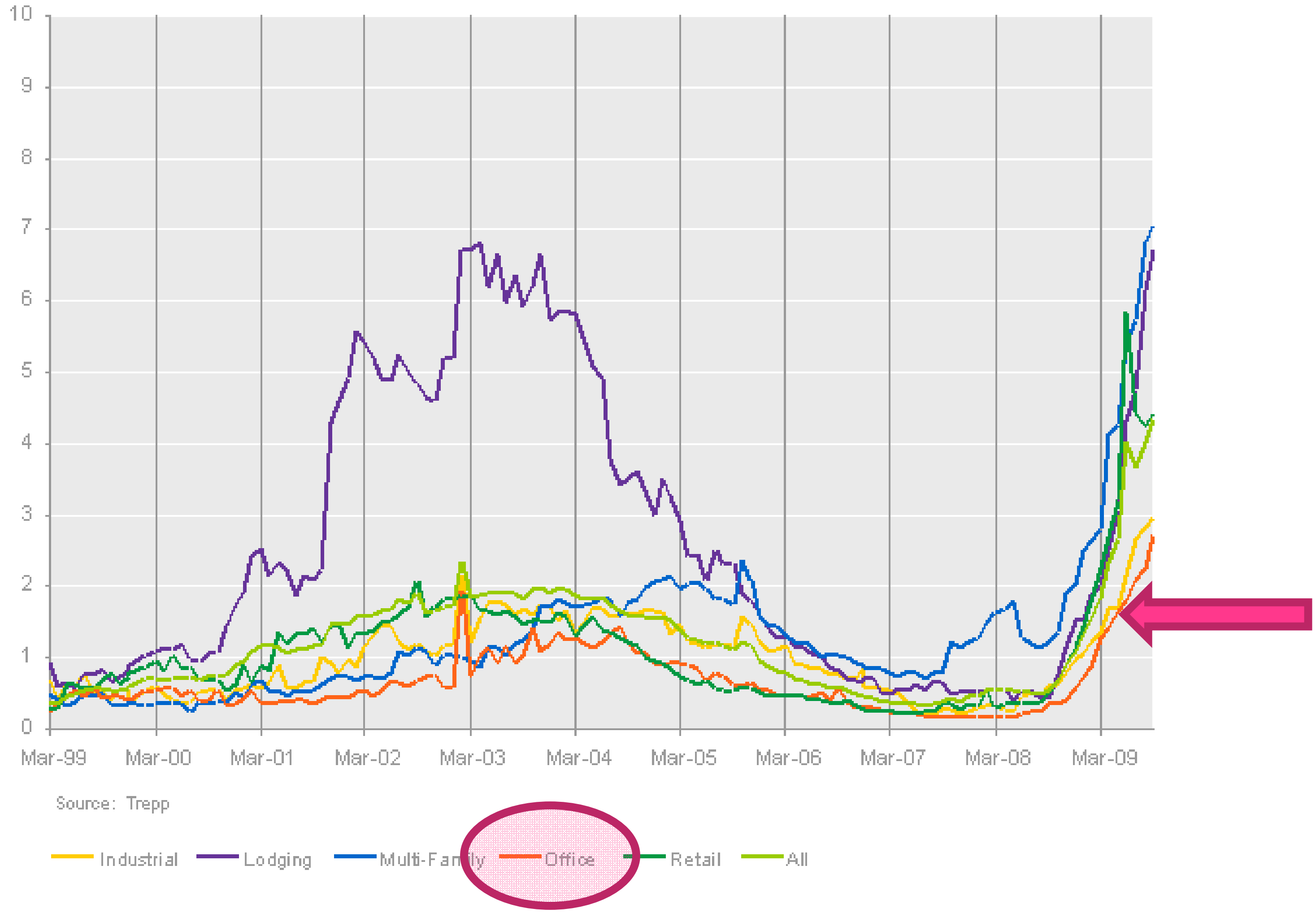
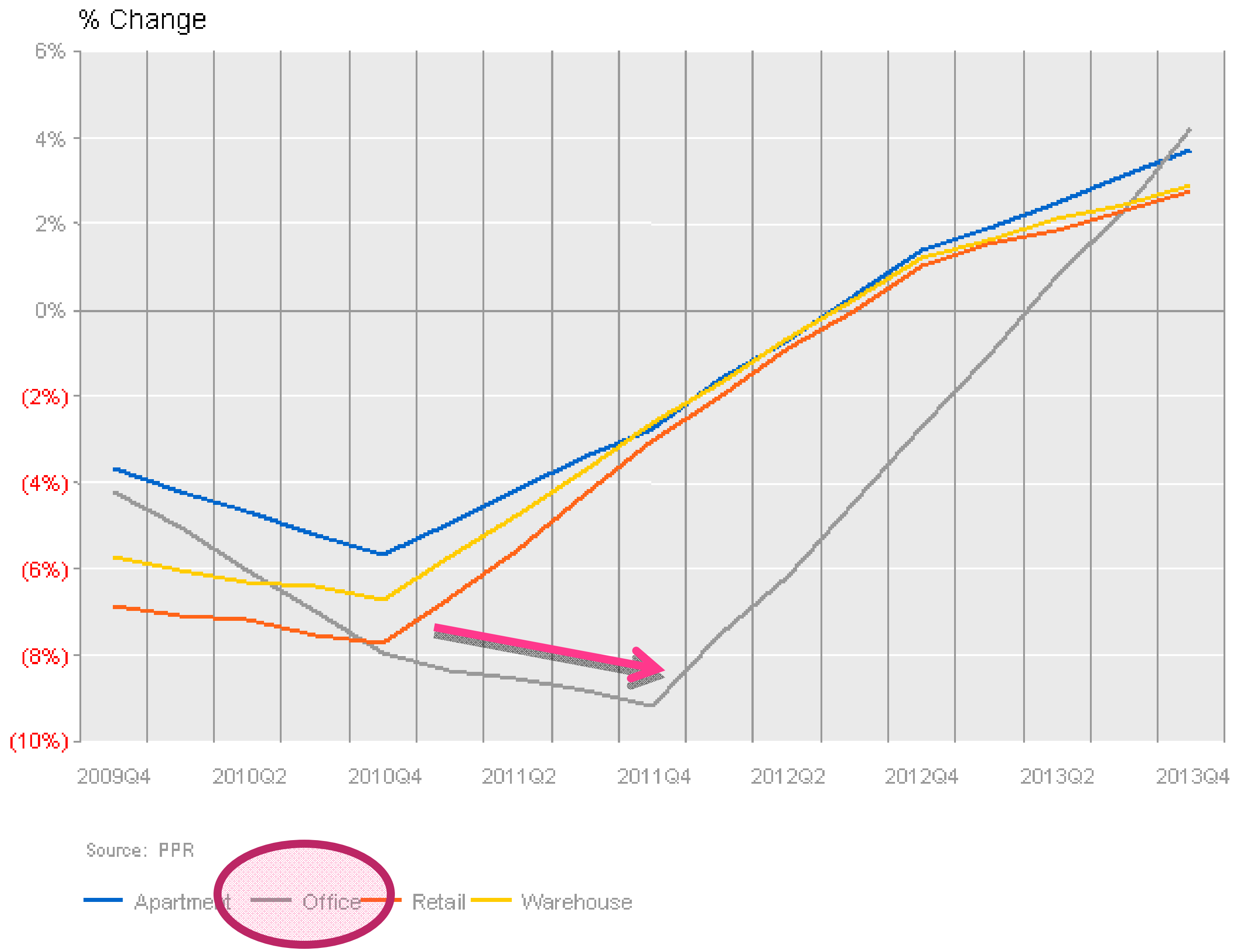


EXHIBIT 2: ANNUAL NOI GROWTH RATE

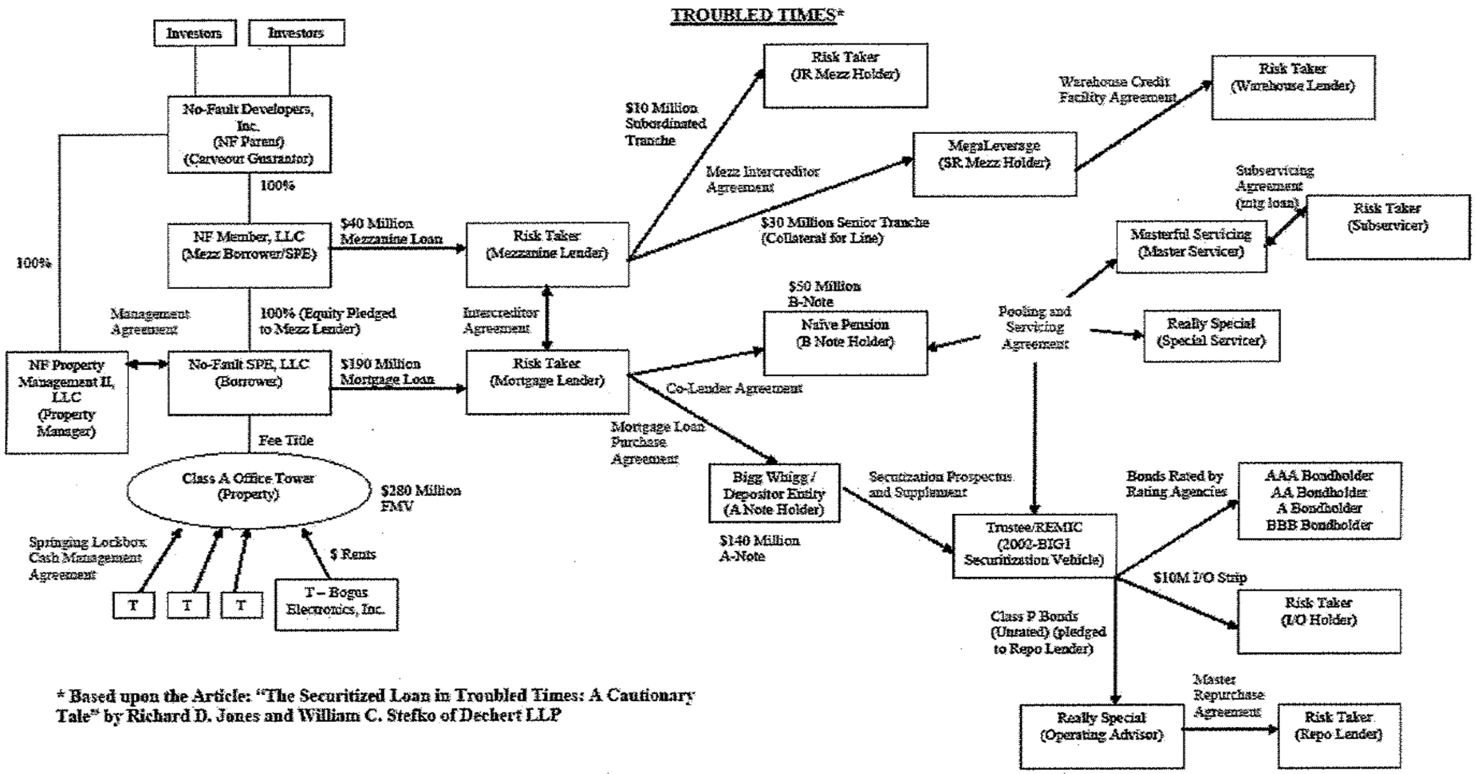


"On a dark and stormy night, the largest single tenant, Bogus Electronics, filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code . . ."

"The Securitized Loan in Troubled Times: A Cautionary Tale"

by Richard D. Jones and William C. Stefko

Illustration of Debt Stack / Parties In Interest



* Based upon the Article: "The Securitized Loan in Troubled Times: A Cautionary Tale" by Richard D. Jones and William C. Stefko of Dechert LLP

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15th Annual Convention
June 8-10, 2009
Waldorf=Astoria, New York City