Securitization of Tenant Improvement Loans

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The financing of tenant improvements in meaningful commercial properties has been an often overlooked, yet potentially pivotal inducement property owners can utilize, to attract or retain new or existing tenants with regard to the commencement or renewal of significant long-term leases. It would appear that this financing approach has been bypassed, largely as a result of the dearth of applicable information within the commercial real estate space, rather than any conscious attempt on the part of property owners to avoid such financing.

The cost of substantial tenant improvements, often exceed by a very material amount, the allowance landlords are willing to offer tenants. Consequently, the tenant is left to fund the balance, which often can result in an undesirable or suboptimal use of capital. Alternatively, the tenant may often be much more favorably positioned to finance their share of tenant improvement costs, over the life of the contemplated lease.

Be it commercial office, distribution center, retail, health care or other substantial rental properties, the financing of tenant improvements can be a decisive factor in enabling a commercial enterprise to fulfill its business plans in connection with a strategic property.

Tenant Improvements Defined

Depending on the application of the property in question, the nature of tenant improvements can vary dramatically, but in all cases, the cost of such improvements involve significant interior modifications and all related hard and soft expenses, such as demolition, debris removal, framing, dry wall, electrical, plumbing, flooring, painting, finishes, furniture, art work, IT hardware, architectural, engineering, legal and accounting services. Moreover, such costs can go beyond basic construction needs, and can include more sophisticated mechanical, electrical and plumbing ("MEP") services employed to incorporate utility cost saving technology, which when compared to additional financing costs, will generate even greater operating cost savings. Examples of relevant tenant improvements can include, but are certainly not limited, to the interior renovation of a corporate headquarters, the retrofit of interior space into a major retail location, the interior build-out related to a sprawling, fashionable urban food court and the conversion of interior space to an in-patient health care facility.

A typical tenant improvement project connected to a meaningful commercial property can cost anywhere between $30-150mm, an amount that can frequently be unappealing to fund with enterprise equity. By contrast, the prospect of amortizing such costs over the life of a long-term lease, can often be more attractive, from both a financial and accounting perspective. Whatever the application, the cost of needed tenant improvements can be a significant barrier to an organization's strategic plans, and the financing of such costs, can provide the solution necessary to execute such plans.

Tenant Improvement Loan Structure

The basic structure associated with a tenant improvement financing is characterized by a 10-20 year, fully amortizing, non-recourse (absent bad-act carve outs) loan to a de novo special purpose entity ("SPE Borrower"), secured by SPE Borrower's claim to unconditional, unencumbered and unabated payment obligations, due and owing from the respective tenant or its guarantor (if applicable). Such loans lack a mortgage on the underlying property, and are effectively an unsecured obligation of the ultimate obligor, passed-through to the lender by the SPE Borrower.

Like any typical unsecured loan, the debt service coverage ratio ("DSCR") with respect to the payment obligations secured, is generally 1.0, and the loan to value ("LTV") is typically 100%. Such loans generally are voluntarily pre-payable, in lieu of a termination subject to yield maintenance or defeasance, and a terminable as a result of other limited events, at a 3 to 10% premium to par, excepting termination due to condemnation or casualty, which is terminable at par. Bad acts are indemnified by a de novo SPE, either capitalized by a net worth of 10% of the outstanding loan amount or guaranteed by up to no less than 10% of the outstanding loan amount, by a credit worthy guarantor.

Given the structure described above, the creditworthiness of the respective tenant or its guarantor ("Obligor"), is paramount to the perceived credit quality of any such loan. Therefore, the rate ascribed to such a loan is largely a function of spread attributable to the Obligor, above the prevailing applicable risk free rate. Typically, this translates into some reasonable illiquidity premium above the credit spread corresponding to similar tenure, unsecured debt for the respective Obligor.

Securitization of Tenant Improvement Loans

Tenant improvement loans by their very nature are quite conducive to securitization, and in fact, have been securitized to date on about half a dozen or more occasions. Thus far, such securitizations have been limited to single loan, private placement, Certificates of Participation ("COP"), although the prospect of 144A offerings is certainly realistic, given larger single or multiple pooled loans.

Given the longer tenure associated with tenant improvement loans, long-term institutional investors, especially life insurance companies, have an natural appetite for tenant improvement loan backed securities ("TIBS"), particularly those in which the underlying Obligor is investment grade rated, resulting in a NAIC designation of 1 or 2. For those TIBS in which the underlying Obligor is speculative grade rated or unrated, other long-term institutional investors apart from life insurers, would more likely be a better fit, particularly those investors not subject to regulatory capital reserve requirements.

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Whether investment grade or not, a TIBS will ultimately be priced at some reasonable spread above the prevailing level at which unsecured debt of the underlying Obligor trades, which fairly compensates the investor for the relative illiquidity of the TIBS when compared to the underlying Obligor's unsecured debt. Clearly, the extent liquidity characterizing the underlying Obligor's unsecured debt will impact the illiquidity spread concession.

Notwithstanding the underlying Obligor's credit rating, or lack thereof, to the extent the underlying Obligor is a substantial organization with a perceived rating of B-/B3 or better, the chances of a favorable TIBS execution relative to alternative sources of debt available to the underlying Obligor, is quite high. Moreover, the TIBS structure exploits all the benefits of institutional investor liquidity, while avoiding characterization of the transaction as debt to the underlying Obligor. Consequently, TIBS execution can harness all the advantages of the underlying Obligor's credit attributes, without inflating the underlying obligor's balance sheet. Therefore, TIBS can have profoundly positive impact on the underlying Obligor's financial metrics such as return on equity and return on assets.

The benefits of TIBS, however, are certainly not limited to the underlying Obligor. The illiquidity concession available to TIBS investors, is undoubtedly a driving factor motivating such investors to acquire TIBS, and provides such investors a means by which to invest in certain credits at levels not possible elsewhere, with no material trade-off of any kind with regard to risk.

Potential Origination Volume

In light of the vastness of the commercial real estate leasing space, the potential market for TIBS is substantial. To date, the market potential has been constrained largely by lack of access of tenants and landlords to information regarding the benefits of tenant improvement loans. Arguably, most tenants and landlords are unaware that tenant improvement loans are actually available to assist them with managing the challenges of funding their much needed tenant improvements.

However, as access to information about tenant improvement loans continues to filter through to tenants and landlords alike, and as business developers increasingly make it their business to proliferate this nascent asset class, the incidence with which such opportunities materialize will undoubtedly grow. Current TIBS volume is estimated annually at $100-200mm. With increasing education among relevant stakeholders nearly certain, this asset class is surely poised for significant growth in years to come.

Scott Sidell, Ph.D. is the C.E.O. of Compo Cove Capital, LLC, who with its strategic partner Lance Capital, are leading participants in syndicating tenant improvement financing transactions.