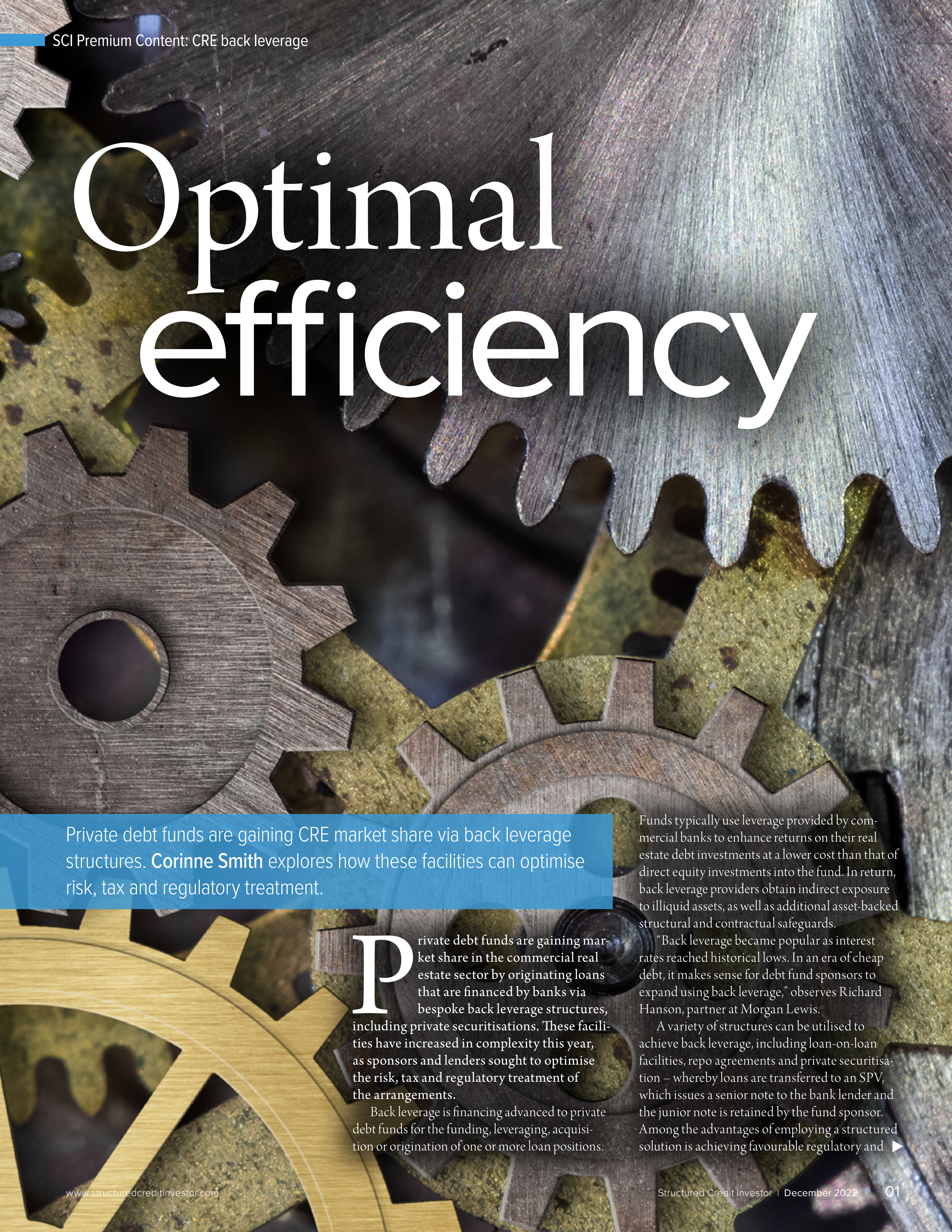
Optimal efficiency



Private debt funds are gaining CRE market share via back leverage structures. **Corinne Smith** explores how these facilities can optimise risk, tax and regulatory treatment.

Private debt funds are gaining market share in the commercial real estate sector by originating loans that are financed by banks via bespoke back leverage structures, including private securitisations. These facilities have increased in complexity this year, as sponsors and lenders sought to optimise the risk, tax and regulatory treatment of the arrangements.

Back leverage is financing advanced to private debt funds for the funding, leveraging, acquisition or origination of one or more loan positions. Funds typically use leverage provided by commercial banks to enhance returns on their real estate debt investments at a lower cost than that of direct equity investments into the fund. In return, back leverage providers obtain indirect exposure to illiquid assets, as well as additional asset-backed structural and contractual safeguards.

"Back leverage became popular as interest rates reached historical lows. In an era of cheap debt, it makes sense for debt fund sponsors to expand using back leverage," observes Richard Hanson, partner at Morgan Lewis.

A variety of structures can be utilised to achieve back leverage, including loan-on-loan facilities, repo agreements and private securitisation – whereby loans are transferred to an SPV, which issues a senior note to the bank lender and the junior note is retained by the fund sponsor. Among the advantages of employing a structured solution is achieving favourable regulatory and ▶

Richard Hanson, Morgan Lewis

tax treatment, which allows banks to hold less capital against the position.

"The structural driver is finding a balance between the right regulatory treatment for the bank lender and the right tax and accounting treatment for the fund sponsor, with the overall objective for the fund sponsor being to create cheaper funding and diversify funding sources. We're seeing more structures being combined to achieve those aims," Hanson explains.

Nick Shiren, partner at Cadwalader, notes that loan-on-loan financings are typically used to finance smaller sized transitional assets. Drawing on repo technology, a traditional facility treats each asset as being referable to a separate loan, but it is also possible to structure the facility more akin to a typical borrowing base facility.

In the US, loan-on-loan facilities are documented under a master repurchase agreement. From a business and financial standpoint, these work in the same way as financing and entail the same reps and warranties, covenants, event of default clauses and remedies.

Aaron Benjamin, partner at Cadwalader, notes that a repo structure benefits from a statutory exemption from automatic stay that US courts would impose on most key contracts of a bankrupt sponsor or borrower under the US bankruptcy code. This exemption allows lenders to liquidate collateral, notwithstanding the imposition of the automatic stay that would otherwise apply.

He adds that there are three other credit pillars that support this structure: daily mark-to-market rights; a partial recourse guaranty by the sponsor, with some 'bad act' full recourse and loss recourse carve-outs; and a repurchase obligation by the sponsor of defaulted loans or breaches of loan-level R&Ws. The 'bad act' carve-outs under the partial recourse guaranty include collusion in bankruptcy, fraud, breach of environmental R&Ws and intentional misrepresentation.

The structures are commonly performing loan facilities, but they aren't exclusively. For facilities that allow non-performing loans as collateral, a lender would require some control or consent rights over the contemplated workout plan, among other conditions.

Nick Shiren, Cadwalader

Shiren views the product as part of the relationship lending offering between an investment bank and debt fund sponsor. "Loan-on-loan financings are one of the funding tools used by sponsors, which may look to the CRE CLO or CMBS market as well, as part of their funding strategy. Essentially, the bank buys into the business strategy of the sponsor," he explains.

> "RISK RETENTION TENDS NOT TO BE AN ISSUE BECAUSE IT'S USUALLY POSSIBLE TO FIND AN 'ORIGINATOR' WITHIN THE SPONSOR GROUP"

He continues: "The debt fund originates assets and asks the bank whether it can put them on the line; the lender can agree or decline to fund the asset. If it agrees, the bank typically takes a strong interest in the sponsor and its ability to adhere to its business plan."

The approval process for onboarding assets is usually collaborative and there are different methods of mitigating risk, including pricing, assuming a greater percentage of recourse and margin calls. "For example, if the NOI or NCF declines such that the repo buyer (lender) determines that the market value of the property securing the mortgage loan has declined, then the lender can issue a margin call to rebalance its advance rate against the new market value of the property (and hence the loan). Additionally, it's possible to solve for unusual asset risk by providing for increased recourse for specific assets," explains Benjamin.

He continues: "The structure is a flexible way for REITs and other funds to obtain leverage at asset-backed financing rates. Part of the business

Aaron Benjamin, Cadwalader

plans for real estate funds has been to use these facilities in order to obtain levered returns."

In terms of tax treatment, vehicles are often domiciled in Ireland, which is attractive for both banks and sponsors – especially US sponsors – if their aim is to achieve tax-neutrality. Shiren is aware of cross-border and multicurrency facilities (in sterling and euro) being structured, encompassing continental Europe, Ireland and the UK.

"This brings additional complexity and requires understanding the lending and regulatory regimes across different jurisdictions. For instance, it is necessary to undertake due diligence on the different banking monopoly rules to ensure that an SPV can actually lend in a given jurisdiction," he says.

Whether a transaction will technically be a securitisation within the regulatory framework is often discussed early on in negotiations and is typically led by the bank, which wants to achieve the associated regulatory capital benefits. Shiren confirms that most banks would take the view that the As such, it is necessary to address the associated risk retention and transparency requirements. "Risk retention tends not to be an issue because it's usually possible to find an 'originator' within the sponsor group and, since the advance rate of the facility is less than 95%, the sponsor will have to provide some equity to the vehicle. This is structured as a first loss piece and is usually sufficient to satisfy retention requirements," he notes.

However, Hanson warns that smaller funds need to be careful in such a scenario. "Securitisation can be beneficial from a pricing perspective, but they also need to be cognisant of their obligations under the securitisation regulation," he notes.

Equally, smaller funds are more exposed to potential margin calls in repo arrangements by the bank. Hanson says that standard features that are always negotiated are mark-to-market terms and decisions regarding control over enforcement and material modifications.

"CRE CLOs can be expensive to structure and it can be prohibitive for smaller debt funds to access warehouse lines to ramp portfolios. On the other hand, CRE CLOs tend to offer more competitive advance rates compared to repo and are attractive to fund managers because they allow more discretion over the assets," Hanson remarks.

Shiren says he is seeing continued interest in CRE CLOs in Europe and believes it is only a "matter of time" before a market emerges on this side of the Atlantic. He adds that many loan-on-loan mandates have CRE CLO take-outs contemplated in the documentation.

Benjamin confirms: "We're seeing certain sponsors warehousing assets that satisfy CRE CLO rating requirements, for example, and sometimes they securitise those assets and other times they maintain their leverage through the repo facilities."

"BANKS HAVE BECOME MORE FOCUSED ON DUE DILIGENCE AND CONTROL RECENTLY, IN ORDER TO MITIGATE DOWNSIDE RISK"

"Banks have become more focused on due diligence and control recently, in order to mitigate downside risk. While certain parameters can be set, ultimately a bank has absolute discretion as to whether to finance an asset," he adds.

Back leverage transactions either provide matched funding or have historically been termed out into the securitisation market. Hanson expects such activity to return, once the public market begins to stabilise following this year's challenging conditions. This may be facilitated by the emergence of a CRE CLO market in Europe, although he points out that many hurdles need to be overcome for this to occur.

Looking ahead, Hanson anticipates that the real estate finance market will be characterised by the need to address loan refinancings, ICRs being breached and LTVs potentially being breached – which will result in banks seeking to delever and funds looking to take market share. "Back leverage is a solution. Although back leverage providers are currently charging higher interest rates, if it is undertaken in a structured way, funds will still be able to enhance their returns," he concludes.

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