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Memorandum

Key Issues For Sponsors in Capital Markets Financing of Commercial Real Estate

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Introduction

For sponsors looking to finance or re-finance commercial real estate assets in the COVID-19 world, financing term sheets are likely to come back from banks looking less friendly—both in terms of economics and the covenant package. Sponsors may therefore look to explore alternatives to bank finance, and one alternative is raising finance in the capital markets directly, so that your bond issuer is your day one lender. Whether you call it an agency CMBS (and as discussed below—this is somewhat of a misnomer) or a secured corporate bond really depends on your investor base and your leverage, but in each case it provides the opportunity of bypassing the lending desks and credit committees of banks. We have considered below the possible benefits and some of the issues—legal and logistical—that sponsors would likely need to consider if going down this route.

Better Economics

The obvious economic rationale for doing this is the better all in pricing that, for certain assets, has been achievable in the capital markets even over the last few years. Banks have managed to distribute a number of their commercial real estate loans into the capital markets via CMBS without having to invoke flex provisions, showing that capital markets pricing has been superior for certain commercial real estate assets. Where the financing is agented, the sponsor will get the direct benefit of this superior pricing. Furthermore, the usual loan arrangement fee will be replaced by a significantly smaller bond arrangement fee that the bank will charge for structuring and placing the notes, the reduced fee reflecting that the bank is not underwriting the loan and does not take any market risk on its distribution.

Where notes are tranched, there may be scope to reduce the all in financing cost even further during the life of the deal by including a voluntary prepayment mechanic that would de-lever the structure reverse sequentially, from the bottom up. As it would redeem the highest-margin notes first, this would reduce the overall weighted average margin of the notes—and hence the all in financing cost in a way that is not available for a single tranche loan. Some sponsors have also been able to incorporate caps on the margin to mitigate the effects of any sequential redemption of the bonds (likely resulting in available funds caps being imposed on the junior classes of notes which are typical protections in underwritten CMBS transactions where the loan margin is fixed on day one).

Greater Source of Capital

The capital markets also provides a route to alternative sources of capital beyond simply the traditional European CMBS investor base (although recent lack of supply may mean pent-up demand among CMBS investors for the right paper). For example, at a fixed rate and lower leverage, the capital markets also affords access to secured corporate investors of the type who subscribed for two successful agented real estate financings from last year—Westfield Stratford City and Logicor. For either type of transaction the investor pool may be deepened still further by offering notes to QIBs in the United States under Rule 144a (although there are additional legal and logistical considerations to bear in mind with going down the Rule 144a route).

No Negotiation With Banks

Another advantage of the agented capital markets route for sponsors is that, where the capital is coming directly from bond market investors, there is (or should be) no negotiation with bank lending desks on particular policy points or bête-noires. Loan negotiation points should be limited to points that are likely to affect the marketability of the notes or raise particular concerns with the rating agencies. Subject to that, sponsors should be freer to test the market with their own, more advantageous, financing terms.

More Control Over CMBS Terms

Another issue that has put some sponsors off their loans going into CMBS (whether agented or principal) is its effect on their ongoing ability to manage their loan, in that loan-level consent decisions are no longer made by the lending bank but by a professional loan servicer appointed by the SPV issuer. The advantage sponsors have with an agented transaction (as compared with a bank-led underwritten CMBS) is more control over the terms of the note-level documentation that govern these decision-making processes—typically the servicing agreement and the note trust deed. This is because the sponsors and their counsel will be directly negotiating these documents and as a result sponsors can look to make these CMBS provisions work better in terms of getting lender decisions more quickly and not getting stuck in the black hole of the securitisation decision-making mechanics. This may include a category of minor consent requests that are contractually hard-wired as discretion matters for the servicer that it would have to allow if certain conditions were met, and generally giving the servicer more leeway to make loan-level decisions, thereby minimising the possibility that decisions are held up at noteholder level.

In this respect, looking at what does and doesn't constitute a basic terms modification under the notes will be key—with sponsors likely to want to restrict these to note level matters as far as possible. On CMBS deals, this has been a key area of focus for recent waiver requests resulting from COVID-related disruptions with the underlying commercial real estate assets: it is really in no one's interests that a temporary interest waiver sought at loan level can't be passed because it accidentally falls within the basic terms modification definition and needs 75 per cent of noteholders to approve it.

Execution Efficiency

Nor are these transactions as tricky to execute from a legal perspective as people might think. The reputational baggage of any securitisation is inherent complexity and execution cost, reams of documentation and legal process which undermines execution efficiency. In fact, the well-kept secret of executing CMBS 2.0 transactions is that the issuer-level transaction documentation, while extensive, is relatively commoditised, and has become largely settled with counterparties who tend to appear on each deal on largely accepted terms. SPV issuers can be incorporated within days and cost relatively little to run. The process of listing the bonds on more user-friendly exchanges such as the Global Exchange Market of the Irish Stock Exchange is generally straightforward. Execution timelines for rated and publicly-listed capital markets transactions are never likely compete with straight bank lending deals, but absent any novel elements to the structure the hold-up is rarely down to any inherent difficulty in getting the deal executed from a legal and logistical point of view.

Less Certainty of Execution

That being said, for sponsors used to locking down financing terms and/or securing committed financing from relationship lenders well in advance of their deadline, there is undoubtedly increased uncertainty in accessing the capital markets. That advantage over the straight bank deal will be less pronounced if bank lenders start looking to re-trade terms in the post-COVID-19 market, but it remains the case that you cannot lock down economic terms with bond market investors in advance of funding, nor can there be any sort of commitment on a capital markets trade until the bonds price and the subscription agreement is signed—by which time you are a long way down the road on the deal. This lack of market certainty can be mitigated partially by soft-soundings conducted in advance of launch, regular updates from an underwriting bank's syndicate and pricing guidelines set by underwriters, but not entirely.

The transaction timeline is also somewhat hostage to the timings of third party processes over which transaction parties have limited control, mainly the rating process. To launch a transaction publicly needs preliminary ratings assigned, which can't happen until rating agencies have finished their analysis and modelling of the collateral and their review of the legal documentation, which in turn can't happen until that has been produced in near final form, which in turn takes a fair amount of time from kick off. So with the best will in the world there is likely to be a period of several weeks between kick off and the sponsor knowing what the precise economic terms of its financing will be.

Disclosure, Marketing and Securities Law Liability

The sponsor will also need to participate in the marketing process, not only in the investor meetings organised as part of the roadshow, but also assisting the arranging banks in the preparation of the marketing materials. This will go beyond the level of involvement in, say, a typical syndication or an underwritten CMBS, where the sponsor's obligations are largely ones of cooperation, with the bank driving the process. The legal position of the sponsor would be a little bit different as well. For agented capital markets trades, as the direct beneficiary of the capital markets financing the sponsor is likely to need to give representations and related indemnities on the accuracy and completeness of relevant parts of the disclosure in the subscription agreement. This in effect imposes securities law liability on the sponsor and clearly goes a step beyond the usual position on an underwritten bank financing or underwritten CMBS, where the sponsor is simply liable under contract to the lender for the representations it gives on the accuracy of the written information it provides.

On disclosure generally, the other issue that sponsors may have with these sorts of financings is how to balance their disclosure obligations with their desire to keep certain commercial information confidential from their competitors. Clearly there is a potential clash in circumstances where the sensitive commercial information is also material information in the context of the offering. In fact this is rarely an issue given that CMBS transactions are typically not listed on a regulated market, meaning that although the Market Abuse Regulation would typically apply, along with the listing rules of the relevant exchange, the more stringent disclosure and transparency requirements that come with a main market listing wouldn't. Although the stock exchange requirements would typically require incorporation by reference of the valuation, this can usually be done in a way that avoids sensitive commercial information being made widely available whilst still being compliant with MAR.

Securitisation Regulation and Risk Retention

The Securitisation Regulation is arguably the biggest issue facing sponsors looking to source tranched real estate finance from the capital markets. It imposes risk retention, due diligence and transparency requirements on any transaction that falls within the definition of a securitisation. It is far from clear that a typical agency CMBS structure does qualify as a securitisation, even if the notes are issued in contractually subordinated tranches. In fact there are strong legal arguments for concluding that it does not. These include the following:

- For a transaction to constitute a securitisation there needs to be credit risk associated with an exposure or pool of exposures which is tranched. This doesn't really fit the pattern of an agented transaction where the loan is simply a pass-through of the economics of the bonds, since the only exposure is that created by the issuance itself. A securitisation creates tranched debt out of an existing exposure, where as in agency CMBS transactions it works the other way round. There is no 'originate to distribute' in agented CMBS deals, the problem that the risk retention rules were designed to solve.
- For a transaction to be a securitisation requires the tranching to determine the distribution of losses during the life of the transaction. However, losses under any loan originated through an agency CMBS will only be realised upon a default at maturity, and they will be realised at the same time for all classes of notes, irrespective of the tranching.
- There is conceptually no difference between the exposure created through the agency CMBS and a comparable exposure created through a bank-funded real estate finance loan (the nature of the instrument being irrelevant for the securitisation analysis because both loan and bond financings can be securitisations) and, whether through the specialised lending exemption or otherwise, no one seriously contends that real estate finance creates a securitisation.

- There is no obvious retaining entity, with the only usual viable solution being to argue that the sponsor itself can somehow fall within the definition of originator, and therefore retain its own debt. Legally this is a contrivance at best, and economically it is a nonsense that almost in of itself illustrates why these rules should not apply to agency CMBS transactions.

Investors Still Requiring Risk Retention

It is for these reasons that attaching the name CMBS to these transactions is unhelpful because they are arguably not securitisations at all. Nevertheless, there has been no clarity from the European Supervisory Authorities on this point and in the absence of any specific guidance the effect of Article 5 of the Securitisation Regulation (and arguably the legacy of the previous regime under the CRR where the requirements were purely imposed on investors) is such that, if a particular investor or its regulator takes a different view, the transaction will need to satisfy risk retention and transparency requirements in order for that investor to be able to invest in it. One can understand the investor position: whether it is an agented or principal deal, from an investor's perspective it is the same paper, and some investors are doubtless set up to require risk retention for any transaction that calls itself a CMBS as a matter of policy. The result is that, despite the good legal arguments to the contrary, most agency CMBS deals are risk retaining for EU purposes as if they were securitisations.

Issues For Sponsors

The problem for sponsors is that encapsulated in the last bullet point above. The impact of having to risk retain results in a sponsor entity having to fund the retention piece, and whether this is done vertically or horizontally it reduces the all-in leverage that the sponsor is able to obtain for its commercial real estate. This is particularly the case if the sponsor is also looking to put mezzanine debt into the financing because the mezzanine debt will be subordinated to the risk retention piece that the sponsor is required to hold, and in effect the LTV attachment point for the mezzanine debt will be 5 per cent wider as a result of the retention obligation: this is likely to reduce the marketability of the mezzanine debt.

Possible solutions include retaining the agented economics of the transaction, but asking a relationship bank to front the loan and retain the 5 per cent as original lender (one of the permitted retaining entities under the Securitisation Regulation). However, leaving aside the inherent artificiality of this structure, this will also typically require the bank to go through its normal origination process (which it is legally obliged to do under Article 9 of the Securitisation Regulation in any case so as to be comfortable that the loan is being granted in accordance with its usual origination standards). Of course, some of the benefits of the purely agented structure described in this article will inevitably fall away under these circumstances. We are continuing to explore other ways of mitigating the effect of this with our sponsor clients. Clearly, the best solution would be for the market to follow legal and economic good sense, and get comfortable that these structures are not subject to the Securitisation Regulation requirements.

Conclusion

We expect that the agented financing will remain a viable source of debt financing for sponsor clients looking to exploit opportunities (both in the commercial real estate sector and elsewhere). Hopefully this article is a helpful summary of both the benefits that it can provide and an early warning of some of the issues that we continue to work through with our clients.

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