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Will Strong Sponsors Give Back the Keys?

Recently, a few well-capitalized borrowers threw in the towel on some assets and handed back the keys. Does this make them a bad borrower? Not necessarily. DBRS defines a strong sponsor as one that is financially capable of doing that which is economically advisable and structured in a way that does not preclude or diminish the likelihood of capital contributions in the event of economic stress. Although financial capability does not suggest that a borrower will cover debt service payment shortfalls unless there is significant equity to protect, nor will they cover refinancing shortfalls in an over-levered asset, DBRS generally recognizes strong sponsors are less likely to default due to a short-term cash flow shortfall and less likely to exacerbate the losses in the event that their equity has eroded.

Non-recourse commercial mortgages inherently include a put option; albeit, this option has potential tax consequences. Regardless of their financial capability, every non-recourse borrower has a fiduciary responsibility to maximize the cash flow and long-term economic value of their investments. When incremental cash flow is positive, it is reasonable to assume that a borrower will make incremental debt service payments regardless of whether the mortgage loan exceeds the economic value of the underlying asset. The resulting consistent payment history is not indicative of the borrower's resolve to cover refinancing shortfalls in the event the outstanding balance exceeds economic value at balloon. When incremental cash flow is negative, but the underlying value of the asset exceeds the outstanding balance on the debt, it may be economically advisable to cover cash flow shortfalls in an effort to preserve an equity position.

While DBRS does not advocate opportunistic disregard for financial obligations, we recognize that a fiduciary responsibility to minimize losses supersedes the financial obligations of a non-recourse loan. In defining a strong sponsor, we would be remiss to assume that a strong sponsor, or any borrower for that matter, will continue to throw good money after bad to feed or recapitalize an over-leveraged asset. There are some benefits to the trust of a borrower recognizing impairment early and giving back the keys. First, it saves the trust some money by eliminating the expenses of a long drawn out foreclosure process. When a borrower "gives back the keys" the special servicer conducts a deed in lieu of foreclosure. Once the deed to the property is obtained by the trust, the special servicer may sell the asset, which leads to the second benefit of early detection and cooperation given an impaired asset. A forthright borrower who recognizes the long-term impairment of an asset may give back the keys earlier than a borrower looking to squeeze every last dime out of the property. This allows the special servicer to get involved much earlier in the process and potentially mitigates losses by allowing the special servicer to recognize a higher net present value when disposing of the asset.

In previous CMBS newsletter articles, DBRS discussed the refinance risk in CMBS pools today, given that the historically low interest rate environment may be less favourable at maturity. This brings us back to the second part of our definition of a strong sponsor from above. Many borrowers today have refinanced away their original equity interest in a property. Amortization would help to recreate equity that may have been refinanced away, keep the borrower's skin in the game, and lessen the chance of a put. However, with the proliferation of interest-only loans, any equity to be gained through amortization is also lost. Thus, the borrower has no equity to protect at refinance, and if the asset is not readily able to support the debt on the property at maturity, DBRS expects a lot more keys to be handed back.

Well-capitalized or not, borrowers will do what is economically advisable for them or their shareholders, including giving back the keys. In a non-recourse lending environment, it is incumbent on the lenders to size loans appropriately, applying structures that amortize principal balances sufficiently to facilitate refinancing in a less favourable economic environment. It is insufficient analysis to rely solely upon a strong borrower to cover the shortfalls resulting from overly aggressive lending practices.

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