

# *PPIP and TALF: Impact on Commercial Real Estate*

## Research

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### Government Acts to Aid Banks, Unfreeze Credit Markets

The performance of the commercial real estate market has been severely impacted by the banking crisis. The widening of borrowing costs and general lack of available financing, coming after years of cheap and readily available debt, has been a big factor in the recent drop in property values and dearth of transactions. As a result, the government has unveiled two programs – the Public-Private Investment Program (PPIP) and Term Asset-Backed Securities Loan Facility (TALF) -- as part of a broader plan to nurse banks back to health. The basic goal of the programs is to unfreeze the credit markets, which are paralyzed in part due to bad loans and mark-to-market losses on the balance sheets of banks.

TALF provides financing for the buyers of bonds, including CMBS. The plan is to reduce the cost of capital for securitized lenders, enabling them to once again write loans.

The PPIP encompasses the purchase of a variety of assets, including commercial mortgages and triple-A rated CMBS. It aims to entice private investors to buy assets at values above where they are marked on banks' balance sheets through the use of low-cost, non-recourse government financing. As part of the PPIP, the government has committed up to \$100 billion of funds to co-invest with private investors in the purchase of up to \$1 trillion of loans and securities. The government will provide 50% of the equity to the buyers of the "legacy loans" and "legacy securities" that will be auctioned by banks. A key component of the PPIP is the low-cost government-guaranteed financing. The Federal Deposit Insurance Corporation (FDIC) will guarantee up to 85% of the financing of legacy loans. The Treasury will finance between 50% and 100% of the equity for the purchase of legacy securities.

Our purpose here is to discuss the potential impact of the programs on the commercial real estate market, including potential investment opportunities and whether they may help revive the CMBS market. Our initial analysis indicates that TALF may help jump-start a limited amount of new lending, while PPIP may produce attractive returns for investors that buy whole loans and CMBS, provided of course that performance of the underlying loans is stable.

However, it is important to note that the mechanics of the program largely are still being sorted out by the government and industry players, so any final conclusions are not possible at this point.

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What's more, one potentially large impediment is the amended mark-to-market standards adopted in early April by the Financial Accounting Standards Board (FASB) that gives financial institutions more flexibility in marking assets. That flexibility may alleviate some of the pressure to sell loans and securities, potentially undermining the objectives of the PPIP.

## Plan to Auction Assets of Financial Institutions

The legacy loans and securities programs would allow financial institutions to identify assets that would be put up for auction. Bids would come from qualified asset managers that form Public-Private Investment Funds (PPIFs) with the government, which encompasses a 50/50 split of equity, plus an additional amount of non-recourse three- to five-year financing. Fixed-rate debt is expected to be priced at swaps plus 100 bps, with floating-rate debt to be priced at 1-month Libor plus 100 bps. The cheap debt is a critical piece of the program, since the disappearance of the securities' lending market in wake of the demise of the major investment banks played a major role in the freeze in the fixed-income market.

### Public-Private Investment Program

- \$75-100 billion from TARP funds
- Assets include commercial mortgages and CMBS
- Up to \$1 trillion of purchasing power

### Legacy Loans

- 50/50 equity split between government and private capital
- FDIC-guaranteed debt up to 85% of purchase price

### Legacy Securities

- 50/50 equity split between government and private capital
- Potential Treasury financing between 50% and 100% of purchase price

## Legacy Loans

The criteria for eligibility to participate in the PPIP remains unclear, but it is likely that the potential universe is centered on relatively large loans that were written for securitization but could not be sold when the CMBS market dried up in late 2007. In particular, banks still hold upwards of \$100 billion of loans that financed M&A activity in late 2006 and 2007. Banks likely will not start lending again until these types of assets are off their books.

*But will banks sell those loans?* The answer could depend on where they are marked. If the bids come in below where they are currently marked, banks would be forced to write down the loans upon sale, which they may want to avoid. It is not known whether the banks can decline to follow through on a sale if the bids do not meet expectations. Banks want to sell loans that have been marked down because of the rise in spreads and the lack of liquidity, at prices above current marks. As a result, banks that have been more

aggressive in marking down loans to date – particularly those that have acquired large commercial-mortgage positions via corporate takeovers – are more likely to sell assets via PPIP.

Many unanswered questions remain, such as mechanics of the financing. The FDIC said it will guarantee the debt “issued by the PPIFs” representing up to 85% of the purchase price, which seems to put the onus on sellers to finance the pools. How much financing will be provided will depend on the FDIC’s determination of the credit quality of the assets. It’s not clear who will service the loans, an important point, particularly if loans need to be restructured. It’s also not known whether banks will be able to auction mezzanine debt. Some 2007-vintage large loans have multiple layers of mezzanine debt in which senior tranches are performing while the junior tranches are underwater.

If it works, the legacy loan program could free up balance sheet space that would represent one step toward resumed lending by commercial banks. It is likely that there will be demand for at least the senior portion of legacy loans on high-quality assets. Investors that buy discounted loans with the inexpensive government financing could potentially get relatively high returns, if the loans perform up to expectations. However, until the program is fleshed out, it is unclear whether there is enough incentive to prompt banks to sell enough volume to achieve significant balance sheet relief.

### **Legacy Securities**

The legacy securities program would enable PPIFs to bid for CMBS, with the Treasury providing one or two layers of financing that could total up to 100% of the equity amount. Junior debt would come with warrants whose terms have not been specified. The March 26 announcement of the outline of the program had an immediate positive impact on AAA CMBS spreads. Although spreads have since retreated somewhat, and volatility remains high, the price of generic senior AAA bonds rose from about 58 cents to 66 cents on the dollar by April 10.

As with the legacy loan program, banks will be incentivized to participate if they can sell assets at prices higher than current marks. That price may vary for different banks, depending on how they have marked their inventory and how eager the bank is to pare product from its balance sheet. Still, for auctions to be successful, CMBS spreads likely have to rally significantly. Otherwise, banks might opt to hold securities rather than sell them at a discount. Some market analysts are predicting that as a result of the PPIP spreads of the most-senior AAA classes will fall as low as swaps plus 400-600 bps. That remains a far cry from the spreads of swaps plus 25 bps at the market peak, but it is a big improvement from recent months, when spreads have ranged between swaps plus 1000-1200 bps.

With senior AAA CMBS currently trading at prices that yield a 12% to 13% unleveraged return, investors could potentially achieve mid-teens returns or higher using the government financing (Exhibit 2). Buying the most-senior classes of CMBS at current prices, with financing pegged to Libor plus 100 bps, could produce returns of anywhere between 13.1% and nearly 50%, depending on leverage and provided prices do not drop. While there are many variables to bond yields, the basic point is that potential returns look high enough to attract bidders if product comes up for bid.

**Exhibit 2: Programs Terms and Conditions\***

Security Characteristics	
Tranche	Duper (30% subord.)
Average Coupon	6%
Expected Life	7 yrs
Price (par=100) at Purchase and Sale	70
7 year Treasury Rate	2.25%
Implied Spread to Treasury	1084
TALF Terms	
Loan Term	3 yrs
Loan Rate =	2.75%
3 Yr LIBOR Swap Rate	1.75%
+ Loan Spread over 3-yr LIBOR (bps)	100

\*Ignores 5% loan fee. Strategy implies sale upon TALF loan maturation.

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**Implied Investor IRR**

TALF Financing	IRR
None	13.1%
75.0%	28.7%
80.0%	35.9%
85.0%	48.5%

The risks to owning CMBS include loss of principal, downgrades and a drop in mark-to-market value. Most CMBS trusts have three AAA-rated levels of seniority: a “duper” class with a 30% subordination level, a “super-senior” class with 20% subordination and a “junior” class, typically with subordination of 10-13%. If one assumes a loss severity (which is the amount of actual loss realized on loans that go into default) of the historical average of about 40%, the duper bondholders will not lose principal until default rates (currently about 2% but rising) hit 75%. Loan defaults would have to reach 50% to impact super-seniors and 25-33% to impact junior AAAs. Some analysts foresee default rates eventually rising to levels that could impact the junior bonds, but few, if any, predict default rates high enough to impact the two most-senior classes. Similarly, the probability of downgrades is more likely at the junior-AAA level. Still, investors need to scrutinize individual deals that are auctioned to determine the probability of defaults.

The use of the program depends on a host of unresolved issues. One problem for investors is financing. The vast majority of outstanding CMBS consists of long-term, fixed-rate bonds. The proposed three- to five-year Treasury financing presents a mismatch that could discourage some investors from participating. In the CMBS market’s previous largest price corrections, in 1998 and 2001, some investors had to surrender CMBS holdings to lenders that provided short-term credit lines. The desire for effective match funding played a big role in the development of the now-defunct collateralized debt obligation market.

Treasury’s financing policy, however, could change before the PPIP is enacted. Industry trade associations, including the Commercial Mortgage Securities Association, are pressing government officials to tailor the plan to suit the needs of the industry. Given the government’s desire to get markets started again, and ongoing retooling of the program, their chances of success seem reasonable.

Another issue is whether the government will limit bids to the PPIFs, which will involve a select handful of large asset managers. Some investors may decide not to participate because they do not want to form to partnerships with other asset managers, which could create control issues.

## TALF 2.0

The TALF program provides for inexpensive government financing of purchases of newly issued securities, under the theory that it will raise prices and lower the cost of capital for securitization programs, thus enabling them to better compete for new loans. At current market prices, CMBS programs would have to charge borrowers about 20% for senior loans, which obviously is untenable. Securitization programs have written virtually no new loans since mid-2007 and no CMBS has been issued since June 2008.

### **Term Asset-Backed Securities Loan Facility**

- Newly issued AAA-rated securities (possibly CMBS) eligible
- Government finance up to 95% of cost
- Financing pegged to Libor plus 100 bps
- Goal to unfreeze securitization markets

Many key details of the program have yet to be announced, including whether CMBS is an approved asset class. Market players generally assume CMBS will participate, but so far it has not been explicitly announced. Other unknowns include the amount of leverage that will be provided and cost of the debt. Industry participants in talks with the government have said that it will take 90-95% financing at a spread of Libor plus 100 bps and term of at least five years to induce investors to buy new bonds.

*Will TALF be enough to jump-start CMBS origination?* If the government agrees to the industry's financing requests, securitization could make a limited comeback, although there would be many hurdles to overcome before the industry becomes viable again. Financing triple-A CMBS – which represents roughly 85-88% of the trust – at Libor plus 100 bps will reduce securitization programs' cost of capital significantly.

One possibility is for lenders to originate loans for securitization via a program in which they sell or finance the senior (triple-A) slice via TALF and retain the entire subordinate portion. This strategy could work for specialty lenders with a servicing arm, but not for large banks, which generally avoid owning lower-rated bonds because of capital charges. A second possible strategy involves securitizing a diverse pool of low-leverage, high-quality loans to produce a pool in which almost all of the resulting securities would carry a triple-A rating eligible for TALF financing, producing a lower blended cost to the lender.

However, there are still many problems that need to be solved. To get back in business, securitization programs need to reduce all-in costs to about 400-500 bps over Treasuries, which would enable them to write profitable loans with coupons in the 7.5% to 8% range. That is difficult as long as the spreads of classes subordinate to triple-A remain inordinately expensive. For example, as of April 3, double-A CMBS was priced to yield swaps plus 4521 and triple-B-minus was priced to yield swaps plus 8521 bps. Even if senior triple-A spreads fell to 400-600 bps as a result of the PPIP, whether that would be enough to enable securitization programs to compete with portfolio lenders and commercial banks would depend on the price of subordinate debt and the overall proportion of that tranche (or tranches).

Subordinate CMBS will remain expensive as long as there are few investors willing to buy the so-called “B-pieces.” Demand for subordinate CMBS is likely to be extremely weak until real estate fundamentals are seen improving and defaults less likely.

Another issue that must be resolved before the CMBS market restarts is the willingness of banks to warehouse loans. CMBS lenders are exposed to balance sheet risk between the time when loans are closed and when they are packaged and sold as bonds. For years, banks hedged this exposure. But when the fixed-income and derivatives markets collapsed in 2008, the value of banks’ warehoused loans and the value of their hedges dropped simultaneously. Before banks lend again, they will want to devise a less-risky method to finance the loans they aggregate. One way around this would be the return of so-called “agent” securitizations, in which the loan is funded at securitization with the coupon determined by bond spreads. Such deals were abandoned in recent years because borrowers did not want to bear the pricing risk. Borrowers no longer have the upper hand, and some might choose such deals for lack of a better choice.

## **Summary**

It bears repeating that the government’s program is in its early stages. Important details – such as what assets qualify, how the pools will be identified, how the auction process will work, the mark-to-market implications and who will service the assets – remain unresolved. Also unknown is whether investors can opt to participate without the government debt or equity, or if participants will be subject to mandates such as executive compensation caps. Other details may still change before the program is implemented, making it difficult to determine the overall impact of the program.

Moreover, much needs to happen before the commercial real estate is healthy again. Chiefly, the tide of job losses and reduced consumer confidence are components of the deterioration of the space market fundamentals, which are an increasingly worrisome impediment to recovery. The problems in the banking sector go well beyond the commercial real estate sector, and banks have a great deal of work to do before they are ready to resume normal lending, something that is crucial to the well-being of commercial real estate.

That said, it appears that the PPIP already has helped to lower triple-A CMBS spreads. The auction process could entice investors back into the market, bringing sorely needed liquidity. The TALF program raises the possibility of new lending where none existed. As we have seen in recent years, the health of the debt markets plays a big role of the overall condition of commercial real estate. So while it is unlikely to be a panacea, the government’s efforts at the very least could be a step in the right direction for the commercial real estate markets.



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