Next Wave Of Doom

‘A Tsunami Is Coming’

Commercial Defaults, Nasty Workouts On Hub’s Horizon

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Want a preview of the next nightmare to ravage the commercial real estate markets? Look no further than the John Hancock Tower. Three investors are battling for control of the Back Bay office tower after the building’s owner, Broadway Partners, recently defaulted on a $700 million mezzanine note.

These skirmishes will soon become commonplace. The Hancock is just an early, if high profile, victim of a coming wave of commercial defaults and nasty, Byzantine workouts that will wrack the commercial markets in the coming months and years.

“A tsunami is coming,” warned George Fantini, chairman of Fantini & Gorga. “There will be a tremendous spike in defaults. This train hasn’t arrived at the station yet.”

Across the country, a glut of cheap, highly leveraged securitized debt is maturing during a period of scarce capital and plummeting real estate values. Tranched mezzanine debt presents similar hurdles. Borrowers will be hard-pressed to refinance much of that debt. And when they fail, complex battles for asset control will break out amongst competing tranches of lenders and note holders.

“The numbers are so big with the Hancock that it grabs your attention,” said Beth Mitchell, co-chair of commercial finance at Nutter McClennan & Fish. But, Mitchell added, “There will be plenty of situations like this, just with fewer zeros involved. There’s going to be a lot of turmoil in the markets.”

Conduit loans financed upwards of 40 percent of commercial lending between 2005 and 2007. The bulk of these notes, sold on three- to five-year terms, will begin coming due later this year, and the torrent won’t relent until after 2012. In 2009 alone, the market is facing down $50 billion in CMBS maturities and $250 billion in commercial mortgage maturities, according to data from Advantus Capital Management.

Broadway Partners, like Harry Macklowe before them, have failed before the rest of their peers because they were especially aggressive in financing their mega-deals with short-term notes, assuming they’d be able to refinance later. That doesn’t mean that they’ve failed where others have succeeded. Their colleagues just haven’t hit the grave yet.

“With declining values, more expensive debt, less plentiful debt, it’s hard to see how all these loans will successfully refinance without some unforeseen force of capital,” Mitchell said.

Many see a frightening link between the subprime residential market and the purchases that commercial conduit loans financed.

“Conduits filled the breach for a lot of B buildings in B or C markets in many cases,” said John McCullough, a senior vice president at HSBC Bank’s Boston office. Lax underwriting and generous terms, like high loan-to-value ratios, low debt coverage ratios and interest-only periods, “pushed leverage to levels it should not have reached.”

Tightening underwriting, higher equity requirements, expensive capital and declining values may conspire to bring the full weight of that leverage crashing down. An owner of an office building bought with a $100-million loan, for example, will face the chore of rolling over $100 million in debt on a building that may only be worth $70 million now. The borrower will have to find cash to plug that gap, dilute asset ownership by taking on a partner, or default.

“If borrowers don’t find a way to refinance and restructure, potentially, you’re looking at a huge glut of commercial real estate heading toward foreclosure or liquidation,” said Kevin Lyons, a senior partner at Riemer & Braunstein.

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“In CMBS pools of $1 billion or so, people were focused on the top 10 of a 100 loans,” said Peter Goedecke of Goedecke & Co. “Clearly, some will go bad.”

And when they do, the tug-of-war scene on display at the Hancock will play out in law offices across the country. The documents governing the loan bonds spell out which tranches of lenders will be in the money, which will be in control of the asset, and which will be wiped out altogether. The problem is these documents have never been deployed before.

“Our worst fears are starting to be realized,” said Mitchell. “Many lenders had never experienced defaults or distressed markets to think through how they’d play out. There was so much pressure on getting money out the door that the ramifications of how they’d deal with each other in a default didn’t seem as important.”

“In some of the large conduit deals, you may only have a part of an asset, and below that a piece, two or three other players – it’s going to be hell to work out,” McCullough said. “Sometimes you won’t even know who the various owners of the other tranches are, or will become when one party decides to sell its position.”

“Baseline assumptions, like who’s the controlling note holder, will be questioned,” Lyons said. “Until you actually have to live through a document getting tested, you don’t know where the pitfalls will come out. There will definitely be provisions that get tested to see how they play out with conflicts, differing positions on value. How will a bankruptcy judge interpret these sections? It’s a great unknown.”

In Broadway’s case, John Buck, Normandy Real Estate Partners, Five Mile Capital Partners, BlackRock, RBS Greenwich Capital, and State Street are vying for control of the $700 million mezzanine loan. It’s unclear which other assets the mezzanine loan was tied to, and how much, if any, value they currently hold. There’s also conflict over the portfolio’s current value – a figure that will determine which firms remain in the money, which firm will control the workout or foreclosure process, and which ones have had their positions wiped out. The Hancock is almost certainly worth much less than the $1.3 billion Broadway paid for it two years ago. But the pivotal question – how much less? – may have to wait on a judge.

“The Hancock is the poster child for the whole process of the last 10 years,” Goedecke said.

But the Hancock combatants are just wrangling over a $700 million loan. “There are billions in capital structured like that,” Lyons said. The typical CMBS bond was tranched 15 times.

“Nobody knows, from an organizational approach, how it will play out,” Lyons said. He does know that things will get ugly.

As defaults multiply, Lyons said, there will be conflicts in which lenders with senior positions in the first loan and low in the mezzanine vote against the interests of their senior tranche to save their mezzanine position. Banks will be pitted against REITS. Investors will be tempted to buy slices of their competitors’ loans in the hopes of stealing their portfolios on the cheap. Goedecke can imagine a situation in which the junior note holder, acting as the asset’s special servicer, is far out of the money and is dragging out action, not to recover value, but to maximize their own fees.

In office buildings, while these battles rage, tenants will blow in the wind. Some of the deals closed at the height of the bubble went through without escrow funds for tenant improvements, and conduits are unable to pump money into these properties, because they can’t increase the value of their loans. Leasing at the Hancock is said to have ground to a standstill because tenant improvement capital is controlled by the junior note holder, and at the moment, that note holder’s identity is up for debate.