

Extension headaches

Structured Credit Investor

31 January, 2011

Extensions expected, NEDs feared in Euro CMBS

Extension risk is set to be a defining theme for European CMBS in 2011, with concern that the market may see its first note event of default (NED) also emerging. More loans are scheduled to mature this year than last and many are expected to struggle to refinance.

The probability of extensions means that senior noteholders can expect longer WALs and greater exposure to eventual losses as a result. However, Nassar Hussain, managing partner at Brookland Partners, notes that extensions are not necessarily a problem.

"With the upcoming wall of loan maturities, there will be numerous loan extensions and the potential for a few bond extensions this year," he explains. "Extensions can be positive depending on the circumstances of the particular transaction, provided they are structured correctly and appropriate incentives are built in. Of course, they can also be negative, where effectively free options are being given and creditors lose control of their destiny."

He continues: "The continuing lack of banking finance available for many assets – particularly secondary assets and large portfolios – means in many cases there is no alternative to extension, otherwise you risk crystallising a far larger loss now than you might in a few years."

But Stewart Hotston, director at Hatfield Philips International, reckons that financing is more readily available than many realise. He says: "People coming into the beginning of this year were very worried about a wall of refinancing coming towards us, but the picture we are seeing is people going and getting refinanced. There are deals to be done out there and there is more money out there than people might think."

Hotston has been surprised by the amount of refinancing that was done in the final quarter of 2010 and so far in 2011. Although it is still early days, he believes this to be a very encouraging sign – but he does also expect to see a lot of loan extensions this year.

Hussain predicts that some senior bondholders will continue to attempt to block extensions, however. He says this is particularly true of the more recent opportunistic investors who bought in the secondary market, but it is also increasingly true of more traditional CMBS noteholders.

"There are likely to be one or two surprises this year, where well collateralised loans at low leverage default as a result of extensions being declined by noteholders. The history of the borrower/sponsors and sometimes the approach of their financial advisers also has an impact on the way noteholders and servicers respond to extension requests," notes Hussain.

He continues: "Interesting transactions to watch this year which may involve extension requests include Fleet Street 1, secured against a UK hotel portfolio, and Uni-Invest, secured against a large Dutch mixed use portfolio."

Clearly, not all loans are suitable for extension. Hotston notes that Hatfield Philips is very clear on what it will accept for extensions and what it will not.

"We have set out quite a strict policy for what we will consider for extension. We want there to be a credible plan for how a borrower will use an extension to turn the situation around and get the loan repaid, either by selling the portfolio or by getting refinanced," says Hotston.

He adds: "Our message to borrowers is to not come back to us in a year or two years needing another extension, because you will not get the one you're asking for now on that basis. If we have even a sniff of that, then we will not give an extension now."

Multi-borrower deals with staggered loan maturity dates may be most likely to see extensions, as their average tail period is often much longer than single-borrower deals, where the tail may be only a couple of years. Hussain says: "You get anomalies in the market. Where loans are secured on poor secondary assets, which may not be well let and you are at or near the bottom of the real estate cycle, then enforcing and selling now would not maximise recoveries (especially if value breaks in the senior notes), so creditors are more minded to extend those and work with the borrower or an alternative asset manager to enhance the underlying value."

There are other situations where the loan is well collateralised against strong prime assets and the loan has performed well, but the borrower is unable to refinance or needs additional time to refinance at maturity. In these instances, unless the borrower offers significant economics in the form of upfront fees, margins (cashpay and sometimes PIK) and a pay-down, creditors may block an extension.

"A number of these transactions have been targeted by opportunistic investors over the years, who have acquired bonds at a discount with the sole purpose of causing an enforcement to take place in order that they can recover par far quicker," Hussain adds.

The risk of a NED nonetheless remains fairly remote, albeit it seems to be increasing. Although deals have come close to NEDs before, Hotston notes that generally situations are resolved before they get to that point.

He says: "If we do start seeing NEDs, then I think it will be limited to a very few. There is a large amount of will to avoid seeing NEDs, partly because a lot of the deals out there are multi-borrower with lots of assets and the complexity of working those deals out is a very daunting task. I think borrowers and noteholders are very keen to avoid a situation which might force a disorderly wind-down of a note structure."

Hotston adds: "Even in a couple of particularly acrimonious examples we have seen, such as Four Seasons, they have managed to avoid getting to the point of no return. So far, somebody has always been willing to blink. Over the next couple of years, we will not see a tidal wave of NEDs, but a few seem inevitable."

The number should remain limited, as NEDs are still hard to crystallise. A NED typically requires either an issuer insolvency or a non-payment of the most senior class of notes. Hussain points out that the former is hard to establish with the limited recourse language transactions have at issuer level. While some have pushed to have note trustees declare an issuer insolvent on a pure balance sheet basis, he says these attempts have not been very successful.

As for non-payment of the most senior notes, Hussain says this too is unlikely. He explains: "With multi-borrower transactions generally or single-borrower transactions secured against portfolios of properties, it is difficult to get to a stage where interest on the most senior class of notes is not paid. If the occupational market for secondary assets continues to decline or you have a single large tenant insolvency, a NED is more likely – especially where the fixed rate under any hedging is high or where an appraisal reduction mechanism switches off the impact of the liquidity facility."

Another factor which might lead to NEDs is that, for some noteholders, it could be in their interest to see one transpire. Hotston points out that while there are advantages to such an event occurring, ultimately it is negative for all involved.

He says: "Some senior noteholders might look to benefit from a NED. If I am sat at the top of the structure and know I am money-good, then I could force that and know I will get my money back. But while that sounds fine on paper, it could take years to turn everything round and there may be a lot of pain while the restructuring goes on."

It is imperative for the good of the market, Hotston believes, that NEDs are avoided. He concludes: "It is important to avoid NEDs. If – even with all the hassle and stress we have had in the market – people still get out of these positions in relatively good order, then it lends credence to the idea that CMBS is an instrument people can invest in. If we start seeing NEDs – even on a limited scale – then that could change."

[This article was published in Structured Credit Investor on 31 Jan 2011.](#)