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VIEWPOINT

The Importance of Sponsor Quality

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Determining the quality of a CMBS (borrower) sponsor can be time intensive and the resulting opinion subjective, however, sponsor analysis is fundamental to assessing CMBS credit risk.[1] The background, business plan, and capitalization of a sponsor should support the successful operation of a property during the loan term and help ensure mortgage repayment at maturity. Sponsor quality is particularly important in affiliate sale-leaseback transactions, where the CMBS sponsor and property tenant are related, since this structure can be used by weaker companies to opportunistically secure financing at a higher-risk to lenders (debt investors).

Sponsor Quality - Investment and Capitalization

One trend remains consistent across the continuum of sponsor quality: limited property investment signals an asset is non-core in an operator's portfolio. While core properties receive routine investment, such as strategic upgrades to enhance value through higher rents and higher quality tenancy, non-core properties are often neglected, deemed irrelevant in a long-term portfolio and/or business plan. Under-investment often results in net operating income (NOI) erosion due to higher vacancy and lower rents, causing value deterioration (anathema to debt investors). A severe lack of investment may signal adverse selection, with the owner purposefully reducing exposure to the asset through a combination of de minimis outlay and strategic mortgage borrowing, especially cash-out refinancing.

The use of leverage varies across sponsors. However, better sponsors are often disciplined, employing prudent leverage to ensure they retain their financed properties through favorable and adverse market conditions. Weaker sponsors characteristically have less capital and subsequently employ greater amounts of leverage on their owned real estate. Since greater leverage results in higher funding

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costs, there is typically limited excess cash flow available for reinvestment into highly leveraged properties. Under-capitalized sponsors using significant amounts of leverage tend to default quickly when property performance is disrupted, especially if they have limited (or no) equity remaining in an asset.

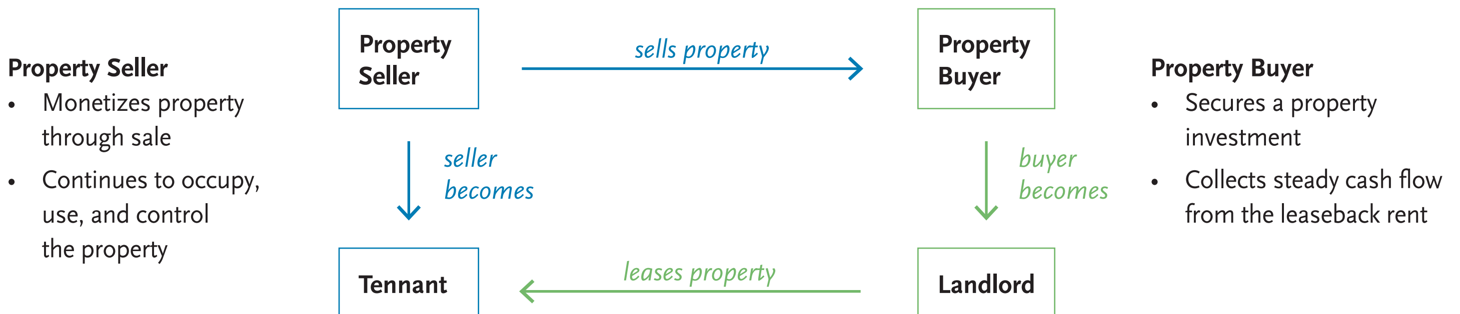
Weaker sponsors are of particular concern to CMBS investors when they use affiliate sale-leaseback structures to secure financing, since the affiliation of the landlord and the tenant facilitates above-market rents and inflated property valuations, which can be used to secure opportunistic financing.

Sale-Leaseback Transactions – Financing Alternative:

Sale-leaseback transactions consist of a seller that agrees to lease a property back from a purchaser, with the term and rent established at time of sale. In these transactions, the seller becomes the lessee (tenant) and the purchaser becomes the lessor (landlord). (Exhibit 1)

Traditionally, sale-leasebacks were limited to investment grade or near investment grade companies because the purchaser (landlord) required a reliable income stream from the seller (tenant). However, sale-leasebacks are now routinely used by companies with owned real estate across the credit spectrum. For stronger companies, sale-leasebacks provide a tool to separate business operations from property-management for enhanced operational efficiency and/or to finance growth (by monetizing real estate value). For weaker companies, sale-leasebacks offer an alternative financing solution when other sources of debt and/or equity are either unavailable or prohibitively expensive.

Exhibit 1: Sale-Leaseback Transaction - In a sale-leaseback transaction, the property seller becomes the lessee (tenant) and the property purchaser becomes the lessor (landlord).

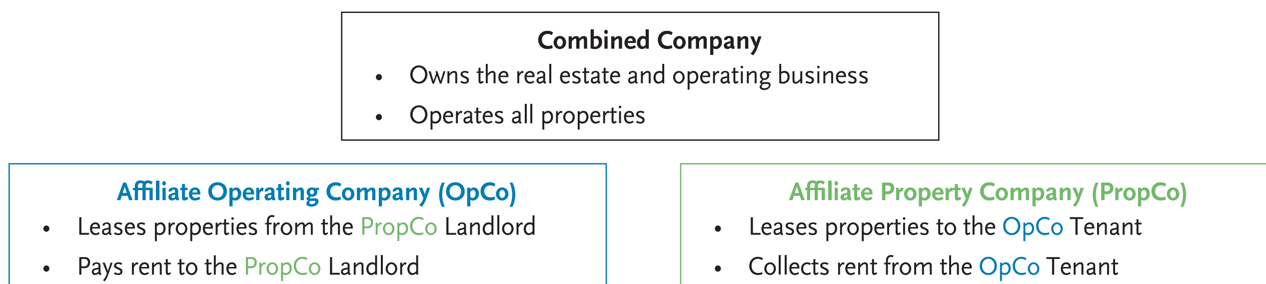


Affiliate Sale-Leaseback Transactions – Exacerbated Sponsor Risk:

The sale-leaseback structure does not require an unrelated third-party purchaser; affiliates can represent both the purchaser-landlord and the seller-tenant. (Exhibit 2) In these affiliate sale-leasebacks, stronger companies with high quality real estate benefit from retaining price appreciation upside (otherwise conveyed to an unrelated third-party upon sale), while weaker companies benefit from circumventing the credit-quality hurdle required by third-party purchasers.

Although the transaction structure is the same, for weaker sponsors, the affiliation of the seller-tenant and purchaser-landlord transforms the motivations from making a sound investment to borrowing a maximum amount. Rather than fair market value, an affiliate purchaser is incentivized to pay the highest price possible for a property to exploit acquisition financing. Likewise, rather than fair market value, an affiliate tenant is incentivized to pay whatever rent is required to afford the debt service on the affiliate purchaser's financing. At closing, the sponsor monetizes the inflated appraisal (by collecting mortgage proceeds) and transfers the (de)valuation risk to the lender (debt investors).

Exhibit 2: Affiliate Sale-Leaseback - Companies can borrow against owned real estate by creating an operating company (OpCo) lessee (tenant) and a property company (PropCo) lessor (landlord).



CMBS Vulnerability to Affiliate Sale-Leaseback Transactions

CMBS lenders use credit guidelines to enforce a minimum standard of quality for originations, including maximum loan-to-value (LTV) ratios, typically 75-80%, and minimum debt service coverage ratios (DSCRs), typically 1.20x-1.25x and calculated as the property's income divided by the mortgage expense. These guidelines work to improve loan quality by requiring that originators reduce offered mortgage balances until LTVs and DSCRs comply. However, the credit-control mechanism is useless when a borrower can make its desired loan balance compliant by simply raising the rent due from its affiliate tenant (i.e. set NOI) to reduce the LTV (through a higher valuation) and increase the DSCR.

If we consider the income approach to valuing commercial real estate, dividing annual NOI by an appropriate market capitalization rate (cap rate), the valuation concerns related to affiliate sale-leasebacks are even more pronounced. Since the appraisal methodology uses property NOI divided by a cap rate to solve for value, one over a cap rate (1/X%) is effectively an NOI multiplier. For example, a cap rate of 5% equates to a 20x NOI multiple, i.e. for each unit of NOI growth there are 20 units of property value gain. If we consider a 65% LTV mortgage, then we recognize that the sponsor is monetizing NOI growth at a 13x NOI multiple, i.e. for each unit of NOI growth the sponsor is collecting 13 units of incremental debt proceeds. Sponsors can monetize property valuation gains through sale (either partial interest or full) or by borrowing against a higher valuation (a cash-out refinance). Thinking of property valuation as a multiple of NOI illustrates the incentive and means for opportunistic sponsors to obtain significant amounts of debt financing through affiliate sale-leasebacks.

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Sample Opportunistic CMBS Affiliate Leaseback – Toys "R" Us:

Perhaps the best example in recent years of a weaker sponsor opportunistically borrowing through an affiliate sale-leaseback structure is Toys "R" Us. With CMBS debt (TRU 2016-TOYS) and mezzanine debt, a land-owning Toys "R" Us entity collected $600MM in proceeds at a blended rate (at closing) of around 6.50%.[2] The debt was secured by the affiliate borrower's interests in 123 Toys "R" Us and Babies "R" Us stores nationwide.[3]

Seemingly oblivious to the declining sales and significant near-term debt burden of the struggling company, the reinstated master lease carried a 15-year initial term (40-year extended term) and the CMBS underwriting assumed nothing less than the designated rent and reimbursements due under the lease. Within a year of issuance, Toys "R" Us filed for Chapter 11 bankruptcy.

Since bankruptcy, a number of valuation revisions evidence the significantly inflated portfolio value used to originate and syndicate the CMBS debt. At origination, the "As-Is Appraised Value" of $878.8MM ($173/SF) resulted in a 58% LTV to the mortgage (CMBS) and the "As-Dark Appraised Value" of $617.9MM ($122/SF) resulted in an 83% LTV.[4] However, upon transfer to special servicing in October 2017, the portfolio received an updated appraisal of $560.7MM ($110/SF), 36% lower than the original appraisal and 9% lower than the "dark value" reported at issuance (87% mark-to-market LTV).

Following a two-day auction of the CMBS assets, third-party purchaser bids were accepted on 32 properties totaling $116.8MM ($93 PSF), just over 25% of the portfolio. The auction outcome reflects that nearly 75% of portfolio assets did not receive qualified bids, suggesting potential adverse selection of these assets and/or additional devaluation risk. As for price discovery, although the 32 approved-for-sale assets reflect aggregate bids of $93/SF, the largest approved sales included one bid for 12 assets at $87/SF and another bid for 15 assets at $64/SF.[5]

The release of the 32 assets with acceptable bids is currently being contested; however, if the proceeds from sale were applied to the CMBS trust (the mortgage), the outstanding principal balance of the AAA class would be reduced to roughly 46% (a 0.46 factor), leaving the outstanding certificate balance at around $380MM (including a 1.0 factor on all non-AAA classes). It remains to be seen whether the third-party sales are executed and what collections will be realized on the 75% of trust assets that were not approved for sale.[6] To contextualize the relationship between a 'breakeven' sale price on the balance of the unsold assets and the subsequent impact on the trust, a sale approximately in the mid $30's dollars per square foot on the remaining 75% of assets would impart a write down on the senior most tranche of the trust.

As we continue to monitor the TRU 2016-TOYS CMBS liquidation process, it is clear that Toys "R" Us did not qualify as a credit-worthy tenant – certainly not for a long-term lease – and that the appraised value used at origination was significantly inflated.

Conclusion: Be Mindful of Sponsor Quality and Avoid Opportunistic Affiliate Sale-Leasebacks

In conclusion, evaluating CMBS credit risk requires determining whether the (borrower) sponsor's background, business plan, and capitalization are supportive of property performance and debt repayment. Whereas stronger sponsors are well capitalized, employ prudent amounts of leverage, and actively invest in their core portfolios to grow value; weaker sponsors are poorly capitalized, dependent upon higher amounts of leverage to finance their business operations, and often lack the ability and/or willingness to invest in their owned real estate.

CMBS investors should remain particularly vigilant about sponsor quality in affiliate sale-leasebacks, since the affiliation of the landlord and tenant provides the incentive and means for weaker borrowers to artificially inflate their property valuations to secure opportunistic financing. As evidenced by the Toys "R" Us CMBS financing, the perceived stability of a long-term lease and fully occupied portfolio can quickly transform into a liquidating trust of vacant properties if the sponsor is compromised by a failing business model and/or a significant debt burden. ■

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Footnotes and Sources:

(1) **Borrower/Sponsor Note:** The borrower of most commercial loans that will be securitized is a special purpose entity (SPE) owning only a single asset or a portfolio of assets – the loan's collateral – and formed to act as borrower for that specific loan. The sponsor is the individual(s) or company behind the borrower, which typically contributes the property to the borrowing entity and holds the majority of the ownership interests in that entity. **Source:** CRE Finance Council CMBS E-Primer

(2) **Debt Financing:** The $512MM securitized floating-rate mortgage carried an initial three-year term with two one-year extension options and was sold to investors at a weighted average rate of 1mL+4.95%. A coterminous $88MM of subordinate mezzanine debt was originated at a fixed rate of 12.50%, for a blended at-issuance rate of around 6.53%. **Source:** TRU 2016-TOYS Offering Memorandum (OM)

(3) **Affiliate Entities:** the landowning CMBS borrower was Toys "R" Us Property Company II, LLC, which pledged owned fee and leasehold interests in 123 Toys "R" Us and Babies "R" Us stores nationwide, totaling 5.1MM square feet (SF); the affiliate tenant was Toys "R" Us-Delaware, Inc. and the CMBS borrower sponsor was Toys "R" Us, Inc., a Delaware LLC; **Source:** TRU 2016-TOYS Offering Memorandum (OM)

(4) **As-Dark Appraised Value:** based on the hypothetical premise that the entire property becomes vacant and available for lease, per the CMBS marketing materials. **Source:** TRU 2016-TOYS Offering Memorandum (OM) and Term Sheet (TS)

(5) **Auction-Related Sources:** MS Research, "Toys R Us Auction Provides Transparency on Value"; KBRA Research, "KCP Special Report: TRU 2016-TOYS Auction Results"; Special Servicer Commentary and Bankruptcy Filings publicly available through Prime Clerk, Docket # 4298, Prime Clerk link: https://cases.primeclerk.com/toysrus/Home-DocketInfo?DocAttribute=3860&DocAttrName=PROPCOIIASSETSALE

Timeline Highlights:

- **October 24, 2016:** TRU 2016-TOYS CMBS bonds price (Propco II Borrower); November 3, 2016 deal closes, contemporaneous with the start of the affiliate master lease (initial 15-year term)
- **September 18, 2017:** Toys "R" Us, Inc. and 24 affiliated debtors each file for Chapter 11 bankruptcy, including the CMBS tenant, sponsor, and borrower in the filing. September 22, 2017, CMBS debt transfers to Special Servicing
- **January 23, 2018:** Toys "R" Us publishes a plan to close 182 of its 735 stores as part of its Chapter 11 reorganization (eight CMBS properties)
- **February 22, 2018:** the store closure plan is expanded to include 200 additional stores (33 CMBS properties)
- **March 15, 2018:** Toys "R" Us announces plans to close all 735 of its U.S. stores, including stores in Puerto Rico and begins liquidation
- **June 11, 2018:** Toys "R" Us, Inc. files a motion to allow for the sale of the TRU 2016-TOYS CMBS trust assets
- **July 16, 2018:** Initial Bid deadline for non-binding indications of interest on the CMBS trust assets (Propco II Debtor)
- **August 7, 2018:** Final bid deadline for the CMBS trust assets (Propco II debtor)
- **August 13-14, 2018:** auction held on the TRU 2016-TOYS CMBS trust assets; the special servicer's credit bid ("stalking horse bid") of $480MM was the best bid; however, third-party bids were accepted for 32 assets (just over 25% of the owned real estate), totaling $116.9MM ($93 PSF)

(6) **Sources:** KCP Special Report: TRU 2016-TOYS Auction Results, August 2018 and Bankruptcy Filings publicly available through Prime Clerk; KCP link: https://www.krollbondratings.com/show_report/12364; PrimeClerk: https://cases.primeclerk.com/toysrus/Home-DocketInfo

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