The Whole Loan Market – Commercial Real Estate's Unitranche

Martin Wheeler, co-head of ICG-Longbow on why investors should consider whole loans in the commercial real estate market.

In the commercial real estate world, unitranche loans do not exist. In real estate 'whole loans' are pretty much the same as corporate unitranche financings; a single, first-ranking loan which covers both the senior debt and mezzanine tranches in a leveraged credit structure paying a blended return. Whole loans are secured against the real estate through a first-ranking legal mortgage. With senior debt currently limited to circa 60 to 65 percent loan to value ratio (LTV), whole loans typically take leverage up to the 75 to 85 percent LTV ratios seen in mezzanine loans.

THE BEGINNNING

Prior to the global financial crisis, senior debt leverage ratios became super-inflated up to or beyond 80 percent LTV. So whole loans, as they are defined today, were commonplace but the banking market categorised them as senior debt. The phrase whole loan emerged from within the commercial mortgage backed securities (CMBS) industry to describe high LTV senior loans, which were split into a securitised "A-note" and a subordinated "B note".

A NEW APPROACH

As the world stabilised post financial crash, many of the lenders previously highly exposed to real estate lending disappeared. Consequently, only a few banks were still lending into the property market, and a 50 percent LTV became established as the new benchmark for senior debt from 2009 / 2010.

In response, new debt funds or managed accounts were set up post-crisis to provide mezzanine funding at attractive rates to top up the overall LTV to say, 75 percent. Mezzanine targeted funding for acquisitions resulting from forced sales as well as refinancing peak of market loans reaching (usually alongside a new equity injection or a debt forgiveness arrangement). However, the banking market was so dysfunctional that, of the remaining banks which claimed to be lending, few were able to provide borrowers with certainty of execution as credit decisions were slow and / or unpredictable and, if credit approval was obtained, transactions dragged on several quarters.

In such circumstances, rather than wait endlessly for the senior debt to arrive, ICG-Longbow and other new entrant funds began advancing both senior and mezzanine themselves through whole loan investments; either holding the whole loan through to repayment or effectively underwriting the senior risk bringing the senior lender in later.

WHOLE LOANS TODAY

Over the last four or five years, whole loans have become a common feature of the commercial property finance market. However, with commercial property values having increased by circa 20 percent since the bottom of the market in mid-2013 and with senior debt in abundant supply at circa 60 percent LTV, whole loans are no longer a one size fits all solution for higher leverage deals. By adopting a more flexible approach, lenders can still offer relevant whole loans,

FIGURE 1: INDICATIVE WHOLE LOAN PRICING STRUCTURE

especially where speed of execution or complex property underwriting is required.

ALTERNATIVE WHOLE LOAN STRUCTURES

The two principle options available to real estate debt funds and other lenders are:

1. to keep the full exposure for the duration of the loan term
2. to split it into senior and subordinated elements after closing and selling the senior risk whilst retaining the higher yielding but subordinated 'B note'

Holding the debt requires the whole loan to generate a sufficiently attractive coupon and fees to meet investors' return objectives. Higher yielding properties which can afford to meet a whole loan coupon (typically in the range of seven to nine percent) fit this profile. Alternatively, properties with lower initial yields, but where income and value growth are expected to generate high total returns, suit whole loans with a slightly lower fixed coupon but with added profit sharing exit fees.

Senior lenders typically avoid complex property underwriting or structuring for small to mid-market properties, and so whole loans may be the only solution available. In addition, property pricing will usually reflect the difficulty of obtaining senior debt, making the whole loan affordable.

Syndicating is required where the borrower needs to obtain a lower overall cost of funding and so works for lower yielding and larger properties where the resulting junior investment is still a material investment for the investor. Lower overall coupons based on post-close senior sell-down makes borrowing via a whole loan an attractive solution as it provides certainty of execution, whilst syndication and pricing risk is born by the lender. Whole loan pricing is typically in the five to seven percent range and, depending on the relative size of the senior and junior elements the subordinated slice will generate returns of seven to 12 percent. Sample pricing for the various elements of the capital structure is broken down in figure 1.

Finally, in the US there is a growing practise of originating and holding whole loans at lower coupons but generating more attractive returns to the lender by leveraging at fund level..Whilst this type of funding is not presently a feature of the UK or European market, it is highly likely to emerge in the future.

THE INVESTOR PERSPECTIVE

Equipping yourself with the option to invest in whole loans provides flexibility, allowing investors to choose between the security of a first charge throughout the term or creating a residual mezzanine-like position.

Retaining the whole loan gives the lender the security of a lower risk investment due to lower volatility of income and a lower loss rate in adversity, whilst the first charge provides full control in default situations. However, assets will need to be carefully selected to ensure that the coupon remains serviceable throughout the term and the borrower's business plan will also need to be fully underwritten if the loan features a profit sharing fee.

Investors may prefer to forego the security of the first charge and retain a subordinated debt investment if higher returns can be achieved through placing the senior debt. A degree of control will be provided through an inter-creditor agreement though as senior lenders remain reluctant to fetter their right to manage a loan in default, the subordinated lender or fund should have sufficient firepower to make cure payments to the senior lender, so as to maintain control through adverse market conditions.

Whilst whole loans are not a solution to every high leverage property financing requirement, they offer borrowers speed of execution in a flexible but simple structure, avoiding the often formulaic and cumbersome approach of the banking market. From an investor's perspective, whole loans offer an attractive risk-adjusted return through a readily investable medium. Consequently, notwithstanding the increased availability of both senior and mezzanine, whole loans offer a highly relevant solution to borrower's needs and investors risk / return requirements. ■

Martin Wheeler is co-founder and joint-head of ICG-Longbow, the specialist UK real estate debt division of Intermediate Capital Group plc. Through its client funds, ICG-Longbow structures and provides senior debt, whole loans and mezzanine funding to the UK's commercial property sector. ICG-Longbow manages funds and other investment vehicles with aggregate commitments of £2.1 billion. ICG-Longbow's 20 strong team deployed over £750 million of real estate finance over the past 12 months, of which nearly 40 percent was in whole loans.