GUEST COLUMN

The Case for Exotic Notes in Commercial Real Estate Transactions

By Francis Mastroianni

PIK (payment-in-kind) Notes and Toggle Notes, which began as alternative debt instruments with safety valve features attractive to the real estate industry, became a life jacket keeping overly aggressive financially engineered deals afloat. Their use has temporarily retreated but their intrinsic value as sophisticated real estate finance tools almost guarantees that they will reemerge as the debt crisis subsides.

The current credit crunch in the commercial real estate market is, in no small part, a result of Main Street's sub-prime mortgage debacle and defaulting residential borrowers. Prior to the chill that enveloped the debt markets in the fall of 2007, Wall Street packaged these and other mortgages into exotic financial products to meet the insatiable demand of CMBS, CDO and SIV investors chasing ever higher yields.

Two products that emerged from this super-charged finance environment and helped engineer some of the major commercial real estate and real estate capital markets transactions of the past several years were the PIK (payment-in-kind) Note and the Toggle Note. Both trace their pedigree to the private equity and leveraged buyout/M&A arenas.

Since the 1980s, Wall Street has used PIK Notes primarily in private equity deals. They were conceived as a hedge against downturns in the retail industry. Toggle Notes offer an even greater hedging ability than PIK Notes as they permit a borrower to elect (or toggle) between accrual of interest payments and cash payments of current interest. **Texas Pacific Group** and **Warburg Pincus LLC** were the first to use Toggle Notes in 2005, when they bought luxury retailer **Neiman Marcus**.

PIK Notes, unlike Toggle Notes, do not require the borrower to make payments until the loan matures and interest is paid "in kind" along the way with additional debt. In PIK Notes, interest payments accrue and compound. Traditionally, PIK Notes have been used in non-real estate private equity deals where initial cash flow was not expected to cover interest payments on the junior debt. In contrast, Toggle Notes give borrowers the option of paying current interest in cash or with more debt in exchange for a higher interest rate when cash payments are skipped. In return for such payment flexibility, lenders typically charge a 50 to 75 basis point interest rate premium when scheduled interest payments are skipped.

The use of PIK Notes and Toggle Notes in the commercial real estate context has obvious advantages. For a real estate borrower, PIK Notes offer an ability to finance a compelling deal despite an initial negative debt service coverage ratio. Toggle Notes offer real estate borrowers the ultimate flexibility of making interest payments on a current scheduled basis or by adding additional principal and reconciling the principal and interest payments at maturity, rather than defaulting on the note during its term.

PIK Notes and Toggle Notes shield real estate borrowers from cash flow crunches and, as a result, are particularly attractive to companies that need to deploy available capital to build their business or accumulate appreciating assets rather than pay debt. If a borrower anticipates greater cash flow in later years (e.g., upon successful lease-up of a building, upon bumps in existing rental streams, or upon repositioning after a major renovation), the Toggle Note can be an invaluable cash flow management and financing tool. In addition, Toggle Notes will always be attractive to borrowers who are subject to cyclical markets such as real estate.

For a real estate lender, PIK Notes and Toggle Notes offer higher yields than conventional debt instruments. With risk premiums at historically low levels until recently, the higher yields available from PIK Notes and Toggle Notes were attractive to investors and lenders who did not have liquidity concerns. For example, as of June 2007, rates on high yield debt instruments were on average 2.40% higher than rates on government debt. This, coupled with a then record low corporate default rate of approximately 1%, created an extremely strong demand for high yield paper in the primary and secondary markets.

PIK Notes' payment-in-kind feature also results in a compounded interest effect, thus increasing overall investment return with relatively more certainty than equity financing. PIK Notes and Toggle Notes also have priority as a debt security that is senior in the borrower's equity capital structure, giving them preference upon liquidation. Both PIK Notes and Toggle Notes can also be secured by collateral of the borrower. For these reasons, PIK Notes and Toggle Notes should be particularly attractive alternatives to conventional mezzanine notes and preferred equity.

As an indicator of the real estate market's growing comfort with PIK Notes and Toggle Notes, deals that featured Toggle Notes accounted for 9% of all high-yield debt sold in 2007, versus less than 1% three years earlier. **Tishman Speyer**'s $5 billion acquisition of Stuyvesant Town and Peter Cooper Village in New York from **MetLife** in November 2006,

Macklowe Properties' $7 billion acquisition of a portion of the **Equity Office** portfolio from **The Blackstone Group** in February 2007, **Lightstone Group**'s $8 billion acquisition of **Extended Stay Hotels** from Blackstone in June 2007 and Blackstone's $26 billion acquisition of **Hilton Hotels** in October 2007 employed PIK Notes or Toggle Notes and offer solid evidence of their utility and acceptance in significant real estate transactions.

The current perception, however, that borrowers are overleveraged and at risk of defaulting has forced debt issuers to restructure real estate deals to more conventional models. Despite this new-found aversion to riskier debt, these exotic real estate debt instruments will resurface as important financing tools once the debt markets right themselves. The last quarter of 2007 saw several successful, high-profile Toggle Note offerings that seem to signal a slow but steady resurgence in the market. Non-real estate deals such as **Thomas H. Lee Partners** and **Fidelity National Financial**'s $1.3 billion buyout of **Ceridian Corp.** in October employed Toggle Notes.

The reduced appetite for these instruments in the secondary market is pushing their yield closer to 100 basis points over the cash-pay and as much as 750 basis points over that of low-risk Treasuries. Such wide spreads are noteworthy since, as of January 2008, the default rate on junk bonds was still well below its historical average of 4.4%, implying a favorable risk versus return premium from these instruments.

As for the use of PIK Notes and Toggle Notes in the commercial real estate industry, it seems inevitable that Wall Street will continue to push the trend in order to provide flexible yet straightforward financing products to meet the market's demand.


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News Roundup

The News Roundup is a summary of publicly reported real estate news briefs. The information has been obtained from sources believed to be reliable, but REFI *does not guarantee its completeness or accuracy.*

Alberta Weighs Real Estate Boost

The CAD16.6 billion **Alberta Heritage Savings Trust Fund** is set to vote on whether to increase its private real estate allocation to 18% from 10%. **Aaron Brown**, senior manager of portfolio research in Alberta's government, is confident the votes will pass. Increasing the trust's real estate and exposures should provide a favorable risk-return profile, long-term capital gains and cash yield, Brown said. Most of the fund's 10% real estate allocation is invested in Canada. As it builds its exposure, the trust will consider foreign markets. "There would be no limit to what we would do," Brown said. He expects the fund to hire managers for international real estate, but not domestic.

Laxey Snaps Up Stake London West End Property Firm

London-based activist hedge fund **Laxey Partners** has bought an 11.8% stake in **Shaftesbury**, the £775 million ($1.5 billion) listed U.K. property firm which owns large parts of London's west end. The U.K. press reported last week that Laxey bought the share for its *Terra Catalyst* fund which has raised £116 million ($232 million) on the Alternative Investment Market.

"Unlike many people, we don't believe the end of the world is nigh for commercial property and there is a great chance to pick up shares. No-one seems to be able to see the light at the end of the tunnel, but we do," said **Colin Kingsnorth**, Laxey co-founder, at the launch of Terra Catalyst earlier this year.

Illinois SURS To Seek Emerging Real Estate Managers

The **State Universities Retirement System of Illinois** plans to propose a search for an emerging real estate manager at its June meeting. The move is part of a plan by the system to increase its Manager Development Program, said **Dan Slack**, executive director. The system doesn't yet have any real estate managers within the MDP. Consultant **Ennis Knupp + Associates** is conducting an asset study for the fund which should be completed this summer. So far, recommendations include increasing real estate to 10% from 6%.

CBRE Investors Buys Dallas/Fort Worth Offices

CB Richard Ellis Realty Trust acquired a 98,750 square foot, two-year-old office building in Lewisville, Texas for $17.7 million. The building, 2850 Lake Vista Drive, is 96% leased to **TIAA-CREF**, although the financial services firm only occupies 68% of the space. The seller was not named.

Lewisville is in the the Dallas/Fort Worth metroplex. CB Richard Ellis Investors says it likes the market because of the high concentration of corporate headquarters. **Jeffrey Torto**, senior director of acquisitions, said the acquisition fit the company's strategy of buying core, high quality real estate with predictable cash flow.

Gary Carr, **Russell Ingrum** and **Eric Mackey** of CBRE brokered the deal.