RECAPITALIZING A REAL ESTATE COMPANY WHEN REAL ESTATE IS OUT OF FAVOR

A Case Study

by Christopher J. Whyman, CRE

The company, a wholly owned U.S. real estate subsidiary of a United Kingdom pension fund, was created in the mid 1970s and financed mainly by loans from its parent. Subsequently, further loans, all at prevailing U.S. market rates, were made to enable the company to purchase U.S. real estate investments. In April 1987, this debt was refinanced by a private placement at the then excellent rate of 8-3/8%. The private placement was secured by a portfolio of U.K. government issued gilt edged securities held by the pension fund in the U.K. The private placement was for a period of seven years and had to be refinanced in March 1994.

Market Background In 1993

- The real estate market crash was in its fourth year and lending on commercial property was very scarce and very difficult.
- Interest rates were dropping to record lows as efforts continued to restart the U.S. economy.
- The U.K. pension fund parent wished to be relieved of the loan security provided by the charge it had given over its gilt portfolio so it could trade more actively and reduce its exposure in gilts.

REIT Consideration

The company actively considered forming a Real Estate Investment Trust (REIT) and visited a number of Wall Street houses. It became apparent that a public REIT would be difficult to form as the principle real estate asset was large (valued on its own in excess of the market value of many of the existing REITs), and the portfolio was diversified both geographically and by product type. The market was looking for single asset class companies with properties located close to one another. In addition, the presence of a hotel in the large mixed-use asset was a problem since REITs cannot recognize direct hotel income. As discussions proceeded, the company management also became aware of a significant problem in running a REIT composed largely of office space—the need to distribute 95% of the income against the market need to fund occasional large sums of money for tenant improvements as leases expire. The REIT route was eventually dropped.

The Company's Search

The company then started early to prepare for its refinancing task. Work commenced 12 months

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before the due date. The company visited and interviewed 24 investment advisor companies, pension funds, institutions and other advisers and moved toward a short list of four investment houses. These included the adviser who had placed the original private placement loan.

The Company's Requirements

- $105 million
- lowest possible interest rates
- five year term or less
- maximum flexibility to prepay early if needed or desired.

The following forms of refinancing were considered.

- Traditional mortgage. It became apparent quickly that this route would not work because the portfolio valued at about $300 million was likely to be of insufficient size to provide backing for a large enough loan without additional security. A hotel was a significant part of the major asset in this portfolio, and hotels were strongly out of favor with lenders. The portfolio would need to be considered without the hotel. Debt coverage would be on the order of 65%, possibly up to 70%, but without the hotel the portfolio on its own was not large enough to support the loan required. Some form of guarantee would be needed in addition to the security of the real estate. Further reasons for discounting were likely higher relative interest rate levels and lack of prepayment flexibility without penalty.

Primary Debt Market Alternatives

	PROS	CONS
Underwritten Public Offering	—Deepest market —Best pricing —Most liquidity —Longest term —Investors view offerings on *take it or leave it basis*	—Level of initial and ongoing disclosure required —SEC review likely to be time consuming
144A	—Most of the same characteristics as public in terms of term and pricing with less stringent disclosure requirements —Investors view offerings on *take it or leave it basis*	—Market not as deep or liquid as public market —Pricing not quite as favorable
Eurobond Market	—Pricing generally competitive with U.S. market —Receptive to the pension fund's name and story —Extremely competitive pricing	—$105 million is considered small
Traditional Private Placement	—Avoid rating and SEC registration —Receptive to the pension fund's name and story	—Pricing generally wider —Expect some convenant negotiations
Commercial Bank	—Receptive to noncorporate credits	—Expect some convenant negotiations
Commercial Paper	—Deep market —Aggressive pricing —Shortest term —Prepayment flexibility —No SEC registration required	—Ratings required —Interest rate risk (can be mitigated through swaps) Refinancing risk

Description Of Primary U.S. Debt Market Alternatives

	Underwritten Public Offering	144A Underwritten Offering	Traditional Private Placement/ Bank Market
General Description	Would require substantial disclosure with respect to the U.K. pension fund. SEC review likely to take 6-8 weeks. Might require restatement of financials for a 5-year period. Broadest market available.	A hybrid market between the private and public arenas; ratings and liquidity make many traditional "public" investors (insurance companies, state funds) indifferent between underwritten 144A and public transactions.	Historically, the preferred market for selling complex structure, or unusual credits.
Pricing	For stronger, well-known credits the liquidity of the market allows for more attractive pricing than private market. Can create same benefits as funding floating rate by swapping out early maturities.	While sensitive to credit ratings and name recognition, pricing can be achieved at a substantial savings over the private market. Can create same benefits as funding floating rate by swapping out early maturities.	Least attractive pricing, but higher initial spread cost can be mitigated through delayed funding strategy if available. Does offer potential of funding on floating rate basis.
Documentation	1. Prospectus 2. Underwriting Agreement 3. Indenture	1. Offering Memorandum 2. Purchase Agreement 3. Indenture	1. Agent's Letter 2. Detailed Loan Agreement
Maximum Term	30 years	15-30 years	Bank "corporate market" 7-10 years Institutional market 15-20 years
Accountant's Comfort Letter Required	Yes	Yes	No
Ratings Required	Yes	Yes	No
Transfer/Settlement	DTC Preferred (Depository Trust Company)	DTC Preferred	Issuer and Investor Direct
Type of Investor	Very large investor base consisting of insurance companies, pension funds, money managers, and mutual funds.	Incrementally larger investor base than the private market. Increasing cross-section of public market buyers.	The market for private project debt consists primarily of sophisticated insurance companies and banks familiar with credits.
Investor Investment Decision	Public Bond Department	Private Placement or Public Bond Department	Private Placement Department or Bank Credit Committee
Degree of Investor Negotiation	None	None	High
Regulatory/Registration Requirements	SEC registration of securities under the Securities Act of 1933 is required.	Rule 144A provides an exemption for resale of restricted (unregistered) securities between qualified institutional buyers (QIBs).	SEC Regulation D exempts registration for private placements when certain conditions regarding the sophistication level of investors and the timing of resale are met.
Timing	As SEC filing and ratings are required, accessing the market can take somewhat longer particularly if the SEC decides to review the filing.	As SEC registration is not required, the market can be accessed very quickly. The credit rating process drives the timing of a 144A or public offering.	As ratings and SEC registration are not required, the market can be accessed quickly. However, negotiating loan agreement can be very time consuming.
Trading Implication	Enhanced initial distribution and secondary trading	Enhanced initial distribution and secondary trading	Illiquid

- Once the company, particularly it's parent U.K. pension fund, had accepted the need for a guarantee and indicated a willingness to provide one, a number of new alternatives opened up. In examining the alternatives with the parent guarantee, it soon became obvious that if the parent sought and obtained a rating from the relevant agencies more choices were available and the interest rate also would be lower due to the size and security offered by the parent. The advice given, and taken, was to pursue the rating diligently and choose the market at the last moment depending on how each was performing at the time.

  The markets considered were:
  Eurobond
  U.S. Public
  144A
  Private Market
  Commercial Banks
  Commercial Paper

Commercial Paper

In light of its flexibility, the generally held view of the economy, the likelihood of interest rates remaining relatively low and the ability to cap interest rate rises, the company chose commercial paper as its refinancing vehicle.

Rating The Pension Fund

This turned out to be a complicated and time consuming affair made more difficult by the different national and state laws (in the U.S.), and, in particular, the nature and status of pension funds and trustees in U.K. laws. After many weeks of late nights, the U.K. pension fund was given an indicative long term debt rating by Standard & Poors of AAA. Commercial paper issued by the company and guaranteed by the pension fund has been rated A-1+ by S&P and P-1 by Moody's. The pension fund became the first ever fund outside the U.S. and only about the third (including the U.S.) to be rated. These were the highest ratings possible, and

Indicative Cost Comparison Across Markets
(January 20, 1994)

Assumption: 5 Year Maturity and AAA/Aaa Guarantee

	Commercial Paper	U.S. Public	144A	Private	Bank	Eurobond Market
Treasury Yield	5.05	5.05	5.05	5.05	5.05	5.05
Spread over 5 yr T						
AAA	.20	.30	.40-.45	.65-.75	.65-.70	.20-.30
AA	.22	.37	.47-.52	.65-.75	.65-.70	.30-.40
Reoffer Yield						
AAA	5.25	5.30	5.48	5.75	5.73	5.30
AA	5.27	5.37	5.55	5.75	5.73	5.40
Expenses	.04-.05	.13-.20	.11-.18	.05-.09	.02-.03	.03-.04
Fee (Execution & Structuring)	.22	.21	.21	.18	.15	.15
All in Cost						
AAA	5.52	5.73	5.84	6.00	5.91	5.49
AA	5.54	5.80	5.91	6.00	5.91	5.59
Floating Rate Conversion						
AAA	LIBOR + .22	LIBOR + .43	LIBOR + .54	LIBOR + .70	LIBOR + .61	LIBOR + .19
AA	LIBOR + .24	LIBOR + .50	LIBOR + .61	LIBOR + .70	LIBOR + .61	LIBOR + .29

Note: Commercial paper and bank floating rate cost converted to fixed rate via swap market. All fixed rates converted to floating rate via swap market.

they were achieved at a time when others were not able to sustain their existing AAA rating.

Benefits Of A Rating

The rating achieved had the following benefits:

- lower interest rates
- greater access to the market especially when money is tight
- greater access to the derivative market if desired
- a significantly improved market view of the company and of the pension fund as very secure businesses.

Successful Issue

Over half of the paper was taken up at a rate on top of the U.S. Government repurchase agreement (repo) rate and the remainder was taken up at the rate commanded by the very best U.S. corporations. Effectively, therefore, the first issue was at about 3.68%, resulting in an annualized savings of $5 million in interest payments.

Swaps, Caps And Collars

Various techniques have been developed to allow an issuer to hedge exposure, including sharp increases in interest rates.

Swaps allow companies to convert several years of a floating rate obligation to a fixed rate by executing an interest rate swap. During the past five years, the swap market has grown dramatically providing substantial liquidity which is enhanced by a number of mechanisms allowing swap underwriting, swap reversal and swap sale.

Caps are like life insurance policies. A premium is paid to insure against an event that it is hoped will not happen. Caps allow the company to enjoy the low cost of floating rate financing and also to protect itself against sharp rises in short-term rates. A cap is a series of calls—the right to buy the underlyer at the strike price. For example, in early April 1994, the issuer of one month commercial paper at 3.62% for an up front premium of 31 basis points per year for three years could have purchased a cap at a strike rate of 7% for that period. Other techniques available include collars (whereby a company, by giving away some of the upside of low floating rates, can cheapen its protection against rising rates), average rate caps, step-up caps and rebate caps (where a company purchases a cap for a higher upfront premium, but if the one month cap is below the rebate rate on the rebate date, the company receives the premium of a conventional cap back as a rebate).

The Players

The Company	Eastern Realty Investment Corporation, Washington D.C.
The Parent	Electricity Supply Pension Scheme (the second largest pension fund in Britain)
The Advisor	Goldman Sachs and Company