The Babson Staff Letter

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Co-Investing: A Strategy For Sharing Real Estate Risks and Returns

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Introduction

As you read about the enormous prices being paid for a prime piece of real estate, have you ever wondered where the money comes from to complete the purchase? Much as we might buy a home, the purchase is financed through a combination of debt and equity. But does one lender loan the hundreds of millions of dollars that it takes to finance one of these deals? For decades, large financial transactions of various types have been facilitated by private placements, bank syndications, re-insurance contracts, and "club deals" among financial institutions seeking to diversify risk and limit their dollar exposure. It often works the same way for these large real estate mortgage transactions.

In the last ten years another kind of real estate transaction called co-investment, where real estate mortgages are shared privately among two or more portfolio lenders, such as insurance companies and pension funds, has accounted for as much as $35 billion in transaction value. Although this level is small relative to the nearly $650 billion in commercial mortgage-backed securities (CMBS) issued over the same time, it is still meaningful and is having a steadily increasing influence on the real estate lending marketplace.

This Staff Letter focuses on the unique characteristics of co-investing: who participates in these deals, what these investors end up owning and where, and how co-investment transactions are structured.

Some Definitions

"Co-lending" and "co-investment" are terms commonly used to describe all investments in which two or more parties share a commercial real estate mortgage investment. Other related terms include club deal, syndication, and participation. The primary distinction among these terms is whether all parties commit to, or enter into, the investment at the *same time*.

It is common to regard a co-investment and, in most cases, a club deal as one in which all parties jointly commit and fund the investment, with each having substantial decision-making authority in the structuring and administration of the investment. A participation or a syndication typically refers to an investment that is originated, committed, and closed by one institution and in which another institution or several invest on or after the closing date. In this case, the originating lender retains substantial authority for servicing the investment.

The Benefits Of Co-Investment

A lender's diversification strategies and exposure policies typically drive co-investment decisions. Virtually all portfolio lenders have maximum dollar limitations for a single asset or portfolio of assets. If a particular loan opportunity exceeds a lender's dollar limitation, co-investing may be the only way to invest in a particular deal. After all, some of the deal may be better than none of it. Other diversification and exposure issues, such as property type and location (market) concentrations, may also be managed through co-investment.

Some lenders use co-investments to lever their origination capacity—staff whose responsibility is to seek out loan opportunities, negotiate, and close the transaction—while others that have no origination capacity

depend on purchasing co-investments in loans originated by others. Such lenders, seeking to obtain the yields provided by commercial mortgages, can co-invest in new loans or purchase participations in existing loans originated, closed, and serviced by others. The "cost" of such a strategy is normally a lower yield. The lead lender typically earns all or most of any origination fee and receives a servicing fee over the life of the loan. This is fair compensation for the originating lender in return for its services originating, underwriting, and closing the loan.

Yet another benefit to lenders has been the ability to compete with Wall Street. In the 1990s, Wall Street investment banks dominated the large loan market, offering large loans in both public and private securitizations. In the early '90s most portfolio lenders were very sensitive to large exposures and focused on smaller loans. As conditions improved in the mid-'90s lenders returned to the market and co-lending again became popular. The investment banks continued both to exploit the efficiency of the capital markets for those borrowers who could conform to the structural requirements of loans destined for the CMBS market and to originate large and more structured loans for private securitization.

Portfolio lenders, by contrast, tended to win the deals that required more unique structuring and thus won over borrowers still unaccustomed to and uncomfortable with public securitization. After the capital markets meltdown in late summer 1998, few investment banks were willing to hold the entire loan and risk a change in interest rates between loan origination and securitization.

Portfolio lenders saw an opportunity to regain lost business, but most needed a co-lender(s) to commit to the large deals. The limited number of capital sources for large loans resulted in wider spreads for those able to do a co-lending transaction. Co-lending provided lenders an opportunity to diversity into very high-quality, "trophy" assets with the best and strongest borrowers—assets they might not have otherwise been able to accommodate individually.

Co-investing also allows a lender to diversify through investment in a number of property markets to soften the portfolio impact of an economic downturn in specific market segments.

Acquiring participation interests in several loans in one geographical market may enable a lender to maintain a specific investment exposure to that market but obtain diversity through several loans within that market. Various properties might react differently to the same economic changes.

Everyone's Doing It!

Once the domain of larger insurance companies and commercial banks, the practice of co-investing or syndicating loans has become more commonplace. Loan size is a relative concept; one lender's small loan may be another's large loan. Loans of $100 million or more for single assets and $150 million or more secured by a portfolio of real estate assets are often funded in a club deal format, as very few lenders will hold such large transactions on their books and take all the risk of successfully syndicating the transaction. Virtually any loan, however, is a candidate for participation. Lenders must consider how large a loan they are willing to commit to and fund prior to syndicating financial interest(s) and at what point the loan is so small that the effort to sell a participation exceeds the benefit.

Co-investments also span the full range of property types and geographic regions. The largest of single asset loans tend to be in major cities, where portfolio lenders develop loan concentrations simply because that is where the critical mass of commercial real estate is located. Co-investing becomes an attractive option, as it enables lenders not only to remain active in these locations, but also control exposures.

Office properties, regional malls, and hotels offer some of the largest single asset loan opportunities; therefore, many of the co-lending transactions involve these property types in and around major cities. Warehouses, neighborhood retail, and multifamily properties tend to have smaller loan balances on a single asset basis; however, portfolios of these property types are well-suited for co-investment. Smaller portfolio lenders can find co-investment opportunities in smaller loans. Basically, there is no size or geographic restriction to the co-investment market.

Picking Your Partner

Clearly the best co-lending partners are organizations with similar investment philosophies, underwriting standards, loan parameters, and risk tolerances. In a participation, the parties investing in the

originator's loan typically perform their own due diligence on the investment and documentation, since the loan with the borrower has already been closed. In a co-investment, where the parties jointly negotiate with the borrower (and each other), the importance of picking a good partner cannot be understated.

Often the relationship between institutions is based upon a relationship between individuals in the respective organizations and a similarity of corporate cultures. Borrowers are often hesitant to negotiate with a club of lenders who have not worked together previously. Negotiations are stressful enough without the added uncertainty and contingencies of working with two or more lenders who may have difficulty agreeing on loan terms and inter-creditor issues.

Among the issues on which there should be common ground are:

- term and amortization of the loan
- degree of leverage and debt coverage
- underwriting methodology
- approval/commitment process
- fixing the mortgage coupon
- third party consultant requirements
- closing requirements
- servicing and voting rights
- regulatory requirements
- legal representation

How To "Seal The Deal"

Most of the institutions active in co-lending prefer to have only one co-investor, although very large deals, of which there are an increasing number, often require three or more co-investors. Experience suggests that the more parties at the negotiating table, the more complicated and time-consuming the process. Commercial banks, on the other hand, appear to be much more comfortable with multiple participants—probably a result of more extensive experience with the syndication format.

It is important that the co-lenders recognize that compromise is an important ingredient in reaching a successful conclusion. Critical issues should be identified early so the parties can reach a resolution. There is usually a solution which can satisfy all the co-lenders.

One lender should be designated as lead lender at the outset and given responsibility for coordinating the negotiations, underwriting, and closing. Being the lead lender requires good coordination, administration, and negotiation skills, because the additional inputs and perspectives of the co-lender(s) add complication to each step of the process. Opinions and biases of co-lender(s) must be accommodated and the process be as seamless as possible to the borrower. A club works best when its members share similar philosophies, risk appetites, and views of the capital markets. A good experience enhances the chance for repeat business with the borrower and lending group.

Organizations vary on who assumes the lead role in inter-creditor negotiations. Some use their attorneys, others the investment underwriter, while some with large co-lending operations have a person dedicated to fostering the co-investment business. Whatever the arrangement, it should be clear to all who has the authority to negotiate for each co-lender.

Banks have a long history of syndicating both term and construction loans. With increased activity among portfolio lenders in floating rate debt, insurance companies have begun investing in bank syndications. These loans are almost exclusively floating rate loans and are either a closed loan into which other lenders invest, or the loan commitment is subject to arranging the syndication.

While banks have some different regulatory requirements and structural features, it has not been difficult for insurance companies to understand and participate in bank deals. On the other hand,commercial banks have historically not invested in insurance company-originated loans, as they are typically long-term, fixed-rate loans originated to match the duration of longer-term liabilities of insurance companies. That will likely change and co-lending between commercial banks and life insurers increase, particularly as life companies offer more short-term financial products.

Co-Lending Structures

There are two basic co-lending structures: *"parri passu,"* the most common structure, in which the participants share risk *pro rata*; and a senior/subordinate structure that contractually places the "first

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loss" risk, the risk of absorbing any losses in the investment up to the amount of the investment, with the subordinate interest holder. A premium return entices the subordinate position to take this risk.

The Inter-Creditor Agreement

It goes by many names—inter-creditor agreement, co-lending agreement, participation and servicing agreement. Whatever it is called, it is the critical document that links the co-lenders together for better or worse! Although the structure of the inter-creditor relationship—*parri passu* or senior/subordinate—will affect parts of the agreement, there are similar fundamental components found in each structure. These include the following:

- Evidence of ownership - note or certificate
- Definition of interests
- Representations and warranties
- Servicing issues and standards/loan administration
  - Servicing fees
  - Payment dates and procedures
  - Lease approvals and SNDs
- Lead lender responsibility, authority, and limitations
  - Voting rights
  - Buy-sell provisions
- Borrower defaults under the loan documents and enforcement procedures
  - Protective advances
  - Commencement of foreclosure
  - Foreclosure bidding
- Procedures in the event lenders become owners
  - Form of ownership
  - Management of the asset
  - Sale of the asset
- Other administrative issues
  - Termination of the agreement
  - Resignation of lead lender
  - Partial Interest sales/transfer rights
  - ERISA
  - Notices

Much time is spent (as it should be) on negotiating the inter-creditor agreement. It should be a blueprint for answering questions and solving problems that might arise during the term of the investment as well as the responsibilities if the property is foreclosed. No one enters a co-investment expecting problems, but it is vital to have a framework flexible enough to accommodate unforeseen difficulties.

Perhaps the most negotiated portion of the agreement concerns voting rights and delineation of the lead lender's authority. Some actions and approvals are within the lead lender's discretion; other actions require unanimous approval or majority vote when more than two lenders are involved. Typically, any action that modifies the loan documents requires unanimous approval of the co-lenders.

The ultimate solution to inter-creditor disagreements is usually a buy-sell provision, which typically provides that the offering party must be willing to be a buyer or seller at the price offered. (This solution is very seldom invoked.)

The benefits of co-investing are many and varied, depending on the participant's role in the transaction. In general, as with other areas of the capital markets, the blurring of lines between sources of capital and the evolving financial sophistication of users of capital is helping change the real estate lending market. Co-lending and syndication have opened up the market to smaller institutions and given other lenders access to loans of a scale or geographic location previously unavailable. It has similarly opened additional opportunities for borrowers. This broadening of the market for both borrowers and lenders has made the market more efficient and increased opportunities to diversify away risk.

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