THE ABCs OF CDOs

By David M. Rosenthal

WHAT ARE CDOs AND WHY DO THEY MATTER TO COMMERCIAL MORTGAGE PROFESSIONALS?

We all know that Wall Street has a seemingly endless appetite for commercial mortgage-backed securities. Conduit financing, or CMBS, evolved in the 1990s as an efficient vehicle for tapping the virtually unlimited supply of investor funds from the securities market to make long-term, fixed-rate loans on stabilized income-producing property.

In a similar manner, Wall Street is now finding a way to provide capital for structured finance transactions, such as non-stabilized properties, vacant buildings and even vacant land. The evolving vehicle for these structured finance transactions is known as a Collateralized Debt Obligation, or CDO.

EVOLUTION OF THE CRE CDO MARKETPLACE

CDOs grew out of the high yield bond boom of the late 1980s. They were initially used as a financing vehicle for non-real estate assets. Commercial real estate (CRE) CDOs were first introduced in 1999. They were generally static transactions backed by fixed-rate collateral such as CMBS B-piece bonds and unsecured REIT debt. This market emerged in response to the permanent financing needs of CMBS B-piece buyers and REIT debt holders who needed a low-cost, stable financing vehicle.

The marketplace changed dramatically in 2004 when a new and innovative CRE CDO structure was introduced. Key features of these "new and improved" managed CDOs included the ability of the collateral manager to: reinvest principal proceeds for a period of time; trade collateral assets for reasons other than credit; and include assets such as B-notes, mezzanine loans and preferred equity. These second-generation-managed CDOs allow for shorter-term, floating-rate financing.

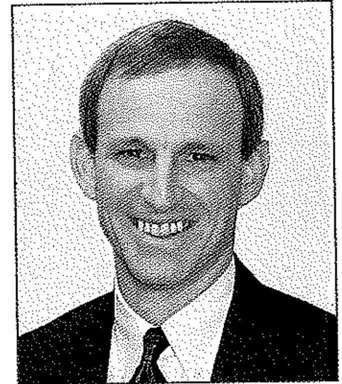
The rapid evolution of this CRE CDO marketplace is positive for commercial real estate finance since it allows for better match-term funding for sponsors, provides for increased flexibility for collateral managers and creates a much wider offering of commercial real estate financing options for borrowers.

CDOs VS. CMBS

CDOs have a number of key characteristics that distinguish them from CMBS, such as:

Target Par Amount. In CMBS securities, typically the par value of the collateral equals the par value of the certificates. CMBS securities are generally fully funded at issuance. CDO structures introduce the concept of "target par amount," where, at issuance of the security, they are not fully ramped up. The "target par amount" may then be achieved over a period of time, sometimes up to six months, by purchasing collateral at a discount. The true par value of the collateral will therefore not be known until the portfolio is fully ramped up.

Reinvestment or Revolving Period. CMBS securities are fixed at issuance. There can be no changing of collateral within a CMBS bond after issuance. CDOs have developed the concept of a "reinvestment period" of three to five years, during which the collateral manager may reinvest collateral principal into new collateral. The manager may also sell defaulted securities and securities that have improved or deteriorated in credit quality, based on their own discretion. As a result, the par amount of collateral in a CDO may change over time, resulting in much greater flexibility in the types of loans that they can support.



Legal Structure. CMBS securities are usually structured as a real estate mortgage investment conduit (REMIC), which is an extremely rigid structure that has to abide by many restrictions in order to maintain its tax-free status. CDOs are typically structured with a co-issuer system that often contains a Cayman Islands limited partnership and a Delaware corporation. This structure allows for substantial flexibility for the collateral manager to purchase and sell securities in the collateral portfolio, issue a combination of fixed and floating liabilities and incorporate a ramp-up period and/or a revolving period.

Credit Enhancement. In CMBS transactions, credit enhancement is generally derived from subordination, and there is a great deal of predictability to the IO cash flows. CDOs allow for credit enhancement by diverting interest cash flows to pay principal or principal cash flows to pay interest if credit quality has diminished. This provides flexibility for the collateral manager, but it does add uncertainty to the cash flows in the preferred shares.

Interest Rate Hedging. Interest rate risk is generally managed in CMBS securities by matching fixed assets to fixed liabilities or floating assets to floating liabilities. In CDO securities, interest rate swaps that are built into the structure are used to manage mismatched assets and liabilities.

WHAT DOES THIS MEAN FOR US?

In the early to mid-'90s many of us asked the same question about the newly developed financing vehicle known as CMBS. Why should we have cared that Wall Street had found a way to provide long-term, fixed-rate commercial mortgage financing? As we all know, that fledgling industry has developed into a $170-billion-per-year financing juggernaut.

So now Wall Street has created a new, highly flexible vehicle for structured finance transactions. Will CDOs be able to compete with existing sources of structured finance? Will existing sources of structured finance be able to compete with Wall Street? Only time will tell.

The views expressed in this article are those of the author and not Real Estate Media or any of its publications.

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