KENSHO INVESTMENT GROUP

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CEO Insight: More safety for real estate investors in Continental Europe

The capital-driven US property market often promises high returns but a recent big loss of a top-rated CMBS bond emphasizes the downside of such investments. European investments and security backers tend to be fairer, safer, and more reliable.

Despite all the lessons learned from risky market practices that have caused the global financial crisis, investors in the top-rated US commercial mortgage-backed securities have once again lost money. The loss occurred on $308 million (48.4 billion yen) worth of mortgage-backed notes on 1740 Broadway, a building in Manhattan, New York City. The buyers of the triple-A rated tranche of the loan were only able to recover 74% of their investment as the loan was sold at a significant discount. Five lower-ranked creditor groups holding double and single A tranches and below lost all their money.

Investment firm Blackstone acquired the property in 2014 for $605 million. The firm took out a $308 million mortgage to finance the transaction. The mortgage was securitized via CMBS bonds and purchased by Travelers, Endurance American Insurance, and others. Deutsche Bank arranged the transaction and the rating agency DBRS Morningstar awarded about half of the mortgage amount, $157.5 million, a triple A class rating, a $38.6 million tranche received a double-A and $26.7 million tranche a single A rating. However, even without the benefit of hindsight, this rating was hardly justifiable.

First, the building was old (though renovated) and had a large single-tenant risk, with one tenant representing 71% of the rental income and a lease term shorter than the loan term. Second, there was no cash sweep trigger in favor of the bondholders. Even after the tenant decided in early 2021 not to extend the lease, the equity holder, Blackstone, was allowed to receive dividends until the end of the lease in March 2022. Only after the tenant actually had moved out and stopped paying rent did the cash sweep trigger kick in.

The problem with such capital market-driven transactions is that there is no one to manage the risk once it turns sour. The owner returns the keys and moves on, and the investors have no rights beyond what is in the contract. We should not just look at the $40.3 million lost by investors in the AAA-rated tranche. There were also $65.3 million in AA- and A-rated bond tranches that were wiped out. Even as a single-A investor, you should only expect payment delays, not total loss.

This case highlights the downside of the capital-driven US property market. Mortgage-backed bond investors should not view a Class A rating as 100% insurance against high or total loss. They must thoroughly inspect the CMBS conditions and approach high ratings with skepticism rather than trust. Compared to the US, European mortgage-backed securities tend to be fairer, safer, and more reliable. Investors are better protected in this environment.

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Of course, German real estate financiers also seek access to the capital market to refinance their real estate loans. They use the covered bond market through the Pfandbrief product, which, however, does not allow for the separation of the lender and the loan security. Lenders use this method to reduce refinancing costs by issuing top-quality covered bonds, but not to withdraw from liability.

The difference in the behavior of US and European investors became evident in Japan during the aftermath of the great financial crisis in 2008, which also left the Japanese securitized real estate market in chaos. The largest player at that time was a US investment bank, which closed and securitized up to 400 billion yen annually in real estate finance. Following the financial crisis, the largest arranger, along with other overseas CMBS players, disappeared from the market, leaving transactions and investors behind.

In contrast, Hypo Real Estate from Germany, closing 250 billion yen of balance sheet lending annually in the years before the financial crisis, stayed engaged and involved in financing arranged by the firm even though it had to ask for German government protection. They resolved every loan, even taking ownership of properties no longer supported by their equity sponsor (a US-based fund), and only closed their office after everything was settled in 2016.

The same was true for German institutional investors, such as open-end fund managers like Union Investment, Commerz Real, and DEKA. They took a hit on their Japan investments following the global financial crisis but held on, eventually experiencing a recovery in prices over time as their investments continued to perform. This holding strategy was facilitated by German valuation regulations, which allow for a much softer price correction of investments.

In conclusion, my comparison of investor protection in the US and Continental Europe seeks to raise awareness among Japanese investors that the overall risk of an investment is influenced not only by the rating of securities but also by other crucial factors such as regulations and business culture. Understanding these elements is especially important during times of crisis, as they can significantly impact the stability and performance of investments. The German word for real estate, "Immobilie," which is the opposite of "Mobilien" (meaning mobile), reminds us that real estate is not a readily liquid asset. Consequently, it should not be understood as a capital market product but rather as a balance sheet item. This practice also leads to less price volatility and explains why Continental Europe is experiencing less distress than we are presently seeing in the US market.

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