HREB Homburg
Real Estate Bank Inc

Repositioning Strategy for Distressed Commercial Real Estate Non-Performing Loan Portfolios

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1 THE OPPORTUNITY

HREB Capital Group LP proposes to forge a partnership between private equity, real estate banking, and property and asset management specialists to transform distressed commercial real estate into performing loans with short term cash flow and high margins in medium term return on capital.

Banks are increasingly willing to sell real estate non-performing loan (NPL) portfolios, because of high costs of setting aside capital on real estate loans, given the tighter regulatory requirements for banks (particularly Basel III). When loans become non-performing, banks may decide that it is best to sell these loans and remove them from their balance sheets, albeit crystallizing a loss, rather than hold them until maturity.

This is also because lenders do not have the resources or inclination to proceed with enforcement on delinquent loans, and they do not have the capacity to take on the management of the underlying properties. Real estate requires intensive asset management, capital expenditure and marketing to make it a worthwhile investment.

As a result, there is a growing market in non-performing commercial real estate mortgages (NPL market). In total, the volume of non-performing commercial real estate transactions across Europe grew to about €11.2 billion in 2012. Cushman & Wakefield predicts that the volume will increase to €30 billion in 2013.[1]

In our view, many of the recent transactions have involved unnecessarily complicated schemes of vendor finance, syndication, and complex securitization that are unwieldy to negotiate and cumbersome to administer (we review recent deals in Section 8).

HREB Capital Group proposes a simple, straightforward, and innovative approach to buying real estate debt from banks at a discount that unlocks the value in the loan in the short term, and that secure these loans in the longer term. In summary our approach is to:

1. Purchase a real estate loan portfolio from a bank in the Netherlands at a discount.

1 *"Pipeline of European NPLs is on the Rise",* *http://nreionline.com/distress/pipeline-european-npls-rise*

2. Reduce mortgage payments to turn the non-performing mortgage loans into performing loans.
3. Securitize the performing loan portfolio.
4. Create an accrual on deferred loan payments, and securitize the accounts receivable.
5. Manage the properties to generate increased value in the asset portfolio.
6. Call the accruals when market circumstances warrants or there is a sale of the properties.

2 WHY THE NETHERLANDS?

KPMG estimates that banks are holding a combined €80 billion against commercial real estate in the Netherlands, with as much €20 billion worth of loans, or a quarter, estimated to be underwater.[2]

There is a prime opportunity in the Netherlands because of high loan to value ratios, increased bank financing through covered bonds using mortgage assets as collateral, and declining real estate prices. In the context of a weak economy and fragile, and mostly nationalized, banking sector, we believe the market in the Netherlands could be looking for new solutions.

The global financial and economic crisis that commenced in 2008 hit the Netherlands hard and public finances have deteriorated badly. The crisis has led to a serious budget deficit and a sharp jump in the national debt to just over 70% of GDP. The government has announced approximately € 18 billion in spending cuts and an increase in taxes (VAT and pension contributions) with a stated objective of raising only an additional €1.3 billion by 2015.[3]

The financial system is all but nationalized. In 2008, the government of the Netherlands nationalized ABN AMRO Bank N.V., and Fortis Bank Nederland (now ASR Nederland), injecting €20 billion in capital reserves, a further €200 billion to guarantee bank loans, and increasing the guarantee on current and savings deposit accounts to €100,000. In 2013, the government was forced to nationalize the fourth-largest bank, SNS Reel.

The bill to date for bank bail-outs in the Netherlands is about €78 billion. The rescue of ABN AMRO and its related entities cost €16.8 billion initially, with subsequent support lifting the cost to €27.9 billion euro.

2 *"KPMG" Europe CRE Non Performing Loan Market Continues to Polarize". 6 March 2013. http://costarfinance.com/2013/03/06/kpmg-europes-cre-non-performing-loan-market-continues-to-polarise/*

3 *http://www.government.nl/issues/budget/budgetary-policy-2011-2015/measures-to-restore-public-finances*

A further €40 billion was required to provide capital to ING, while the SNS buy-out cost approximately €10 billion. While the Dutch government plans to sell ABN AMRO in an IPO in 2014, it is unlikely to recuperate its costs.

The Dutch Government has declared that “If the government fails to take radical measures, Dutch public finances will be unsustainable”. In February 2013, credit rating agency Fitch downgraded its outlook for the Netherlands from stable to negative. The Netherlands is rated triple A with a negative outlook and it sits just four places away from Tier 2.

There is growing unease that banks in the Eurozone are badly under-capitalized, despite meeting stress tests, as the effectiveness of the entire Basle III leverage ratios itself is being doubted. The Netherlands’ bank stability score dipped 0.2 points year on year and 0.1 points in the second quarter of 2013, which is hardly an auspicious environment for a re-privatization of any banks.[4]

Banks in the Netherlands remain extremely vulnerable to shock, particularly from real estate. It is estimated that up to 58% of the econonmy of the Netherlands is related to real estate. The mortgage market brought down SNS Bank as property values slid and loans went bad. A current funding gap among Dutch banks of close to €500 billion is increasingly being financed by covered bonds using mortgage assets as collateral. This has made Dutch banks even more vulnerable to large decreases in house prices.[5]

House prices in the Netherlands have been declining since 2009, and the continued weak real estate market, coupled with bank exposure to it, was a key contributor to Moody’s downgrade of Dutch banks in June 2012.[6]

Both the Dutch government, and the banks, particularly ABN AMRO and Fortis, therefore could be highly receptive to being helped by divesting fragile state-owned banks of a large portfolio of distressed commercial real estate mortgages.

Therefore, the banks may be highly receptive to a NPL sale and HREB has an innovative, solution, with a potentially high return to equity investor partners.

4 *https://www.moodys.com/research/Moodys-downgrades-Dutch-banking-groups-most-outlooks-now-stable--PR_248387*

5 *OECD Economic Surveys: The Netherlands, June 2012. http://www.oecd.org/eco/50550641.pdf*

6 *Moody’s Investor Service, “Key Drivers of Dutch Bank Ratings Actions”, 15 June 2012.*

3 REPOSITIONING DISTRESSED COMMERCIAL MORTGAGES

Dutch gross mortgage debt, currently standing at €640 billion, totals 106% of GDP, which is higher than any other EU country. Also, the Loan-to-Value (LTV) of Dutch mortgages is high from both a historical and an international perspective.[7]

Amsterdam-based merchant bank Kempen estimates that among the €4.4bn CMBS loans maturing through 2014, it sees €1.7 billion in troubled office portfolios.

While CMBS can yield high returns, the risk in CMBS is refinancing and that risk is extremely high - especially since the commercial banks that advanced the loans usually do not know the first thing about real estate. Also, banks' ability to lend has been impaired and loans are typically very large, elevating the risk. In 2012, two-thirds of loans did not refinance at maturity. They either defaulted, or there is a postponement on those loans and no action, or only limited action has been taken as yet.

The sad fact of the matter is that commercial banks, not being expert in real estate, face the biggest risk in banking of them all - intellectual risk: the banks simply don't know what to do. As a result there is paralysis, and mounting concern about what will happen in 2013 and 2014, when CMBS will be competing with other maturing loans for limited available financing.

Homburg Real Estate Bank proposes a different solution that safeguards and secures the real estate assets through an innovative structure and provides for high returns.

The HREB Capital Group Limited Partnership harnesses a unique combination of participants in a new partnership model that repositions distressed commercial real estate in a way that:

- Assures immediate cash flow on new performing mortgages re-written at current terms and conditions on the basis of 60% LTV on present day valuation
- Safeguards assets while the market recovers
- Provides participation, through postponement of remaining debt plus the accrual of interest thereon.

7 *https://www.rabobank.com/en/images/Dutch_Mortgage_Market_a_liability.pdf*

The participants in this formula are:

- Syndicated private equity with an appreciation and knowledge of real estate
- Homburg Real Estate Bank's Special Purpose Vehicles for asset management (HREB Asset Management LP)
- Homburg Property Management Services (Homburg Services Group Europe b.v)

4 HOW IT WORKS

Private equity investment provides the capital to gain the assignment of mortgage paper from Dutch banks to HREB, at a discount on face value.

The costs of acquisition of commercial mortgage paper in the Netherlands is minimal. There are no transfer costs for assignments in the Netherlands, meaning minimal costs for transfer of title when done through the transfer of the mortgage deeds.

We would purchase the mortgage portfolio at 75% of present market value. Hence, private equity participation is secured with an investment that remains lower than the face value of the mortgages, and also lower than the collateral at current market value.

We would then split the mortgage, and rewrite a portion based on a LTV of 60% present day valuation.

HREB would issue new mortgages to the current owners, with new loan to values at present terms and conditions. This enables the borrowers to meet their obligations, and turns the non-performing loans into performing loans. Borrowers would have an incentive to re-write mortgages, since the alternative is default, and all of the undesirable consequences of repossession.

Keeping the owner invested in the property:

- maintains cash flow on new performing mortgages
- ensures regular checks for maintenance and upkeep of the property

The remaining part of the original mortgage remains on the books, and accrues interest. This accrual can be realized when the property is sold, or when economic conditions enable the borrower to pay it. In the meantime, this accrual is secured against the property.

Mortgage portfolios will be held by the HREB Capital Partners LP, or is assignees.

Homburg Management Services ensures that the assets are well managed income-producing properties, by providing:

- expert advisory services on leasing strategies to landlords to maximize occupancy
- market research and consulting on market conditions to maximize rents
- routine examination of properties to ensure adequacy in maintenance

Therefore, the Limited (equity) Partners benefit in these ways:

- The physical real estate assets are maintained on the balance sheet of the mortgagor.
- The securities accrue interest on the postponed portion of the original mortgage.
- The re-written mortgages are kept up to date through stable lease income from refinanced properties at current market values based on present lease contracts.
- In the medium term, participation in the upswing through realization of the deferred interest accrual when property prices rise and is refinanced, or the real estate is sold.

Illustration

Assume that a bank made €500 million in loans on real estate valued at €650 million when times were good. However, the current market value is now only €400 million. With equity finance, HREB would purchase the mortgage paper for €300 million (75% of current valuation).

Private equity participation is secured with a €300 million investment with a face value of €500 million on €400 million of collateral at market value.

The banks would have an incentive to gain the €300m in cash, as this frees them of the current liabilities on their balance sheets, and future risks of default, which affect their already unstable and declining credit ratings. At the same time, the banks can convert the liability into cash, and then leverage the cash into Tier 1 capital to secure central bank finance.

HREB would then issue new mortgages, with new loan to values at present terms and conditions, based on a €400 million valuation at 60% LTV.

A new first mortgage would be written, being €240 million at present terms and conditions. The remaining balance of €260 million from the original mortgage would continue to accrue interest at the last posted rate in the original mortgage loan document.

Sixty percent of the €400 million of collateral at market value is securitized, producing €240 million of Grade A securities.

Having refinanced €240 million of the original acquisition cost of €300 million, the exposure for the HREB Capital Group is only €60 million, with a security on the properties of the original mortgages of €260 million. This carries a potential profit over this of €200 million, plus accrued interest.

Homburg Management Services will provide property management and expert advisory to maximize lease income, keeping mortgages up to date, and ensuring the property is adequately maintained.

The partnership receives and accrues cash flow from:

- Up-to-date mortgage payments
- Interest accrual on deferred interest
- As inflation increases the market value of properties, ability to re-issue Grade A paper on leveraging increased equity in the properties
- Realization of the deferred interest (on the postponed portion) with a sale of the property or refinancing with the eventual upswing in property values.

5 STABLE INCOME ON COMMERCIAL MORTGAGES WITH EXPERT PROPERTY MANAGEMENT

Distressed commercial property through repossession does not generate satisfactory results. Homburg's approach starts with keeping the property owner alive to maintain cash flow from the properties.

The Homburg International Group draws on 44 years of international experience in land development, new construction, property management, and asset management in numerous countries. With a track record of over $10 billion in commercial property transactions, Homburg has joint-ventured with some of the leading names in the industry, and has an unparalleled track record in the repositioning of distressed real estate assets -an experience that dates back to assisting in the clean-up of the US Savings and Loans crisis through the Resolution Trust.

Property management services from the Homburg International Group, incorporating the most up to date technology in property management and building systems, includes a Yardi property management software deployment.

The Homburg International Group also relies on the market research and business advisory of the Homburg Institute, a think-tank of more than 70 of the top academics and advisors in commercial real estate in 13 countries.[8]

Homburg Management Services' close involvement with landlords can assure a secure, timely and stable repayment of mortgage obligations, as well as management of the property. Landlords benefit from expert advisory services on market conditions and leasing strategies to maximize occupancy, and the properties are examined on a routine basis to ensure adequacy in maintenance.

Most banks normally never see the properties that they hold in their mortgage portfolios, and even if they did, commercial banks are not experts in real estate to know what they are seeing. They are hardly in a position to advise on the rental market. By contrast, Homburg Management Services ensures a safe, and secure property management providing guidance to landlords.

6 SAFE INVESTMENTS ON CURRENT VALUE

What is more, the mortgage portfolios are held in a secure limited liability partnership (LLP) structure in Canada. The LLP partnership structure has been used by Homburg for over $10 billion of real estate assets over the last 15 years.

The Partnership laws in the province of Nova Scotia are among the most favorable to limited partners in the Canadian legal landscape.

Securing private equity investment in the SPV structure ensures that each asset (fund) is protected from all of the others through protective fire-walls. The legal structure ensures that all assets can be held individually, while the portfolio as a whole is leveraged into financial products.

Because of a dual taxation treaty between the Netherlands and Canada, there is no withholding tax on the mortgage interest. This means that distributions can be paid to Canada from the Netherlands without withholding tax.

8 *Visit online at http://www.homburgacademy.org/ and http://www.homburginstitute.com/*

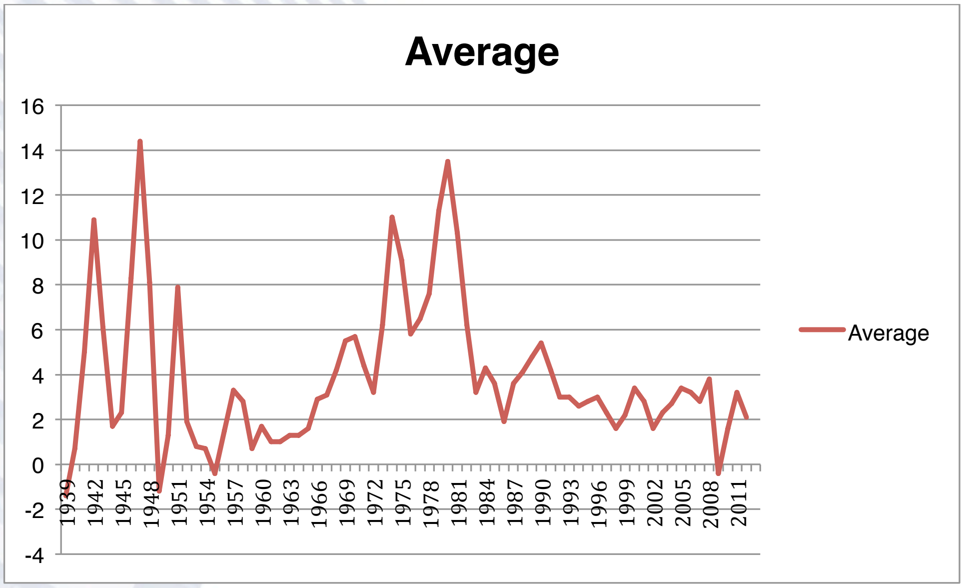
7 REAL ESTATE CYCLES AND ASSET APPRECIATION FOLLOWING FINANCIAL CRISIS

There are several truisms about real estate and inflation cycles that guarantee the realization of the accrual (deferred interest) in the HREB approach to repositioning distressed commercial real estate mortgage portfolios:

1. There is always inflation
2. Real estate asset returns have always outperformed inflation
3. Debt-saddled governments need more inflation
4. There is always an upside to a real estate cycle

1. There is always Inflation

There has been inflation in every year since the end of the Great Depression in 1939, with the exception of 1949, 1955, and in the depths of the Great Recession in 2009.



Source: http://www.usinflationcalculator.com/inflation/historical-inflation-rates/

Data is for the United States for comparability with REIT returns, for which no data is available for the Netherlands, but the principle holds true for the Netherlands

2. Real estate assets have always outperformed inflation

The second truism is that real estate assets have always outperformed inflation. This has held true since at least the 1970s[9]:

- The period 1974-1981 was the most inflationary eight years in the history of the US Consumer Price Index at 9.3% per year, but equity REIT returns averaged 16.3% per year.
- In the years 1978-1980 (the worst three-year period in six decades), inflation averaged 11.6% per year. Again, publicly traded equity REITs outpaced inflation with income and total returns as high as 23.1% per year.
- During the first eight months of 2011 annualized consumer price inflation was 5.1%, yet equity REIT returns protected purchasing power with annualized total returns averaging 8.4%.

Inflation also acts upon real estate differently than on other assets: Studies have shown that inflation lowers after tax returns on bonds and stocks more than those on real estate, which is often cited as the reason for the portfolio shift, from the 1970s, that has made real estate the largest asset class held internationally.[10]

3. Debt-saddled governments need more inflation

It is not uncommon for government to re-inflate their economies deliberately following a recession, particularly when providing counter-cyclical liquidity to the market in times of distress has caused an increase in the national debt.

Because of this trend over the last 20 years, coupled with the size of the national debt particularly in the United States amassed during the recent financial crisis, some economists are predicting an 'inflation tidal wave' as governments inflate their way out of debt.[11]

9 *See for instance Brad Case and Susan M. Wachter, "Inflation and Real Estate Investment". NAREIT Research Paper, forthcoming. Available at: http://realestate.wharton.upenn.edu/research/papers/full/716.pdf*
Data is for the United States for comparability with REIT returns, for which no data is available for the Netherlands, but the principle holds true for the Netherlands

10 *See Feldstein, Martin. "Inflation and the Stock Market." The American Economic Review, Vol. 70, No. 5, (December 1980), pp. 839-847; Lawrence H. Summers, 1981. "Inflation and the Valuation of Corporate Equities," NBER Working Papers 0824, National Bureau of Economic Research.*

11 *There is discussion among economists about the numbers, but general agreement that inflation is likely to increase. For the strongest case, see David Skarcia, The Great Super Cycle: Profit from the Coming Inflation Tidal Wave and Dollar Devaluation, John Wiley & Sons, NJ, 2011.*

4. There is always an upside to a real estate cycle

The final truism in real estate is that when real estate bubbles burst, values will always come back. This repeatable pattern of real estate cycles was observed by Homer Hoyt as long ago as 1947:[12]

Real Estate Cycle

12 *Homer Hoyt, "The Effect of Cyclical Fluctuations upon Real Estate Finance," Journal of Finance, Vol. 2, No. 1, April, 1947, pp. 51-60.*

It is generally the case that the illiquid nature of real estate makes property markets correct more slowly than stock markets. This is known as a "process of attrition", as lenders are reluctant to push foreclosures, and owners, who have bought close to the top of the market, are reluctant to realize losses. Housing transactions dry up and prices deflate. This process of attrition for Hoyt "prolongs the agony", which Richard Homburg calls "the effects of a bad marriage" - everyone knows it's over but neither party wants to take action.

Severe downturns in the property market are often characterized by banking failures, surging vacancies, and a glut of supply on a lackluster market. Hoyt's research found that the wreckage is generally cleared away in four to five years. In the best-selling book, This Time Is Different, Professors Reinhart and Rogoff also find that real estate price declines last on average for 6 years following a financial crisis.[13] The downward phase of the cycle is prolonged by the deleveraging that follows great credit booms.

Most current disagreement among analysts is about whether we are currently in a period 19 of the cycle, where the wreckage is being cleared away, or whether we are still in period 18 where there is stagnation and foreclosure. However, the fact remains that we are close to the end. It is particularly important that the end come quickly for the Netherlands where it is estimated that up to 58% of the economy is related to real estate, unlike in North America where real estate accounts for about one third of GDP.

In longer term historical perspective, the real estate market must revalue, if for no other reason than to justify new construction. Construction is a key to economic regeneration, and a principal vehicle through which governments re-inflate their economies, particularly as governments are currently facing the specter of deflation, at a time when the management of public debt demands inflation.

13 *Carmen Reinhart and Kenneth Rogoff, This Time is Different: Eight Centuries of Financial Folly, 2009.*

8 THE SIMPLICITY AND EFFECTIVENESS OF THE HREB APPROACH

Homburg Institute has studied the deal structures, within the publicly available information, of a number of high-profile NPL deals, including:

- Lloyds Banking Group £900m sale of the Project Royal portfolio to Lone Star Funds, the Dallas-based private equity firm.[14]
- Royal Bank of Scotland completed Project Isobel, the £1.4bn sale of distressed property loans to Blackstone.[15]
- Credit Suisse Group AG (CSGN) financed the sale of $2.8 billion of property loans to Apollo Global Management LLC.[16]
- The Irish National Asset Management Agency (NAMA) has purchased loans with a nominal value of €74 billion at a discount of 57% from participating financial institutions.[17]
- In 2011 Kennedy Wilson, acquired a $1.8 billion real estate loan portfolio from the Bank of Ireland.[18]

With the exception of the NAMA, these deals have been generally extremely complex, and in our view, unnecessarily cumbersome, for the following reasons:

1. Competitive bidding for the banks' NPL portfolios have caused pressure to structure deals quickly, with little thought to optimal long-term repositioning strategies of the assets. By contrast, HREB's more thoughtful approach builds in the long-term realization of deferred interest payments, and structures the repositioning through new debt and partial postponement of interest (accrual)v to maintain a stable and performing loan portfolio in the short term that are positioned for windfall gains over time.

14 *"Lloyds to sell £900m of Property Loans", Financial Times, 7 December 2011. http://www.ft.com/intl/cms/s/0/9b5e6668-20bb-11e1-8133-00144feabdc0.html#axzz2i0KdiQRF*

15 *However, this complex vendor financed 'false deleveraging' did not supply the bank with additional tier-1 capital.*

16 *http://www.bloomberg.com/news/2011-11-23/european-banks-get-false-deleveraging-.html*

17 *http://www.nama.ie/about-our-work/key-figures/*

18 *http://www.reuters.com/article/2011/10/24/kennedywilson-idUSL3E7LO29H20111024*

2. Some of the more tenuous deals depended on vendor financing, which is both counter-intuitive to the ethos of the restructuring, and bound to garner political attention. In comparison, HREB's approach to forge a partnership between private equity, asset management and property management is much simpler and clean.
3. Where foreclosure or forced sale has the preferred strategy of the asset management company, this has been the absolutely wrong strategy. Selling the property in a market with historically low market values and high inventory might realize razor thin margins, depending on the discount obtained from the purchase from the bank. Foreclosure in an NPL deal is a strategy for sharing the hair-cut between the banks and the asset-managers acting as liquidators. HREB's approach draws from the experience of 44 years of asset management in real estate, with a proven track record for unlocking value and creating profits for all stakeholders.
4. Syndication of equity participants resulted in delays, disagreements, and partnerships sometimes falling apart. Any NPL bid process carried out in the view of the public in the media is bound to pressure brands to save face as deals mature and evolve, and partners can withdraw for reputational reasons. HREBs approach is to deal directly with the banks in the Netherlands, before a crisis erupts.
5. Shifting participants in the NPL deals has also included public disagreements among equity partners over the preferred asset and property management, also resulting in instability. By contrast, HREB's resources and experience span both asset management as well as property management, bringing the entire structure into a seamless vertically-integrated enterprise.

Prepared for Homburg Real Estate Bank by the researchers at Homburg Institute Canada, October 2013.
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