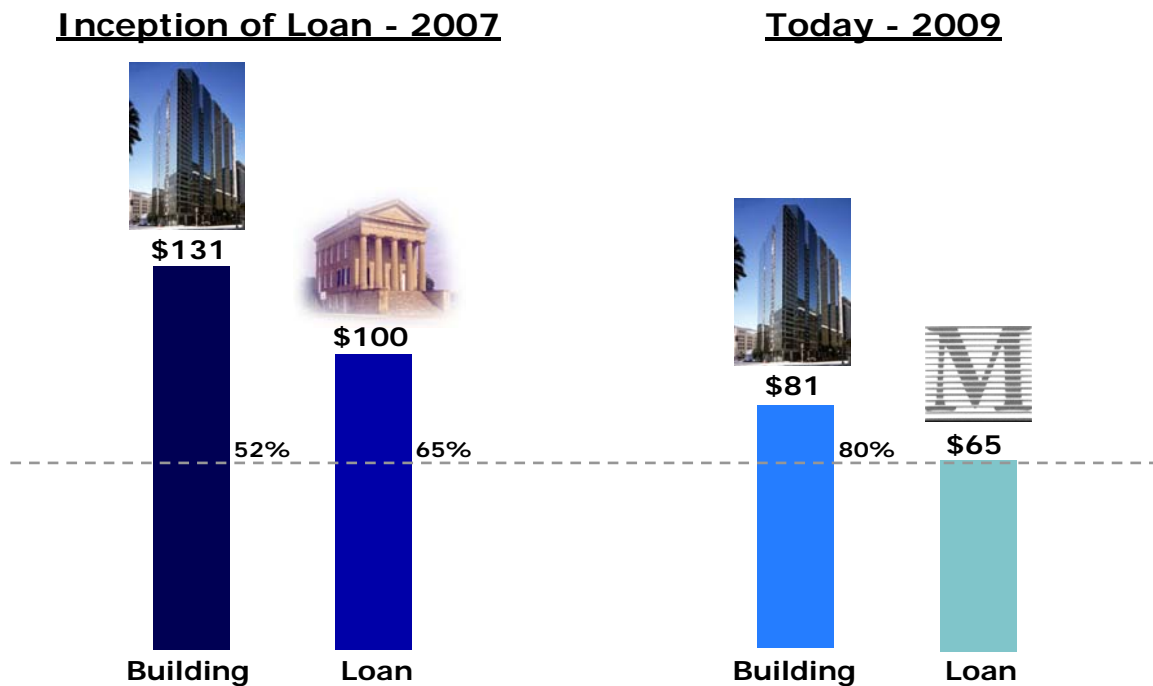


Example: Discounted Mortgage Loan Purchase



In this example a loan was bought from a nationalized European bank at a discount. The loan is secured by a suburban office building; the owner has been repositioning the building

- Total cost to owner of building encompasses costs to: buy, rehabilitate, and substantially release. The building is now in like-new condition and 80% leased; some tenants will leave over the next few years. Note the 'distress' is in the capital structure, not so much at the building level
- Original loan proceeds or principal: paid to owner of building at inception two years ago, and due back to the lender at maturity, three years from now. The difference between the value and the loan amount due is the building owner's equity. Loan to Value (LTV) is 76% ($\$100/\131)
- Current estimated value of the building, according to our manager, assumes very weak leasing and sales market for next few years
 - The current building value is now \$50 below the owner's cost (down to \$81 from \$131), so the owner would lose this amount if the building were sold today
 - The current building value is now \$19 below the loan amount due at maturity (down to \$81 from \$100), three years from now
- Our manager just bought the loan from the lender for \$65, or 65 cents on the dollar (\$65 price vs. \$100 face or principal amount of loan is 65%). Our manager now owns the loan and gets all of the interest and principal payments due to the original lender, who took a loss and is out of the deal
 - The current building value is now \$16 above the price our manager paid for the loan (\$81-\$65). Our manager is the only one 'in the money' and so controls the destiny of this building
 - Our manager's exposure to the building is at 80% LTV (\$65/\$81). This is roughly the cost at which he would own the building if he foreclosed



Example: Discounted Mortgage Loan Purchase

▪ Income Streams

- The loan has a fixed interest rate which is now being paid in full, so the loan is 'current'
- The income generated from the building's tenants is 1.25x the coupon due on the loan; this is called the Debt Service Coverage Ratio (DSCR)
- Based on their discounted price, our manager has a higher current yield (12.5%) than the original lender

▪ The Situation

- Since the value of the building is well below the amount he owes on the loan at maturity, the owner of the building could decide to stop paying interest, cut his losses and allow the owner of this loan to foreclose. Mortgage loans are most often non recourse, meaning the lender gets only the building on foreclosure and cannot pursue the owner's other assets. Thus, stopping payments and letting the lender foreclose or giving back the keys is a valid option
- The building is 80% leased. Someone will have to put money into the building to protect the income stream generated by the building; tenant improvements and leasing commissions must be paid to add and/or replace at lease expiration tenants to increase or maintain income. At present, unless he sees real potential for value recovery and has capital, the owner of the building is not motivated to spend money
- In today's market, it is common to have loans like this that are current (interest is being paid, there is no interest default) but that are under water (there is negative equity, loan due at maturity exceeds building value) and are facing maturity defaults. This issue comes to a head either at maturity or when capital must be invested to renew/replace a tenant and prevent interest default. In recent years, loan covenants have been relaxed, so there is less likelihood of a covenant default; common covenants would relate to maintaining specified LTVs or DSCRs

▪ Possible Outcomes

- The new owner of the loan has a basis (price) that is much lower than the principal owed and this creates opportunity
- At one extreme, the owner of the loan could foreclose and own the building at 80% of its current value (\$65/\$81) and 52% (\$65/\$125) of what it cost the building owner. In this example, foreclosure is straightforward. If this is the intent at purchase, we call it loan to own
- Another possibility is a workout. This is likely to involve both parties seeing value improving over time, some capital outlay on the part of the building owner, and:
 - Partial paydown of the loan. This increases the likelihood that the loan is not underwater when it comes due, thus reducing the owner's risk, and puts cash in the hands of the owner of the loan thus reducing his risk
 - Extension of the loan maturity to give the owner time to recover value
 - Resetting the interest rate to one that the building can service (the goal is to avoid default) and usually one that provides the owner of the loan a higher spread than the original loan. Combined with a paydown, this can meaningfully increase the current yield for the owner of the loan



Mortgage Loan buyers need multiple skill sets

The following factors determine the price paid for the loan and the ultimate returns:

- **Basic Real Estate Skills**

- What the building is worth now and through maturity
- How much net income the building will generate from its tenants now and through maturity
- What the capital needs of the building will be
- How to operate the building if foreclosure results in direct ownership

- **Real Estate Lending Skills**

- The likelihood of foreclosure and a good estimate of the cost and timing probabilities
- The lenders rights
- If restructuring is a possibility, the owner of the loan must be able to identify and negotiate appropriate terms with the owner of the building

- **Networks**

- Contacts with banks to access the loan purchase
- It helps to know the personality and circumstances of the owner of the building

This is a simple example:

- There is one loan, also called a **whole loan** or **first mortgage**
- In many cases, especially with larger assets, a single building will have multiple loans. The **first mortgage** or **senior loan** has first rights to cash flows. The second mortgage is usually referred to as **mezzanine** or **mezz debt** or it may be called a **B-Note**, a term borrowed from securities vernacular. The loans may be **syndicated** or shared among multiple lenders
- If there are multiple loans and/or lenders, an **intercreditor agreement** defines the rights and obligations of each party

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