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THE WEEKLY UPDATE ON REAL ESTATE FINANCE AND SECURITIZATION

B-Piece Buyers Seen Stepping Up 'Kickouts'

Buyers of subordinate commercial MBS are expected to begin flexing their muscles much more aggressively in coming months.

Market players expect B-piece buyers to put increasing pressure on lenders to address marginal loans, either by reducing the size of the securitized portion or kicking out mortgages entirely from collateral pools.

The sudden shift in the landscape has been prompted by concerns about deteriorating loan-underwriting standards. Spreads on below-investment-grade bonds have already widened out by about 75 bp in recent weeks and are viewed as likely to increase further.

Issuers are bracing for the financial hit they will take on warehoused loans that would have passed muster a few weeks ago, but now will be have to be restructured to be made acceptable to high-yield investors.

"B-piece buyers are generally taking a harder look at things," said the head of one CMBS program.

The balance of power in negotiations between issuers and B-piece buyers has waxed and waned over the years. In the late 1990s, when there were only a handful of B-piece buyers, they wielded enormous clout.

But issuers gained more of an upper hand as the B-piece market became more liquid. Not only has the number of B-piece buyers grown, but their appetite for paper has expanded because the emergence of the real estate CDO market has enabled them to recycle capital more efficiently. CDOs have reduced B-piece buyers' cost of capital, which has put downward pressure on CMBS spreads. The yield of first-loss classes in recent months stood at 20-21%, down from as high as 28% in the late 1990s.

In addition to negotiating pricing, B-piece buyers wrangle over loans that will be included in collateral pools. Years ago, they sometimes rejected up to 10% of the collateral pool, but "kickouts" have since declined dramatically. "For a while, the number was zero," said a CMBS executive who negotiates with B-piece buyers.

The market downturn, coupled with rating agencies' promised crackdown on subordination levels, provided a jolt that is likely to stiffen the spines of B-piece players. With the values of their CMBS portfolios declining, B-piece buyers will almost certainly turn more cautious. What's more, an unlikely ally has suddenly emerged — vigilant triple-A investors. Senior investors, who traditionally have been passive, forced the issuers of a $4.2 billion fixed-rate GE Commercial Mortgage Trust deal that priced last week to remove five collateral loans totaling $227 million and to downsize another mortgage by $50 million. The main concern was that the loans were on nonstabilized properties, which historically have been financed in the floating-rate market.

Market players said the message is clear: Issuers will find it difficult to jam loans on transitional properties into fixed-rate CMBS deals. "That party is over," said one B-piece buyer.

Securitization programs have unpalatable options for such loans that are in their warehouses: Carry the loans on their books until the property stabilizes, sell them at a loss, or carve out B-notes so the portion of the loan in the securitization is less risky.

The problems of B-piece buyers have been worsened by troubles in the CDO market. Largely because of the subprime-mortgage debacle, CDO spreads have widened out. Issuers are having trouble selling all but the triple-A and double-A tranches. Also, the rating agencies have said they will raise CDO subordination levels. That means B-piece buyers not only have higher capital costs, but also face worries that they will be unable to finance a greater portion of acquired CMBS. Those factors point to B-piece buyers becoming more picky.

Even so, some market players see a subtle shift, and not a major jolt, as happened when the aftershocks of the 1998 bond market downturn that forced **Criimi Mae** — then the most-active B-piece buyer — into bankruptcy and left other B-piece buyers facing margin calls from warehouse lenders.

One reason for optimism: Unlike in 1998, liquidity remains strong. In fact, the number of B-piece buyers has risen lately as new buyers — including **Presidio Investments, Hillenbrand Partners, J.P. Morgan Capital** and **Five Mile Capital** — have entered the field. For example, a partnership among Presidio, **Invesco Funds** and J.P. Morgan Capital has circled the junior classes of a $3.5 billion fusion deal scheduled for this month by **CIBC** and J.P. Morgan Chase.

Since being founded in 1998, Dallas-based Presidio, which invests on behalf of the **Hunt** family, had focused on property investments. But sources said the firm, wary that prices have risen too much, has determined there is more value in the B-piece market. Presidio is willing to take over properties if borrowers default.

Hillenbrand was formed a year ago by **Eric Hillenbrand,** who bought B-pieces at **Banc One** and predecessor **First Chicago** before leaving in 2004 after J.P. Morgan bought Banc One. The firm recently raised about $200 million of equity via **Morgan Stanley** and is bidding on new-issue B-pieces. Hillenbrand expects to have $750 million of capital raised by the fall.

The group at J.P. Morgan Capital involves the remnants of Hillenbrand's former group, which was less active for a few years but is once again bidding for B-pieces. Five Mile, an opportunity fund manager based in Stamford, Conn., recently began bidding on B-pieces, although it is not believed to have won any auctions. ❖