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PERSON OF THE WEEK: Jerry Dunn On TIC Trends And Loan Origination

Jessica Lillian, Tuesday 21 July 2009 - 09:45:08

This week, MortgageOrb checked in with A10 Capital, a firm that recently established a lending group to originate commercial real estate loans and provide financing for distressed-debt investors. We talked to Jerry Dunn, the company's CEO, about strategies for originating commercial mortgages right now, the problems affecting the tenant-in-common (TIC) market and, finally, when recovery may happen in the commercial mortgage industry.

Q: Are you actively originating commercial mortgages right now? What is the typical deal profile for a transaction that can still happen in this market?

Jerry Dunn: Yes, A10 Capital is in a unique position because we raised significant capital prior to the credit crisis, but we have only been originating loans since after the Lehman bankruptcy occurred.

We are willing and able to make commercial mortgage loans because we have no legacy assets and significant "dry powder." We are also seeing an increase in financing requests from distressed-debt buyers.

All lenders have tightened underwriting criteria. Most lenders have reduced maximum loan-to-value thresholds to 65% and increased their debt-service coverage ratio minimums.

Life insurance lenders are being very selective and cherry-picking only the highest quality properties, and banks are focused on financing their best bank relationships. We specialize in filling this large void by originating nearly bankable commercial mortgage loans.

Q: What are the biggest problems currently plaguing the TIC market specifically? When might this sector see some relief?

Dunn: There are two primary problems. First, the general decline in commercial real estate fundamentals and resulting values has exposed questionable practices, mismanagement and unsound business models of many TIC sponsors and syndicators.

As an example, some TIC syndicators were selling buildings to TIC investors with a 25% markup just 30 days after they acquired them. As the loans on these marked-up properties are now coming due, many of them are unable to refinance because they have very little, if any, true equity left in the building.

Second, the recent wave of foreclosures on TIC buildings is educating lenders on the challenges of working out a distressed TIC loan. Instead of working with one sophisticated owner, lenders are burdened with the administrative challenge of dealing with 25 owners on one property, some of which have little or no commercial real estate experience.

Moreover, we have seen some TIC groups use aggressive stall tactics that significantly lengthen the foreclosure process. The most aggressive tactic we have seen is a situation in which each TIC owner puts its legal entity into bankruptcy in successive months, essentially creating a perpetual delay to the lender's foreclosure.

As a result of these two problems and the lessons learned from them, we believe that many lenders will reassess whether lending to properties that are owned in TIC structures is prudent.

Q: During your $100 million capital raise two years ago, did you foresee the current crisis? Has the severity of current conditions exceeded expectations?

Dunn: A10 Capital was formed in anticipation of the credit crisis. For many years, our founding partners were critical of the aggressive underwriting and pricing practices of the conduits and many bank lenders.

Based on this, our founders raised significant capital and assembled our team prior to the crisis. It was our belief that a significant correction was inevitable, although I can't say we thought it would be this dramatic.

Q: Given that you finance deals that conventional lenders may shy away from, what steps do you take to mitigate risk?

Dunn: Most of our loan requests are on transactions that conventional lenders would have financed in the past. The reason they are shying away is not the transaction itself; it is that they are de-leveraging their balance sheet or are hampered by legacy loans.

We come from bank and securitization backgrounds, so our credit culture is very sophisticated and robust. We mitigate risk by doing extensive due diligence on the property and market, which includes taking into account trends in the fundamentals and the impact that has on future collateral value.

However, because we are not regulated, we can complete the same level of due diligence as a conventional lender in a fraction of the time to ensure that we can meet tight deadlines of opportunistic purchases.

Q: When do you foresee a recovery for the commercial mortgage industry?

Dunn: I am generally an optimistic person. However, it is impossible to ignore the massive systemic issues that have converged on the industry all at once. The deep recession has put significant pressures on commercial real estate fundamentals.

The fact that the commercial mortgage-backed securities market is shut down and that banks have dramatically reduced originations has taken an enormous supply of capital out of the system.

At the same time, there is a huge demand for capital, given the approximate $1.4 trillion of loan maturities that will be hitting in the next five years across banks, life companies and conduit portfolios.

At a macro level, unfortunately, we foresee a long recovery period for the commercial mortgage industry.

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