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'Frankenstein' Security Mounting a Post-Crisis Comeback in U.S.

April 28 (Bloomberg) – A Wall Street financial instrument that amplified losses during the U.S. property-bubble collapse is seeing a revival.

A specialty finance lender backed by private-equity firm H.I.G. Capital on Friday sold $209 million of commercial mortgage bonds tied to 31 properties. Underwriter Deutsche Bank AG called it a "middle market intermediate-term commercial real estate" deal. Moody's Investors Service used a title more familiar to Wall Street: a commercial real estate collateralized loan obligation, or a CRE CLO.

These instruments, which flourished under a similar name before the financial crisis, are making a comeback as specialty lenders look for new ways to fund a real estate market that's facing $1 trillion of maturing debt over the next three years.

While the latest securities have been bolstered by stronger collateral and lower leverage, the structure was once so moribund that attempts to reanimate it prompted a reference to Dr. Frankenstein's monster in a 2013 Royal Bank of Scotland Group Plc report by analyst Richard Hill.

Three similar deals were sold in the first quarter, according to a report by Morgan Stanley, where Hill now works.

The underlying collateral is less risky than the kind backing securities that collapsed amid a wave of mortgage defaults in the credit crisis, according to the report by Hill and Jerry Chen. Morgan Stanley says around $5 billion of CRE CLOs could be sold this year through 15 transactions, compared with eight such deals in 2013.

"While the envelope is getting pushed a bit, levels and structure remain healthy – significantly better than pre-crisis levels," Ed Shugrue, chief executive officer of Talmage LLC, which manages $1.2 billion mainly in commercial real estate, said in a telephone interview.

Higher Yields

Investors are being lured back to such instruments because they offer high yields, compared with other securities that have similar ratings, amid a seventh year of near-zero short-term interest rates. The largest, highest-rated component of the H.I.G. Capital deal, which was issued by A10 Capital, pays a rate of 125 basis points more than a lending benchmark. That's 29 basis points more than the average spread for the highest-rated corporate bonds, according to Bank of America Merrill Lynch index data. A basis point is 0.01 percentage point.

A10's Capital's deal paid investors as much as 375 basis points over a benchmark for lower-rated portions, data compiled by Bloomberg show. The highest-tier notes include

protection from losses of as much as 46 percent. Moody's awarded AAA grades to those notes, the only component of the seven-part deal it was hired to rate.

Stronger Protections

A CRE CLO is in the family of structured products closest to a commercial mortgage-backed bond. The securities pool loans or other debt and divide the pool into slices with varying risk and return, which are then sold to investors.

The new securities come with stronger protections and a slightly different name than the CRE CDO label – a reference to collateralized debt obligations – seen in deals before the crisis. Issuance of CDOs tied to commercial real estate surged to a record $50 billion in 2006 before coming to a halt the next year as credit markets started seizing up.

The A10 Capital deal includes four additional classes of incrementally riskier bond slices. A10 will retain two smaller portions that would be wiped out first in the event of defaults.

DBRS, which assigned grades from AAA down to B on the deal, said in an April 15 ratings report that A10's "greatest strength" is its experience and ability to perform hands-on management.

'Another Bubble'

One aspect that resembles the older variety is the return of the so-called managed structure. That means the issuing firm has the option to invest in loans it chooses, while investors may not be fully aware of what exposures the issuer may add into the deal.

In their report, Hill and Chen wrote that flexible structures "should not be viewed negatively if they serve as term financing vehicles for issuers with strong track records and a primary business of originating and investing in these types of assets."

Instead, they're concerned that unproven managers may issue these securities just to increase assets under management and to enhance yield. "With no underlying business purpose, we caution that a proliferation of such deals could potentially contribute to another bubble in commercial real estate prices as systemic leverage increases," they wrote.

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