COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS) - AN ALTERNATIVE DEBT FINANCING INSTRUMENT FOR DEVELOPERS

The CMBS (Commercial Mortgage - Backed Securities) market, once highly preferred by developers as an alternative funding instrument, has come to standing still in recent years, thanks to the ample banking liquidities and relaxed lending policy.

Developers widely used CMBS during the 98 – 99 credit crunch period after the Asia Financial Crisis as it offered advantages unrivalled by other conventional financing options. Cheaper pricing is one of its benefits.

However, the intense competition in the loan market has undercut its edge. Banks' eagerness to throw large credit lines at even cheaper rates have driven developers with less incentive to structure the complex the CMBS deals.

Despite government's new spate of housing policies to prop up the residential market recently, the property market outlook was even grimmer with dwindling demand and falling prices. Developers are more fiercely cutting their sales prices to entice buyers who are increasingly scarred away by the soaring unemployment figures.

Sagging corporate earnings and surging property provisions would hit property developers amid this bleak market outlook. To aggravate the matter, we anticipate banks would be less aggressive in lending and adopt more stringent lending rules.

The depressed stock market wouldn't lend a helping hand to developers either as they find it difficult to place their shares to raise funds.

Against this backdrop, we have reasons to believe that CMBS market will be back in vogue.

We think developers with large recurring rental incomes and in high gearing such as Great Eagle, New World Kerry and Sino would likely use CMBS in the future to raise funds.

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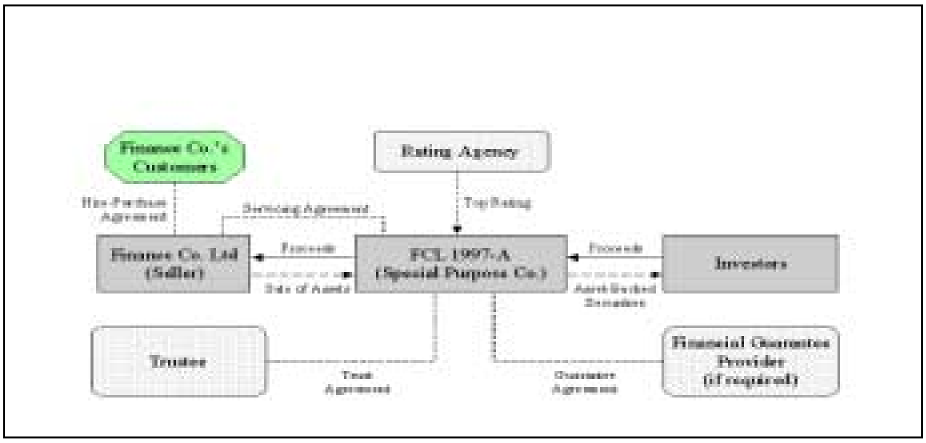
WHAT IS ASSET SECURITISATION?

Asset-backed securities are securities which are based on pools of underlying assets. These assets are usually illiquid and private in nature. A securitization occurs to make these assets available for investment to a much broader range of investors. The "pooling" of assets makes the Securitisation large enough to be economical and to diversify the qualities of the underlying assets. A special purpose trust or instrument is set up which takes title to the assets and the cash flows are "passed through" to the investors in the form of an asset-backed security. The types of assets that can be "securitized" range from residential mortgages to trade receivables and even music royalties. The asset-backed security usually qualifies for a top rating and enables the issuing company or bank to raise funds at a very attractive rate, while freeing up capital and retaining customer relationships and servicing revenues.

COMMERCIAL MORTGAGE-BACKED SECURITIES

The CMBS are debt securities using commercial assets as collaterals and incomes generated from the property assets are used to pay back the loans and the interests. Property assets are normally sold to a special purpose vehicle (SPV) which then issues CMBS and the sales proceeds from the securities will then be returned to the original property owners. CMBS is widely considered as an innovative financing instrument in the debt market.

An Illustration of CMBS Structure



Source: Professor Giddy's globalsecuritisation.com

SECURITISATION DEALS IN HONG KONG

Date	Properties	Fund Raised	Developer	Remarks
Sept 1995	174 luxury apartments in Queen's Garden, Central	HK$959mn	Eton Properties	Hong Kong's first single asset securitisation
Nov 1996	425 apartments and 779 carparks in Pacific Palisades, North Point	HK$1,045mn	Sino & the Ng family	
Mar 1997	5 commercial buildings comprising 2mn sq.ft. of offices & 0.5mn sq.ft. of retail space	HK$2,340mn	Sino & the Ng family	
Feb 1999	7 commercial buildings comprising 1.7mn sq.ft. of offices and 0.9mn sq.ft. of retail space	HK$4,485mn	Wharf	Largest securitisation so far in Asia
Jun 1999	21 commercial, residential and industrial properties comprising 2.445mn sq.ft. & 3,385 carparks	HK$2,356	Sino	
Dec 1999	Windsor House, Causeway Bay	HK$1,821mn	Chinese Estate	First CMBS to be wholly denominated in Hong Kong dollars
Sept 2000	Kln City Plaza, Kln City and Paliburg Plaza, Causeway Bay	HK$1,400mn	Paliburg	First Hong Kong CMBS with the originator in liquidity problem

Source: Asia Financial (Research)

CASE STUDY OF CMBS FOR PALIBURG

At the end of 2000, Paliburg, a developer that has encountered liquidity problem with negative working capital since 1998, successfully raised a funding of HK$1.4bn through issuing commercial mortgaged backed securities (CMBS). One would wonder why investors would wish to lend such a big sum of money into this risky venture as many banks had actually stopped making new loans to Paliburg.

The risks involved in Paliburg's deal were actually very much contained. Kowloon City Plaza in Kowloon City and Paliburg Plaza in Causeway Bay, two "crown jewel" commercial properties owned by Paliburg, were pooled into the SPV - Commercial Plaza Securitisation Ltd.. Thanks to the strong recurring rental incomes from the two properties, the CMBS obtained very high rating from Moody's, i.e. Aaa - a rating unlikely obtained by the financially-distressed parent company.

In addition, the default risk of the CMBS solely rests on the performance of rental incomes from the two properties. Any credit deteriorations to Paliburg would not bring any repercussion to the CMBS holders. CMBS holders have the first priority of claim on the two assets that are being pledged in the securitisation in case of default.

As a result, the $1.4bn CMBS were sold off to institutional investors including insurance companies and pension funds. Paliburg used the proceeds to pay back the outstanding mortgages of the two commercial properties and the remaining surplus was used as working capital for the company.

The HK$1.4bn CMBS represented a major step forward in Paliburg's debt restructuring. At that time Paliburg was unable to restructure its debts within existing lenders and suffering from high default interest. The CMBS enabled Paliburg to raise funding and reduce its financing cost as well.

For Paliburg, not only it benefited from lower pricing and improved liquidities through the CMBS, it also achieved in diversification on its lenders. The CMBS were subscribed by investors who were not existing lenders of Paliburg and some of them were foreign funds which previously had no exposure to the Hong Kong property market.

One remarkable feat in the Paliburg's CMBS was that the complex structure has remained intact and continues to perform despite Paliburg announced in February its problems in paying two exchangeable bonds. The CMBS structure was not challenged by liquidators or had its quality downgraded by rating agencies.

The CMBS structure has gone one step further to protect the interests of its investors. Since Paliburg Plaza is also the headquarters of Paliburg and its affiliates, a "Liquidity Reserve" was built to cover the property reinstatement costs and potential loss in rental income due from the in-group tenants.

The Loan-to-Value (LTV) ratio in the Paliburg's CMBS of HK$1.4bn was actually quite high - LTV of 68% based on Moody's valuation, compared with other CMBS transactions, for example, 42% for Windsor House and 38% for Harbour City.

Given Paliburg's tight financial position, one would think it might be better for Paliburg to dispose all its interests in these two properties and realize the full market value. In fact, for a long period of time leading up to the issuance of the CMBS at the end of 2000, Paliburg had been active in seeking buyers for the two properties, but to no avail.

Obviously Paliburg didn't want to part the assets at big discounts, destroying shareholders' values.

One beauty of CMBS for property developers is that it can help release value while retain control ownership and future growth of assets. We understand Paliburg was undertaking a planning application for additional commercial floor areas on top of the existing Kowloon City Plaza and the market value has not yet factored into this development potential. The CMBS would be able to preserve the value for the property owner.

CMBS FOR CHINESE ESTATES

Not all developers using CMBS as a last resort in fund raising, local developer Chinese Estates used securitisation at the end of 1999 because it offered more attractive pricing than the conventional financing methods. Towards the end of 1999 there was a negative sentiment amongst banks in the Euro and US markets due to the Y2K concern, this had actually posted an additional concern for developers who wished to lend at this critical time.

The CMBS deal had provided Chinese Estates an alternative financing source with better market liquidities. Chinese Estates issued CMBS to raise $1.8bn with Windsor House in Causeway Bay as an underlying asset. Windsor House, a high quality investment property in the bustling Causeway Bay retail market, had a strong cash flow.

The Chinese Estates's maiden CMBS was the first Hong Kong commercial mortgage-backed issue that was rated Aaa, even higher than the then Hong Kong's local currency ceiling of Aa1. The top ratings from Moody's permitted Chinese Estates to raise funding more cost effectively than a corporate loan or secured bond.

Benefits Of CMBS

- Lower pricing
- Improved liquidities
- Diversification on lenders
- Non-recourse to parent company
- Release value while retain future growth potential
- Off-balance sheet financing

In UK, developers also use asset securitisation as an alternative to circumvent the capital gains tax liability arising from an actual disposal of property assets.

Obstacle to off-balance sheet financing

However, one major distinction between UK and Hong Kong securitisation market is that most of securitisation issues in Hong Kong are not of off-balance sheet structure. i.e. remove the property asset from the issuer's balance sheet. The outcome of off-balance sheet financing can help an issuer improve various financial ratios such as return on equity and gearing level.

The low investment yield in Hong Kong properties has actually impeded developers using off-balance sheet technique in securitisation. Prime properties in general command a yield of 4% - 6% whereas interest rates on loan would fluctuate from 6% to 10%.

In securitisation, assets are transferred to a SPV, if they are selling at full market values, then the rental incomes from the property asset must be able to pay back the financing costs, unfortunately this is quite rare in Hong Kong at the current market environment.

Comparison with conventional financing methods

Compared with the traditional bank mortgages financing, CMBS has its unique advantages. Because the bonds are backed by tangible assets rather than the credit–rating of a corporate borrower, rates are lower. CMBS is a non-recourse loan to the issuer as it is fully secured by the underlying property asset.

EXAMPLES OF FINANCING METHODS BY DEVELOPERS

Method	Bank Loan	Share Placement	CMBS
Example	Kerry Property in June 2001 raised HK$6bn through a 5 year unsecured syndicated loan at interest rate 50bps over HIBOR	Sino Land in January 2001 raised HK$783mn through a share placement	Paliburg in September 2000 raised HK$1,400mn through securitisation of two commercial properties
Advantages	Easy and quicker in arranging finance; Lower arranging cost	No interest cost, Fast and efficient to raise capital	Lower interest rates; Non-recourse to originator; Release value of asset and retain future growth potential; Lenders diversification
Disadvantages	Interest expense cut into earning; Require higher corporate rating; Stringent loan covenant	Dilution effect in both earning and net asset value per share; Unfavorable in a depressed stock market	Complex deal structure; Costly funding arrangement

Source: Asia Financial (Research)

Stagnant activity in CMBS

The depressed stock prices barring access to equity market even for the top-rated property companies should have driven developers to look for alternative source of capital. However, it has not triggered a proliferation of CMBS deals in Hong Kong market. The CMBS activity has actually turned quiet after the Paliburg deal. The ample liquidities in the banking sector and the sluggish loan growth market have all contributed to the demise of CMBS activity.

Sino Land, once an active issuer in asset securitisation, has now requested for “clean loan’ (no collaterals offered) in fund raising, indicating borrowers nowadays have an upper hand amid the intense competition within the banks.

It is tough for securitisation arrangers to compete for clients, which have access to cheaper funds. Top-tier companies in Hong Kong are now paying margin as low as 40bps to 50bps for term transactions. There is no incentive to do securitisation and it does not make a difference whether an arranger creates a triple A or double A paper.

However, as our economy is miring in a slump underpinned by sagging corporate earnings, credit squeeze by banks will be on the rise and banks are more reluctant to lend. Alternative financing instruments like CMBS will be, in our view, back in vogue.

Which developers most likely opt for CMBS?

We reckon developers in high gearing and with large recurring rental incomes will have high tendency to use CMBS as an alternative funding source.

DEVELOPERS’ GEARING

Developers	Net gearing (%)
CKH (0001.HK)	9%
SHK(0016.HK)	18%
Henderson(0012.HK)	24%
Hang Lung(0010.HK)	29%
New World(0017.HK)	49%
Sino (0083.HK)	22%
Kerry(0683.HK)	40%
HKR(0480.HK)*	5%
Swire ((0019.HK)	21%
Wharf(0004.HK)	22%
Amoy(0101.HK)	18%
Hysan(0014.HK)	15%
Great Eagle(0041.HK)	51%

Source: Asia Financial (Research)

CMBS TARGETS

Developers	Properties suitable for CMBS	2000 rental incomes (HK$mn)	Reported occupancy rate
Hysan	2.63 mn sq.ft. at Causeway Bay	1,476	97%
Swire	1.6 mn sq.ft. Pacific Place and 5.7mn sq.ft. in Quarry Bay	4,692	97% for Pacific Place
HK Land	3.9 mn sq.ft in Central	2,555	97.2%
Great Eagle	1 mn sq.ft Citibank Plaza and 286,000 sq.ft. Great Eagle Center In Wan Chai	609	96% for Citibank Plaza 98% for Great Eagle Center
Wharf	4.46 mn sq.ft. in Harbour City and 1 mn sq.ft. Times Square in Causeway Bay	3,189	90%

Source: Asia Financial (Research)

We think developers such as Great Eagle, New World Kerry and Sino would likely use CMBS to raise funds.

Future developments in securitisation

In Hong Kong, securitisation, as an alternative financing vehicle, taps into the debt market and its development has not yet evolved into the equity market. We have not seen any real estate investment trusts (REITs) in the local market.

REITs in the USA are based on a specific provision of the Inland Revenue law which makes such dividend payments tax exempt. CMBS, on the other hand, is a more market driven transaction. Unless HK adopts a law similar to REIT law in USA, there is obviously no scope to have REITs here.

CMBS market in China has not yet developed, due to foreign investors in general still worry China's legal framework, especially on the part governing repossession.

On region-wise, South Korea proves a better market for CMBS. Indeed, South Korea is the trailblazer in Asia's securitization deals. According to the Financial Supervisory Services, the total volume of asset-backed securities (ABS) issued last year amounted to 49.38 trillion won (US$37.3 billion), up 629% from 6.77 trillion won in 1999. Of the amount, 27.72 trillion won or 56.1% were collateralized bond obligations (CBOs). The Korea Asset Management Corp (Kamco), the government agency mandated to solve the Korean non-performing loans' (NPLs) problems, was the largest ABS issuer with 4.84 trillion won involving 21 transactions.