

CRE CLOs AND DISTRESS

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THE CRE CLO STRUCTURE: OVERVIEW

Collateralized loan obligations (CLOs) are securitization vehicles that have traditionally been backed by pools of “bank loans”—senior-secured corporate loans with floating rate coupons. CLOs generally comprise a diverse pool of loans and serve as a key secondary-market liquidity source and structured finance tool for lenders. The transactions are structured with a variety of tranches carrying varying risks and returns. Cash flow received from the underlying loans is distributed to investors in the CLO via a waterfall: Investors in the highest-rated tranche are first to receive cash flow distributions and investors in the most junior tranche are last. Typically, CLOs are actively managed, often by a party affiliated with the primary loan originator.

The commercial real estate (CRE) CLO market peaked in 2021, with issuance volume of \$45.4 billion. More recently, economic factors, principal among them higher interest rates, have caused a significant slowdown in CRE CLO issuance: According to Morningstar DBRS, CRE CLO issuance for the first half of 2024 totaled just \$2.28 billion. However, there is a general sentiment among market participants that the sector will rebound.

The CRE CLO structure is fundamentally the same as the traditional CLO structure, except that the underlying collateral loan pool consists of floating rate mortgage loans secured by commercial real estate assets. Generally, robust demand for new CRE CLO issuance leads to greater liquidity in the overall commercial real estate market, while declining demand has the opposite effect.

CMBS VS. CRE CLOs – THE FUNDAMENTAL DIFFERENCES

Commercial real estate owners looking for debt through the capital markets historically have tapped the commercial mortgage backed securities (CMBS) market. CMBS are a securitization vehicle, as well, through which investors can purchase securities issued by the securitization trust, which holds mortgage-secured commercial real estate loans through a variety of tranches depending on desired risk and return. CMBS transactions may be “conduit” transactions, where the underlying loan collateral constitutes a diverse pool of mortgage loans, or single-asset single-borrower transactions (SASB), where the underlying loan collateral is a single loan secured by a single property (or a portfolio of cross-collateralized properties owned by the same sponsor). In comparison to the CRE CLO market, the CMBS market is a considerably larger source of capital for commercial real estate financing, providing significant liquidity for originators of commercial real estate loans and owners of commercial real estate projects.

While both CMBS and CRE CLOs allow investors to participate in the commercial real estate finance market without directly making loans, thereby providing liquidity to the overall commercial real estate finance market, the two types of vehicles differ fundamentally in structure, risk profile, and flexibility. The underlying loans in CMBS transactions are generally fixed-rate, longer-term (five, seven, or 10 years) with significant call protection, secured by stabilized, cash-flowing real estate assets.

The mortgage loans are standardized in nature, offering investors a relatively predictable risk-return profile. On the other hand, CRE CLOs bundle together a more diverse and often riskier set of commercial mortgage loans: floating-rate, short-term (typically two to five years) loans, secured by transitional real estate assets, which can include future funding components. Loans intended for a CRE CLO are often underwritten such that they depend on the property owner/borrower's execution of a business plan to reposition an asset with potentially significant exposure to rising interest-rate risk, as recently seen.¹

CMBS securitizations consist of a static pool of assets, as opposed to CRE CLOs, which are generally "managed deals," meaning that the sponsor (*i.e.*, the principal originator of the collateral loans) of the CRE CLO transaction will be able to add and/or remove loans from the pool during a designated reinvestment period. The equity (*i.e.*, first loss) holder in a CMBS transaction is typically a third party who purchases the "B-piece." The sponsor of a CRE CLO typically retains the equity piece in a CRE CLO transaction, effectively utilizing the CRE CLO market as a financing source to provide liquidity in support of an active lending platform. Both types of transactions include appointing a servicer and a special servicer and will be governed by a pooling and servicing agreement (PSA). Often, the principal originator of the CLO-securitized loans will remain as the servicer, although third-party servicers may be engaged, particularly for "special servicing" functions.

A key difference between the two structures is that CMBS transactions must comply with strict real estate mortgage investment conduit (REMIC) tax and securities rules. This difference comes into play particularly when considering workout strategies and post-foreclosure actions. The CRE CLO will have much greater flexibility than the CMBS REMIC, which will be constrained from taking certain actions or otherwise be subjected to significant tax consequences.

Another unique feature of the CRE CLO structure is the collateral manager, typically appointed by the CLO sponsor, who acts as the primary party responsible for the day-to-day management of the CLO. As noted above, asset management functions and day-to-day servicing of individual loans are often performed by the sponsor or an affiliate, but some will appoint third-party servicers, particularly in the context of special servicing.

CRE CLOs' greater inherent flexibility allows the collateral manager to be more dynamic in administering the collateral pool. However, unlike CMBS transactions, CRE CLO transactions will include covenants and coverage tests from the issuers/sponsors, which offer significant downside protection to investors. There are two principal coverage tests: the overcollateralization test and the interest coverage test.

For the overcollateralization test, if the collateral pool's principal value falls below a certain trigger value, the waterfall will reset and cash flow from the loans that otherwise would have been available for distributions to the equity and junior tranches will instead be redirected to repay principal of the senior tranches. This test requires that the principal value of the collateral loan pool exceeds the outstanding principal amounts of the transaction's issued securities by an agreed-upon amount.

The interest coverage test measures the extent of cash flow from the collateral loan pool available to pay interest on the outstanding securities. As with the overcollateralization test, if the interest coverage test level is not met, the cash flow waterfall will reset so as to pay principal on account of the senior tranches.

Since CRE CLOs are actively managed, sponsors have the ability to buy loans out of a portfolio to avoid triggering tests that would reroute the cash flow waterfall, maintaining performance of the overall CRE CLO transaction and minimizing losses for investors. Loans purchased out of a CRE CLO are then then restructured or resolved outside of the CLO and potentially re-contributed to the CLO if appropriate and after a period of "seasoning," as described below.

¹ https://www.crefc.org/cre/content/News/Items/advocacy-items/2022_Private_Label_CMBS_and_CRE_CLO_Issuance_Summary_and_2023_Outlook.aspx

DISTRESS IN CRE CLOs – STRATEGIES AND OPTIONS

CRE CLOs at Increasing Risk of Distress

Recent economic challenges, including rising interest rates and shifting property values, have put pressure on the performance of a range of commercial real estate projects and loans secured by those projects and, in turn, on the performance of a number of CRE CLOs.² The underlying loans in these collateral pools, often secured by properties that are not stabilized or whose financial performance has been adversely affected by increased operating costs and debt service expense, are particularly vulnerable.³ As more loans within these structures have encountered difficulties, consistent with the overall commercial real estate finance market, the risk of increased distress in CRE CLOs and the effective management of affected loans become a pressing concern.

Removing Troubled Loans From the Collateral Pool

One of the primary strategies available to sponsors when CRE CLO loans become troubled is to buy the troubled loan out of the collateral pool. This action, though costly, allows the sponsor to work out the loan free of any constraints imposed by PSAs and avoid tax consequences that may be triggered by “significant modifications.” By doing so, the sponsor can restructure the loan on more favorable terms or sell the asset without the limitations that typically apply within the CLO structure while causing less disruption to the CLO and its payment terms than would otherwise be the case. Once the loan is worked out, it can be held on the balance sheet for a period of time (*i.e.* “seasoned”) and then returned to a collateral pool. This option is particularly attractive when the sponsor believes that the underlying asset has potential for recovery but requires more aggressive management than permissible within the CLO structure.

Addressing Non-Performing Loans Held Within the Collateral Pool

If removing the distressed loan from the collateral pool is not viable, special servicers, typically in conjunction with the collateral manager, will need to explore alternative strategies within the existing structure. These strategies include some of the same approaches generally available to commercial real estate lenders including:

- **Modifications/Extensions/Additional Invested Capital:** Often, the initial focus will be on whether there can be mutually acceptable modifications to (effectively, concessions regarding) the underlying deal terms, including performance or covenant waivers, alternative uses for funded reserves, payment deferrals, and/or maturity extensions, which would result in a viable turnaround plan for the underlying property and what, in turn, is required from the borrower/sponsor in exchange for such modifications. For example, a sponsor may be required to invest additional equity into the deal for the payment of re-leasing or capital costs or as an operating expense or debt service reserve.
- **A/B Note Structure:** Another option that may be considered is to restructure the loan by splitting it into an A note—which is adequately secured in terms of property value and cash flow and has priority in the payment waterfall—and a B note, which is subordinate and carries higher risk and may only be required to be paid to the extent cash flow is available from the property, possibly after the payment of new money the sponsor invests in the deal. This structure is often used when the total outstanding loan amount exceeds the value of the underlying property and is intended to provide an economic incentive for the investment of fresh capital by the sponsor while allowing for a portion of the loan to be placed into a performing status.

² The CRE CLO distress rate (which includes loans 30 days delinquent, past maturity, in special servicing, or experiencing a combination of these factors) rose by 114 bps in May 2024 to 9.74%, with an additional 36.5% of CRE CLO loans appearing on servicer watchlists. [See *As Interest Rates Rise, CRE CLO Distress Jumps to 9.74%*, CRE Daily, June 19, 2024.](#)

³ The office sector has experienced the highest distress levels, with a rate of 16.8% as of May 2024, followed by multifamily loans (13.3%), retail (7.8%), industrial (4.7%), and hotel loans (4.1%). Loans in the “other” category had a 6% distress rate. *Id.*

- **Equity Kicker:** Another option is to introduce an equity kicker, where the lender receives an equity stake in the underlying property or project in addition to the restructured loan terms. This can align the interests of the borrower and the lender and potentially provide upside if the property's value improves.
- **Other Creative Structures:** Special servicers may also explore other creative solutions that are not typically available in the CMBS context, as long as those solutions are permitted under the terms of the documents governing the CRE CLO. These approaches might include modifying interest rates, extending loan maturity time, or offering extended payment holidays to give the borrower time to stabilize the asset. In return, a CRE CLO lender may require additional guaranties, establishment of additional cash reserves or letters of credit, or pay-downs of principal. Such flexibility can be crucial in navigating distressed situations and preserving value for investors. All parties will need to consider potential tax consequences arising from any proposed modification.

Overall, the options available to servicers in managing distressed CRE CLOs are varied and complex. Servicers, asset managers, and sponsors of CRE CLOs must remain vigilant and proactive in understanding how these strategies could impact loans securitized through the CRE CLO structure, the overall performance of the CRE CLO securitization, and investors in the CRE CLO, particularly in a volatile and uncertain economic environment. The attorneys at Ballard Spahr, with our extensive experience helping clients navigate distressed CRE transactions, are well equipped to identify and implement the best solutions for these evolving challenges.

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