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Dealing with B certificates' legalese

These mortgage-backed securities involve a lot of work

Barry Critchley

Alan Pyle, one of the two founding partners of **RFA Mortgage Services** – a real estate investment management company – offers one piece of advice for investors thinking of participating in the so-called B certificates in offerings of commercial mortgage-backed securities: be prepared to do a lot of work.

“The mortgages aren't complex. The real estate isn't complex. The complex part is all the legal documentation,” said Pyle, noting that a short-form prospectus for an offering of CMBS typically runs to about 200 pages. On top of that there is also a pooling and servicing agreement, which is also typically a 200-page document. That document governs the operations of the trust.

“There is a ton of documentation,” said Pyle, who formed RFA Mortgage Services with Don Rodney.

Pyle is speaking from experience. His firm is the only Canadian entity which has purchased the so-called B certificates on a Canadian originated CMBS offering. (US institutions were the typical buyers of the securities.)

RFA has just participated in its second offering of B certificates. It outlayed about \$12.7-million of principal amount to purchase five classes of securities on the recent \$254-million offering by **Solar Trust**. (Earlier it spent about \$19-Million on a CMBS financing by Column Canada.)

RFA purchased five classes of certificates – the class Fs through to the class Ks. (There were no class I certificates.) Those five classes of certificates, all bought at a discount, were rated BB and below (though the class Ks weren't rated).

Those certificates were sold by way of an offering memorandum – a private placement. (In contrast Solar Trust – whose recent deal was put on hold over the summer because of less than satisfactory pricing – was a public offering.)

RFA invests in those certificates for a group of external investors. On its first deal, that group consisted of one individual; on the Solar Trust deal, the list ran to half a dozen individuals. “We are gradually broadening the investor base the Canadian way – slowly

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and surely we will get where we want to be,” said Pyle, who said his firm would like to participate in four class B investments a year.

Adds Ross Brennan, chief executive of CMO Inc., the unit 100% owned by TD bank that originates the mortgages: “ We sold an excellent portfolio that had the lowest subordination level of any North American conduit.”

The investment made by RFA is the so-called second loss on any CMBS.

The first loss is the equity in the buildings. Equity represents about one-third of the value of a building. The other two-thirds is represented by debt.

On Solar Trust’s portfolio, for instance, the average loan to value ratio of the 67 buildings in the portfolio was 65.87%. At maturity, the scheduled loan to value ratio is expected to be 51.74%: the difference between the two percentages represents the principal repayments prior to maturity.

RFA is a buy and hold investor, given that there is no market for the class F to class K certificates. And how much it makes on its investment depends on the discounted price it is able to purchase the B certificates – and the performance of the portfolio over time: the greater the losses, the worse the performance.

For instance, if there were no losses then at maturity, the class K certificates – the security that sits at the bottom of the pile – would return \$4-million. If the losses were \$1-million, then \$3-million would be returned at maturity. If the losses are \$5-million, then the holders of the class K certificates and class J certificates (\$665,000) would lose everything, as would holders of some of the class H certificates (\$2,667,000). The losses referred to here relate to losses incurred after the equity holders have taken their hit. Overall, RFA expects to make returns in the 20% range on the class K certificates and lower returns up the line to the class F certificates.

On the other hand, in the event of a liquidation, the proceeds would be applied to paying off the holders of the class A certificates.

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