

Slicing, dicing risk and reward

RFA Mortgage out to raise profile of 'B piece' investments



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Inside Finance

For someone who is set to make Canadian history, Alan Pyle, one of the partners behind Toronto-based RFA Mortgage Services Inc., doesn't mind if other players crowd into his market niche.

"We would like to see more investors involved. We would like to see this area get more credibility," said Pyle, whose RFA Mortgage Services is planning to become the first Canadian buyer of the non-institutional certificates that are a key part of an offering of commercial mortgage-backed securities.

The offering in question is the upcoming transaction by Column Canada Issuer Corp., a \$292-million deal which is set to come to market this week.

In the past, the so-called "B piece" on CMBS offerings by Canadian issuers has been bought by U.S. investors or has been retained by an entity linked to the issuer.

"We are the first third-party Canadian buyer," said Pyle, who with a burst of patriotic pride adds that "the successful evolution of CMBS in Canada requires that there be Canadian B buyers who understand Canadian markets, Canadian lending practices, and Canadian laws."

Adds one CMBS practitioner: "Placing the B piece is always tricky. It's a delicate subject because the pricing of the B piece affects the economics of the whole transaction."

Here is how the B piece, that's also known as the non-institutional certificate, works:

■ A bank or an entity linked to a securities firm funds a pool of commercial mortgages;

■ an issuer then files a prospectus to sell commercial mortgage pass-through certificates to investors.

Typically, the issuer structures the deal in such a way that half-a-dozen differently rated securities are created. The typical range is from AAA at the top to around BBB at the bottom. The idea behind creating so many different securities is to "slice and dice" the mortgages to meet everybody's preferences for risk and reward.

■ Typically, there are more mortgages in the pool than securities being sold off;

■ that gap creates the opening for non-institutional certificates to be issued.

On Column Canada's deal, there are \$310.1-million of underlying commercial mortgages in the pool. But only \$292.2-million of securities are being sold to investors. The difference, \$17.9-million, is the non-institutional piece — the B piece.

■ That piece has a rating that is below investment grade, meaning below BBB.

And, in a typical situation, the B piece is made up of a number of different pieces. In Column Canada's case, five different securities are being offered.

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The rating on those five pieces runs from BB, to BB-, to B, and to B-. There is also an unrated piece. RFA Mortgage Services plans to buy all the five securities.

Like all investors, RFA — which hopes to make two or three B piece investments a year — is attracted to this piece of the real estate market because of the potential reward — and the risk.

On the positive side, the returns — if everything works out — start in the mid-teens and work their way upwards.

RFA's returns come from two main sources: It buys the B piece at a discount; and it gets a monthly interest cheque.

But there is risk involved given that the mortgages are long term. "Conceptually, it's difficult to understand the risk," said Pyle, who along with his partner Don Rodney has been investing in and managing real estate assets for about 20 years. In short, things can — and do — go wrong.

Pyle said that investors in B piece require "a specialized skill. You have to understand the underlying real estate and how the mortgage security works."

The reason: Pyle and Rodney,

along with the investors in its fund, "are the first to suffer any losses that might occur. Accordingly, we have a vested interest in making sure that the problems are dealt with professionally and quickly," said Pyle.

But in assessing the risk, the two are also cognizant that their investment isn't at the bottom of the pile. Instead, a group of investors — those who hold the equity in the underlying buildings — hold that distinction.

And the protection afforded to the holders of the B piece is fairly substantial. The reason: Those institutions whose business is in making commercial mortgages typically advance a loan on the basis of 75% loan to value. That ratio means there is 25% equity in the building. And the equity holders take the first hit.

In practical terms, the 75% loan to value ratio means the building's value would have to fall by 25% before the holders of the B piece would take a hit.

The final area of protection for investors in the B piece is that they have some say about what goes in the pool. "A lot of due diligence of the commercial mortgages being included in the pool is required," said Pyle, who added that it's not uncommon for investors in his part of the business to reject some of the mortgages the issuer wants to include in the pool. Once the B piece investor has signed off, the prospectus can then be filed.

This column will resume in the middle of August. Time for a little vacation.

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