

Alternative asset swaps a partial solution for what ails us

By David Eyzenberg

President of Prodigious Capital Group & Adjunct Professor in the NYU Schack Institute of Real Estate Masters Program.



What ails us?

Much has been written about the current financial crisis that we currently find ourselves in. Fingers have pointed at the Federal Reserve for keeping rates too low for too long thereby creating excess liquidity. Others have pointed fingers at the Government for under regulating where they should have and overregulating where they shouldn't.

Opinions voiced from soapboxes have implicated lenders for their supposed greed and arrogance which led to their frothy endeavors that contributed to the current situation. On-and-on the list goes for the ever elusive scapegoat.

Interestingly few palpable solutions have been offered. Investors poised to pounce on the once-in-a-life time buying opportunities that were supposed to materialize due to market distress have found few offerings. Billions of dollars sit idle waiting for the coming tsunami of distressed buying opportunities to come.

To placate themselves, or maybe to inject a little guilty into holders of distressed product, phrase such as "delay and pray", "pretend and extend" and "a rolling loan gathers no loss" have been bandied around.

The reality is that most market participants realize, but few acknowledge, that vast quantities of equity and debt positions are impaired. However, one really has to ask the question of why would anyone want to deliberately and voluntarily take a loss? Why should holders of impaired assets take a loss for the benefit of providing fodder for the vulture investors sitting on the sideline?

What has been lacking in this ongoing dialogue is how to create a win-win situation for both parties. How can we facilitate the shifting of impaired assets to those more capable of handling them without saddling the current holder with crippling losses? The answer can be found in a modern twist to the venerable system of barter.

Barter? As in I'll trade you?

The word Barter generally does not resonate as an application to high-level financial engineering. Many will imagine the old farmer bringing his home grown potatoes to the market and exchanging them for some milk, chicken or some other form of commodity.

In fact the definition of barter is a transaction where services or goods are exchanged for other services or goods without the use of a common unit of exchange, i.e. money.

Retail Barter and its more institutionalized version, Corporate Trade are a multibillion dollar industry in the US. Qualifying corporation regularly liquidate surplus real estate through corporate trade transactions, usually involving an exchange for media credits.

The premise involves the ability of a corporation to sell their asset at or near book value (usually well in excess of market value) to the Corporate Trade firm in exchange for purchasing goods or services that the company buys or plans to buy through the Corporate Trade Company. Under this win-win scenario the Institution expunges an asset from its balance sheet without having to sell at a loss.

However, a company's ability to participate in this sort of exchange is strictly limited by its requirements for a certain service or good. Practically speaking only those firms with very large ongoing advertisement budgets can get fully benefit from this transactional structure. Therefore, another asset class must be evaluated within the scope of a barter transaction in order to expand the pool of potential participants.

Defeasance with Inflated Currency?

There are at least two instances of barter type transactions conducted on an ongoing basis in the market; Defeasance of securitized commercial mortgages and the acquisition of real estate by Real Estate Investment Trusts ("REIT") utilizing operating partnership units ("OP units").

In a defeasance transaction a participant that initially invested into a pool of commercial real estate backed mortgages is willing to allow the swapping out of some of that collateral for an alternative piece of collateral. The two primary assets used for the substitution are US treasury obligations and/or agency securities. They new

basket of collateral is meant to mimic the payments that would otherwise have been received if the original mortgage remained in place.

However, at its root this is simply a barter transaction, an exchange between two assets with the perception of each providing equal benefits. Under this win-win scenario bond holders continue to receive their expected payment stream and the borrower realizes the benefit of extricating himself from financial structure that no longer suits his purposes.

For reasons ranging from diversification to tax benefits, property owners have opted to sell properties to REITS (assuming they are structured as UP-REITs) in exchange for OP units. Put simply, this scenario involves the owner exchanging his property for shares of a company.

This transaction is made possible because the owner perceives that the value he is getting via the OP shares is equal to or greater than what his property was worth. The REIT benefits from this situation because it is in effect acquiring the asset at a discount by using inflated currency (assuming its shares are trading at a premium to Net Asset Value). Again this demonstrates a win-win barter transaction.

The cure for what ails us?

The solution to at least partially dealing with the current quagmire of the capital markets will be found through the combination of barter and defeasance with inflated currency. One such structure involves the swapping of an equity/debt position in real estate in exchange for Life Settlement Policies. Under this scenario an owner, wither a bank, individual or corporation, can swap their position in the asset in exchange for a multiple, around 3x, of par value Life Settlement Policies.

Subsequent articles will explore what Life Settlement Policies are and how their characteristics differ from Real Estate as well as how these transactions are structured and benefit the seller from both a cash flow and balance sheet basis.

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