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Palo Alto Refinancing Deal Highlights Shifts in CMBS and Loan Servicing Strategies

By Joe Gose

A $38.6 million conduit refinancing of 529 Bryant St. in Palo Alto that provided owner Menlo Equities the opportunity to take a long-term position in a coveted downtown property represents a harbinger of the commercial real estate lending environment.

Not only does it signal the willingness of commercial mortgage-backed securities (CMBS) lenders to more aggressively go after deals, but it also highlights an effort to improve loan servicing, which has largely been a source of angst among borrowers that have tapped CMBS debt over time.

Palo Alto-based Menlo Equities, in fact, wanted to secure a loan from a portfolio lender such as a life insurance company due to its past experiences with CMBS loans and servicers, said Eric Von Berg, a principal in the San Francisco office of mortgage banker Newmark Realty Capital, Inc., which facilitated the CMBS loan through Wells Fargo Bank.

Yet given the pricey neighborhood, it became apparent that a conduit loan was the best option available for the company, which wanted to pay off investors amid its aim to take a long-term stake in the 84-year-old building. The 45,319-square-foot property, also referred to as the Palo Alto Internet Exchange, went through a major renovation a decade ago after becoming an Internet colocation data center and Internet exchange in 1996.

While a life insurance company was willing to lend $599 per square foot in proceeds on the property, Von Berg said, it wanted fast amortization to protect its exposure at lease expiration. According to a prospectus filed with the Securities and Exchange Commission, Redwood City-based colocation and data center provider Equinix, Inc. holds a master lease in the building until May 2025 (and one 10-year extension option) and subleases the space to other tenants.

Alternatively, Wells Fargo provided financing totaling $850 per square foot, he said. Additionally, the 10-year loan features a 30-year amortization schedule, a 70.2 percent loan-to-value ratio, a 4.47 percent interest rate and five-and-a-half years of interest-only payments. That's a significant departure from five years ago when CMBS lenders would not consider financing the building, he said.

"It's just night and day how the CMBS world has changed over the last five years," Von Berg added. "Downtown Palo Alto properties are hard to find, so it made a lot of sense to hold this property for the long term."

Newmark Realty's intent to assume the role of primary servicer after the loan was bundled and sold with other mortgages also served as a key to locking down the transaction, said Von Berg and Kevin Kujawski, CFO for Menlo Equities, a privately held commercial real estate investor and developer focused on value add properties in technology markets.

"Newmark was able to offer several CMBS choices, where Newmark retains the primary servicing role for the life of the loan," Kujawski said in a statement. "That was important to us."

Newmark Realty has built up its servicing business over the last few years and oversees a servicing portfolio of more than $8 billion. It bills the service as a new business model in which Newmark Realty essentially oversees a CMBS loan from placement to the last loan payment. While other mortgage banks may offer similar services in other parts of the country, Von Berg said that Newmark Realty is virtually the only one providing it in the California, Washington, Nevada and Arizona markets.

The primary servicer's role typically includes reviewing leases, taxes and insurance, conducting annual inspections and handling borrower requests, among other functions. CMBS borrower gripes about servicers in the past have stemmed from the notion that the servicers have often acted more like debt collection agencies and were ill-suited to handle all the moving parts associated with a commercial property, Von Berg said.

What's more, he added, servicers generally land the job by being the lowest bidder and have largely been considered unresponsive to borrower needs. He likened the situation to the buyer of an expensive high-performance sports car that later discovers that warranty work must be done by a cut-rate mechanic—whose primary business might be repossessions—that happened to be the lowest bidder among a pool of similar shops.

"So many real estate investors have wrestled with the headaches of dealing with servicers over the life of their loan," Von Berg said. "The general real estate community found it to be an untenable situation."

Tagged CMBS, Menlo Equities, Newmark Realty Capital, Palo Alto, San Francisco, Wells Fargo