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Riverton Developer Says Cash Flow Shortfall Due to Faulty Projections of Turnover Rate; Sponsor Likely to Make September Payment

By Danielle Reed and Allison Pyburn

The notice of imminent default for a USD 225m commercial loan stemmed from erroneous projections of housing turnover at Riverton Apartments, the loan sponsor's spokeswoman said.

Last week it was announced that the loan, sixth-largest in CD 2007-CD4, a CMBX-3 reference obligation, was transferred to special servicing due to imminent default. The news sent shock waves through the CMBS market, pushing CMBX spreads out to historic wide levels.

The developer, Rockpoint Group LLC and Stellar Management had been unable to convert many apartments to market rent, which is the reason for the shortfall. The USD 250m loan – the USD 225m A-note plus a USD 25m mezzanine loan – had been underwritten using future cash flow assumptions. Despite the average USD 894 rent in place per unit in the 1,230-apartment complex in Harlem, the loan was underwritten assuming an anticipated average rent of USD 2261, according to JPMorgan research. The sponsor had expected to de-regulate roughly 53% of the units and receive market rent from those units by 2011, the JPMorgan report said.

A spokeswoman for Stellar Management said the projections of future cash flow had been based on historical rates of turnover at the apartment complex, 12 buildings stretching between 135th and 138th streets to the south and north and Fifth Avenue to the Harlem River Drive to the east and west.

The developer made improvements to the buildings after purchasing the property for USD 130m in 2005, the spokeswoman said. (The loan was refinanced to USD 250m in 2006.) After that, and given the downturn in the economy, there was “probably less incentive for anyone to move.... They're not seeing the turnover that occurred in the prior five years before these improvements were made.”

Unlike other buildings that had been built as affordable housing under the Mitchell-Lama program, this particular building was in Harlem, and the residents were legally entitled to their below-market-rent apartments, the spokeswoman said. In other Mitchell-Lama buildings, in neighborhoods like Tribeca or the Upper West Side, new building owners have been able to de-regulate apartments on the grounds that tenants earned too much income to qualify for below-market rents or that an apartment was not a tenant's primary residence. However, at Riverton, “they are legal tenants and there is no reason for them to move out if they don't want to,” the spokeswoman said. By and large, the “population that's there now... [are not] people who have apartments in other places. They don't have houses in the Hamptons or Florida.”

While confirming that the cash flow from the rentals had not been sufficient to cover the sponsor's debt service on the building, the spokeswoman added that it is likely the sponsor will nonetheless find a way to put in an “equity infusion” to cover the September payment. The future

of the loan and the building remains uncertain. Mezzanine note holder CBRE disclosed in second quarter results it had recorded a loan loss to cover its entire position on the loan. The mezzanine notes were collateralized by equity in the sponsor.

Though the spokeswoman denied that community or political pressure had any causal relationship to the difficulty converting units to market rents, an affordable housing advocate disagreed. "It appears that the close scrutiny granted to the 'top 10 CMBS loan' for the Riverton neglected both the legal issues of rent stabilization and... the political issue of tenant mobilization," said Sue Susman, president of the Central Park Gardens Tenants' Association. "The fact that many real estate interests were buying largely rent-regulated developments with promises to investors of returns impossible under rent regulation sent a red flag to tenant advocates perhaps two years ago. It was obvious that such returns would only be available with the ouster of the majority of the tenants – and that's hard to do" without developers using extremely aggressive tactics, she said.

To counter developers' efforts to convert apartments to market rents, "many tenant advocates and leaders of individual building tenant associations are part of a coordinated effort for tenants in current and former Mitchell-Lama buildings known as the PIE campaign," she added. "P" stands for protection for tenants, "I" for incentives for owners to stay in the Mitchell-Lama program and "E" is for enforcement of the law, Susman explained.

News of the apparent cash flow shortfalls for the Riverton loan caused State Senator Jose Serrano to put an entry in his blog 19

August. Though Riverton is not in his district, many buildings in similar situations are, according to a staff member in his office. "My overriding concern is the tenants: low-and-middle-income, hardworking residents who often face harassment every time one of these private equity firms gets its hands on a building," Serrano wrote. "I know people who live at Riverton. They make up the bedrock of the uptown community. We're talking about community leaders, business owners and homemakers. Did Stellar expect them all to just leave under their own volition?"

The issue is broader than "a small corner of Harlem or the Bronx," Serrano continued. "These deals have ripple effects that hurt the overall economy. When the Masters of the Universe... recklessly gamble on our homes, everybody else is left holding the ball."

Stellar and Rockpoint are the sponsors for other rent-regulated developments around the country where a certain percentage of units are projected to be converted to market rent. In San Francisco, a 3,221 unit development called The Villas Parkmerced recently lost a class action lawsuit charging violations of the city's rent control ordinance.

According to the lawsuit and tenant petitions filed with the city's rent board, the Villas used rebate coupons to "obscure the true base rent" charged to tenants. Brayton Purcell LLP are attorneys for the plaintiffs.

For two named plaintiffs in the case, the Villas stated a monthly rent of USD 1675 per month, but issued an addendum to the lease in a second document which included 12 coupons called "bonus bucks" that essentially deducted USD 350 from the rental cost each month, according to

Brayton Purcell. The arrangement allowed the company to raise rent the following year to USD 1703 - a 28.5% increase from the USD 1325 in actual rent paid the previous year - violating San Francisco rent control regulations of only a 1.7% annual rent increase, according to the attorneys.

According to the class action settlement agreement, tenants living in the development between October 2002 and November 2007 that received "bonus bucks" or similar concessions may be entitled to compensation. The Villas loan is the largest in CD 2006-CD2. Its USD 300m trust balance constitutes 12% of the

pool; its whole loan balance is USD 550m, according to Standard & Poor's. As of 31 December, debt service coverage for the loan was 1.61x, and as of 31 May, occupancy was 87%, according to S&P. The rating agency has written down the loan 13% since it was issued. The loan, on watch list due to the class action settlement, will be removed "in the near future," S&P wrote in an 8 August press release.

The spokeswoman for Stellar in New York was unable to comment on the San Francisco project. It is unclear whether the rate of conversions of apartments to market rents there have met expectations.

Danielle Reed
Reporter, Structured Finance
Debtwire
646-378-3150 direct
917-710-3201 cell