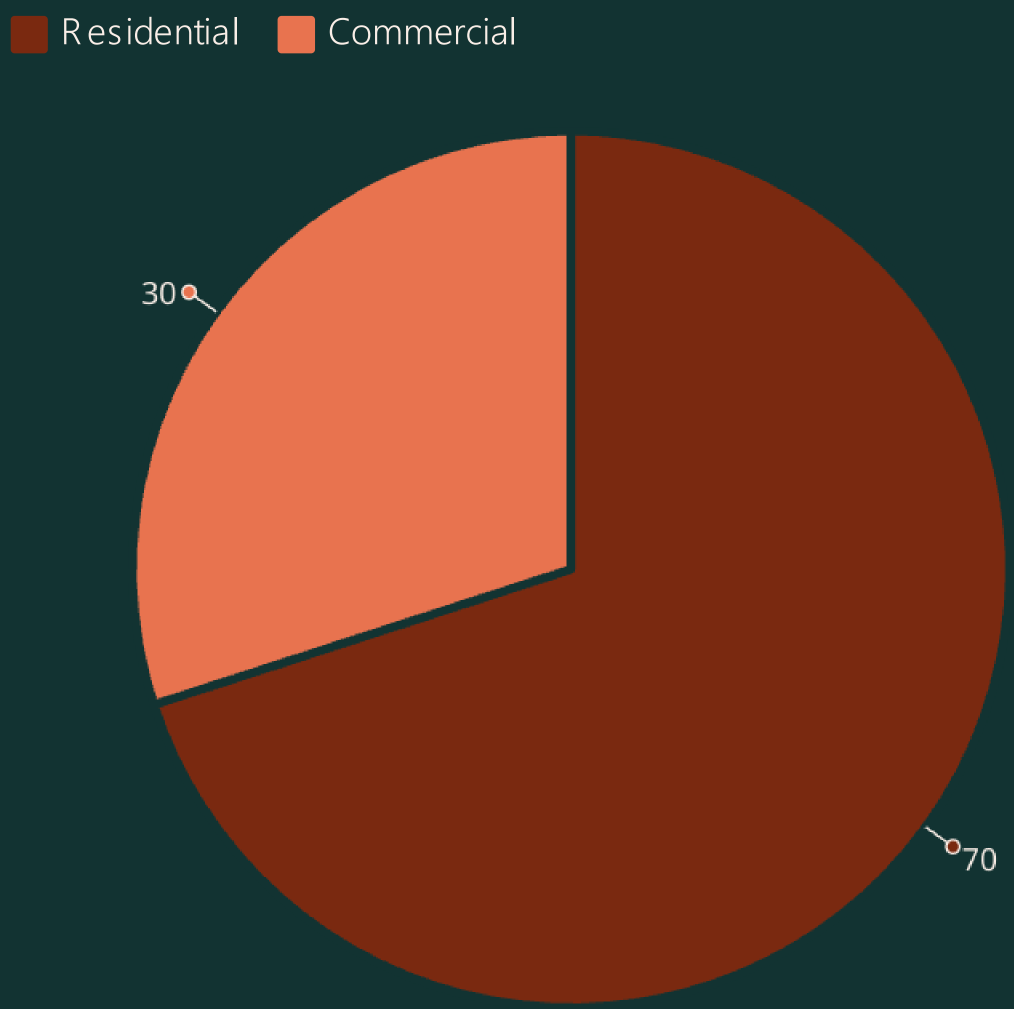
Mortgages from an Investment Perspective

Real estate debt creates two investment products: levered property equity and debt secured by property. Each appeals to different investors based on risk tolerance and income needs.

The Debt Market Landscape as of 2023



The U.S. debt market exceeds $53.3 trillion, with about 30% based on mortgages. During COVID-19, mortgage-backed securities briefly surpassed Treasury securities as the largest fixed-income issuance.

U.S. Mortgage Debt Overview

$19.8T

Total Mortgage Debt

Outstanding in the U.S. as of 2023

$5.9T

Commercial Mortgages

Funding income-producing properties

$2.1T

Multifamily Mortgages

A significant portion of commercial debt

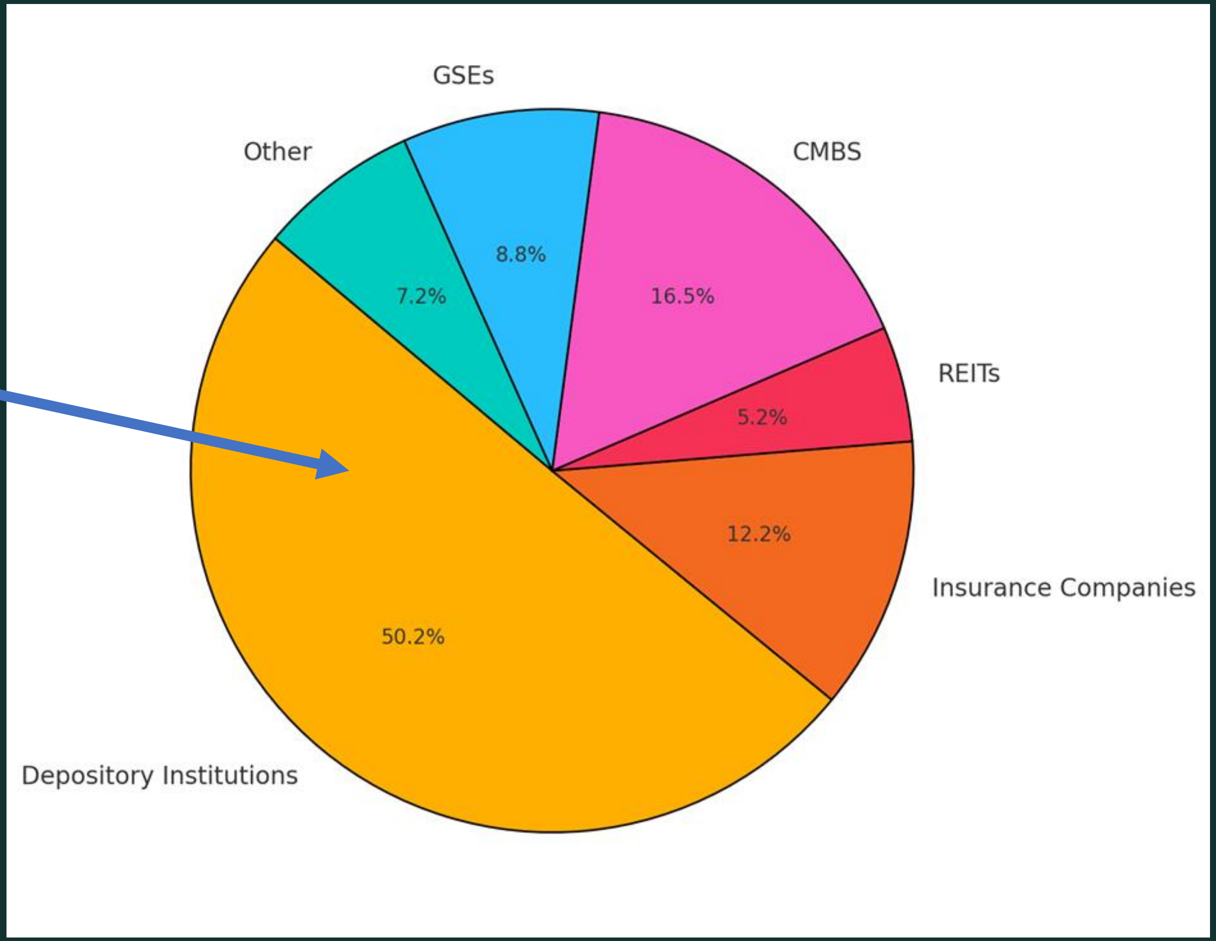
Commercial Mortgage Capital Sources

Depository Institutions

Local and regional banks provide most commercial mortgage capital

GSEs

Significant role in multifamily housing finance



Life Insurance Companies

Major source for larger properties and longer-term loans

CMBS

Over $960 billion in securities backed by commercial mortgage pools

Multifamily Mortgage Funding

GSE Funding

Government Sponsored fund approximately 24% of multifamily development

CMBS Funding

Commercial Mortgage-Backed Securities provide about 25% of multifamily funding

Other Sources

Banks, life insurance companies, and other lenders provide the remaining 51%

Cyclical Nature of Commercial Mortgages

1

1980s Boom

Significant flow of mortgage capital into commercial real estate

2

2000s Peak

Capital flowing at $300B annually, with $100B through CMBS

3

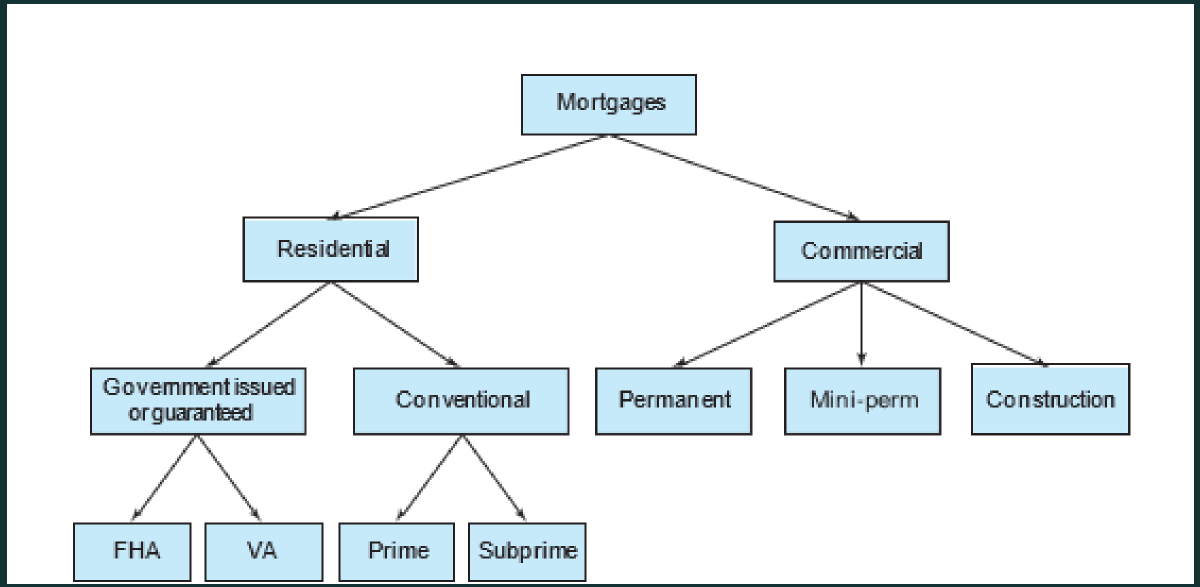
2008 Crash

Negative flow as lenders retrenched and reduced exposure

4

COVID-19 Impact

Unprecedented challenges with office vacancies and remote work



Residential Mortgages

- Smaller individual loans but more numerous
- No income from property
- Borrowers are typically non-professionals
- Properties are relatively homogeneous
- More government involvement

Commercial Mortgages

- Larger individual loans but fewer in number
- Property generates income to service debt
- Borrowers are often financial professionals
- Properties tend to be unique
- Less government involvement

Residential vs. Commercial Mortgages

Permanent vs. Construction Loans

Construction Loans

Short-term financing for building projects (1-3 years)

Bridge Financing

"Mini-perm" loans bridging construction and permanent financing

Permanent Loans

Long-term financing for completed properties (5-10+ years)

Legal Structure of Mortgages

Promissory Note

Establishes the debt obligation between borrower and lender

Mortgage Deed

Secures the debt by conveying potential ownership of collateral

Recording

Establishes priority claim to the collateral property

Mortgage Legal Theories

Lien Theory States

Lender holds a lien on property, giving right to force foreclosure sale if borrower defaults

Borrower retains title to property until foreclosure

Title Theory States

Lender holds ownership title until loan is paid off

Borrower only retains right of use and possession while meeting obligations

Allows lender to take possession more quickly in default

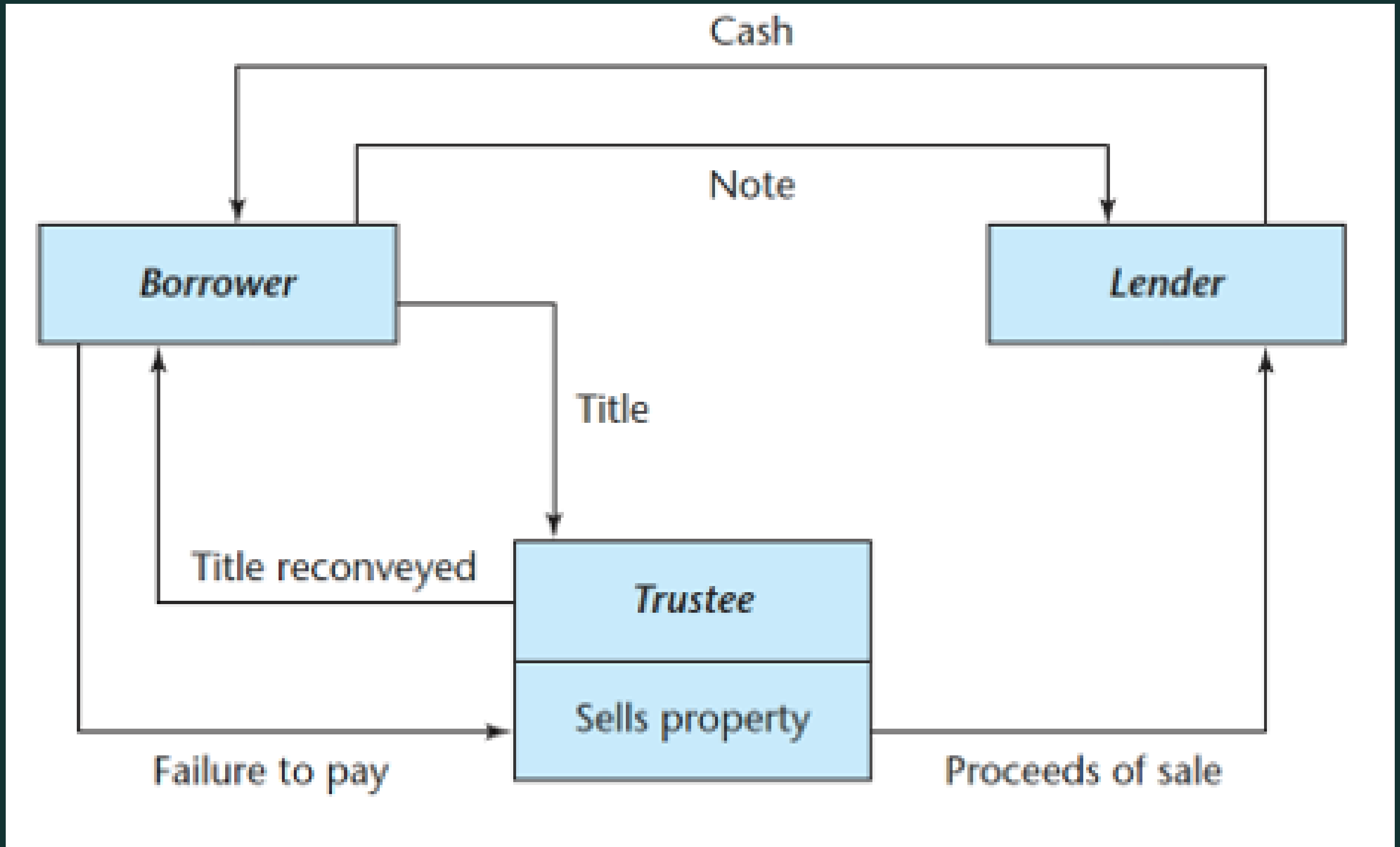
Deed of Trust Structure

Loan Origination

Borrower receives funds and gives title to trustee

Default Scenario

tee can sell property on lender's behalf



During Loan Term

Trustee holds title for lender's be

Loan Repayment

Trustee returns title to borrower when loan is paid

Priority of Claims in Foreclosure

Property Tax Liens

Always first position regardless of recording date

Mechanics' Liens

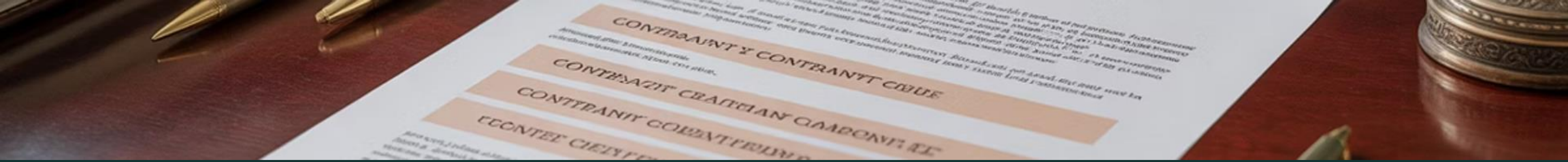
Can take priority within specific time windows

First Mortgage

Most senior debt position among mortgages

Junior Mortgages

Second, third mortgages paid after senior claims



Common Mortgage Covenants

Promise to Pay

Borrower's commitment to repay principal, interest, and penalties

Good Repair Clause

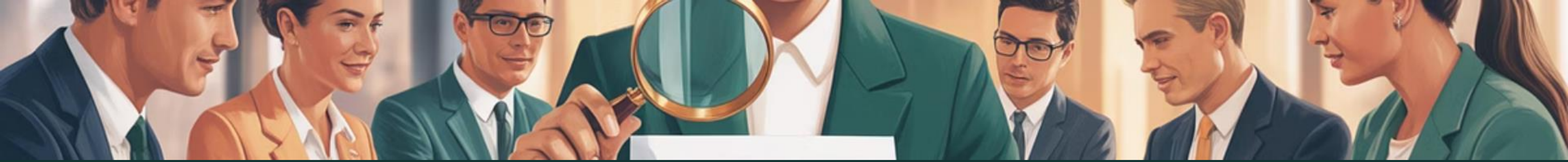
Requirement to maintain property in good condition

Acceleration Clause

Allows lender to demand full loan balance immediately under certain conditions

Due-on-Sale Clause

Enables loan acceleration when property is sold



Additional Mortgage Provisions

Prepayment Clause

Grants borrower right to pay off loan before maturity, often with penalties in commercial loans

Subordination Clause

Makes loan subordinate to other loans, even if recorded earlier

Exculpatory Clause

Creates non-recourse loan where lender can only claim the collateral property

Default and Foreclosure Process

Default Occurs

Borrower violates mortgage agreement, typically by missing payments

Forbearance Option

Lender may delay action, allowing borrower time to resolve issues

Litigious Actions

Court proceedings that may lead to foreclosure sale

Non-litigious Resolution

Alternatives like loan modification or deed in lieu of foreclosure

Costs of Foreclosure

Legal Expenses

Typically around 10% loan balance but can be be higher

Property Deterioration

Maintenance issues and and tenant problems during foreclosure

Time Costs

Lost revenue and interest during lengthy process (typically 1+ year)

Reputation Effects

Negative impact on both borrower and lender reputations

Non-litigious Resolutions

Lenders prefer to resolve problems without litigation. Options include loan transfers to new borrowers, short sales where property sells below mortgage balance, and deed in lieu of foreclosure arrangements.

Workout Strategies

Loan Rescheduling

Extending loan term or providing temporary payment holidays

Debt Forgiveness

Reducing principal in exchange for equity participation or higher future yield

New Partners

Bringing in additional equity or debt partners to strengthen the deal

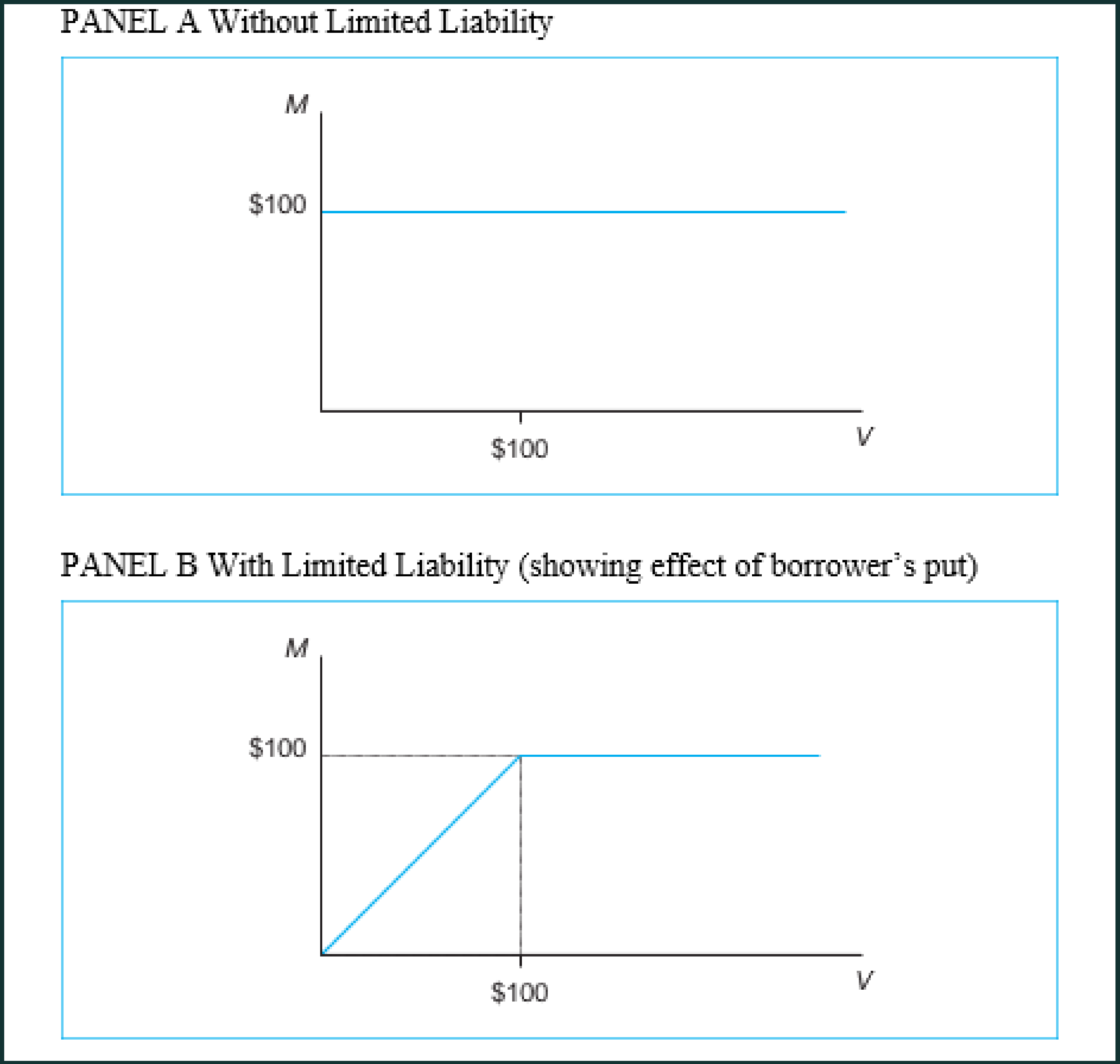
Specialized Mediation

Using workout specialists as advisors, brokers, and mediators

The Borrower's Put Option

A put option gives its holder the right without obligation to sell a specified underlying asset at a specified price. In the context of a nonrecourse mortgage, the underlying asset is the collateral property, and the borrower's ability to default on the loan effectively gives him the ability to sell the property to the lender at a price equal to the outstanding loan balance.

By defaulting on the loan, the borrower is said to "put" the property to the lender, thereby ridding himself of a liability equal, at least in book value, to the outstanding loan balance.



Strategic Default Considerations

Underwater Loans

When property value falls below loan balance, rational default becomes likely

Negotiation Leverage

Foreclosure costs give borrowers leverage to force workout deals

Reputation Effects

Both sides consider long-term reputation impacts in default decisions