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Loan Defeasance Made Simple:

Tools for Reducing Costs and Unlocking Flexibility

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Defeasance has always been a critical financial mechanism for commercial real estate investors looking to sell or refinance properties with prepayment restrictions. But today's rising interest rate environment has created opportunities that investors shouldn't overlook. Defeasance costs in many cases are now lower than the outstanding loan balance, offering potential savings that can be game-changing.

Let's explain how defeasance works, why it's so valuable, and what makes today's market particularly advantageous for those considering loan defeasance.

What is Loan Defeasance?

Most CMBS and Freddie Mac fixed rate loans include a prepayment restriction clause that prohibits early payoff, protecting the lender's projected interest income. Instead of repaying the loan outright, the borrower is permitted to defease the loan by substituting a portfolio of secure assets, such as U.S. Treasury bonds and Agency bonds, as collateral for the property.

These bonds generate enough cash flow to cover the remaining payments to the loan maturity date, satisfying the lender while enabling the borrower to release the property for sale or refinance. By strategically navigating this process, commercial real estate investors gain significant financial flexibility.

Today's Market Offers New Opportunities

Rising interest rates have fundamentally shifted the economics of defeasance. Here's why it matters for today's investors:

- **Lower Defeasance Costs**
  Rising rates have reduced the price of defeasance securities – specifically the government or Agency bonds required to replace property collateral. This decrease has, in some cases, resulted in defeasance costs that are lower than the loan's outstanding balance.

- **A Competitive Alternative to Yield Maintenance**
  Unlike loans with yield maintenance, where the 1% minimum premium adds an unavoidable cost, defeasance offers a "no minimum" cost structure. This flexibility can unlock significant savings.

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A Real-World Example

To illustrate the opportunity in today's market, here's an example of a Northmarq-originated loan. A fixed-rate Freddie Mac loan, issued at the height of the pandemic, was recently eligible for defeasance. The loan balance at the time of defeasance was $59.4 million. Because of discounting opportunities tied to interest rates, the total defeasance cost came in at a reduced amount of $55.6 million resulting in a discount of approximately $3.8 million.

While this is an extreme case, it highlights the potential upside for commercial real estate investors considering defeasance in today's environment. These kinds of results can be especially prevalent for loans issued when interest rates were near historic lows, as their yield requirements now align favorably with the higher-rate market.

Why This Matters Now

The market for defeasance has shifted dramatically due to macroeconomic factors, creating a window of opportunity for investors. For those with commercial loans originated in recent years, a potential discounted defeasance cost could mean the difference between a simple transaction and a multi-million-dollar savings.

If you're considering a sale or refinance, now is the time to evaluate whether defeasance could unlock significant flexibility and cost savings for your portfolio. With the current market dynamics at play, defeasance is not only a powerful tool – it could be the most financially advantageous move you make this year.

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