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## **Lehman old guard uses bankroll and bare knuckles for real estate redemption**

Four months before it filed for bankruptcy, Lehman Brothers dropped off a hodge-podge of risky commercial real estate (CRE) debt at the Federal Reserve discount window in exchange for cash. That USD 1.7bn SASCO 2008 C2 securitization shifted back to Lehman when it entered Chapter 11 and the estate has been working it out – along with dozens of other CRE investments – ever since.

Lehman's board of directors sacked the senior bankers responsible for its real estate book ahead of the bankruptcy filing, leaving the portfolio to a cadre of mid-level and junior employees and financial adviser Alvarez & Marsal. Two years on, that team has emerged as one of the most aggressive dealmakers in the post-crisis CRE landscape by capitalizing on historic knowledge of the legacy staff and the defunct bank's unique status as a bankrupt entity.

"They have an opportunity to reinvest and create long-term value," said Anthony Westreich, CEO at Monday Properties and a partner to a Lehman office property joint venture that underwent a recapitalization in June.

Most banks remain reluctant to write down real estate exposure put on during the glut, but Lehman is willing to take haircuts when needed, and then deploy capital to salvage the underlying assets. If the Lehman leftovers' strategy pays off, they could redeem their fallen brand with the currency Wall Street values most, outsized trading returns.

"We start at today's value," said Anthony Barsanti, a Managing Director in the estate's 55-person CRE unit and 12-year Lehman veteran responsible for valuing some of the bank's real estate portfolio in the freefall of 2008. "That is the advantage of the bankruptcy, it resets our basis."

In practice, that means the only Wall Street investment bank in Chapter 11 now runs a gung-ho proprietary desk even as its former competitors – Goldman Sachs and Morgan Stanley – scramble to amputate their internal investment arms. Lehman's CRE team manages 1,100 positions in over 700 deals worth USD 14.4bn in equity, debt and hybrid securities backing over 1,600 commercial properties, according to Jonas Stiklorius, a director at Alvarez & Marsal.

Not everyone takes pleasure in Lehman's reversal of fortune. "They made a boneheaded loan that they couldn't get securitized and now that's their advantage, which is sort of ironic," said a large hedge fund manager who bought several pre-crunch Lehman real estate deals.

Lehman syndicated much of the senior debt securitized by real estate assets on its books, and held on to the riskier equity, subordinated and mezzanine instruments that proved harder

to unload. Rather than liquidating the trades or letting them sink deeper under water like other banks, the Lehman veterans and three restructuring specialists from Alvarez & Marsal – Jeff Fitts, Phil Cyburt and Nancy Shanik – are aggressively managing them.

That strategy leaves Lehman as a lone bank trawling fund-infested waters, said John Schneidman, also a Managing Director on the CRE team and long-time Lehman employee. Hedge funds now dominate the trade in CRE-backed junior debt and equity as they seek to control restructurings of the underlying assets, with Paulson & Co., Centerbridge Partners and Pershing Square Capital Management leading the charge.

The deals Lehman re-worked in recent months range the gamut from REITs-gone-private Archstone Smith and Innkeepers USA Trust to billion-dollar property portfolios in New York and Rosslyn, Virginia. Some of the vulture funds that typically scour the distressed debt markets seem discomfited by the estate's sometimes hard-nosed approach.

Lehman launched a pre-emptive strike last month in the Innkeepers bankruptcy by negotiating a pre-arranged restructuring that set off an uproar among other creditors, particularly David Tepper's Appaloosa Management. Not content to object to the plan in the court presiding over Innkeepers, Tepper's fund petitioned the judge presiding over Lehman's own bankruptcy case to intervene.

When all is said and done, LAMCO, the non-debtor subsidiary tasked with the management of the Lehman estate's illiquid assets, will likely restructure over 80% of the CRE assets in its portfolio, Shanik and Fitts said. The USD 11bn in cash the Lehman estate reported as of 31 March will certainly help in those efforts.

Use of what is essentially creditors' money to rescue real estate assets may raise questions of fairness, said the large hedge fund manager, who has not participated in a workout with the bankrupt bank. But, he added, Lehman seems to be taking a case-by-case approach when it comes to spending the estate's money, and so far, making the right decisions.

## **Hubris**

In its quest to transform from a traditional investment bank to a bulge-bracket real estate lender, Lehman aggressively expanded lending limits, and then overstepped them. The firm almost doubled its CRE balance sheet limit to USD 60.5bn in 1Q08 from USD 36.5bn in 1Q07 and still exceeded the internal cap by USD 5.2bn in 1Q08 alone, according to the examiner's report generated as part of the bank's bankruptcy.

Barsanti, Schneidman and others working under Lehman's Real Estate Czar Mark Walsh helped structure 10 headline-grabbing deals worth over USD 1bn in 2007. The LBOs of Hilton Hotels, Archstone-Smith, and Innkeepers led the pack. A USD 2bn financing for Broadway Partners to acquire a CRE portfolio also in 2007 pushed the bank's capacity to the limit.

And much like Drexel Burnham Lambert did with junk bonds in the 1980s, Lehman elbowed aside larger Wall Street shops by pioneering more aggressive structures. Lehman dominated deal flow by taking bridge equity positions – slices of paper with attributes of both debt and equity that often provided the final dollar amount to push transactions over the finish line.

Between 2Q06 and the 2Q07, Lehman's real estate bridge equity positions in the US increased tenfold, from USD 116m to USD 1.33bn. Even as subprime cracks began to spread into other pockets in 2007, bridge equity positions doubled to more than USD 3bn by the end of 2Q08.

The Office of Thrift Supervision's raised a red flag in 2007, stating that Lehman had exceeded its risk appetite limits, due to Archstone in particular, and followed up in 2008 with a negative report focused on CRE and criticizing the firm for entering into deals without sound risk management.

### **Dark days**

Both the scale of the bank's exposure and its reliance on riskier instruments created enormous downside potential when the mortgage securitization carousel came to halt. Lehman began in 3Q07 to try to apply the brakes but by then its deal-making engine had picked up too much momentum.

The pressure to slow down the real estate finance operation coincided with a growing awareness internally that existing investments were overvalued. Lehman's highest level of management then pushed back against the need to take resulting writedowns.

E-mails published in the examiner's report show Barsanti receiving information in July 2007 from TriMont Real Estate Advisors, a valuation specialist, noting that certain properties were overstated, some by as much as 50%.

Barsanti stated in an interview with the examiner that during the 2Q07 valuation process, Head of US Originations for Global Real Estate Kenneth Cohen told him "he was only allowed to write down positions to a certain dollar value," according to the report. Cohen subsequently reversed course and allowed Barsanti's suggested re-valuations.

Barsanti and Cohen's conversation mirrored similar exchanges in Lehman's top executive suite with CFO Chris O'Meara pushing back at valuations from Cohen that he thought were "excessively conservative," according to the report. Ultimately, the examiner decided that while colorable claims exist against senior executives for questionable disclosure and repo activity, there was insufficient evidence to establish an institutionalized application of write-down caps for the real estate group.

Senior management did launch an aggressive selling strategy in November 2007 to reduce the CRE portfolio from USD 55bn to USD 43bn by March 2008, but the bank couldn't find

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buyers at the right price point and as of May 2008 still held positions worth USD 49.3bn. As pressure mounted, Lehman traders dropped their offers and unloaded USD 8bn of paper by August, cutting exposure to USD 41.3bn.

Over the course of 2008, Lehman wrote down its CRE positions by more than USD 3bn with USD1bn of that coming from principal transactions in which Lehman had committed proprietary capital. Barsanti played a key role in that re-valuation and when Lehman filed for bankruptcy, it still booked USD 41bn of CRE exposure on various balance sheets.

### **Banding back together**

After Lehman entered Chapter 11 and sold its North American operations to Barclays Capital, Barsanti, Schneidman and their co-workers found themselves in the employ of the UK-bank overnight. A chaotic interstice ensued during which the bankers went to Barclays – while remaining in Lehman’s landmark headquarters at 745 Seventh Avenue – and the CRE portfolio stayed with the bankrupt estate.

Barclays put its name on the digital marquee of the building that same day but “[investors] in those [CRE deals] were still calling us because they didn’t know who else to call,” Schneidman said.

Alvarez workout specialists were also at 745 Seventh Avenue trying to wrap their heads around Lehman’s disparate deals and quickly recognized the need to retain the bankers who had put them together. “It was a matter of someone calling up our people at Barclays and saying, ‘We’re putting the band back together, you should come over’,” Stiklorius said.

Faced with a choice between the unknown at Barclays and the opportunity to manage the portfolio they’d built at Lehman, many chose the latter. Their efforts to make things right and to provide a sense of continuity to the CRE operations is a large reason Lehman has been effective in restructuring efforts, said Monday Properties’ Westreich.

Combine that continuity with the workout expertise provided by Alvarez & Marsal – founder Bryan Marsal runs the Lehman estate – and a distressed CRE juggernaut is born. As of June 2010, Alvarez had earned USD 311m in fees from the bankruptcy.

Before tackling individual deals, the CRE team focused on consolidating the disparate assets acquired by various entities within the bank under one estate-wide umbrella.

### **Bankrolls and bare knuckles**

From day one, the estate took an “entity agnostic approach,” erasing the lines between the different entities at Lehman that carried exposure to CRE debt, Fitts said. More recently, the team has been collapsing the securitizations – dubbed “entanglements” by staffers – Lehman structured for repo to facilitate restructuring of the underlying loans.

Judging by the handful of CRE restructurings Lehman has disclosed, the team combines selective double-down bets to avoid restructurings – the Lehman expertise – with brash bare knuckles fighting in active workouts – something Alvarez has seen its fair share of.

In 2Q10 alone, the bankrupt bank spent USD 60m in new debt or equity investments on real estate assets owned. The estate spent another USD 262m in July to pay down a mortgage on six office buildings in Rosslyn, Virginia the bank bought for USD 1.3bn in 2007 through a joint venture with Monday Properties.

The partners opted for repayment rather than refinancing when they realized the upside potential in the properties given high occupancy rates of 98% and overall strong performance, according to Westreich,

Some of the CRE team’s post-bankruptcy investments have been more defensive. Lehman recently bought back from Prudential Financial Investment a USD 255.4m bond with liens on a building at 237 Park Avenue in Manhattan, said a source claiming knowledge of the trade.

That’s because Lehman already held USD 437m of mezzanine debt secured by the asset that ranks junior to the B-note. A new B-note holder could have potentially moved to foreclose on the property and wiped out Lehman’s position, according to the source. With the exception of a USD 419m senior mortgage, which is securitized in LB 2007-3, Lehman now owns all of the property’s USD 1.23bn debt stack.

In the case of Innkeepers, Lehman holds a senior USD 250m mortgage, but it is only secured by 20 of the privately held REIT’s 92 subsidiaries. While it owns the minority of the debt borrowed in the REIT’s 2007 buyout, Lehman is the only creditor able to actively negotiate a workout because the other USD 1bn of loans were sold off to various CMBS vehicles governed by stringent real estate mortgage investment conduit (REMIC) rules.

That hasn’t stopped Appaloosa – a typically combative vulture fund – from crying foul and alleging that Lehman is playing unfairly. “[Lehman] seeks authority ... to sell an asset it does not own, may never own and cannot yet value — all without ... marketing the contingent assets in question or subjecting its sale to higher or better offers,” Appaloosa’s counsel at Willkie Farr & Gallagher wrote in an objection filed 11 August in US Bankruptcy Court.

The new-old Lehman shot back with a filing of its own disclosing that it had received expression of interest in the Innkeepers assets from a number of parties and outing Appaloosa as one of the would-be buyers. In the end, the estate argued, no offers materialized and the proposed plan emerged as the best option to preserve value.

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When asked about the pending battle in both the Lehman and Innkeepers cases, Bryan Marsal responded with a succinct e-mail. “If another creditor disagrees with either position, that creditor will have its day in court,” he wrote.

Source: Debtwire

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