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Rare Debt Deal in Detroit

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Even Detroit's commercial real-estate market is feeling the love from Wall Street's debt rally.


CoStar Group

One Kennedy Square in downtown Detroit

Take One Kennedy Square, a 10-story office property built in 2006 on the site of Detroit's old city hall. A venture of Redico Corp., a Southfield, Mich., developer, recently got a $27 million loan refinancing from J.P. Morgan Chase & Co. The bank has rolled the loan into a pool of more than $1 billion in commercial mortgage-backed securities that it is selling off to investors in a deal set to close this week.

In many bigger cities, such a modest refinancing wouldn't be a big deal. But it is in Detroit, a city that has been plagued for years by high unemployment, low demand for office space and a gloomy outlook. The city's unemployment rate stood at 19.6% in August, more than double the seasonally adjusted national unemployment rate of 8.1%, according to the Bureau of Labor Statistics.

The deal would mark the first time in five years that a Detroit office building has gotten a securitized loan, according to Trepp LLC, a real-estate research firm. Access to commercial mortgage-backed securities, or CMBS, makes markets more liquid and the loans are coveted by borrowers because they typically don't require onerous personal guarantees. CMBS loans give sellers and buyers another source of financing beyond the traditional banks or life-insurance companies.

"The markets have been closed to Detroit," says Dennis Bernard, president of Bernard Financial Group, a commercial-banking firm that represented J.P. Morgan and the building's owners in the transaction. "This time, we thought we could do it. We were like the little engine that could."

Of course, a big reason the little engine made it over the mountain in Detroit was Wall Street's increasing appetite for commercial-mortgage securities. With yield-chasing investors gobbling the bonds up, the volume of new issues is expected to hit $38 billion this year, up from $33 billion last year, according to a Bank of America Corp. strategist.

But there is some disagreement over whether the CMBS market is expanding too fast. Moody's Investors Service has been warning that credit standards may be loosening too much as lenders rush new issues to market.

Indeed, Moody's last week took the unusual step of criticizing the credit ratings on the $1.1 billion bond issue that included the mortgage on One Kennedy Square and 42 other commercial-property loans. The report said the valuation of properties in the pool "is shortsighted in an environment of historically low interest rates, and underestimates the refinance risk of loans that mature in ten years."

The loan pool received ratings by four other firms, including Standard & Poor's and Fitch Ratings. Moody's took a look at the pool several months ago but wasn't asked to rate it by J.P. Morgan. Moody's generally saw more risk in the deal than other rating agencies and its initial feedback reflected those views, people with knowledge of Moody's thinking said.

J.P. Morgan declined to comment on the Moody's report. Mr. Bernard said the Detroit loan was conservatively structured and validates lenders' confidence in downtown's resurgence.

Moody's executives declined to discuss individual loans in the controversial issue. But a close look at the One Kennedy deal shows that the property has a number of things going for it, but also reason for caution.

Located at 777 Woodard Ave., the 245,000-square-foot building is 96% occupied and sits across from the Campus Martius Park and Compuware Corp. headquarters. The central business district area has also grown more lively since Quicken Loans founder Dan Gilbert began snapping up numerous buildings at steep discounts and filling them with employees relocated from the suburbs.

Also, the loan is only 65% of the building's estimated value, which an appraisal put at $170 a square foot. And the building's net operating income of $4.4 million in 2011 could easily cover its annual debt service, estimated to be about $1.8 million.

But some uncertainty looms. In the wake of the auto-industry's restructuring, some 27% of the Motor City's downtown office space remains vacant, one of the highest rates in the nation, according to Reis Inc., a real-estate research firm.

In less than five years, leases on nearly half the building, or a total of 114,000 square feet now occupied by such tenants as accounting firm Ernst & Young U.S. LLP and Marketing Associates, a Michigan advertising firm, will expire. Also, at the end of 2017 tax incentives will be eliminated, increasing the building's operating expenses.

Redico didn't return calls for comment on the loan.

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