

Insurance Company High-Yield Real Estate Investments

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The Value Outside Counsel Can Contribute

The insurance industry has played a significant role in the commercial real estate (CRE) market for more than a century. A major part of CRE investments for insurance companies has been commercial mortgage loans, traditionally consisting of first-lien, low-leveraged loans for stable properties. Before the 2008 downturn, insurance companies expanded into mezzanine financing, “B” notes, and junior loan participations. However, after 2008, many insurance companies pulled back from such nontraditional investments and returned to their roots in low-leveraged first-lien mortgage loans.

The last 10 years has been a period of unprecedented low interest rates. While the CRE market has not been immune to this, CRE investments have provided an opportunity to achieve higher yields than other sectors. During this same period, real estate values have rebounded to their pre-2008 heights. These factors have made the CRE lending market more attractive to insurance companies and have led to increased investment portfolio allocations to CRE. However, these same factors have also led to increased competition in the CRE lending market with CMBS loan originators, government agencies, commercial banks, and debt funds.

In the face of this continuing low interest rate environment, more money to invest, and greater competition to win deals, insurance companies have searched for higher-yielding debt investments in less crowded areas. These investments have taken the form of:

- Mezzanine and other high-yield structured financings
- “Participating” mortgage loans (i.e., loans with returns tied to asset appreciation or cash flow)
- Construction loans
- “B” notes

- Junior loan participations
- Preferred equity (sometimes with features resembling debt)
- Joint ventures

Having been active in the CRE market for more than 25 years, we have witnessed close hand the changes in the investment activity of our insurance company clients. With many clients having retreated from riskier and higher-yielding CRE investments 10 years ago, it is not a simple process for them to pivot back into this area for a number of reasons. First, in-house professional knowledge and experience have dwindled as investment and legal professionals moved into other areas or retired. Second, the legal and market considerations for these investments have changed considerably in the last decade, which makes earlier institutional knowledge stale. Third, by their very nature higher-yielding investments carry more risk and thus require careful underwriting and execution. Despite these challenges, many insurance companies have been venturing back into the high-yield CRE investment market.

In conventional CRE mortgages, low leverage with a hefty equity cushion can provide a comfortable degree of protection against risks, such as unexpected environmental or property condition deficiencies or a sluggish leasing market. However, in higher-yielding and higher-risk investments, the insurance company may be an equity investor or a junior debt holder, all much closer to the first-loss position.

Outside legal counsel can provide substantial value to insurance companies in addressing the challenges of high-yield CRE investing, especially in the following areas:

- **Finance and equity transactional expertise** – the legal documents will still comprise the backbone of the transaction. Expertise in collateral, intercreditor, and other documentation issues is essential.
- **Environmental** – a solid and practical understanding of environmental issues remains an important specialty in both conventional mortgage loans and high-yield investments.
- **Tax** – while not an issue in debt transactions, tax counsel is critical in private equity and joint venture transactions.
- **Construction** – construction expertise is a must-have skill in construction loans and equity investments involving new construction or redevelopment.
- **Leasing** – knowledgeable leasing counsel is desirable in equity investments in which the investor is closer to operational matters.

- **Creditors' rights and litigation** – while no institution enters an investment expecting it to fail, one must always be prepared for that possibility in high-yield riskier investments.

In our experience, it is highly desirable that outside counsel for a high-yield investment platform provide a multidisciplinary team of lawyers who can address the various legal areas involved in such investments. As one of the few firms that offer an integrated team of such lawyers who represent insurance companies in the full spectrum of CRE transactions, we will continue to report on issues and developments in this area.

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