THE REAL DEAL
NEW YORK REAL ESTATE NEWS

From slam dunk to junk: US developers face Israeli bond market reckoning

Proposed rule change would relegate most US firms seeking financing to junk status

‹ April 2021 Issue

Apr. 19, 2021 07:30 AM

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(Getty images)

About a decade ago, the Israeli bond market (https://therealdeal.com/issues_articles/2399096/) emerged as an attractive source of capital for U.S. real estate companies at a time when traditional sources of financing proved somewhat scarce.

For U.S. firms, a corporate bond issuance in Israel provided the ability to raise debt without saddling a building with a mortgage, and at favorable interest rates compared to those available closer to home. For Israeli institutions with limited domestic investment opportunities, the bonds provided attractive returns.

But the easy access to financing at low rates has also had a downside, as firms like Starwood Capital Group, Brookland Capital and Canada-based Urbancorp took on more than they could handle and defaulted on their debt.

And after the latest scandal involving a U.S. real estate company — All Year Management — and the Israeli bond market, the Israel Securities Authority decided to take action. But is it too little, too late or is it too much?

A proposed rule change (https://www.isa.gov.il/%D7%92%D7%95%D7%A4%D7%99%D7%9D%20%D7%9E%D7%A4%D7%95%D7%A7%D7%97%D7%99%D7%9D/Mutual_

that targets how mutual funds assess a company's rating would effectively relegate foreign issuers — mostly American real estate firms — to junk bond status starting next year.

With the vast majority of U.S.-issued Israeli bonds classified as junk, Israeli mutual funds would be forced to sell (https://translate.google.com/translate?hl=&sl=iw&tl=en&u=https%3A%2F%2Fwww.globes.co.il%2Fnews%2Farticle.aspx%3Fdid%3D1001363577) much of their holdings, increasing the cost of financing for American developers. It's no surprise the industry has come out in opposition to the proposal.

In a letter to the ISA, Israel's Association of Mutual Fund Managers said the rule will "lead to a wave of bankruptcies of various companies due to the inability to refinance debt by those companies."

While noting that the attractiveness of the Israeli bond market derives from its liquidity and direct exposure to retail investors, an ISA spokesperson said the market also "needs to be highly supervised." Its risk profile, she added, "is not appropriate for certain investors that have preferred to invest in solid funds." The changes will take effect in January if finalized; interested parties have until April 21 to comment.

Among U.S.-based firms that have issued bonds on the Tel Aviv Stock Exchange, the response has also been negative.

"It paints all U.S. issuers with a bad brush because of poor behavior by three companies in total," said Michael Shah of Delshah Capital, a New York developer that has issued three Israeli bond series since 2015. (https://therealdeal.com/2016/01/08/delshah-raises-82m-on-israeli-bond-market/) Shah said the firm has spent six years "being good borrowers and cultivating our relationship with the Israeli market."

Lightstone Group CEO David Lichtenstein called the ISA's move "silly" (https://www.wsj.com/articles/israeli-bond-proposal-threatens-to-curb-borrowing-by-u-s-real-estate-firms-11616500828) in an interview last month with the Wall Street Journal, comparing it to shutting down "the stock exchange after Enron." The New York-based developer has issued two Israeli bond series backed by a nationwide portfolio.

Other commentators view the rule change as reasonable given the latest shakeup in the bond market — the collapse and delisting of developer Yoel Goldman's All Year, (https://therealdeal.com/issues_articles/all-years-bad-year/) whose four outstanding bond series have a total face value of about $700 million.

"It's a pity that this is only happening now, after the risk has materialized in two of the [American real estate] companies — and despite the warning signs spread before it," journalist and market analyst Yaniv Rahimi wrote in a March opinion piece in Israeli business newspaper Calcalist. Rahimi was referring to the recent All Year debacle as well as the challenges facing Starwood, which last year defaulted on Israeli bonds tied to a regional mall portfolio (https://therealdeal.com/2020/09/28/last-bidder-standing-has-big-plans-for-starwoods-troubled-mall-portfolio-but-first-creditors-must-sign-off/) in the U.S.

Glocal

Questions about the risks associated with non-Israeli bond issuers go back to mid-2016, when Canadian condo developer Urbancorp filed for bankruptcy just months after raising $48 million in Tel Aviv. That prompted several scrapped IPOs and an investor backlash that lasted for about a year.

Then in late 2018, Boaz Gilad's Brooklyn-based Brookland (https://therealdeal.com/2019/09/20/brookland-capital-was-never-run-correctly-or-efficiently-new-leader-says/) suspended trading while All Year disclosed an "accidental" transfer of funds to Goldman's personal account, leading to another bond market meltdown (https://therealdeal.com/2018/12/24/us-real-estate-firms-flocked-to-israel-in-search-of-cheap-debt-now-the-markets-turning/) that lasted several months.

Following both the 2016 and 2018 crashes (https://therealdeal.com/issues_articles/the-israeli-bond-market-shakeout/) , market commentators argued that Israeli investors would learn to be more selective in their investments and subject U.S. bond issuers to more scrutiny. But now, the ISA seems to have decided that stronger regulatory intervention is needed.

While U.S. borrowers may argue that turmoil in the Israeli bond market is just the fault of a few bad apples like Urbancorp, Brookland and All Year, the ISA sees a broader systemic problem — a failure to distinguish between ratings for local (Israeli) companies and global firms.

SELECT U.S.-BASED ISSUERS OF ISRAELI BONDS

ISSUER	SERIES	SECURED?	RATING	INVESTMENT GRADE UNDER NEW RULES?	INTEREST RATE	MATURITY DATE
Pinnacle	C	No	AA-	No	4.35%	11/15/27
Moinian	B	No	BBB+	No	3.75%	12/30/24
Silverstein	A	No	AA	Yes	3.38%	12/31/24
Lightstone	A	No	A+	No	6.05%	5/31/24
Spencer Equity	B	No	A	No	5.15%	3/31/28
Westdale	A	Yes	AA-	No	4.8%	10/30/25
Lightstone	B	No	A+	No	3.95%	11/30/25
Silverstein	B	No	AA	Yes	3.49%	12/31/27
Pinnacle	E	Yes	AA	Yes	5.45%	8/31/25
Extell	B	No	BBB+	No	6.25%	12/31/21
Westdale	B	No	A+	No	4.35%	7/31/28
Pinnacle	D	Yes	AA	Yes	3.15%	5/31/24
Delshah	B	Yes (mezz)	A-	No	4.6%	10/1/23

*MIDROOG/MOODY'S RATINGS WERE CONVERTED TO MAALOT/S&P RATING EQUIVALENTS
SOURCE: TEL AVIV STOCK EXCHANGE FILINGS

"In recent years, there has been an increase in the issuance and listing of bonds by companies with no affiliation to Israel," the ISA said in announcing the proposed rule change. It noted that most of the companies in question are incorporated in the British Virgin Islands with business activities focused in the U.S.

"These companies are rated by Israeli rating companies on a local scale and not on a global scale … despite their global characteristics and the risks associated with their activities," the ISA said.

To address this apparent discrepancy between local and global rating scales, the ISA's new rules will require Israeli mutual funds to narrow their definition of "investment-grade" for bonds issued by foreign companies, raising the lower threshold by seven grades from BBB- to AA.

Under this new definition, only four of the more than 30 bond series issued by American developers will still be considered investment-grade. Those are two issued by Silverstein Properties with a total value of more than $1 billion and two issued by Joel Wiener's Pinnacle Group with a total value of about $540 million. The total face value of bonds in the Tel Bond-Global index, which tracks foreign issuers, is more than $13 billion.

Silverstein declined to comment on the proposed rule change. Pinnacle did not respond to a request for comment.

No place like home

With a few weeks left before the ISA makes a final decision on whether to implement the new rules, at least one major New York developer is still moving ahead with plans to raise new debt in Tel Aviv.

Just days after the ISA announced its proposal, Gary Barnett's Extell Development disclosed to the Tel Aviv Stock Exchange that it was considering a new bond series. Ratings agency Midroog rated the proposed issuance, worth up to 150 million shekels, or about $45 million, and gave it a grade of Baa1 (equivalent to BBB+) — a few notches above junk under existing rules, and deep in junk territory under the proposed new rules.

Extell declined to comment. Kushner Companies, reportedly considering a $100 million Israeli bond issuance (https://therealdeal.com/national/2020/12/29/kushner-companies-plans-100m-israeli-bond-raise/) in December, also did not comment.

If American developers' access to the Israeli bond market faces new constraints, they will have to rely more on lenders closer to home. With interest rates at historic lows, it isn't a bad time to be a borrower in the United States.

In particular, many U.S. developers that issue bonds in Israel have also tapped the CMBS market to refinance their properties in recent months — and at interest rates that are comparable to those they pay in Tel Aviv.

Take Silverstein's recent $165 million refinancing of 120 Wall Street (https://therealdeal.com/2021/02/12/heres-what-tenants-are-paying-at-silversteins-120-wall-street/) , its 670,000-square-foot office tower in Lower Manhattan. The loan came with an interest rate of 3.2 percent, while its two Israeli bond series have interest rates of 3.38 and 3.49 percent. But the CMBS loan is secured by a senior mortgage on the property, while the Israeli bonds are unsecured corporate debt.

Meanwhile, Delshah was able to pay down one of its Israeli bond series with a $180 million loan (https://therealdeal.com/2021/01/04/delshah-closes-on-180m-refi-for-morningside-rental-project/) from Arbor Realty Trust on its 205-unit luxury rental conversion project in Manhattan's Morningside Heights.

Prior to its December meltdown, even All Year came close to securing a big refinancing in the CMBS market. The developer was negotiating with Citi and Goldman Sachs for a $652 million refinancing of the Denizen rental complex in Bushwick, according to an October rating report (https://www.dbrsmorningstar.com/research/369008/dnzn-commercial-mortgage-trust-2020-dnzn-presale-report) from DBRS Morningstar. The deal would come with a 3.69 percent interest rate and would include 10 other multifamily properties. A $410 million piece of the loan was to be securitized in a CMBS transaction, whose tranches had preliminary ratings ranging from AAA to BB.

But that deal evaporated soon after and the provisional ratings were officially withdrawn (https://www.dbrsmorningstar.com/research/374042/dbrs-morningstar-discontinues-and-withdraws-provisional-ratings-on-dnzn-commercial-mortgage-trust-2020-dnzn) in February as All Year faced foreclosure. In a massive understatement, the rating agency noted that "this transaction is not expected to close in the immediate future."