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FUNDING FOCUS

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Debt Exchange has created demand in a previously illiquid market.

Looking to buy or sell loans or loan portfolios? Debt Exchange Inc. could be the place to do it.

Volume has been strong at the Boston-based firm, which specializes in the sale and resale of commercial and residential real estate debt, commercial and industrial loans and other corporate debt.

Financial services companies in search of improved liquidity have turned to DebtX to sell performing and non-performing loan portfolios. The company's online business platform has simplified the process and reduced costs for buyer and seller alike.

DebtX said it sold about $548 million in loans during September, the company's highest monthly total since it was formed in 1999. Last year, the company's sales totaled about $400 million, and Chief Executive Officer Kingsley Greenland expects 2002 sales to exceed $1 billion.

The company's September sales included $260 million in judgments, deficiencies and charge-offs, $198 million in performing residential real estate loans, $73 million in commercial real estate loans and $17 million through participation in a term-loan facility.

The company unveiled a plan in June to provide loan-advisory services to Midwestern financial institutions with less than $5 billion in assets. It also established a broker/dealer division to expand its services in the secondary market, particularly in the areas of interest-only strips and mezzanine loans.

Jim Kalergis, editor of Specialty Finance Weekly, *talked with Greenland recently about his business and the state of the market. An edited transcript of that conversation follows.*

Specialty Finance: Tell me about the evolution of DebtX.

Kingsley Greenland: We came together January of 2000 and built a data platform, which was launched in August of 2000.

We are a marketplace — a place for sellers to go get advice and counsel and structure in such a way as to maximize proceeds from sales. A bank or a funder would buy [our services], and then we would structure the format and put it up on the website and sell it. That's done both through the functionality of the website and the experience [of DebtX's management]. The principals of the firm have all been in this business for over 12 years each.

"It was just a brokerage community before we came along. Somebody would pick up the phone and call the five or 10 people that he or she knew who would buy loans. If they bought that type of loan, you'd have a trade. If they didn't, you may not."

— *Kingsley Greenland, CEO Debt Exchange Inc.*

What makes up the majority of your business?

The vast majority is commercial debt — commercial real estate. We also do business loans and corporate and industrial loans. But most of the C&I loans that we do are generally illiquid — below $250 million outstanding.

What are margins typically like for the transactions you enter?

The margins, frankly, are all over — and it's a function of the illiquidity in the loan or the lack of liquidity. They are also based on performance characteristic, asset class, location, age, size and number of overall portfolios. Obviously it's more expensive to sell an individual loan than it is to sell a portfolio of loans on a prolonged basis.

The enhanced execution we're able to provide through the website and this buying community that we have more than offsets the ultimate costs.

What sort of involvement do you have with commercial mortgage-backed securities?

Our primary customers are banks, and we do a tremendous amount of business in the CMBS world. We deal with most of the issuers and special services and trustees. But at the end of the day, the volume that comes from that is far less than from banks because those loans are originated to be put on the shelf for 10 years. You wouldn't expect to see a whole lot of movement or a whole lot of secondary market activity. CMBS is by its nature a secondary market exit. You're originating loans to be put into an artificial structure and then selling the bonds. There's not a whole lot of ongoing trading of the underlying assets. The bonds themselves trade instead of the underlying assets.

Having said that, we do sell — for most of the issuers — loans that didn't make it into a securitization because [the issuers or the buyers] didn't want them. We do a lot of clean-up calls and wind-downs — the tail end of the trust. After eight or 10 years there's a small piece left, they want to sell that out, and we do that. So, we're very active in that world, but it's not the biggest piece of our life.

Where did people go to sell these illiquid loans prior to the formation of DebtX?

It was just a brokerage community before we came along. Somebody would pick up the phone and call the five or 10 people that he or she knew who would buy loans. If they bought that type of loan, you'd have a trade. If they didn't, you may not.

On the buy side, there was an impediment in that, to be able to get the largest institutions to come in and buy, you had to have huge pools.

It was a market that was highly fragmented.

What we've seen since the establishment of DebtX is … an increase in liquidity across a broad spectrum of assets. That's because the model that we have is different from the fragmented brokerage community in a couple of ways.

First, we have enough volume so that there are always products available. There is a deep buy side — a lot of buyers out there. In the old model, somebody might get called once every six months and, when they got that call, they'd say, 'No, I'm not in the market today,' or they'd be out on vacation. Now, there is a deep buying community.

The second piece is that the cost to buy has been reduced significantly. In the old model, you either got shipped a box of papers or, more likely, you had to fly to a "war room." Now, everything is on the website. There is no friction expense before you decide that you're interested in an asset or not. It is very quick and very easy.

Are you the only company to offer this kind of online model?

Of those surviving, yes. I can't say we were first to market the product. There was a company called Secondary Market.com, which is no longer around. They may have beat us to market by a quarter.

Do you have any real competition today?

One of our biggest competitors is the brokerage community and their old model — there are still a lot of people out there doing it. But really our biggest competitors are buyers who want to buy their product direct [and] the institutions themselves, who say, "Do I want to plug into the Exchange or do I want to have a trader at my own desk try and sell these types of assets part time?"

We start to get all sorts of asset classes. But most of the larger banks have a trading desk where they're trading CMOs or CMBSs or Treasurys, whatever the case may be. Occasionally, the institution has some assets they want to sell and they'll give them to their trading desk and see if they can sell them as opposed to going through a competitive format. Understandably, they get it cheaper.

We have 1,400 registered users right now. That eclipses anything you'd see on a regular basis on the buy side on a historical basis.

If companies or individuals are interested in becoming a buyer on your system, what qualifications do they have to meet?

At the very least, you have to be an accredited investor within the definition established by the SEC. On top of that, depending on how well known you are, we may do varying levels of due diligence on you.

You also have to agree to the protocols within the exchange and sign confidentiality agreements and things like that. Basically, you need to be able to prove that you can close if you bid.

In general, we do not disclose the sellers or the buyers. But having said that, the FDIC — they disclose it, so I feel comfortable about mentioning them — has used us eight times in the past 14 months.

If you're selling loans and portfolios for the FDIC, does this mean you have a heavy emphasis on non-performing assets?

Just because they closed down a bank doesn't mean that all the assets are bad. It just means the bank was bad. But, without getting specific, I believe that even for the FDIC the vast majority of what we've sold has been highly performing.

We have some customers that just like to prove that they have liquidity in their portfolio. They just want to understand the secondary market, and they'll sell very good loans on a regular basis just to be ahead of the curve and sophisticated about liquidity and portfolio management.

I think about 80% [of the loans sold by DebtX] are performing. There are a couple of reasons why we're seeing [a high amount of] performing [loans]. One is the effectiveness of this exchange. An institution can sell a few performing loans and get very granular — in other words, get to a local bank through the exchange whereas before they would have to gather a couple hundred million dollars, call an investment bank and throw it into a securitization. We sell loans on an individual or a portfolio basis. The historical model was that you needed size to offset the transaction cost and to get the interest of the buyers. That's no longer the case.

If you were to look at our site today, we have pools of loans — 3,000 loans, 200 loans, 17 loans, one loan, three loans, two loans, five loans, one loan, one loan, one loan, 10 loans, one loan — and it's all across the board. There is about $500 million [in loans for sale] on the site right now.

Have there been any kind of regulatory concerns, given the current business environment?

There has been some of that on the margins. People are looking for more transparency when there is an exchange of significant value. Something like DebtX becomes valuable in that those transactions are much more transparent. Everybody can sit there and say, "They paid the fair amount. It was competitively marketed. Everybody had access to it. There was an organization in the middle that was sophisticated."

We also have a broker/dealer unit, so we're a member of the NASD. We take a very conservative interpretation on what is a security.

Why is the current environment so favorable for your business?

Part of it is that we have a demonstrated success that we can explain to people. It's no longer an idea and we are trusted within the industries in which we deal. We can give some empirical numbers.

Although it might appear that there has been significant growth recently, the growth has been pretty good all throughout. [The growth curve] is not a hockey stick, but it is a little bit exponential. One month it's 2%, the next month it's 4%.

So I think the business model is starting to work. That's one reason business is picking up or that it appears the volume is picking up. The other is the demonstrated success aside from the business model. Customers are saying, "They did what they said, I'm going to use them again." They tell somebody else and we end up getting a referral. It just kind of continues to chug along.

We have been in the black since September of last year, although we were not [profitable] for the whole year. SF