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Redefining Distressed Opportunities

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Abstract
[Excerpt] As the commercial real estate (CRE) industry embarks on a new year and hopes to put the pain of 2009 behind it, industry players should keep in mind that much of the wreckage left in the wake of the world financial crisis remains unresolved and billions of dollars in looming CRE loan maturities further cloud the outlook. By the end of Q1 2010, nearly $222 billion worth of CRE was distressed, of which $27 billion had been resolved. At the beginning of 2009, many predicted that a flood of distressed assets would be coming to market and hundreds of billions of dollars were raised to target the supposedly imminent opportunities. However, most of these investors have found the inventory of distressed opportunities wanting. If all of these properties are still in trouble and investors are aching to deploy their capital, why aren’t more deals getting done? Will 2010 be the year when the levees break? This report seeks to answer both of these questions.

Keywords
Cornell, real estate, world financial crisis, CRE loan maturities, distressed, investor, opportunities, Real Capital Analytics (RCA), CMBS, non-CMBS, Commercial Mortgage Backed Security, Las Vegas, Miami, Detroit, Cincinnati, Manhattan, property type, liquidate, mortgage, foreclosure, “extend and pretend”, “a rolling loan gathers no loss”, “Restructured/Extension”, regulatory policy, lenders, resolution, debt
As the commercial real estate (CRE) industry embarks on a new year and hopes to put the pain of 2009 behind it, industry players should keep in mind that much of the wreckage left in the wake of the world financial crisis remains unresolved and billions of dollars in looming CRE loan maturities further cloud the outlook. By the end of Q1 2010, nearly $222 billion worth of CRE was distressed, of which $27 billion had been resolved. At the beginning of 2009, many predicted that a flood of distressed assets would be coming to market and hundreds of billions of dollars were raised to target the supposedly imminent opportunities. However, most of these investors have found the inventory of distressed opportunities wanting. If all of these properties are still in trouble and investors are aching to deploy their capital, why aren’t more deals getting done? Will 2010 be the year when the levees break? This report seeks to answer both of these questions.

Before we begin answering those questions, let’s review where we are and the damage that has been wrought by the past two years of turbulence. Since the crisis began, Real Capital Analytics (RCA) has tracked commercial properties in default, foreclosure, bankruptcy or otherwise distressed, and has collected the most robust database of troubled assets that serve as collateral for both CMBS and uniquely, non-CMBS loans. At the end of Q1 2010, RCA tracked nearly $160 billion in CRE that remains distressed. RCA data shows that over $61 billion in distressed CRE has been resolved or restructured thus far.

Figure 1, below, shows that, although distressed CRE has been relentlessly piling up over the past two years, the upward drive has not translated into an increase in commercial real estate being taken back by lenders as REO. In fact, we are seeing lenders and borrowers increasingly willing to initiate workouts as both sides, seeking to avoid the costly liquidating process. While the aggregate distressed statistics are daunting each property type, region and market is feeling the heat in their own way.

Figure 2 illustrates the estimated aggregate dollar value of the market’s distressed situations (bars) as well as the relative size of the distress compared to the size of each market (diamonds). Market activity is based on the total transaction volume in each market from the past four years.

The presence of overheated markets such as Las Vegas and Miami and battered rust belt cities such as Detroit and Cincinnati at the top of this
list is expected. However, it may surprise some to see cities like Houston and San Antonio towards the top, as they are generally viewed as more insulated from the recession. On the other hand, while Manhattan was the epicenter of the global financial crisis and has, by far, the largest value of CRE in distress, with over $15 billion, that represents only 12% of its market. This stands in contrast to a market like Pittsburgh, whose nearly $590 million worth of distress represents over 20% of its market.

While each market has its own unique variables contributing to distress, from weak demand drivers to the lack of financing, conclusions regarding regional distress are easier to draw. The West and Southeast lead the way, with over $48 billion and $32 billion in distress, respectively. Buoyed by population growth, these regions experienced many large boom era portfolio transactions that drove up pricing to astronomical levels. Interestingly, the Mid-Atlantic ($12 billion) and the Midwest ($18 billion), two regions that least felt the economic growth of the last decade, have the least amount of distress. It seems that the slower the rise in pricing, the lighter the fallout.

The story is similar when the distress is broken down by property type. The retail and hotel sectors are the most distressed, with over $44 billion and $34 billion, respectively. While the absolute distressed value of office ($38 billion) and apartment ($37 billion) properties exceed the absolute distress value of hotel properties, office and apartment totals represent far less of their total sector size when compared to both retail and hotel property. Development sites and projects are next with $26 billion, while industrial property brings up the rear with just under $7 billion in distress at the end of Q1 2010.

Now that we have a lay of the land, we can begin to tackle why the mounting inventory of distressed CRE has failed to provide enough attractive opportunities for most investors. One big reason is that a confluence of factors has alleviated the pressure on lenders to liquidate. These factors range from the political, with regulators giving lenders more tools and flexibility to modify troubled loans without seriously wounding their balance sheets, to the ironic, as some loans were underwritten so poorly that it behooves lenders to work with borrowers to restructure in order to avoid both parties taking enormous losses in a fire sale of the collateral. As a result, an increasing portion of distressed situations are being restructured in some way, as is described below.

In order to track these rapidly evolving workouts more comprehensively, RCA created a “Restructured/Extension” classification in our troubled-asset methodology. This classification captures properties where ownership or debt terms have changed but may not have resolved the cause of distress. On the debt side, the most common type of restructuring is to extend the maturity date, although interest rate, loan balance and/or other terms can be modified. A restructuring of ownership, such as when a mezzanine lender steps into the equity position or the lender exchanges debt for equity also typically signifies unresolved trouble. However, the classification does not include properties that have gone back to
the 1st mortgage holder via foreclosure. From “extend and pretend” to “a rolling loan gathers no loss” and new, more morbidly humorous phrases that reflect the new reality of workouts, the “Restructured/Extension” classification, has been implemented to provide greater clarity in a world that is no longer black and white. While the trend of restructuring is present across the board, some situations seem to be more amenable to being worked out. The following page delves into the factors influencing the likelihood of a restructuring.

The map above shows the geographic distribution of restructurings with five especially noteworthy workouts that may inspire industry participants as we all try to address both the $160 billion in distressed situations that have not been addressed and any new trouble that may come during the rest of 2010.

Putting aside issues of regulatory policy, there are a number of situation specific factors that influence whether a distressed asset can be restructured on terms agreeable to both parties. These factors help the lender answer one critical question: If I were to liquidate this asset today, what percentage of the amount owed would be recovered? In order to attempt to answer this question, RCA has been conducting a quarterly analysis of loans that have moved through the distressed cycle to a resolution. Please refer to the appendix for RCA’s Recovery Rate methodology.

The Q1 2010 analysis covered a sample of nearly 400 defaulted commercial mortgages with an outstanding balance totaling over $7.6 billion. The gross proceeds recovered by lenders totaled $4.8 billion, equating to an overall mean Recovery Rate (RR) of 63%, before costs and fees. This means that on average, lenders are failing to recover over 1/3 of the amount owed to them. The average size of the loans in the sample was $19.4 million and the weighted average RR was just 58%, meaning the larger the troubled mortgage, the lower the RR. However, the overall RR masks the variety of factors that influence a lender’s success in recouping the capital owed on distressed commercial real estate. The main division in RR’s is between loans made for development or redevelopment activities (Dev/Redev) versus those made for acquisition or refinancing of existing properties (Acq/Refi). Figure 4 shows that Acq/Refi loans have a much higher RR than Dev/Redev loans, because they are much easier to extend or modify since there is generally some cash flow to service the debt. That being said, while development sites are being foreclosed on and liquidated more often than any other property type, stalled and incomplete developments are more likely to be worked out, because their value decreases every day the property sits partially built. The following page delves further into the factors influencing a lender’s RR on a particular asset, including the property type and the type of lender involved.
The presence of some property types at the top of the RR rankings, as depicted in Figure 5, may be surprising. Retail and Industrial property are generating the highest overall RR, tied at 71%, while Hotel property is in third place with a mean RR over 67%. The relatively high RR on distressed industrial property makes sense given the sector has the lowest total of properties in distress and was the recipient of less speculative capital during the boom. But how on earth could defaulted retail and hotel properties be generating such high RR during a consumer led recession? The answer is that lenders are often practicing a strategy of selective liquidation and only liquidating those troubled loans that are likely to generate a relatively high RR. For those hotel and retail properties that are too far gone, lenders are increasingly working with borrowers and other stakeholders to come to an agreement that avoids taking a loss on their investment. If an agreement cannot be reached and the lender takes title on the asset, many lenders are still waiting for an improved market before attempting to sell.

The most resolution activity occurred in the office and apartment sectors, which are generating mean RR of 64% and 63%, respectively. However, there is significant variation within both sectors. Built or converted condominiums generate lower RR than rental properties because resolutions usually involve bulk units sales and the uncertainty surrounding units in properties that the buyer does not own necessitates building a discount into the bulk purchase price. Similarly, offices located in central business districts are generating slightly lower RR than their suburban office peers as activity in central business districts was concentrated in failed redevelopment and conversion projects.

The composition of a lender’s CRE loan book and its general risk profile combine to influence how a lender is going to address a particular distressed situation. Figure 6 (Lender Distress by Stage in Distressed Cycle) divides the distressed CRE assets held by each lender type into groups based on what stage they are in the distressed cycle. Figure 7 (Lender Distress by Collateral Type) then breaks down the same set of
distressed assets by whether the property is likely to be producing income or not.

More conservative lenders like international banks and insurance companies are choosing to address their problems more squarely than other lender groups, as both the high quality of the collateral and more concentrated pockets of distress give them confidence the situation is manageable. Those troubled situations that international banks or insurers find unmanageable are being liquidated. Figure 6 shows that these lenders have seized, restructured or resolved over 65% of their distressed assets from this cycle, far more than the other lender groups. However, this is also a reflection of the type of collateral backing distressed loans held by international banks and insurers. Their loans are more likely to be backed by income producing property than collateral held by most of the other lender groups, as depicted in Figure 7. Financial firms are in a similar boat. This is less because of the quality of the underlying collateral and more because of their real estate experience allowing them to separate the viable situations from the unviable.

CMBS Trusts, which are controlled by Special Servicers working on behalf of bondholders, are hardly liquidating troubled loans at all. The vast majority of their troubled assets remain in limbo and an increasing portion are being restructured. Most notably, General Growth Properties (GGP) and its various CMBS creditors recently reached an agreement on GGP’s debt. National banks are in a position similar to CMBS. Though, national bank’s fewer stakeholders make distressed situations easier to workout or liquidate. However, national banks, as well as their regional and local peers, are far more exposed to development-related loans, accounting for over 50% of their troubled loans. Given the lower RR for Dev/Redev loans, the composition of these banks’ commercial real estate balance sheets complicates matters further as they struggle to keep their capital levels above water.

All of the factors described so far in this report can be decisive when a lender is determining whether to restructure a distressed situation or liquidate an asset. Industry participants should take note of these trends as they formulate their strategies going forward. We can now return to the question of whether 2010 will provide the bonanza of distressed opportunities that many industry participants are salivating for. The following describes a pair of recent directives by regulators that have made any flood of distressed opportunities unlikely.

First, the policy statement issued by banking regulators on October 30th, 2009, “Prudent CRE Loan Workouts,” provided banks with tools and guidance to avoid defaults, maturity, or otherwise, by encouraging loan modifications and extensions. Banks now have more creative options that will limit the impact of workouts on their capital levels. Whether this
security of capital levels will lead to increased lending remains an open question, but it will surely result in far fewer fire sales as the incentive for banks to recognize losses has been diminished.

The second policy directive deals with CMBS (commercial mortgage-backed securities), which account for nearly a quarter of the outstanding commercial mortgages nationally and over 40% of the commercial mortgages currently in distress, according to data compiled by RCA. An Internal Revenue Service (IRS) policy ruling in mid-September 2009 (Revenue Procedure 2009-45) diminished the hopes held by many investors that CMBS would be a treasure trove of distressed opportunities. The ruling enabled special servicers to negotiate with borrowers prior to default and provided restructuring options that would have previously put the special servicers at risk of violating the REMIC (real estate mortgage investment conduit) guidelines that govern CMBS trusts.

In light of this evolving market environment, industry participants seeking to take advantage of the distress in the marketplace may need to reconsider their strategies. Instead of providing first mortgage financing for investors to purchase distressed notes or property, more attractive opportunities may be in providing mezzanine loans, preferred equity capital, and financing for discounted payoffs. In this way, both lenders and borrowers work in tandem to avoid painful fire sales. Equity investors who were hoping to pick up distressed properties at massive discounts and using their expertise to stabilize them may be better served by taking advantage of the depressed pricing environment to scoop up stabilized assets. Third party service providers planning to handle the sales of lender’s REO or note sales may find that their workout, receivership, and leasing services are in greater demand.

The continued trickle of distressed opportunities may disappoint those industry participants seeking to capitalize on them, but if one takes a broader view of the CRE market as a whole, these changes are good news. As banks stabilize themselves, they can slowly begin to originate more loans to not only enable new transactions to occur but also effectively recapitalize those in trouble. In terms of CMBS, the crisis has exposed some of its flaws. Policy makers have sought to remedy these flaws. As a result, the securitization model will endure in an improved state. While the outlook for 2010 remains uncertain, the blood letting that has occurred over the past two years combined with these policy directives limit the possibility of further deterioration.

All data cited in this report is from RCA, is subject to future revision, and is based on properties and portfolios of $5 million and greater.

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Recovery Rates Methodology

The analysis in this report is based on only non-performing mortgages backed by significant commercial real estate which have been liquidated in 2009 and 2010. The average size of the first mortgage loans in the sample is $19.4 million.

Recovery Rates are calculated by dividing the Resolved Price (the gross proceeds from the disposition) by the Distressed Amount (the outstanding balance of the first mortgage loan at the time of the default).

Recovery Rates do not take into consideration fees and costs incurred by the lender during the course of resolving a non-performing loan, which can be significant. It is estimated that expenses related to a foreclosure and liquidation are typically around 5% to 10% of the outstanding balance and sometimes more.

A loan is considered liquidated, or resolved, when the property or the note is sold to a third party. Seller financing may be involved in such a transaction but is not incorporated in the Recovery Rate.

Mezzanine positions, if any, have been excluded from the analysis and Recovery Rates are based solely on the outstanding balance of the first mortgage loan, or the A and B loans if originated and held by the same lender.

In the event a resolution occurred at a price greater than the distressed amount, the recovery rate was capped at 100%.