

Profiting From Distress: Opportunities Now Available

Distressed assets, distressed debt and distressed lenders abound in the current marketplace, creating unusual conditions for deals.

By David Ross

If you are a commercial real estate developer or investor in the market today, you undoubtedly have heard a great deal about distressed assets lately. Congress talks about them. Bankers talk about them. Borrowers talk about them. Investors talk about them.

Capital in the real estate markets today is, by and large, focusing on the distressed sector, where market participants feel there are huge problems and, therefore, an opportunity for superior risk-adjusted returns.

Commercial real estate distress can be present in several different forms. First, distressed real estate can refer to the underlying real estate asset itself experiencing distress. That is, the property may be losing tenants due to a pullback in that particular sector (retail, office, industrial, multifamily, hospitality, etc.), which would affect occupancy and possibly rental rates.

This situation would create significant downward pressure on revenue and net income, which would affect the value and financeability of the property.

Distress can also refer to the financial viability of the capitalization of a property that is otherwise fundamentally sound. For example, a property may have been financed at 80% loan-to-value (LTV) on a three-year interest-

only bridge loan three years ago, and the loan has come due.

However, today's financial markets are no longer lending at 80% LTV. If the sponsor is lucky, it might obtain 65% LTV today. Therefore, this property is now in distress, as is the sponsor and the loan.

Furthermore, a sponsor (or one or more of the principals of the ownership entity) may own a portfolio of various properties, and a portion of them may be underwater and causing distress. For example, if a sponsor owned four 80% completed condo projects in Florida and one multifamily rental property in Washington, DC, it may have to feed the four condo projects to get them completed and, ideally, sold.

The need for capital for the distressed assets may cause the sponsor to sell the performing multifamily asset only because it can. However, the sponsor will be selling into a buyer's market; and depending on the need for cash, it may have to take a low offer just to try to rescue the portfolio.

Nonperforming debt

The term "distressed asset" can also refer to loans or notes that are under stress or nonperforming. Distressed debt can be debt on properties that are now overleveraged but otherwise performing (the other side of refinance distress). It can also refer to debt that is nonperforming - i.e., the underlying collateral can no longer service the debt

or is worth less than the loan amount. Or, it can refer to the notes of distressed lenders.

In addition, there are many distressed lenders in the U.S. today. These are lenders that need to raise capital to stay in business.

One way of raising capital is to sell loans or notes. Obviously, it is easier to sell a performing note, on which the lender can likely obtain better bids, than a nonperforming note. Consequently, in many cases, distressed lenders are being forced to sell their better loans into a buyer's market. The fact that they absolutely need to sell these loans is not lost on the buyers.

Obviously, there are distress situations that encompass more than one of the above scenarios. For example, one might have a distressed property encumbered by a distressed loan from a distressed lender and, therefore, by definition, be a distressed sponsor.

Among all this distress, where are all the opportunities? This is the \$100 million question that everyone has been asking for the past year and a half.

Most of the capital on the sidelines is seeking distressed real estate or distressed loans that it can buy at a deep discount from face value or yesterday's value in order to ensure that the investor is getting a material return no matter what happens with the economy. The major opportunities and strategies for individual and middle-market borrow-



ers and investors fall into the following categories:

■ **Buy or repay your own existing real estate debt at a discount.** For example, if the sponsor of a retail center has lost one of its anchors and the lender is nervous about the ability to repay the debt and the property's ongoing performance, the sponsor may be able to negotiate to buy or repay the debt at a discount in order for the lender to get a watched or nonperforming asset off of its books sooner rather than later.

However, there are many factors that will enter into play here, including the health of the lender, the regulatory constraints or pressure it may or may not have, how it holds the loan on its books (magnitude of write-downs, if any), and so on.

■ **Buy unrelated debt at a discount.** This is similar to the scenario above, except that the sponsor does not own the underlying real estate collateral. Lenders are selling debt - that is a fact. Some of the variables a buyer needs to contend with are collateral value, debt sale price, degree of borrower stress, and additional lender liabilities (such as unfunded construction draws).

Buyers need to understand what their goals are: either owning a note or getting to the underlying collateral (getting ownership to the real estate) and whether they are compatible with the specific situation.

■ **Buy distressed real estate.** As noted above, real estate can be in distress for a number of reasons. In all of these cases, there is an opportunity to bail out the sponsors and/or lenders by buying an asset at a discount to yesterday's values. (Frequently it may be the lender that has ultimate say in the sale of a distressed property due to the level of debt that encumbers it.)

The trick is getting to a price that works for everyone, yet provides the

buyer with a basis where it can create the returns necessary to satisfy the capital stack - both debt and equity.

Financing a distressed asset

Investors have been trying to take advantage of the stress in the system for more than a year now and lenders have been selling. However, most institutional investors will tell you that there has been a wide bid-ask spread in the pricing that has kept the distressed-asset sales to a minimum. (Sellers are asking more than buyers are willing to bid.)

Furthermore, many active buyers

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may be regretting the prices they were willing to pay in the early stages of this economic downturn. In many cases, the notes some buyers bought for 90 cents on the dollar are probably worth much less than they paid for them only 12 months ago.

In the early stages of this downturn, real estate owners were, like lenders, unable or unwilling to sell their properties for what most buyers were willing to pay.

There is a growing realization and acceptance of the current economic realities, and there have been incremental adjustments in bid-asked spread. Sellers seem to be getting somewhat more realistic about assets that they really want to sell.

But many argue that there will not be a real deluge of distressed asset sales until lenders are under more pressure to sell or there is some other triggering event. That said, there are still opportunities in distressed real estate and debt right now.

Finally, how do you finance a distressed asset opportunity? As most of us know, it is more difficult to finance performing properties than it has been in decades. So, how do we finance investments in distressed assets?

There are lenders that specialize in this investment class, and for the most

part, they are not banks. They are opportunity funds, hard-money lenders, some hedge funds, equity funds, and other non-bank lenders. Almost all of them are looking for high octane returns in exchange for their assistance in the capitalization of your distressed asset investment.

Many will charge a high interest rate and some points, while others will charge a more reasonable interest rate and seek a piece of the upside. Still others will invest as straight equity (no debt).

These lenders will look at financing the repayment or acquisition of an existing loan on one of your own properties if the basis is right, or

they will look at capitalizing your investment in third-party distressed real estate or notes.

They will usually look for some new equity investment from the principals, or possibly some other collateral in lieu of new equity. The amount of that equity investment will be very much dependent on the basis of the acquisition.

For example, if a sponsor owns an office building that was valued at \$40 million two years ago and has \$30 million of debt on it today that you can buy for \$20 million, the new lender will evaluate what the office building's net income is and what it is actually worth today, and what it thinks it will be worth in the near to mid-term.

Then, the lender may offer to lend something well inside of that at a mid-teens interest rate. The decision for both the lender and the potential buyer should be based on whether the property can pay the high cost of capital for a year or two and still provide a reasonable return to the sponsor.

If not, then neither the sponsor nor the lender will likely do the deal, and its back to the drawing board to see if the existing lender will take less than \$20 million for the note.

Consider another example: a retail center that is experiencing problems and is headed toward foreclosure. The

potential buyer is very experienced in retail and knows that the buyers can do better than the existing owners - and the track record bears this out.

The potential buyer approaches the owners and the existing lender and offers them a discounted payoff to acquire the property. At some price, this arrangement may solve problems for both the existing lender (get a non-performing asset off the books) and owners (the lender releases them from their personal guaranties).

If the buyer is able to achieve the right strike price (i.e., basis), a capital provider can be found that would provide somewhere between 50% and 85% of the purchase price at a high rate of return. Again, some lenders would charge just an interest rate, and others would insist on participating in profits. In any event, if the basis is right, it can be capitalized.

Although conventional wisdom is that there is still a bid-ask spread in the distressed-asset sector, we are seeing more transactions actually occur and more capital line up to either buy or finance these types of transactions.

It is important for prospective investors in this sector to understand that the cost of capital is quite high to support this kind of investment and, therefore, the cost basis, business plan and realistic return projections must be appropriate.

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