

Bargain Hunting In the Northeast

Some of the nation's most popular investment markets are in the Northeast, which means that bargain-hunters need to focus on class B assets when looking for distress deals

If you're looking for distress in the Northeast, you'd be advised to think class B properties and suburban markets. That's one of the observations of Dennis Walsh, a Boston-based senior director at Tremont Realty Capital, when asked about where the opportunities lie in the region's

BY BOB HOWARD inventory of distressed assets. And if you're planning to focus on a specific property sector, the greatest sources of opportunities in the Northeast are in the office, retail and hospitality sectors, says Yitzie Sommer, a Marcus & Millichap vice president who points out that, "the market for industrial and especially apartments has always been, and continues to be, very tight" in the region. Sommer also echoes Walsh's observation about suburban markets, saying "Suburban areas outside of Boston and in Long Island have been the source of good opportunities for investors."

Walsh explains that lenders and owners of top-tier properties in central business districts simply aren't going to offer discounts, even if a property is under some distress, because the gateway cities in the region "are such prime markets for so many investors." Those in control of the top-quality properties, he points out, "assume that the asset will be worth something at some point, if not now," because places like Boston; New York City; and Washington, DC are so popular with investors both in

the United States and abroad. "There is an expectation that properties will always be worth something to someone in the gateway cities because they are not secondary or tertiary markets, and they are high on the list for investors who take a longer-term view of things," Walsh explains.

The inventory of distressed assets in the Northeast totals \$26.2 billion, according to the latest figures from New York City-based Real Capital Analytics, which notes in its August report that the distress picture in the Northeast and the rest of the US "has fundamentally changed." Lenders now are more aggressively moving to liquidate or resolve troubled assets, RCA explains, and inflows of new distress have declined since the onset of the financial crisis, dropping to their lowest level--\$12.7 billion in the latest quarter after three straight quarters that topped \$18 billion.

One of the places where Walsh foresees more opportunities in class B buildings in the future is in the area of mezzanine debt and preferred equity. In general, he says, "The mezzanine and preferred equity holders, in the instances that I know of, are not as well-positioned to ride it out for the long haul, so they have to take liquidity today at whatever discount they can get." Unlike senior debt holders who have the wherewithal to hang on and even to invest new capital in a property, many of the mezz and preferred equity

holders are "finite funds that have fully exhausted their capital," Walsh explains. "Therein lie opportunities."

Another reason that suburban properties, and office buildings in particular, will present more opportunities in distress going forward is that those are the properties that have suffered the most vacancies, Walsh says. As an example, he says that vacancies run from the low-20% to the mid-30% range along the tech-oriented I-495 Beltway around Boston. The beltway "has been through the boom and bust of the tech companies because land was more available to develop there," Walsh says. As a result of the high vacancies, "There have been more opportunities in distress and lenders willing to do something." He explains that, in contrast to top-tier markets where lenders and owners can expect to reel in new tenants, the lenders and owners of suburban properties are ready to deal because they "realize there is not going to be a quick fix in terms of getting a tenant in and leasing it at a market rate and then selling it."

Yet another reason that opportunities in distress are more likely to arise in class B and suburban markets is cited by Sommer of Marcus & Millichap. With regard to office properties in particular, he says, "CBD districts have fared better through the recession and have shown signs of rebounding in 2011, while suburban markets have, and continue to struggle with, vacancy issues." Therefore,

Manhattan Grows Most Distress (by dollar volume)

Manhattan: \$15.1 Billion	Westchester: \$402 Million
Northern New Jersey: \$2.8 Billion	Stamford: \$382 Million
Boston: \$2.3 Billion	Hartford: \$261 Million
Long Island: \$2 Billion	All Others: \$1.5 Billion
NYC Boroughs: \$1.5 Billion	Total NE Distress: \$26.2 Billion

Source: Real Capital Analytics

Sommer adds, “There will be greater distressed office opportunities in suburban markets, but there will still be distressed loans or assets that come to market from the region’s CBDs.”

Cases where there are opportunities in the CBDs, Sommer notes, are more likely to be opportunities for investors to become equity partners. “Equity opportunities on troubled assets have occurred primarily in high-profile assets in Manhattan, where lenders are unwilling to take the asset back but are pushing the current borrower to find equity to reinvigorate the property and get the loan to performing status,” he says.

The latest RCA figures show Manhattan with the highest volume of distress in the Northeast, \$15.1 billion out of the region’s \$26.2 billion total distress. Looked at another way, however, the Manhattan market fares better, according to RCA. Its report points out that among US markets, Manhattan ranks relatively low—31st—in terms of the volume of distress compared with the total volume of investment sales. It contrasts that with Las Vegas, where the market’s \$17 billion in distress ranks highest in the country in terms of distress compared with investment sales.

Sommer and Walsh both point out that, in terms of sectors, multifamily is arguably the least likely to offer big-discount opportunities in distress.

Investor interest has also increased in the hotel sector, thanks to improving fundamentals in the hospitality industry, but the question is whether buyers of distress will be able to find enough deals. “There are a lot of buyers for distressed hotels, but not enough assets offered for sale,” Walsh says. He cites the upcoming auction of the Renaissance Boston Waterfront Hotel, where German bank Deka Immobilien holds the \$90-million debt on the leasehold interest. The debt works out to less than \$200,000 per room for the 471-room hotel. “It should definitely fetch interest because it is relatively new, and at that level of dollars per key, it should generate a lot of interest, whatever its current NOI,” Walsh says.

In addition to the strong demand for multifamily and hotel assets, Sommer points out that retail properties, to some extent, are drawing the attention of distress-oriented investors. “The abundance of retail in suburban areas and the increased construction that took place during the boom in the path of suburban growth in the second or third ring of suburbs has produced distressed retail assets in the area and investors are actively looking at this product,” he says. In view of the current stall that exists in new-home construction, however, he says that investors “are wary of going too far from the urban

core and are demanding very attractive pricing for these assets.”

When investors do find distress opportunities in the Northeast, they may also find that they have to pay more than they would for comparable assets in other parts of the country. “Limited new construction and high barriers to entry, in addition to the long-term positive outlook for the region’s economy, have increased investor appetite for distressed assets in the region,” Sommer points out. “These factors have also increased the competition for assets, pushing prices above national averages.”

Market improvement and the amount of capital in the market looking for opportunities have had a significant impact in distressed pricing both nationally and in the Northeast in 2011, he says, but the effect is more pronounced in the Northeast. Lenders selling loans or assets have posted recovery rates in the region that are above the national averages, with some assets generating recovery rates in excess of 90% in the Northeast, although the average in the region is closer to a range of 75% to 80%.

Prices also are rising because of the more efficient marketing of assets, according to Walsh. Especially in the gateway cities and top-quality assets, “More often than not, these deals are vetted, they go through a market-clearing process, or they go to an auction, so there is little left on the table in terms of a big discount,” he says. “It may still be a discount, but it won’t be at the level of an off-market deal.” ■



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