



with Bob Knakal

Special services step up sales

Q: You indicated in one of your reports that there was about \$6 to \$7 billion in note sales transactions in 2010 and that you expected a similar amount in 2011. Has the pace of distressed sales been on track with your expectations thus far this year?

A: It is important to note that distressed asset sales take three forms.

In addition to note sales, which to this point in the cycle has been the most prevalent type of distressed transaction, there are "short sales" in which the borrower co-operates and conveys title to the property at a price lower than the mortgage amount and, lastly, REO sales (in which a bank has foreclosed on a property, therefore it is Real Estate Owned by the bank) and the bank then sells the fee interest to the property.

We believe that these three types of distressed asset sales probably totaled something on the order of \$9 to \$10 billion in New

York City last year. That is out of the total of about \$20 to \$21 billion which consisted of \$14.5 billion in property sales and \$6 to \$7 billion in note sales.

Thus far, the activity in the distressed sector in 2011 has been on pace to achieve about the same aggregate total that we saw in 2010.

However, a noticeable difference is that the overwhelming majority of note sales which occurred in 2010 were transacted by banks with only a small percentage being generated by special servicers. Banks began to move aggressively to sell notes at the beginning of 2010 and the special servicers did not become tangibly active until late summer or early fall.

While we expect the totals in 2011 to roughly equal the totals of 2010, we predict a shift with the overwhelming majority of note sale activity this year coming from the special servicers as banks have already unwound

significant portions of their portfolios.

It is important to realize, however, that the distressed dynamic is likely to be with us for probably another two or three. This is due to the fact that values have just recently bottomed-out. We are projecting a 12% appreciation rate on a price per square foot basis in Manhattan in 2011 and expect value to stop dropping in the outer boroughs and stabilize this year.

Considering that values fell approximately 36% from peak to trough, this 12% appreciation rate, if annualized, would take three years before value would be back at the peak market levels.

Even if value went back to those peaks, loan-to-value ratios are more conservative today than they were in the 2006 and 2007 lending environment.

This means that property with maturing debt would not be refinancable at the same level which would require additional equity to be contributed by the borrower in order to effectuate the refinancing.

What it is also important to note, is that there is significant shadow inventory within the distressed sector. I refer to this as "shadow" because the distress is generally not being overtly acknowledged by any of the parties at this point.

Some floating-rate debt issued in 2006 and 2007 was at such low rates that properties may have positive cash flow even though they possess very significant negative equity positions.

In these cases, the mortgage, from the

bank's perspective, is still performing and the borrower has little incentive to do anything provided that positive cash flow exists.

However, as soon as the mortgage matures that transaction will need to be deleveraged and recycled in order to retain a positive cash flow position.

Many of these floating rate loans are indexed at just 150 to 200 basis points over LIBOR. At the time of this writing, LIBOR was just 27 basis points, therefore, many of these loans carry rates of approximately 2%.

It is not difficult to see how these properties would have positive cash flow given such low interest rates. Upon maturity, it is highly unlikely that a bank would renew a loan at anything near the 2% existing rate.

Based upon these dynamics, we expect more distress to come over the next two to three years.

Rising interest rates will only add to this dynamic and most people in the marketplace believe that rates will go up significantly over the next couple of years.

Clearly, the best properties in the best locations will continue to do well and outperform the market in general.

However, we could see a very significant divide between the better properties and the secondary or tertiary properties in terms of performance.

This would not be unusual in the early stages of market recovery.

"Upon maturity, it is highly unlikely that a bank would renew a loan at anything near the 2% existing rate."