A Rolling Loan Gathers No Moss

What to expect from distressed assets (hint: not much, at least for now)

For nearly 18 months now, one of the hottest topics of discussion in commercial real estate has been the status of delinquent loans and distressed properties. In the New York City investment sales market, we have seen both property values and the volume of sales plummet from their peaks. In terms of value, we have observed increases in average capitalization rates of as little as 110 basis points for multifamily properties to as much as 325 basis points for office and retail properties. These cap rate increases correspond to price reductions of between 20 percent and 60 percent, depending on product type.

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Columnist

If we look at the volume of sales, activity in 2009 is off its peak by over 75 percent in terms of the number of properties sold and down over 90 percent in terms of aggregate sales price. The difference between these two percentages shows that the trend has been toward smaller transactions, as those are more likely to obtain financing. Community and regional banks have remained active throughout the credit crisis, particularly in the multifamily sector. Unfortunately, the shadow banking system has evaporated, causing significant stress in the debt markets for larger assets. The CMBS market, for example, produced $230 billion of transactions in 2007. Since July of 2008, this number has been $0.

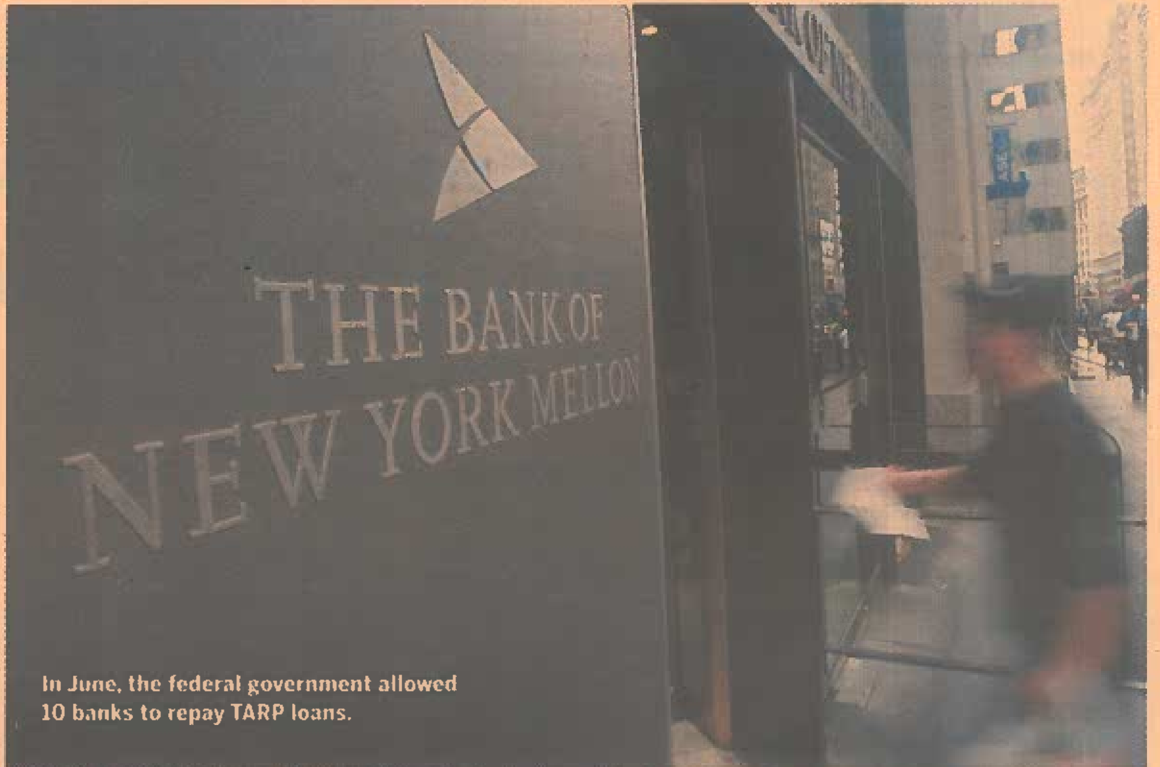
The distressed assets that are coming to market in the greatest numbers are stalled development projects and properties owned by investors using OPM.

This drop in value, accompanied by extraordinarily low levels of volume and weak debt markets, has created dynamics from which a tsunami of distressed assets is anticipated to wash over the market. In 2005, 2006 and 2007, there were a total of $109 billion of investment property sales in New York City. We have estimated, based upon the composition of those sales, that approximately $80 billion of that total was invested in about 6,000 properties that currently have negative equity balances. If we add to this an estimate of the number of property owners that took advantage of cheap debt available at high loan-to-value ratios, this total grows to 15,000 investment properties that likely have negative equity today.

Clearly, not all of these properties will come to the market in the form of distressed notes or foreclosure sales, as there are a number of owners who have the ability to carry their debt and have the desire to hold the assets long-term. Notwithstanding this fact, thousands of these properties will trade hands in the distressed market. For nearly 100 lenders and special servicers, we have analyzed nearly 1,000 properties that serve as collateral for their loans. This should present investors with tremendous opportunities, but thus far, this massive pipeline of distress has only been trickling into the market.

There are three main reasons why the available supply of these distressed assets on the open market has been so low. Banks simply do not want to realize the losses that are so clearly imbedded in their balance sheets. The Fed has encouraged banks to make loans and to simultaneously shore up their capital ratios—two opposing objectives.

TARP money was given to banks so it could be deployed into the market, but given all of the strings the government attached to the money, not surprisingly, the banks did not lend the money. They have simply been trying to shovel it back to the Fed as quickly as possible: another well-intended government program, implemented by too many cooks in the kitchen, that missed the mark. The result is that banks have focused on keeping their capital ratios healthy, and the last thing they want to acknowledge are these losses.



In June, the federal government allowed 10 banks to repay TARP loans.

For this reason, new phrases have become part of our daily vernacular, such as "extend and pretend," "a rolling loan gathers no loss" and "kicking the can down the street." The fact is that many are just walking around the can altogether.

The second reason for the lack of distressed-asset supply is the various temporary beneficial components of some loans that have been allowing owners to hang on by a fingernail even though the light at the end of the tunnel is a freight train headed directly at them. Interest-only periods and interest reserves have succeeded in keeping some properties afloat, but these benefits are generally not for the duration of a loan. As soon as amortization kicks in or the interest reserve dries up, reality must be faced. Similarly, some properties are on life support aided only by a mortgage rate floating over three-month LIBOR, which closed Friday afternoon at a mere 30 basis points. Those loans are probably carrying interest rates of 2.5 percent to 3 percent, well below today's average rate of just over 6 percent.

Lastly, because many lenders do not want to publicly expose their problems, they have opted to restructure loans with the existing borrowers. While achieving a quiet solution, this approach often produces sub-optimal results for the lender. This is something not being ignored by equity research analysts or shareholders.

Recently, the flow of distressed assets has been increasing ever so slightly. Banks are well into the foreclosure process, and this is starting to result in REO listings coming to market. Additionally, many lenders are realizing that investor demand for distressed notes is extensive. On each of the notes that we have sold this year, we have had in excess of 50 offers. Interestingly, these bidders consisted not only of the high-net-worth individuals and old-line families that have dominated the landscape since the summer of 2007, but also institutional investors who have returned to the market after forming distressed acquisition funds solely for this purpose.

Thus far, the distressed assets that are coming to market in the greatest numbers are stalled development projects and properties owned by investors using OPM. A surprising percentage of prominent investors inject very little of their own capital into transactions and essentially manage other people's money in their real estate investments. When a property's performance starts to go sideways, the passive equity partners are the first to shut off the capital valve, which results in delinquencies and foreclosures.

We expect distressed assets to be prevalent in our marketplace for years to come as our increasing unemployment rate will continue to degrade our fundamentals. Many economists expect unemployment to remain at elevated levels through 2010. Additionally, 2006 and 2007 vintage loans maturing in 2011 and 2012 will find refinancing a big challenge, adding to the number of sellers, either lenders or owners, who have no choice but to sell.

Our current conditions present pronounced opportunities for brokers and investors alike as we expect the flow of distressed assets to increase substantially over the coming quarters.

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