CONCRETE THOUGHTS

Spring Thaw

Discretionary sellers return! Sales activity picks up; further evidence: 1031 exchanges

EXECUTIVE SUMMARY

- Sales decline was caused by supply constraint as discretionary sellers withdrew.
- They're returning as advantageous loan terms for distressed properties burn off or mature.
- The volume of 1031 exchange purchases is increasing—another sign of sales volume rising.
- Sales activity could increase by at least 40 percent this year.

We in the investment-sales sector are painfully aware of the anemic sales volume our market experienced in 2009. The number of sales diminished from its peak by 74 percent, and the total dollar volume of sales was off by 91 percent. By any measure, these figures represented record lows for at least 26 years and, perhaps, longer. The perception held by many observers was that this lack of volume was caused by either a lack of demand or a very wide "bid-ask spread," indicating that the level of expectation of buyers and sellers was sufficiently far apart to bring a halt to trading activity.

It has been my opinion, however, that this lack of volume was caused more by supply constraint than a lack of demand or the oft-mentioned bid-ask spread. There were simply not many properties for sale. Normally, the supply of available properties for sale is fed by discretionary sellers. As value began to drop in 2007, these discretionary sellers withdrew from the market. When this happens, distressed sellers usually swoop in to fill the void and add supply to the market. This did not happen in numbers anywhere near what most participants in the market were expecting.

Fortunately, today we are seeing a loosening in the supply of properties for sale, as distressed assets are beginning to flow in a tangible way, and discretionary sellers are returning to the market. In order to understand why this dynamic is occurring, we should take a look at what caused the supply constraint.

There was never a doubt in anyone's mind that New York City was chock-full of investment properties that were fundamentally underwater. These properties had mortgage-debt balances in excess of their value. Based upon the average reduction in value, from the 2007 peak, of 32 percent and the very high total loan-to-value ratios that were obtainable in 2005 through 2007, in both the sales and refinancing markets, Massey Knakal estimated that approximately 15,000 properties were in this negative equity or distressed position. This total represented about 9 percent of the stock of 165,000 New York City properties we track on an annual basis.

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On these 15,000 distressed properties, there was approximately $165 billion of mortgage debt, we estimated. Based upon current standards, with today's values and loan-to-value ratios, a conservatively underwritten market would have only $65 billion in debt on these properties. While this may be reality, it is clear that $100 billion will not come out of the market in the form of losses.

The reasons for this include the facts that (1) some of these properties can still cash-flow at 110 percent or 120 percent loan-to-value ratios; (2) some owners have alternative sources of capital and, if they want to own the asset on a long-term basis, can feed a property that is in a negative cash-flow position; and (3) some lenders will modify loans to allow the existing owners to hold on. Because of these possibilities, we expect total losses to reach $30 billion to $40 billion. About $15 billion in losses have already been realized, so we should have $15 billion to $25 billion to go.

So why haven't we seen a more significant flow of these distressed assets in the market? The answer: Everything that has happened from a regulatory perspective has allowed lenders and special servicers (who are the primary holders of distressed assets) to avoid having to deal with their problem properties. Changes to FASB's mark-to-market accounting rules are one of the issues; another is significant modifications to REMIC guidelines that provide servicers and special servicers much more latitude in dealing with underwater CMBS loans. Bank regulators are allowing portfolio lenders to hold loans on their balance sheets at par even if they know the collateral for the loan is worth only 60 cents on the dollar. And many transactions that are fundamentally underwater are still hanging on by a thread due to advantageous mortgage terms. These include interest-only periods during which no amortization is added to the debt service payment; interest reserves upon which distressed assets can stay current even without sufficient current net income; and interest rates floating over LIBOR, which opened the morning of May 10 at 34 basis points.

For example, I analyzed a portfolio for a client of mine last week who paid about $100 million for a portfolio a few years ago. The total debt is about $85 million and, today, the properties are worth about $65 million. Even with a $20 million negative-equity position, the portfolio is cash-flowing because the debt is floating at 150 over LIBOR. Considering the mortgage rate is 1.84 percent, it is not difficult to see how positive cash flow is obtained. Mortgage maturity becomes a critical factor in the fate of these properties. At maturity, no lender will extend and pretend at such a low interest rate.

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As these advantageous loan terms burn off or these loans mature, it will trigger steps likely to bring distressed assets to market. We are already seeing this occur in a substantial way.

Consider that Massey Knakal's Special Assets Group has completed the valuation of nearly 1,200 pieces of underlying collateral for suspect loans on behalf of lenders and special servicers thus far in this cycle. From September 2008 through September 2009, we obtained just 12 disposition assignments within this sector. Since then, we have been retained to sell 78 distressed assets. These assignments have included note sales, short sales and REO sales. Clearly, this increase in distressed-asset flow is palpable.

The reasons for this increased flow are numerous. Profits at banks have been enormous, as the Fed's highly accommodative monetary policy is allowing for the recapitalization of the banking industry. These profits have allowed lenders to incrementally write down bad loans, making it less painful to dispose of distressed assets.

As we have been in the downswing of the cycle for more than two years now, we are seeing advantageous loan terms burning off, prompting action. Many foreclosure actions are beginning to run their course, allowing lenders to offer deeds on their distressed assets. Note sales are also gaining in popularity, as lenders and special servicers are becoming increasingly frustrated with the cumbersome foreclosure process in New York. This can take two, three or even four years to complete. Lenders and special servicers that operate in states like Texas and Georgia, where the foreclosure process can be completed in 30 to 90 days, can't fathom the length of the process here. When they become aware of the significant recoveries possible relative to collateral value, a note sale becomes an easy decision.

While we are seeing a solid increase in the supply of distressed assets, we believe this flow could increase substantially if interest rates rise. Many economists argue that the Fed's exit from the marketplace would increase rates. When the Fed ceased its asset-buying program, which created $1.25 trillion of mortgage-backed securities and treasury sales, we saw the 10-year T-bill rise from about 3.5 percent to more than 4 percent. About two weeks ago, the Fed announced that a second method of exit would begin soon, as it embarks on a program to sell nearly $1 trillion of assets over an extended period. This would normally exert upward pressure on rates.

Today, the 10-year has settled back down at 3.6 percent, as the turmoil overseas in Portugal, Ireland, Italy, Greece and Spain has created a flight to safety, and the U.S. T-bill is at the top of that list. It will be interesting to see if the recent announcement of an E.U. bailout abates some of this demand for quality and safety.

The fundamentals within the market appear to be improving, as positive absorption in residential and commercial buildings have caused concessions to be reduced, and rents have appeared to stabilize. These improving fundamentals have created incentive for some discretionary sellers to add to the supply of available properties for sale. We are seeing the results of this discretionary selling reflected in the increase in 1031 exchange activity. Distressed selling produces no 1031 activity, as there is simply no equity to reinvest. Discretionary selling produces residual equity, which produces exchange transactions. This activity had all but evaporated over the past couple of years, but has come roaring back based upon the return of discretionary sellers to the market.

The increases in the supply of properties available for sale, from both distressed and discretionary sellers, have thus far been met step-for-step by the excessive demand present in the market. New York families and high-net-worth investors, both domestic and foreign, have been joined by a resurgence of institutional capital, creating tremendous demand. Now, 1031 buyers have joined the party.

These dynamics bode well for the balance of 2010 and substantiates the projection we made at the end of last year, that sales activity would increase by at least 40 percent this year. This would be a welcome occurrence for those of us who lived through 2009 and rely on transaction volume for our livelihood.

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