CONCRETE THOUGHTS

Take Note! Distressed Asset Waves Swell

What they mean for the New York market, and what to look for as they hit

EXECUTIVE SUMMARY:

- More distressed assets are hitting the market gradually, especially via note sales.
- Demand still outpaces supply, however, preventing downward pressure on values.
- Cumbersome New York foreclosure procedures are a big reason for the gradual distress wave.
- Distressed assets will make up a significant part of market activity in 2011, 2012.
- Capital gains and estate tax changes will contribute to this activity, too.

In the investment sales marketplace, perhaps no other topic has been discussed more frequently than the distressed-asset market. Since September of 2008, the most frequent calls from investors were those asking for "distressed" or "opportunistic" properties. At that time, most participants in the marketplace anticipated a tsunami of distressed assets coming to market from lenders and special servicers. This wave never arrived, but the distressed sector has instead been experienced as a consistent string of rolling waves, which seem to be gaining momentum, as the waves are getting slightly larger each quarter.

Robert Knakal
Columnist

Distressed real estate assets have been hitting the market in growing numbers in the form of both note sales and asset sales. A significant component of our work as brokers has been canvassing banks and special servicers to try to obtain exclusive listings on these distressed properties. To date, Massey Knakal's Special Assets Group has overseen the valuation of more than 1,800 properties. Throughout 2008 and much of 2009, these valuations produced little in the form of tangible listings. Beginning in the latter stages of 2009, and continuing into 2010, the flow of these assets has occurred with growing frequency.

These asset and note sales have increased the supply of available properties by a healthy margin. Adding to this distressed supply are discretionary sellers who have come to the market in significant numbers, attempting to beat the anticipated increase in the capital gains tax rate. While supply has increased, demand still exceeds supply by such a wide margin that the additional supply has not exerted any downward pressure on value. Yet.

One of the main reasons why we have seen increases in the supply of these distressed assets from banks and special servicers is due to growing frustration with the cumbersome and lengthy foreclosure process in New York. With numerous defense mechanisms available to borrowers in the Empire State, the foreclosure process can take as long as two to four years. This explains why relatively few REO sales have occurred, and why note sales have become so popular.

Note sales become a compelling option given the significant number of investors who are interested in acquiring notes and the very significant recoveries available relative to collateral value. A note sale can also remove a nonperforming or sub-performing asset from a lender's balance sheet quickly.

From a brokerage perspective, a note sale adds an additional layer of complexity to the sales process. Not only does the broker have to conduct as much due diligence on the underlying asset as possible, but paperwork due diligence on the note and mortgage must be done as well. This paperwork due diligence often consists of reading through hundreds of documents to obtain an understanding of what potential remedies may be available to the borrower and how secure the lender's position is. In the event there is subordinate debt, understanding the mechanisms within the intercreditor agreement is essential. Are there any personal guarantees and does the lender have any current statements to show whether those guarantees are worth anything? All of these variables must be understood in order to know what is being sold.

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Additionally, qualifying the note buyer becomes a critical part of the broker's job. For a typical note sale, in which the collateral is a New York City–based property, dozens of offers can be obtained in a relatively short period of time. Unfortunately, many of those making offers on these notes have neither the ability nor the intention to purchase them in a straightforward transaction.

The acquisition of a note is far more complicated than purchasing a simple fee interest in a property. Some bidders do not realize what they are getting involved in until they are well into the process. Others negotiate a contract but have no intention of acquiring the note unless they are able to negotiate successfully with the borrower for a deed acquisition, prior to contract execution for the note.

And another group will simply not accept the no-representation or almost-no-representation contracts that lenders often require when they are selling a note. It is only through experience that the broker gets to understand the modus operandi of various participants.

Another telltale sign that a note buyer may not be worth spending a lot of time with is when they constantly ask if there are any notes available for sale at a certain percentage of par value. The percentage of par value is much less important than the percentage of collateral value that a note may sell for. It is collateral value that the lender focuses on and collateral value that the broker focuses on. Typically, if a lender can sell for a very high percentage of collateral value, it is worth selling the note as opposed to going through the lengthy and uncertain foreclosure process.

Some recent transactions that my team and I have closed show that the recovery available to lenders through the note sale process is significant relative to collateral value.

We recently completed the sale of a $63 million note collateralized by a downtown Manhattan office building for approximately 91 percent of its generally accepted market value. A $57 million senior note on a newly constructed condominium development in Williamsburg was sold for approximately 93 percent of the building's current market value. We sold three construction and development loans, which totaled just over $55 million and were collateralized by two condo projects in Staten Island, for approximately 95 percent of the properties' current market value. And lastly, in an example where the bidding became extraordinarily competitive, we sold a $75 million loan, which was collateralized by 22 apartment buildings on Manhattan's Upper West Side, for 100 percent of the property's current market value.

With recoveries this high compared to collateral value, is not surprising that notes are coming to market with greater frequency.

As we move forward in this marketplace, we do not expect to see a massive tidal wave of distressed assets coming to market, but rather continued slow rolling waves, as mortgage maturity is the main reason that distressed assets will be added to the available supply.

Some experts have expressed opinions that distressed assets are disappearing from lenders' balance sheets and they don't expect a significant number to come to market in the future. We disagree with this perspective. We believe that we are less than halfway through the deleveraging process that the market must go through. Assets that are most impaired are those with 2006 and 2007 vintage debt.

At that time, values were the highest and loan-to-value ratios were the most aggressive. Many of those loans are maturing in 2011 and 2012, and many of those properties possess meaningful negative equity balances.

Interestingly, many of the properties in New York City that had significant negative equity positions are still able to throw off positive cash flow. This is due to the highly advantageous terms that were available on 2006 and 2007 loans. Zero amortization, large interest reserves and loans that are floating over LIBOR (which opened at 29 basis points Oct. 4) have enabled this positive cash flow to exist. When these loans mature, it is unlikely lenders will "extend and pretend" (without significant equity injections), given the significant amount of negative equity that exists.

Moving forward, trends within the distressed-asset market will likely have the most profound effect on sales volume for the next couple of years. We have seen increases in volume, as more of these distressed assets have come to market and discretionary sellers have moved to beat the anticipated increase in capital gains taxes.

The capital gains tax impact is effectively "stealing" transaction volume from 2011, as sellers' behavior has been altered by this externality. Just as we saw after the cash-for-clunkers program ended, causing auto sales to plummet; and after the first-time home buyers' tax credit expired, causing the housing market to experience an all-time drop in volume, we expect a lull in sales volume from the capital gains tax impact, which will exert downward pressure on volume. With the inheritance tax expected to hit 55 percent next year, we expect that this will exert upward pressure on transaction volume, as estates may have no choice but to sell assets to pay this exorbitant tax.

These impacts could offset each other, leaving the magnitude of the flow of distressed assets to determine how active the sales market will be. If things go as we expect, 2011 sales volume should exceed 2010 levels by a nice margin.

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