That Distressed Assets Wave?

Hasn't arrived and may never—but a steady flow has clearly begun

It is said that history repeats itself. However, when it comes to distressed commercial real estate assets, that saying needs to be modified by adding "but in different ways."

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The New York City building sales market started to feel the effects of the credit crisis tangibly in the summer of 2007. From that time through the fall of 2008, it was tempting to believe that maybe things wouldn't be so bad. However, with the collapse of Lehman Brothers and the fundamental restructuring of Wall Street as we knew it, in October of 2008, it became clear that the economic condition of the country was significantly worse than we'd anticipated.

As it became clear that we were headed into very choppy waters, many people in the industry, including myself, had predicted a tsunami of distressed assets coming to market. This dynamic has not played out, as little has happened in the two and a half years since our awareness grew about the pending problems with commercial real estate.

Notwithstanding this fact, current economic conditions have certainly created profound stresses in the marketplace. During the asset-bubble-inflating years of 2005 into 2007, there were $109 billion of investment sales completed in New York City. Based upon reductions in property values, and the loan-to-value ratios that existed during those years, we estimate that about $80 billion of that activity, or roughly 6,000 properties, have negative equity positions. This means that the amount of the mortgage is in excess of today's value.

Adding to that figure properties that were refinanced during the same period, approximately 15,000 properties in New York City, we estimate, are in a negative equity position.

We further estimate that these properties have approximately $165 billion in debt, and that, if these properties were underwritten using today's standards, a conservatively leveraged market would have only about $65 billion in debt on those properties. This $100 billion of excess leverage is what is creating distress in the marketplace.

It is unreasonable to think that the entire $100 billion of leverage will be extracted from the marketplace, due to the fact that several owners have additional sources of income, allowing them to support properties that are losing money. If they want to own the assets long term, they will continue to feed the property. Also, with a substantial percentage of these properties, the borrower and lender will simply work out terms between them.

We do, however, anticipate that by the time we exit this cycle, $30 billion to $40 billion of excess leverage will be extracted from the marketplace, and that will occur in the form of recycled capital stacks, which will create losses.

Thus far in the cycle, very little of this activity has actually occurred, as everything that has happened legislatively has created a disincentive for lenders to deal with troubled assets embedded in their balance sheets.

Modifications to FASB's mark-to-market accounting guidelines; bank regulators' allowing lenders to keep loans on their balance sheets at par even if the lender knows that the underlying collateral is worth only 50 percent of that value; and modifications to REMIC guidelines have allowed banks, servicers and special servicers to do little to get recycling in motion in a substantive way.

Additionally, the Fed's highly accommodative monetary policy—where banks are able to borrow at close to zero and lend at significantly higher rates or, conversely, simply buy risk-free Treasury bonds—puts the lenders in a position where they are highly profitable. This advantageous recapitalizing of the banking industry enables quarterly earnings to serve as ammunition to offset losses.

For these reasons, there has been very little activity in the arena of distressed commercial real estate assets up to this point. This has caused significant frustration on behalf of buyers looking to acquire these assets. In fact, the low supply of available assets has prompted bidding wars for those few distressed assets that have come on the market.

We have, however, recently seen a shifting tide. Rather than a tsunami of distressed assets coming to market, this distressed asset recycling process will consist, we believe, of slow rolling waves over time. They will be created by several factors, including interest reserve burn-off; expiration of interest-only periods; conversion of floating-rate provisions to fixed-rate; and, most importantly, mortgage maturity.

In the distressed-asset area, properties that are most significantly strangled by excess leverage are those with 2006 and 2007 vintage debt. Most of these loans will mature in 2011 and 2012, creating distressed conditions over the next two to three years.

Other advantageous loan terms, which were common during the bubble years, are often creating land mines in capital stacks.

Interest reserve provisions were typically a component of pro forma transaction loans that were relying on significant value-added strategies to increase net operating income. As real estate fundamentals have degraded over time, these pro forma increases have been unobtainable, creating interest reserve burn-offs without cash flow levels to service the debt.

Many loans had interest-only periods that were typically not for the entire duration of the loan. As amortization kicks in, the additional cost will typically push total debt service payments to a level in excess of net income.

Additionally, those loans that are floating over LIBOR, which opened Monday morning at 23 basis points, may be paying debt service at a rate below 2 percent. At such a low debt service rate, properties with negative equity may, in fact, still have cash flowing. However, when the rate is reset to a market rate of approximately 6 percent, the net income falls far short of being able to service the debt.

These factors are starting to loosen up the congestion in the distressed-asset pipeline. This has been particularly evident over the past two to three months.

Going back to mid-2008, Massey Knakal has completed in excess of 1,000 valuations for lenders, servicers and special servicers, giving them an idea of the value of the underlying collateral for their loans. From October 2008 through October 2009, these valuations resulted in our being retained to sell only 12 distressed assets. Within the past three months, we have been retained to sell 32 distressed assets. This is a trend that many of my friends at other building sales firms have seen as well.

There are four factors that we believe are adding to the motivation of sellers to bring their distressed assets to the marketplace now.

First, the foreclosure process in New York is extremely long and cumbersome. Many lenders and servicers are based outside of New York; and, in almost every other jurisdiction in the country, the foreclosure process is much more streamlined than it is here. Going through the New York system, which is often complicated by bankruptcy filings both on personal and entity levels, can, at times, take two to three years.

We further estimate that these properties have approximately $165 billion in debt and that, if these properties were underwritten using today's standards, a conservatively leveraged market would have only about $65 billion in debt on those properties. This $100 billion of excess leverage is what is creating distress in the marketplace.

As lenders become impatient with this process, decisions are made to monetize their assets now. This is particularly beneficial when realizing that, due to the short supply of availabilities, lenders are able to achieve prices at 95 percent to 100 percent of the collateral value for notes being sold.

Second, it is becoming clear that fundamentals will not improve dramatically in the short term. The unemployment rate remains elevated and job losses continue. Given the methodology for calculating the unemployment rate, it is predicted by many economists that the official rate will stay elevated even after job creation occurs, as the participation rate will continue to escalate.

Third, as lenders monetize toxic assets, they are able to make new loans that are highly profitable and less risky. Bank spreads, or profitability, two years ago was as small as 30 or 40 basis points, based on the competitive marketplace for deploying debt capital. Today, those spreads can be 300 or 400 points over treasuries, creating a situation where each dollar lent is 10 times as profitable as it was two years ago. Moreover, these loans are made with less risk, as the amount of the loan is 60 to 65 percent of today's lower value, as opposed to 75 to 85 percent of yesterday's inflated value.

Fourth, it is becoming clear that at some point the Fed will have to sequence an exit from the marketplace and, regardless of the method used, it will have a negative impact on commercial real estate. As discussed in last week's Concrete Thoughts column, there are four routes the Fed's exit could take: terminating assets purchases (which is a program that consists of mainly buying mortgage-backed securities and is expected to cease in March of this year); draining excess bank reserves in the form of reverse repos and/or term deposit facilities; raising the federal funds rate in tandem with increasing interest rates on reserves; or selling assets outright.

Nos. one, three and four above will have the effect of raising interest rates, which will put pressure on lenders to either compress their spreads or pass along the increases in the form of higher mortgage rates for borrowers. It is very likely that a small percentage of these increases will be absorbed in the form of compressed spreads, while the balance will result in higher mortgage rates.

The second Fed option, the draining of excess bank reserves, will serve to limit the pool of capital available to be deployed in the form of mortgages. Any of these actions will have a negative impact on commercial real estate values; therefore, waiting to sell assets would appear to have a negative impact, at least in the short term.

This growing trend is positive for our marketplace, as the sooner natural bottoms are allowed to be reached, the sooner a sustainable rebound can happen. While the huge wave of distressed assets we were all anticipating coming to market has not resulted, it does appear that a slow and steady flow of these assets has begun, and it should continue over an extended period of time.

This will not only create steady opportunities for buyers and brokers but, importantly, will lead to a more fundamentally sound market.

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