SummerStreetAdvisors

Look beyond 'bricks and sticks' to fix CRE's future

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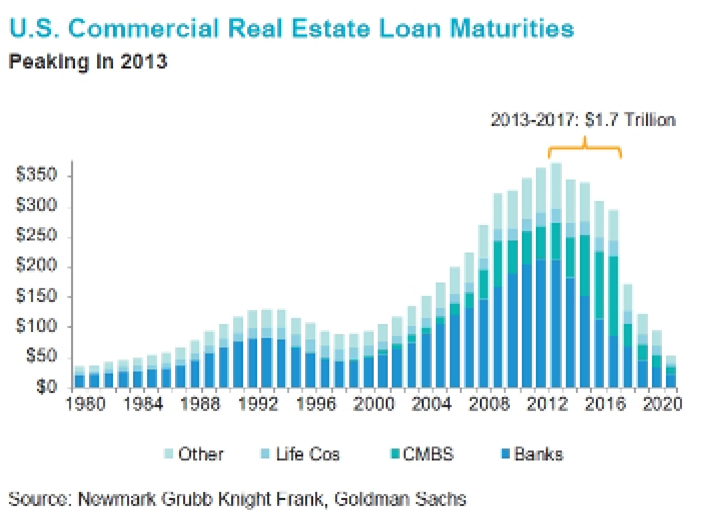
As competition to close new commercial real estate deals heats up, so does the pressure to loosen credit standards, lapse into overly-optimistic underwriting and ignore the operational context in which the asset sits. If industry participants are not careful, history could repeat itself in the very process of resolving the fallout from The Great Recession.

To be sure, there will be plenty of occasions ahead to apply lessons learned in the deepest trenches of the 'new normal'. In 2007 alone, loan originations reached $570 billion, helping set the stage for continued focus on the massive amount of loan maturities yet to occur. From 2013 through 2017, an estimated $1.7 trillion of CRE debt will rollover with 2013 being the peak year at $375 billion. So the industry faces new tests of ability to skillfully navigate this crucial stage of recovery and growth.



Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

"There's on-going opportunity for the industry to bring more order and logic to the process through the hard-earned wisdom of the past couple of years," says Jack Mullen, Founder and Managing Director, Summer Street Advisors. "Every deal sows a seed for the future, good or bad."

More than 'bricks and sticks'

For years ahead, almost all CRE deals will involve 'fixing' yesterday's problems. One of the most important ideas to keep in mind is that "the real estate solution isn't always in the real estate," continues Mullen.

"Of course, accurate valuation and grasping real estate operating fundamentals remain key, whether a transaction is simple or complex. These days, finding an optimal solution can sometimes be more dependent on how stakeholders view the macro picture beyond a 'bricks and sticks' analysis," Mullen explains. "Clients can become so fixated on reducing friction with regard to a particular lender or borrower that it just becomes an easier solution to 'just to be done with it' and dispose of the asset in order to get it off the books."

What's necessary to close the gap between willingness and execution often has nothing to do with real estate financing. "Achieving a deal is a function of time and money as much as anything else. The nominal dollar amount of a loss drives decisions as well. Lenders, especially in the CMBS world, might decide to sell a $2 million loan at 50%, and suffer the $1 million loss in order to devote time, resources and monies to resolve a $20 million loan. This strategy may increase the overall recovery since the absolute and relative dollar loss impact of the $20 million loan is clearly more significant," says Steve Jason, Managing Director at Summer Street.

Each situation calls for scrutiny from the bottom up (focusing on basic real estate fundamentals), and the top down (looking at the asset and its entire structure as a whole). A robust assessment includes rigorous analytics, plus considers factors such as local market nuances, legal issues, logistical barriers, even personalities of the players. The key to the right fix could be financial, legal, or operational. Finding an optimal solution requires looking at all facets of the situation.

Three core strategies

Despite the unprecedented scope and length of the current economic downturn, solutions for CRE troubles fall into three basic categories. While sound finance is a prerequisite for all cases, Mullen and Jason agree that pivotal insights tend to come from non-quantitative, and sometimes subtle, factors beyond the number crunching.

1. Restructure the debt: Whether a note is non-performing or performing, keep an open mind when assessing the situation, options and remedies. Revisit the deal to understand the reasons behind the initial structure. A fresh perspective makes it easier to recognize all the stakeholders' rights and remedies, as well as factors that assist or hinder the parties from reaching agreement.

One common example can be a faulty "cash flow waterfall' where property funds pay interest prior to being applied to operating expenses. Although, technically, while this structure keeps a loan "current" since funds are available to pay debt service, in actuality, the property could be deteriorating as a result of residual property revenues being inadequate to pay for upkeep.

"In these situations, you've got to find a solution because the assets are burning," says Jason. "There are cases where the borrower may use drastic measures merely to sustain the property, which could be in the form of a bankruptcy filing or a diversion of funds if it feels a lender has no recourse." Jason says. "You need ability and patience to unwind a situation, to do what's right for the stakeholders," he adds.

"In many hard-hit secondary and tertiary markets, an immediate exit may not be feasible, so the primary goal in resolving the distressed loan may be to devise a plan that keeps the asset from deteriorating and holding it until there is market recovery," adds Mullen.

"Defaults have dominated the CMBS world, but taking time to untangle the debt stack can sometimes create opportunities," says Mullen. "It's possible to assess, value and model a plan to extract profit out of performing notes within a distressed CMBS portfolio.

Restructuring performing debt is rare, but it does happen. Borrowers tend to know of problems far in advance of lenders such as tenants who are planning to vacate. Take notice of proactive borrowers who initiate the conversation and be willing to consider different options. Too often, borrowers are forced to take egregious action to get attention and then it might be too late to create a suitable outcome.

2. Inject fresh capital: Alternative lenders, pools of opportunistic equity and newly formed mortgage REITs raised a record $73 billion (35%-debt, 65% equity) in 2012 to finance transitional properties and provide "rescue capital," according to Jones Lang LaSalle. So far, the big challenge is not in attracting the fresh capital for legacy bank loans and CMBS, but, in large part, the problem still lies in banks' reluctance and delay in adjusting their valuations. Since, typically, this opportunistic capital requires higher returns, this slow moving valuation adjustment continues to clog the pathway for new equity sources to fund deals and move these pathway for new equity sources to fund deals and move these assets forward. To be sure, the sheer volume of distressed CRE, regulatory pressures and economic uncertainty are understandable hindrances.

3. Foreclosure or take back the keys: Beware of the borrower that doesn't protest when asked for a deed in lieu of foreclosure, caution Mullen and Jason. Be cautious about taking ownership, especially for a property in a downtrodden market. Research every aspect of the property to understand its history, potential and pitfalls.

Industrial properties are more likely to have environmental liabilities that need to be identified and managed appropriately. Deteriorating multi-family and office properties may be plagued by decreasing tenant quality, poor management, and a host of problems not quickly remedied – and not always easily discoverable unless you know where to focus.

Foreclosure should be considered on a much more granular level than the CRE industry has done historically. In some case, judges have taken a very dim view of foreclosure and, while the past may point to a speedy foreclosure, reality may dictate a much more arduous process. In the end, every effort should be made to determine if the assumptions of the past remain to be true.

Like statutory foreclosure, deeds in lieu can taint the local perception of the property. If the borrower is a good operator but has too much debt, it's better to restructure the loan.

'Swallow a loss, learn a lesson'

Banks are caught between a rock and hard place with more than $100 billion of REO on the books, according to FDIC data for close of third quarter, 2012. The industry is poised for banks to unload nonperforming CRE assets. The right variables may now be in place, namely, tightening yield spreads, pressure from regulators to improve loss reserves, and limited financing options. If market liquidity and asset pricing continue to improve in 2013, there is cautious optimism that banks, especially smaller institutions, will use bulk sales to strengthen balance sheets.

"In addition to allowing banks to focus more attention on core banking activities, unloading non-performing real estate assets lets banks off the hook for costly upkeep, real estate taxes, property insurance, and other tasks related to managing these assets," says Mullen. "In the current low-growth and low-cap rate environment, banks and investors cannot count on increasing NOI or further decreases in cap rates to drive real estate values significantly higher," says Mullen.

"In most cases, REO should be moved to sale quickly where losses are inevitable," says Mullen. "It helps to keep the perspective from the Chinese proverb, 'swallow a loss, learn a lesson'."

Emotional business

For the most part, real estate finance is driven by data, but behind every deal are people. The ideal 'win-win' outcome, where all parties make money, is not likely to prevail in the 'new normal' for the foreseeable future.

"Resolving distressed CRE can be very emotional for those involved, whether it's $200,000 or $200 million at stake. If there's rancor or bad blood, one or more parties can lose objectivity to make a sound business decision. There will be cases where the biggest success is getting everyone to the table," says Mullen. "Sometimes the personal aspects need to be evaluated alongside financial remedies. These are the situations where an independent third party can really help."

Lessons learned, one deal at a time

"The best time to learn about real estate is when it's broken," says Mullen. "This recession has shown us old and new ways for real estate to break. We have to apply what we learn from our experiences in bad times to reap the benefits of better times in the future."

Uncertainty in domestic and international politics and financial markets is sure to continue. Investors, lenders and borrowers will need to keep one eye on the rear-view mirror and the other on the road ahead; one foot grounded in strong underwriting and the other in asset management fundamentals. The future of CRE depends on stakeholders exercising discipline and wisdom, one deal at a time.

Summer Street Advisors, LLC (SSA) is a commercial real estate and financial services advisory firm. SSA offers a rigorous, data driven approach in providing commercial real estate and loan investment valuation and analysis, transaction due diligence, bank and REIT advisory, asset/portfolio management and loan underwriting.

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