Dog Days, Part II: Investors Still Reluctant to Buy Into Stormy Distressed Market

With Prices Still In Flux, Many Buyers Won't Go Out On a Limb -- But Some Sellers Are Starting to Become 'More Realistic'

Mark Heschmeyer, *CoStar Group, August 12, 2009*

Steven Aberman, senior acquisition manager for WBS Properties in Boca Raton, FL, has watched the 43-acre lakefront development of Grand Oaks in Avon Park evolve from raw land that sold for $2.5 million three ago into finished lots. The turnkey gated community now consists of 127 lots, with 25 premium lakefront sites featuring unobstructed views of 280-acre Lake Damon in Central Florida. Aberman just bought the property last month.

"We purchased it fully developed, roads completed, water, gas fully completed, a finished paved pool area, and a boat launch after over $2.5 million in improvements was spent by [the] seller. We bought the whole community for $1.4 million," Aberman said.

Aberman's success typifies the current state of distressed investing. It's a game of patience and waiting for the right price. And for many, the waiting game isn't over just yet.

As we reported last week in Part I of "The Dog Days of Distressed Debt," our examination of the distressed investment landscape, falling property values are still one of the biggest drawbacks to raising money for distressed assets. In the same way, buyers and sellers waiting out the storm are also one of the major hurdles to deploying the money raised so far. Both the sell side and buy side of the market are still waiting for a narrowing of pricing expectations -- a process that is only just beginning.

"What may be counterintuitive is that our return expectations are actually rising; we perceive greater risk in the intermediate term. To us, it makes some of the deals that have been done this year a little puzzling from a pricing perspective," said Steven Sandler, CEO of Crosswind Capital in Rye, NY, and a regular Watch List contributor. "Although completed transactions have been scarce these past six months, those deals that have closed bear all the hallmarks of guys trying to catch the falling knife."

"Current commercial owners need to come to grips with the fact that the valuations of eight to 12 months ago are gone," said Thomas D. Kuffler, president of Civic Asset Management in Scottsdale, AZ. "We are continuing to see rents fall and vacancies increase. Our commercial rental market consists of a shuffling of current tenants downsizing and or upgrading into nicer buildings as their leases come due. Owners need to position themselves as best they can to compete with the REO product in terms of rental rates and concessions; which if they are underwater is going to be tough to do."

"As an MAI with over 20 years experience I can tell you that I have not seen anything to come close to how quickly values have dropped," agreed P. Scott Voltz, MAI, MBA Voltz Commercial Realty Advisors in Santa Clarita, CA. "Brokers report that buyers are only waiting for deals."

Pathfinder Partners in San Diego is in the market raising money for its Pathfinder Partners Opportunity Fund II that will invest in both commercial properties and commercial mortgages. Mitch Siegler, senior managing director of Pathfinder Partners, said they are starting to observe some narrowing of the bid/ask gap.

"Certain banks are becoming motivated to sell at more realistic prices," Siegler said. "We looked at 800 potential opportunities in 2008 and made just two investments -- primarily because sellers simply weren't realistic about pricing. We just closed our first deal of 2009 [acquisition of a loan on a finished, detached residential subdivision] and are under contract to close [in about two weeks] an REO purchase of a new condo project."

Cash is King

To get a deal done in this environment takes a willingness to move quickly and come in with a lot of cash.

"Investors wanting to buy distressed commercial real estate must be able to buy properties as-is, where-is and without any due diligence periods. The days of 60- to 90-day due diligence periods are long gone. When a lender is ready to sell, they want it sold," said Stephen Karbelk, president of National Commercial Auctioneers in Tulsa, OK. "That inherently gives the new distressed funds an advantage. They can come in and buy quickly in an all-cash deal."

That's a phenomenon that has already begun, according to Jay Boyle of the Investment Division Grubb & Ellis | BRE Commercial in San Diego.

"Our team has closed two deals in the last two weeks, with two more in escrow. The two sellers were pension funds that had liquidity events unrelated to that specific property and were part of a larger portfolio-repositioning strategy. The buyers were all cash," Boyle said.

continued on next page ...

Dog Days

... continued from previous page

The all-cash buyers can be put into two categories, according Bob Pounds, senior vice president, investment sales at NAI Welsh of Minneapolis/St. Paul.

"One group is looking for the safest real estate they can find, which would be a property that has a long-term lease with a tenant of investment grade credit with a good business model in an 'A' location," Pounds said. "The other group is looking for more risk. They're looking at well-located distressed properties in excellent condition that have a weak rent roll. The intent is to capitalize on the seller's precarious position of either near term debt maturity or the need to reduce long term liabilities."

Getting deals done piecemeal, however, is not the most efficient for the new funds coming in with millions to spend or sellers with huge portfolios of distressed assets.

"I too have been collecting names of CEOs in charge of these funds. They seem to form every day," said Ron Opfer in the Commercial Asset Division at Coldwell Banker Premier Realty in Las Vegas. "I don't see them coming forward to banks individually to buy one off properties, at least not at the banks I work with. My guess is that they are waiting for the private partnership to be more attractive. I spoke with a higher up at the FDIC (Federal Deposit Insurance Corp.). They indicated they are not going to do any more auctions like they did for Silver State Bank in Las Vegas. Several of my clients have properties with the FDIC. They too are being told that there will not be an auction, rather, the properties will be placed in the private partnership pools."

In Ernst & Young LLP's latest survey of distressed investors, the accounting/consulting firm noted that 45% of respondents said they have not yet purchased any distressed assets because they believe it is simply too early in the cycle of distress for them to even attempt to purchase nonperforming loans right now. This strongly suggests that many investors, at least, believe seller "ask" pricing on the few deals that are coming to market is still too high.

So when will the slow momentum of the dog days of distressed investment end?

The Ernst & Young survey noted slightly more than 30% said they believe the market is already witnessing significant default activity. However, the majority (47%) of respondents said they believe that a significant increase in commercial mortgage defaults will begin before the end of the fourth quarter of this year. About 20% are looking to 2010 before major default pressure comes to bear on the market and distressed sales begin in earnest.

Targeted Assets

According to Ernst & Young respondents commercial whole loans are overwhelmingly the primary investment of choice for distressed investors with more than 45% eyeing the asset category. Residential and land loans were the next most popular categories, each selected by 18% of the respondents as being a preferable investment, followed by residential acquisition and development (A&D) and construction loans at 11%. Commercial and residential mortgage-backed securities (CMBS/RMBS) and loans backed by hotel assets each attracted less than 10% of respondents.

"The key for most investors is transparency and having enough good information to make an educated offer. Whole loans are relatively easy for most investors to quickly get their arms around which may be one hint of their attraction to respondents," explained Chris Seyfarth, Ernst & Young LLP's National Director of Nonperforming Loan Services, and the report's author.

Seyfarth suggests that this presents the potential for a deep, highly competitive market in the near term -- and this could impact pricing and execution quite heavily from the outset.

On the plus side for sellers, E&Y's survey indicates that investors' return expectations are not unreasonable. "Only 35% of those investors polled claim to have return requirements above 20% and an equal number actually are shooting for returns in the 10% to 15% range," said Seyfarth. The balance of investors sit in the 16% to 20% range, suggesting that the spread between bid and ask pricing may narrow quite quickly once deals begin to flow to the market.

CoStar Group Watch List readers also weighed in on the topic. The following are excerpts of comments and insights from wide sample of real estate executives across the country on the state the distressed investments. The comments are broken out by asset type.

Debt Is Really Income, with the Potential To Become Property

Mortgage pricing substantially favors multifamily assets as debt is still available at 6% or less for higher leveraged the assets via the agencies [Fannie Mae, Freddie Mac]. Conversely, commercial properties are financed at levels of 60% of value or less with strict cash-out requirements and other provisions (e.g., recourse) previously thought too onerous as lenders cherry-pick deals.

With distressed debt deals offering very appealing rates and principal reduction, astute investors redouble efforts in this investment arena. "Loan to own" opportunities appeal to such buyers, especially those with development and management expertise. Banks and other distressed financial institutions provide an ongoing pipeline of deals.

More market clarity is expected in the fall when investors return from the summer holidays. For now, most institutions consider asset management as their top priority." He suggests, "Many legacy owners are more concerned about losing income stream rather than capturing new opportunity plays.