The San Diego Union-Tribune.

'Vultures' circling commercial properties

Mike Freeman, *The San Diego Union-Tribune, June 22, 2009*

Now that the housing crash appears to be nearing bottom, all eyes have turned to offices, hotels and other commercial real estate as the next properties that might be poised to collapse.

So-called vulture investors have begun popping up in search of troubled commercial buildings, which they hope to acquire at steep discounts.

In San Diego, the latest of these investors is Cypress Realty Advisors LLC, founded by commercial real estate veterans Ron Lack and Mark Wayne.

They say they have commitments from wealthy investors – they wouldn't disclose the amount – to help fund the purchases of offices and other distressed commercial properties in San Diego County, Orange County and Silicon Valley.

"Look at anybody who purchased commercial real estate in the last three years, 2005 to 2008. They're upside down," said Wayne, a former broker with Cushman & Wakefield. "Their equity has evaporated, their occupancy has evaporated, and their debt is maturing."

Cypress isn't alone. Pathfinder Partners of San Diego has been buying troubled mortgages backed by multifamily projects and office buildings for more than a year.

It initially raised $5 million to get started. Last month, it raised a $50 million fund to purchase additional mortgages. Recent acquisitions include the first mortgage on the 62 remaining units in the 102-unit Mer Soleil condo project in Otay Ranch. It also bought the mortgage on a 44,000-square-foot office building in Sorrento Valley.

"We're seeing deals," said Lorne Polger, a real estate lawyer and co-founder of Pathfinder Partners. "But we haven't seen the pricing that is attractive to us. That's starting to change."

Cypress and Pathfinder say they're early to the market for distressed commercial property. Steps by the federal government to shore up banks and loosen credit markets may help rescue commercial landlords – leaving vulture funds with slim pickings.

But firms like Cypress and Pathfinder are betting that the problems in commercial real estate are large enough – and that banking regulators won't let them linger on lender balance sheets – that attractive deals will hit the market within the next year or two.

Driving the predictions of pain for commercial landlords are crumbling business fundamentals and the freezing up of credit markets.

Demand is down in everything from offices to hotels to retail buildings. The result is higher vacancy rates and lower rents. Because commercial buildings are valued on cash flow, they often are worth less today than they were two or three years ago.

Owners of the tony W Hotel in downtown San Diego said this month they would default on a $65 million mortgage because the hotel's value has plunged below the loan amount.

On top of that, the credit crunch has dried up the market for commercial mortgage-backed securities. About $170 billion of commercial mortgages held by nonbank investors come due this year, according to the Mortgage Bankers Association.

That could make it difficult for landlords to refinance. Delinquencies on commercial mortgage-backed securities are at record highs of 1.85 percent in the first quarter, said Jamie Woodwell, the bankers association's vice president of commercial real estate research.

Pathfinder and Cypress are focusing on smaller buildings, in the $5 million to $20 million range. They eventually expect to be able to attract larger, institutional investors to their funds to buy bigger commercial buildings.

Others aren't so sure. They wonder if the dire predictions for commercial real estate may be overblown, and they suspect the very low prices that vulture buyers seek won't be as widespread as some experts believe.

"I'm not saying there won't be opportunities and there won't be very attractive pricing, but it won't come on fast," said Brian Driscoll of Grubb & Ellis/BRE Commercial's Capital Markets Group. "It's going to stretch out for a long period of time."

Alex Zikakis, president of Carlsbad-based real estate investment firm Capstone Advisors, agrees that the timing of a possible commercial real estate bust is tough to predict.

Zikakis compared the dire forecasts for commercial buildings with what has happened in housing construction and land purchases.

Even though the housing market fell apart in 2006, some banks still haven't written off large chunks of residential land and housing development loans they made during the boom, he said.

"The real question to me is, are the banks going to keep extending everybody's debt trying to bridge through this, much like they're trying to bridge though the home-building and land-development industries?" Zikakis said.