An Unexpected yet Advantageous Flow of Distressed Assets

A research report prepared by the Steven L. Newman Real Estate Institute, Baruch College, CUNY by contributing author Robert Knakal, Chairman, Massey Knakal Realty Services, New York, NY.

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”.

The NYC 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 anticipated.

As we were heading 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.

If we also consider the properties that were refinanced during that same period, we estimate that there are approximately 15,000 properties in New York City which 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 only have about $65 billion in debt on those properties. This $100 billion of excess leverage is what is creating distress in the marketplace. For an illustration of how this market condition is playing out globally, see Figure 1.

It is unreasonable to think that the entire $100 billion of leverage will be extracted from the marketplace due to the fact that some owners have additional sources of income that can support properties which are in a negative cash flow position. If these owners want to own the assets on a long-term basis, they will continue to feed the property. There will also be a substantial percentage of these properties that will simply be worked out between the borrower and the lender. Still others are able to cash flow, due to very low interest rates, at loan-to-value ratios of 90, 100 or even 110 percent. Owners will hold onto these properties.

---

**Figure 1: Global Troubled Assets**

<table>
<thead>
<tr>
<th>Assets</th>
<th>#Props</th>
<th>Vol (mil)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Troubled</td>
<td>8,926</td>
<td>$189,068.8</td>
</tr>
<tr>
<td>Lender REO</td>
<td>1,741</td>
<td>$36,552.4</td>
</tr>
<tr>
<td>Current Distress</td>
<td>10,667</td>
<td>$225,621.2</td>
</tr>
<tr>
<td>Restruct’d/Ext’d</td>
<td>1,023</td>
<td>$29,672.9</td>
</tr>
<tr>
<td>Resolved</td>
<td>1,989</td>
<td>$38,337.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>13,679</td>
<td><strong>$293,631.2</strong></td>
</tr>
</tbody>
</table>


---

1This article is an updated version of Robert Knakal’s January 12, 2010 Commercial Observer column, “Concrete Thoughts.”
properties, even if negative equity is significant, hoping that rates will not rise and fundamentals will rebound, restoring lost equity. We do, however, anticipate that by the time we exit this cycle, $30 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 the mark-to-market accounting guidelines of the Financial Accounting Standards Board (“FASB”) have permitted bank regulators to let lenders keep loans on their balance sheets at par even if the lenders know that the underlying collateral is worth only 50 percent of that value. Modifications to Real Estate Mortgage Investment Conduit (“REMIC”) guidelines have also created a path for 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 commercial real estate distressed arena 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 of late. Rather than a tsunami of distressed assets coming to market, we believe that this distressed asset recycling process will consist 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 proforma2 transaction loans that were relying on significant value-added strategies to increase net operating income. As real estate fundamentals have degraded over time, these proforma increases have been unobtainable, creating interest reserve burn-offs without cash flow levels to service the debt.

Many loans had interest-only periods which 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 which are floating over the London Interbank Offered Rate (“LIBOR”), now 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 be cash flowing. However, when the rate is reset to a market rate of approximately 6 percent, 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 Realty Services 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 thru 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.

As lenders become impatient with this process, decisions are made to monetize their assets now. Figure 2 illustrates clearly this dynamic. This is particularly beneficial when realizing that, due to the short supply of availabilities, lenders are able to achieve pricing of 95 percent to 100 percent of collateral value for notes that are being sold.

Second, it is becoming clear that fundamentals will not improve dramatically

2The Latin to English translation of proforma is “as a matter of form.”
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. Also, as Figure 3 shows, the number of stalled construction sites in New York City continues to climb.

Third, as lenders monetize toxic assets they are able to make new loans which 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 to deploy 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. Numerically ironic, 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 a reverse reposition and/or term deposit facilities; raising the federal funds rate in tandem with increasing interest rates on reserves; or selling assets outright.

Numbers 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 occur the sooner a sustainable rebound can grow. While the huge wave of distressed assets we were all anticipating has not resulted, it does
appear that a slow and steady flow of these assets has begun which 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.

Something all participants in the market are trying to figure out is how things will progress after a natural bottom is reached. We believe that as values hit bottom, they will bounce along that bottom for a year or more as several factors play against each other. Negative pressure on value will be exerted by the potential of inflation and the impact of the Fed’s exit from the market, both of which would place upward pressure on interest rates. As rates rise, lenders would have to determine how these increases will impact their lending rates. Most bankers that I have spoken to have indicated that they will allow their spreads to compress for the first 50 to 75 basis point increase. Above that level, rate increases will be passed along to borrowers in the form of higher mortgage rates. It is easy to see how this would negatively impact value.

Another factor exerting negative pressure on value will be the deleveraging process that the market must endure. As we have reviewed, there are 15,000 properties with negative equity levels. Even if just 10 percent of these come to the market, it would double the level of available properties as in 2009, just 1,349 properties were sold in all of New York City. Doubling the supply would soften value as investors would have many more choices and there would presumably be fewer bidders on each asset. This diffused demand would hurt value. We estimate substantially more than 10 percent of these assets will come to market.

Exerting upward pressure on value will be the massive amount of capital sitting on the sidelines waiting for opportunities to buy. Demand far outpaces supply today as all segments of the investor arena are active today. When we started to feel the onset of the credit crisis in the summer of 2007, institutional capital, which inflated the asset bubble during 2005 to 2007, evaporated from the market. An overwhelming percentage of our buildings, from mid-2007 to the present, have been purchased by high net worth individuals and old-line New York families which have been investing in the city for decades. Recently, we have seen a resurgence of investors using institutional capital. These purchasers have been aggressively bidding on many of our exclusive listings.

Joining the high-net-worth individuals, families and institutional buyers have been an impressive number of foreign high-net-worth investors. In fact, we have not seen such and influx of foreign capital coming into the market since the mid-1980s. Interestingly, these foreign investors are primarily not full time real estate investors but have made money in other businesses and are electing to deploy capital into New York real estate at a time when values are down and the U.S. dollar is relatively weak. These conditions have created an acute imbalance in the supply/demand dynamic.

After the market reaches a bottom, whether value bounces up slightly or down slightly will be dependent upon which of the factors mentioned above becomes the most dominant. We do not, however, expect a surge in appreciation until our distressed asset problems are fully resolved.

This research report is published by the Steven L. Newman Real Estate Institute, Baruch College, CUNY.

The Newman Real Estate Institute gratefully acknowledges the support of the sponsors who make possible our efforts to promote critical thinking on topical issues for the real estate industry.

The views expressed in the research report are those of the authors and not necessarily those of Baruch College, City University of New York, or any of its affiliated organizations, foundations, and sponsors.

Please address inquiries to Jack S. Nyman, Director, at: