



CB RICHARD ELLIS

SPECIAL REPORT

Myths and Realities of Investing in Distressed Commercial Real Estate Assets and Mortgages

A Special Report from CBRE Econometric Advisors Research and CBRE Capital Markets

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FOREWORD

This paper was first prepared for the Boston meeting of the Urban Land Institute, which asked us to prepare a short paper on the status of distressed commercial real estate in the United States and the options and strategies for investing in such assets. Clearly this is the foremost issue facing commercial real estate in 2010 and the future health of the industry depends greatly on the industry's ability to address and solve distress related to commercial real estate assets.

This whitepaper estimates the size and separates the myths from the realities of this crisis both as both to the distress and to the opportunities. Main takeaway: This real estate "correction" is not parallel to the one experienced in the 1990s. The government and industry participants have learned from their earlier experiences and the competition for investing is fierce.

In pulling this paper together I reached out to the Investment Strategy team at CBRE Econometric Advisors for data and analysis as well as the Recovery & Restructuring Services Team within CBRE Capital Markets that specializes in this area for structures, deal examples and "on the ground" observations. The strength of this paper is the combined views of both teams.

We thank Stephen Blank, Senior Fellow, Finance, at ULI for his guidance and fellowship in our preparations for ULI.

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MYTHS AND REALITIES OF INVESTING IN DISTRESSED COMMERCIAL REAL ESTATE ASSETS AND MORTGAGES

By Mark Gallagher, Spencer Levy, Wesley Wells and Raymond Torto¹

This paper focuses on defining commercial real estate distress in today's market, quantifying it, comparing it to the early 1990s, and then examining the avenues and opportunities for investing in distressed commercial real estate.

DISTRESS TODAY

Distress can arise via the income statement or the balance sheet. And of course, stress on the income statement can filter through to the balance sheet. Theoretically, distress on the income statement is when Cash Flow (CF) is less than CF* where the latter is the "breakeven" level. No judgment in this calculation... cash flow is a hard number, i.e., either you are paying your expenses or you are not.

Most often income distress translates into an owner defaulting on debt payments for reasons that can range from a lost tenant or no income, to no TI/LC capital to attract a new tenant, to rising debt costs above cash flow. Income statements for real estate are generally private, but distress emanating via the income statement is reflected in delinquency rates on debt. It is here where the issue becomes public.

Balance sheet distress is when Loan to Value (L/V) is greater than L/V* which is today's, not yesterday's standard. Balance sheets, unlike income statements, involve more of a "judgment" component. For instance many CRE observers believe that there are many properties where the L/V is above L/V*, based on market indicators of value, but this fact is yet to be fully or completely recognized on the balance sheet. A recent whitepaper released by several governmental bodies and regulatory agencies also notes that the value of a

commercial real estate asset doesn't necessarily have to be written down to current market value (L/V*) so long as the sponsor is timely with payments and the bank believes that the loan will not become impaired. This "judgment" component further complicates the discussion of whether or not an asset is "distressed" as referenced on the balance sheet. In its simplest form, income statement distress is quantifiable where balance sheet distress may or may not be. The qualitative nature of balance sheet distress, combined with lack of trades to establish price discovery is what is causing an opaque market, thus driving investors "mad".

What might trigger the recognition? Clearly, when a loan matures or when the L/V is in violation of "enforced" debt covenants. Also in today's environment there is also strategic distress, i.e., actions by owners to bring about discussions for some resolution on the debt. For instance some non-performance is by choice rather than by the math. Investors with securitized debt sometime are willing to go into default so that the special servicer can talk to them about their loan, rather than continue to pay as agreed in the loan docs.

Each of these distress situations creates opportunities for those who, as a necessary condition, have the capital to fill the equity gap or to "right size" the deal. Not only are the appropriate financial conditions necessary to enter into a negotiated workout agreement but there also has to be a level of experience associated with the counterparties not typically found in the repertoire of the traditional commercial real estate investor. While the skill set is not all inclusive, investors and developers need to be able to rebuild the income statement in order to achieve asset stabilization, negotiate and utilize the skills and experience necessary to bring parties together, employ various government programs in an effort to recapitalize an asset and to utilize the capital markets in an effort to restructure the asset's balance sheet. These are special skills in that they are not the same as owning a real estate asset, managing

1. Mark Gallagher is Senior Strategist at CBRE Econometric Advisers, Spencer Levy is Senior Managing Director, Eastern Division, CBRE Capital Markets, Wesley Wells is Associate, CBRE Capital Markets and Raymond Torto is CBRE Global Chief Economist.

the tenants and the asset, collecting the income and paying your expenses.

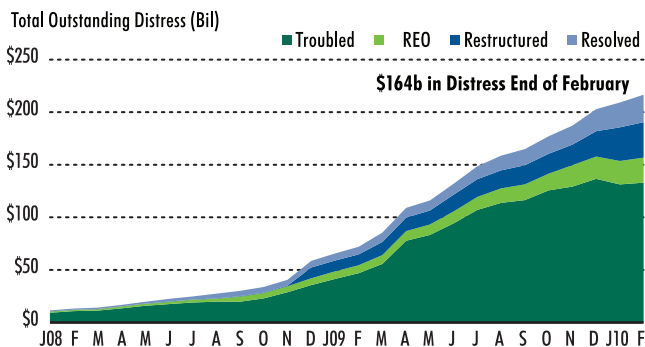
In our view buyers today are not looking for real estate that is distressed by way of the income statement. Rather, buyers are looking for distressed sellers [capital markets distress] not necessarily distressed assets [fundamental distress].

CURRENT REALITIES

The unfortunate reality is that the amount of problem deals has increased profoundly in recent quarters, especially in the banking and CMBS sectors. While life companies and agency multifamily lenders continue to report relatively low delinquency rates, credit quality continues to deteriorate across the board in 2010.

- Outstanding distress as of the end of January 2010 was \$164b of property in default, bankruptcy, foreclosure or REO. Since 2007, \$207b in properties has fallen into distress as \$45.3b has exited distress through restructuring/modifications of the mortgage or via sale or recapitalization. Recent data show that the volume of properties entering distress is increasing month to month, but so is the volume of resolutions leading to lower monthly net additions. For instance the recent monthly net increase in distress was \$3b well below the \$10b monthly increase average in 2009².

Figure 1: Total Outstanding CRE Distress



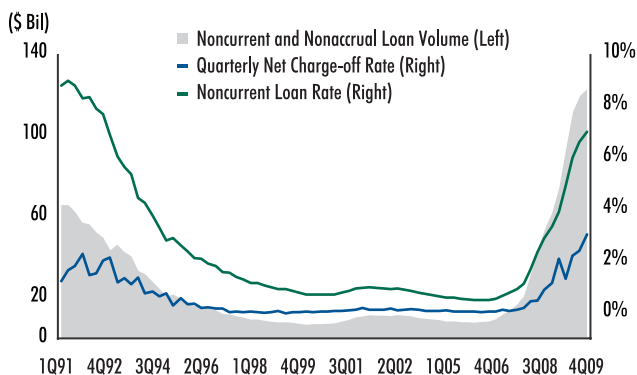
Source: Real Capital Analytics, March 2010

2. Real Capital Analytics. US Capital Trends. March 4, 2010.

- Bank and thrift CRE exposures have tripled in dollar terms from the 1990s with today's number about \$1.8 trillion. As a percentage of assets, however, the number is about the same at 13.5%³.
- The most recent delinquency rate on a broad measure of banking institutions' commercial real estate loan portfolios reached 7% in the fourth quarter of 2009, up from 3.9% just a year earlier. The rate is fast approaching a 9% figure that was reached in 1991. See Figure 2.

Figure 2: Bank Commercial Portfolios Will Face More Stress Than in the 1990s

Construction and Development, Nonfarm Nonresidential and Multifamily Real Estate Loans at FDIC Insured Institutions



Source: FDIC

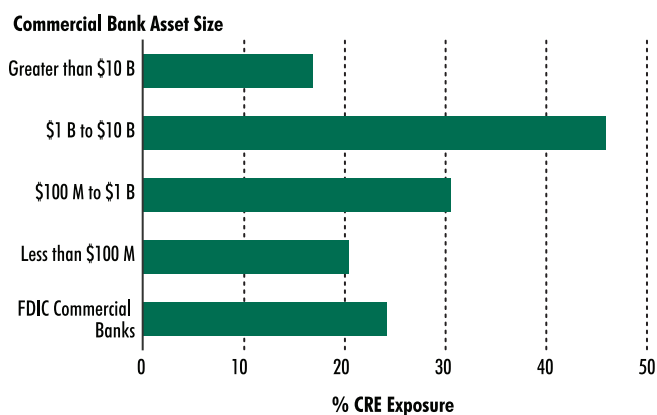
- The overall volume of nonperforming commercial real estate and development loans on banks' portfolio now exceeds \$123 billion, more than 80% higher than levels reached in 1991 (in current dollars). See Figure 2.
- Last year, 140 banking institutions failed, while today 702 are precariously perched on the FDIC's "Problem Institutions" list. The number of failed institutions is likely to grow in 2010⁴.
- Smaller-sized institutions, those with total assets between \$1 billion and \$10 billion, could be

3. Joe Jampietro, Presentation to PREA, March 23, 2010.

4. See "Lending Falls at a Record Pace", *Wall Street Journal*, February 24, 2010.

disproportionately affected, since their exposure to commercial real estate lending (measured as a percentage of total loans and leases) is almost double the exposure of the banking sector overall⁵. Further complicating the process, small and even some mid-sized institutions have difficulty tapping the capital markets therefore preventing them, in many cases, from being able to trade assets and take the appropriate marks as said action would trigger review by the bank regulators and put them at risk of insolvency.

Figure 3: CRE Exposure Generally Higher at Smaller Commercial Banks



Source: FDIC, 2009Q2
 Commercial Real Estate Exposure = (Total Construction & Development, Nonfarm Nonresidential, and Multifamily Loans Plus REO) / (Total Loans & Leases Plus REO)

- The CMBS sector is facing a similar downdraft in credit quality. According to Trepp, more than 4,300 fixed-rate conduit loans representing \$68.5 billion in outstanding principal balance (10.43% of total balances) were in special servicing as of March⁶.

5. According to CBRE Econometric Advisors' analysis of FDIC data, total commercial real estate loans (which includes construction and development, nonfarm nonresidential, multifamily loans and REO) accounts for approximately 46% total loans, leases, and REO for institutions with total assets between \$1 billion and \$10 billion. The comparable figure for all FDIC insured institutions is slightly in excess of 24%. Note this does not include other bank assets such as securities.
6. It is important to note, however, that 3,571 of these loans (6.91% of Outstanding Principal Balance) were characterized as "non-performing", while the remaining loans are characterized as "performing".

FUTURE REALITIES

What is the potential "future distress"? Future distress will be determined by deteriorating real estate fundamentals which weight negatively on property net operating income and by rising cap rates⁷. The last few years have seen transaction based value indices decline about 40% peak to trough, according to Moody's REAL CRE Index. Based on the forecasts of investment fundamentals by CBRE Econometric Advisors, the recovery in values is likely to be long. For instance, the estimate for the office sector is that values will recover to their pre-recession peak in 2017⁸. This slow recovery is encouraged by the forbearance allowed in restructurings and workouts by the regulators and accounting bodies.

Everybody notes that distress today is demand-driven, not supply driven as in the 1990s. The industry has overpriced, not overbuilt. While vacancy rates are as high or higher than in the 1990s, the distribution of vacancy today versus the 1990s is remarkably different. In the 1990s, vacancy was in newly developed assets and was highly concentrated, more easily assembled by financial institutions or agencies and re-priced into the market. Today's vacancy is much more like marbled fat in a rib-eye steak, spread throughout the market. Every asset has at least a little!

How big is the future distress? Given the above discussion regarding future fundamental performance and values, CBRE-Econometric Advisors looked at this question by undertaking a loan-by-loan analysis of the only publicly-available data set, CMBS⁹. The study identified the loans and the size of the gap between tomorrow's

7. Property market fundamentals forecasts prepared by CBRE Econometric Advisors expect occupancy and rents to remain soft in 2010, with recovery awaiting 2011.
8. CBRE Econometric Advisors' Spring 2010 *Investment Outlook* indicates that NCREIF appraisal-based values will register additional declines, with the industrial sector showing the largest peak-to-trough decline (48%), followed by office (37%), multifamily (40%) and retail (30%). Through 2009Q4, NCREIF values have declined from peak as follows: industrial (32%), office (34%), multi-family (31%) and retail (25%).
9. The tool used for this analysis was Moody's Commercial Mortgage Metrics (CMM).

value, and reasonable refinancing option versus the asset's current debt levels. The study found that of those loans that mature in 2010 and 2011, approximately 50% of loans measured by outstanding principal balance would face a refinance shortfall issue¹⁰.

If we take the leap of faith that maturing CMBS loans have a similar credit profile to those originated by others, this would indicate a potential distress pool of some \$280 billion in refinancing loans over the next two years¹¹. Clearly, a large proportion of this loan volume is likely to be modified or extended by lenders, consistent with the policies of the regulators that have taken shape over the past year. However, time does not heal all wounds and one would expect a rising tide of distressed sales, particularly in the banking and CMBS sectors. We have found that banks are more likely to "resolve" issues or sell loans prior to foreclosure rather than take a property as REO, while special servicers have suggested that selling REO might be the best way to maximize value for the bondholders (on a case-by-case basis) but the topic of "tranche warfare" is still at-large.

CURRENT OPPORTUNITIES: SELLERS

In any business negotiation it is imperative to understand the other side of the table. In today's market there is paucity of sellers as values are uncertain and in most observers' view at the bottom of the market. Nevertheless there are some sellers from the following categories:

- The FDIC whose fiduciary responsibility is to protect the Deposit Insurance Fund ("DIF"), not necessarily to maximize sale dollar volume. In one sense they

10. See "The Re-Cap Gap" CBRE *Global In-Sights*, at www.cbre.com.

11. This is calculated by applying the finding that 50% of CMBS loans in the Re-Cap Gap study would fail to refinance, to Foresight Analytics' estimate that the total maturing commercial and multifamily loan volume from all lending sources for 2010-2011 is estimated at approximately \$560 billion. Most observers would think the CMBS pool has the less worthy due diligence and hence this estimate is worse case.

are the only "true" or willing seller as they do not have sentiment tied to the trade.

- Passive equity interests by funds hit by redemption requests.
- Special servicers who need to monetize an asset for bondholders (although we are still having "tranche warfare" discussions daily). Most Special Servicers are not incentivized to trade as they stand to lose more than they stand to gain.
- Banks that can take the capital hit to their balance sheet and are looking to raise cash (for both loans and REO).
- Sellers of trophy assets in top-tier markets (e.g., Washington, DC) where cap rates have compressed due to the "scarcity premium".

THE BARRIERS TO MARKET SALES

As anybody looking at the market for distressed assets knows there is a great disconnect between the amount of assets categorized as distress and the amount that is up for sale. There are various reasons:

- FDIC- "Trash for Cash". Most of the assets are not in the wheelhouse of large fund operators or money managers; large loan pools are made up of loans with small unpaid principal balances (UPBs).
- For instance, recently a portfolio with a \$2b unpaid balance was put on the market (and traded)... the loans that made up the portfolio averaged \$2.5 MM each. This makes due diligence and underwriting very difficult for any prospective buyer.
- FDIC structured sales are not providing price discovery. Structured sales are providing substantial leverage (up to 85% at a low cost or in some cases actually zero interest) that even when the large pools trade there is a big question mark as to whether this constitutes true price discovery. True price discovery is really the core issue in the market.

- Typically the bid/ask for passive equity interests in portfolios, banks, investors, etc. is still too wide to promote trades as the debt capital markets (while healing) are not in the condition to compensate for the artificially depressed cap rates from 2004-Q2 2007 caused by too much capital being available in the market via securitized finance. Banks are not willing (from an accounting perspective) to write down assets they don't have to and owners/investors still typically believe that their assets are worth more than what buyers would pay on the open market.
- Special Servicers are modifying debt but with some basic rules of engagement which are as follows;
 1. The asset must be kept in receivership. Foreclosure or deed-in-lieu wipes out the loan
 2. The modified loan amount cannot exceed the original loan amount
 3. There are stipulations in the pooling & servicing agreement that dictate how long the loan can be extended past maturity. They typically average 1-3 years
 4. Some of the servicers believe that they can extend the loan for the term of the securitization, which we have not seen tested, but will cause a firestorm with the "A" note holders
 5. The servicer needs some belief that the borrower will be able to meet payments because they do not wish to go through the modification a second time.
 6. Loan to value will differ, but even when the LTV is high, there will be substantial escrows and reserves required.
- Some banks are selling loans that they have already marked to market (or close to market) to relieve themselves of the eventual foreclosure headache. Still, the theme again is that most banks would prefer to extend and modify loans (while hoping assets rebound in price) rather than trade assets. The loans/REO assets they are selling typically have small unpaid balances or are tough assets in tough markets.

OPPORTUNITIES: THE AVENUES FOR MARKET SALES

There are several avenues where distressed assets are coming to the market. These are:

- The FDIC Structured Sales Program is one that is offered primarily to large investors that have successfully registered with the FDIC. The winning bidder partners with the FDIC to form a Limited Liability Company where the management (and oversight) of the portfolio is in the hands of the winner but the cash flow is split amongst the winner and the FDIC by a predetermined waterfall. The waterfall depends on the leverage assumed by the winning bidder.
- Most notable was the Starwood acquisition of the Corus ORE portfolio. The most typical format will be the upcoming "Deutsche Bank 2" portfolio consisting of whole loans and loan participations backed by hospitality assets across the country. The "DB 2" portfolio is currently out for bid and a teaser for the upcoming \$1.88b offering from AmTrust has already been released to prospective investors.
- Loan workouts can take many forms. One example of a recapitalization/discounted payoff in which CBRE was involved is where the borrower originally sought to refinance the property but proceeds did not cover the outstanding obligation. The borrower did not have any equity to inject into the property to "right size" the loan.

CBRE was engaged to assist in the recapitalization and/or negotiate a DPO for a senior and a mezzanine loan, both of which were owned by a large bank. CBRE found equity partners looking to invest equity in distressed commercial real estate and targeted a number of potential partners that would have interest in either a joint venture or an outright note purchase.

In this case CBRE worked with the borrower and the bank and negotiated a principal reduction of both the senior and the mezz loan combined to \$28.9 MM.

After our efforts to reduce the principal balance of both loans, the property eventually traded to a private equity investor (procured by CBRE) that paid the bank \$20.2 MM in cash. The original borrower stayed in the deal via a “hope note” and the retention of leasing and management fees.

OPPORTUNITIES: THE BUYERS

Equity is abundant in this market and unfortunately it seems that there has been too much capital raised that is looking for a home. This abundance of capital in the market is making many investors comment that buyers are over-paying for whatever assets are available. Further, and in ironic fashion, in many cases we are solving a problem of over-leverage by utilizing leverage (FDIC Structured Sales Program and special servicers are both issuing debt at an inexpensive cost-of-capital to maximize the price a buyer is willing to pay).

It is important to note that there was a major shift in capital flows in the early 2000’s unrelated to CMBS. Specifically, up until the tech bubble in 2000-2001, commercial real estate investing was considered an “alternative” investment class to most pension funds, endowments and their advisors. After that, it became a primary investment (i.e., a lot more dedicated capital) because of the real or perceived security of investing in “hard” (commercial real estate) assets rather than operating businesses. Hence in 2010 unlike the early 1990’s when there was relatively less institutional capital chasing commercial real estate (because it was an alternative investment), today there is a tremendous amount that was allocated during the 2000’s and it is not going to go away overnight (or potentially ever).

As a result there is so much capital chasing so few deals we are seeing cap rate compression for distressed

assets: unprecedented demand which is driving values higher. The recovery of asset values, in general, may be stronger than most expect even if fundamentals continue to deteriorate in 2010¹².

Many of the equity funds with discretionary capital to invest are very confused as to whether to participate on the debt or equity side given the returns they promised investors. Naturally, as a fund manager, many groups want to get the capital out so badly they are perhaps willing to accept “unrealistic” pro forma assumptions and overpay for deals.

Most equity groups want (and need) to have cash flow associated with their investments in order to obtain yields stated in their fund docs. For this to happen, they need in-place cash-on-cash to be around 9-13% and a then have to add-value by way of leasing, recapitalizing the asset (the portfolio), etc. Most equity groups look for returns in the 15-20%+ levered range (12-18% unlevered), down approximately 200-300 basis points from their return expectations in 2009.

Some groups are sitting on funds dedicated for land for eventual development and/or flips to developers when the market returns. Except for highly lucrative infill sites in the 24 hour cities, most land is still trading at a substantial discount as investors are having to “price in the unknown” in order to achieve their 2.0x minimum equity multiple on their investment. That multiple, combined with the “unknown” makes the bid/ask still very wide and unlikely to trade. Land will likely trade at heavily distressed prices either via the FDIC’s Structured Sales Program (loans) or via CBRE’s contract to sell ORE through the FDIC.

12. There is evidence in other parts of the globe that pricing is moving higher ahead of fundamentals.

OPPORTUNITIES: WHAT DOES IT TAKE TO BE SUCCESSFUL?

There are many avenues to opportunity but expect lots of competition. Some examples:

- **FDIC Structured Sales Program:** Very popular in the beginning but many groups are tired of investing the money in the due diligence process (which can run a firm upward of \$500,000 not including the refundable \$250,000 you give to the FDIC). Those that have won bids in the past are glad this is happening as it improves their odds in future deals as interest wanes from their competition. Also, the fact that they have partnered with the FDIC in the past bodes well for these groups as the FDIC likes familiarity.
- **Talk Directly to the Banks:** Good idea for investors targeting secondary and tertiary markets for assets collateralized by loans made by midsize and community banks; it's tougher to deal with the larger banks and the primary markets. CBRE has a number of clients that have had success by doing quiet, "off-market" deals with their contacts at their local community banks and/or "small/regional banks". Again, the banks that have the capital buffers to sell assets that don't fit into their portfolio (via perhaps the acquisition of another bank) or assets that they deem to be problematic in the future are still willing to sell loans/REO but many (most) of the loans and REO are unattractive to the large fund investors.
- **Become a Lender:** This option has lots of positives if one would concentrate on mezz and preferred equity ventures to fill the capital void for maturity

defaults as banks and servicers are encouraged to workout and restructure loans. It's vital for these lenders to have strong relationships with both the borrowers and the banks so while many groups will have this focus, only a few will be standouts (and those that do stand out will do very well).

- **Be creative:** there are very few trades out there via traditional methods. Focusing on niche opportunities (UCC Sales, 363 Bankruptcies¹³, etc.) will place one ahead of the competition by minimizing the buying pool. This helps in two regards: 1) The obvious: The fewer buyers in the pool, the higher the probability you can win (given an even playing field) and 2) Many "non-professional" investors that are overpaying for assets in a "traditional" manner ("traditional" defined as buying loans or REO) will not look at 363 bankruptcy or UCC foreclosures as they don't want to overcome the learning curve. The sophistication of the bidding pool should mean that the bids come in with less variation from the mean than offerings where anyone and everyone is planning to participate.

Good hunting!

13. UCC sale process is one where a mezzanine lender forecloses out the equity while keeping the senior debt in place. The 363 Bankruptcy sale is similar in that we run a "full and fair" process for the benefit of creditors to determine a winner. Lenders often prefer the UCC foreclosure to the first mortgage foreclosure because it is typically much faster (and non-judicial). There are similar things that can get in the way however (such as bankruptcy of the borrower or entity). It is worthy of note that distress values are rising and at some point they will reach the point where someone other than the mezz lender is going to show up at these auctions and may win on pure economic value (as opposed to the option value embedded in the security). We are not there yet (particularly for the development deals), but may be getting closer

BIOGRAPHIES OF AUTHORS

Mark Gallagher is a Senior Strategist in the Investment Strategy Services (ISS) Group of CBRE-Econometric Advisors.

Prior to joining CBRE-EA, Mr. Gallagher was a Vice President at Centerline Capital Group, where he worked on high-yield debt acquisitions for the firm's managed funds, conducted CMBS acquisition due diligence, and underwrote agency multifamily mortgage originations. Previously, Mr. Gallagher was an Investment Officer in Real Estate Capital Markets for the John Hancock Real Estate Finance Group where he worked on a team responsible for acquisitions and portfolio management of CMBS, real estate-backed CDOs, and real estate fund investments.

Mr. Gallagher earned a M.A. in economics from the University of California, Santa Barbara, and is a CFA charterholder.

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Spencer Levy is Senior Managing Director in CBRE Capital Markets, responsible for more than 300 investment sales and debt/equity finance professionals in the Eastern United States. In addition, Mr. Levy is the national co-head of CBRE's Recovery and Restructuring Services (RRS) initiative. RRS works with banks, special servicers, government entities and borrowers to assist them with their commercial real estate services needs with large portfolios of distressed whole loans and REO and complex individual distressed assets. Prior to joining CBRE, Mr. Levy was a Principal at Stifel Nicolaus (formerly Legg Mason Capital Markets), and also served as Assistant General Counsel of the Witkoff Group. He is a Harvard Law School and Cornell graduate.

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Raymond Torto is CBRE's Global Chief Economist. He directs CBRE's worldwide team of commercial real estate market analysts and serves as the firm's primary spokesperson on macro economic issues and the global commercial real estate market.

He is active in many organizations, including the PREA Board and ULI. A former Professor, and author, he teaches Executive Education in the Harvard School of Design. He holds a Ph.D. from Boston College.

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Wesley Wells is an Associate with CBRE Capital Markets and is an integral member of Recovery & Restructuring Services (RRS). RRS serves clients that have a need to address problematic assets that include non-performing & sub-performing loans as well as REO that has found its way onto the balance sheet. RRS specifically represents stakeholders in distressed asset scenarios, namely creditors, debtors, trustees and purchasers, throughout every stage of the asset life cycle.

Mr. Wells is responsible for developing relationships and communicating with interested acquirers of distressed assets that come to market through the RRS platform, specifically hedge funds, private equity investors, distressed real estate funds, foreign investment groups and high net-worth investors. He is also licensed by FINRA to participate in real estate related securities transactions with CBRE's investment bank, CBRE Capital Advisors.

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