

FINANCE

Advisors and Investors Prepare For Uncertain Debt Markets

Receivers, special servicers and others meet at San Diego conference to discuss challenges posed by troubled loans

BY MANDY JACKSON
CREJ Staff Writer

Commercial mortgage delinquency rates are low, but receivers, special servicers, attorneys, advisors and investors are preparing to meet the next wave of defaults.

Attendees at the recent Trigild Lender Conference 2008 in San Diego converged at the Omni San Diego Hotel from Oct. 22 to 24 to talk about dealing with distressed debt during the three-day conference hosted by Trigild Inc., a distressed property management, loan recovery and real estate receivership specialist headquartered in San Diego.

Bill Hoffman, president and chief executive officer of Trigild, said that his company hears about loans in which the borrowers may run into trouble long before they go into default. That's why Trigild and many other businesses that specialize in distressed debt began gearing up for an onslaught of new workout and receivership assignments last year.

"There are very few companies that have been doing this for many years," Hoffman said.

A lot of businesses get into loan workouts during bad times in real estate, a practice that is common among developers who have little else to do during a downturn.

Now, he said, dealing with troubled loans and the related assets is seen as more of a specialty business and lenders are reluctant to work with developers who participated in the past

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few years of aggressive real estate investment, especially builders who had trouble on condominium projects.

Of 50 distressed assets Trigild is overseeing currently, 35 are condominium projects and rental apartments converted to for-sale condominiums.

Hoffman said borrowers behind traditional commercial real estate assets will be the next developers and investors to default on their loans, though the fallout will not be as bad as it has been in the condominium market. He said it appears that condo-hotels are next in line to fail, since those projects were overbuilt and undersold.

Hoffman expects the number of distressed hotels to double or triple in the next year. As banks are faced with more borrowers looking to restructure the debt on their hotels to avoid a default, he said lenders are more likely to put hotels into receivership, especially those that were struggling long before tourism and business travel slowed this year.

Unique Challenges

"We're now at a point where the securitized loans are starting to fail," said Stacey Berger, executive vice president for corporate strategy and business development at Midland Loan Services in Bethesda, Md., during an Oct. 23 panel on unique challenges in this next phase of rising mortgage delinquencies.

The delinquency rate for loans held in commercial mortgage-backed securities was 0.53 percent in the second quarter, up 0.05 percent from the first quarter of 2008, according to the Mortgage Bankers Association. Delinquency rates were below 1 percent during the second quarter for all commercial and multifamily lenders, except for banks and thrifts with 1.18 percent of their loans 90 or more days delinquent.

Lisa Brazie, strategic consultant in the Dallas office of law firm Alston + Bird LLP, said if any of the mortgage holders in one asset's capital stack is a securitized lender, then that entity could become the lead lender in terms of making decisions about any kind of a workout, resolution or modification.

Brazie also noted that if there is a mezzanine lender involved in a distressed asset, then the mezzanine debt provider has to sign off on any loan modifications along with the other lenders. Such necessary approvals can cause a stalemate.

"We don't necessarily believe these [structured financings] can't be worked out," said Peter Korda, partner with law firm Seyfarth Shaw LLP in New York City.

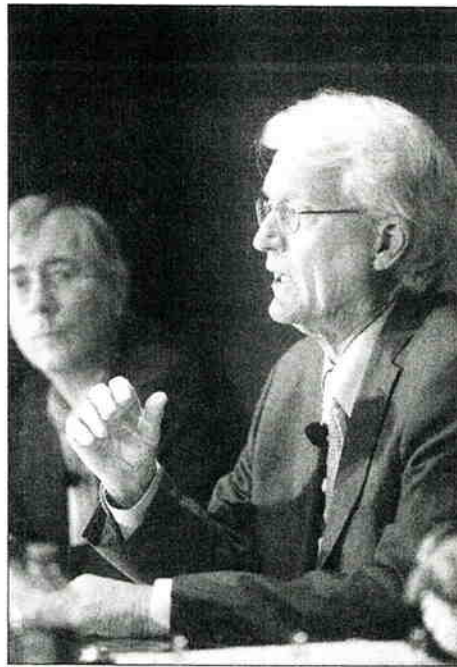
Korda said subordinate lenders have rights, until circumstances trigger an appraisal and there is a downward revision of the asset's value. The lead lenders can keep ordering appraisals to retain control of an asset's debt, but that adds time and cost to a process in which losses are already mounting.

Michael Criscito, managing director in New York City at Credit Suisse Securities (USA) LLC, said he already has been involved in a number of distressed properties with many layers of financing, and conflicts are numerous as lenders attempt to unwind the debt.

Attorneys looking at the intercreditor agreements once an asset is in distress read the contracts differently than the counsel who wrote the documents, Criscito said. There are often conflicts about when special servicers are required to take over servicing the debt.

"We have seen issues on the servicing side where the parties had draft documents, but not execution documents," Berger said. "There are different rights and definitions that don't sync up with servicing."

Loan servicing agreements were drawn up



Bill Hoffman of Trigild Inc. discussed action alternatives for distressed commercial loans at the Trigild Lender Conference 2008 on Oct. 23 at the Omni San Diego Hotel.

and signed quickly to get transactions and loans to close on time with the intent to get some signatures and close some loopholes after closing, but Korda said those blanks often were never filled in.

"We spend more time on the discrepancies in these documents than working on the problems with the loan," Brazie said.

Working it Out

Kevin Semon, special servicing manager at Midland Loan Services in Kansas City, Mo., said during an Oct. 23 panel on alternatives for dealing with problem loans that his company is seeing borrowers who've thrown their hands up in the air and don't want to work out the problems with their assets and avoid default on their loans.

Midland is trying to work with borrowers who want to stick with their properties and see them through to the best possible ending.

Gary Marsh, a partner in Atlanta at law firm McKenna Long & Aldridge LLP, said some borrowers are beginning to claim that their lenders talked them into signing up for risky loans or they're claiming other misdeeds on the lender's behalf.

Marsh advised lenders not to move too quickly and give borrowers plenty of notice regarding the potential for default, to be friendly and objective in communicating with borrowers, and to be cautious in talking to third parties who might be asked to intervene in a receivership or some other means of working out the debt.

Like doctors, the first rule of workouts is "first do no harm," according to Margaret Mann, partner at Sheppard Mullin Richter & Hampton LLP in San Diego.

Mann said the guarantor behind a troubled loan can be a lender's best friend, worst enemy or even a landmine. That's why lenders should proceed cautiously in attempting to extract collateral from guarantors of bad debts. It's likely that the guarantor will move ownership of assets claimed as collateral to new entities to avoid foreclosure.

"Keep the borrower involved," Semon said. "Try and keep them at the table as best you can to try and facilitate a resolution."

That way, lenders may be able to resolve a troubled loan in 60 to 90 days rather than wait out a protracted foreclosure. Midland often has two different forms of resolution in play at the same time to seek the best result. The notes securing a bad loan may be readied for sale while the borrower pursues a buyer for the real estate, in case the borrower can sell the asset for more than the mortgage notes are expected to generate.

Buying Bad Debt

During a discussion of the sales of distressed debt and recovery of funds on Oct. 23, Jason Carney, of Silver Point Capital LP in Greenwich, Conn., said the speed of execution is everything to lenders who are trying to sell troubled loans. Carney is responsible for sourcing, evaluating and executing whole loan acquisitions and other distressed or subperforming debt instruments for Silver Point, a private equity fund.

"They're focused on getting the loan off the balance sheet," he said. "Price isn't so much an issue as certainty of close."

David Tobin, principal at Mission Capital Advisors LLC in New York City, said some sellers of troubled real estate debt are indicating at auction that they can't dispose of loans at the prices bidders are willing to pay, while others realize that the bids are all they can get for the bad debts.

"Anyone who sold in the last 18 months is happy now," Tobin said.

The problem now is that both sellers of distressed debt and buyers don't know where to set the values for problem loans in light of the ongoing tightness in the credit markets. And it may become even more difficult to assess real estate debt values as investors compare opportunities.

Tobin noted that corporate bond defaults are expected to triple in the next year, giving investors the option of buying bad debt from highly rated corporations or debt secured by real estate that is likely to be slow to perform.

Lorne Polger, senior managing director at San Diego-based Pathfinder Partners LLC, said just one year after founding the opportunistic investment company, it became clear to Pathfinder's partners that the opportunity to buy distressed debt and control commercial real estate would be bigger than anticipated.

The private venture formed in 2006 to buy first trust deed loans in which the borrowers were in default. Initially, the focus was on apartment properties and distressed condominium conversions. The company expanded its geography and property types and now looks at troubled loans on commercial properties in California, Florida, Texas, Arizona, Nevada and Washington.

Last month, Pathfinder Partners entered into a joint venture with I3 Realty Ventures LLC, whose four principals are senior executives with Grubb & Ellis/BRE Commercial in San Diego, to collaborate on investment opportunities and work jointly to raise capital for Pathfinder's second distressed commercial real estate investment fund.

The partners expect to raise \$50 million in equity by 2009 to invest with other equity partners in up to \$500 million worth of real estate next year. Pathfinder is targeting acquisitions in the \$10 million to \$25 million range, though trades as low as \$5 million will be considered in Southern California.

Polger noted that the company is still finding a disconnect between what banks want to sell distressed debt for and what buyers are willing or able to pay. Pathfinder is looking for prices that allow the 15 percent to 20 percent internal rate of return that the company and its investors need to justify holding troubled assets for three years in an environment where capitalization rates are rising.

Polger anticipates a change in asking prices for distressed debt as losses mount for banks. They'll run out of capacity to hold bad loans, so they'll have to start selling quickly and at lower asking prices.

Pathfinder offered to buy a bank loan it valued at \$21 million in summer 2007, but the bank wanted \$25 million. Now, the investor is offering \$7 million and it looks like the buyer and seller may be closer on a price for the debt on the same asset in Florida.

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Economist Expects Credit To Remain Tight into 2010

FINANCE *Weakness among property types conflicts with fundamentals underwritten in commercial real estate loans in recent years*

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Fundamentals for commercial real estate are weakening across property types, which doesn't help an investment market that is already struggling from a lack of available credit in the financial marketplace and lenders facing rising delinquencies.

Sam Chandan, chief economist for Chicago-based commercial real estate data provider **Reis Inc.**, gave an overview of U.S. commercial property types and market conditions during the final day of the Trigild Lender Conference 2008 on Oct. 24 at the Omni San Diego Hotel.

San Diego-based distressed property manager and receiver **Trigild Inc.** hosted the annual event that brings together loan servicers, attorneys, investors and others who focus on troubled commercial real estate debt.

While delinquencies still are low for loans financed by conduits for commercial mortgage-backed securities, Chandan said the delinquency rate is rising and the CMBS market will begin to see more systematic defaults during the last quarter of 2008 and into 2009.

"Businesses and households have less access to credit than they have had in decades," Chandan said. "Things have not been this dim in the post-War period."

For many households, servicing the debt on their home loans is impinging on their ability to buy things other than necessities. That's bad news for businesses, Chandan noted, because they can't increase prices for their products enough to cover rising production costs when consumers are spending less money.

"The general consensus is that the economy will continue to slow in the fourth and the first quarters and won't get back to a normal rate of growth until 2010," Chandan said.

Because the economy took a turn for the worse faster than lenders expected, vacancy is rising and rent growth is below expectations and it is more difficult for borrowers to refinance debt.

Chandan said commercial mortgages have a delinquency rate of 1.3 percent now and he's expecting that number to reach 5 percent in a year, but whether or not those delinquencies turn into defaults depends, in part, on lenders' willingness to modify loans to keep the borrowers from defaulting.

"Insuring the orderly refinancing of commercial mortgage debt will be one of the most important challenges we face," he said, noting the problem will be less disruptive than it has been in residential real estate.

Retail seems to be the first of the traditional property types to struggle as consumers cut their spending. Retailers, such as Starbucks, that opened too many new stores during the housing boom are closing locations that are not performing.

With \$80 billion worth of office, apartment, retail, industrial, portfolio and privatization transactions during the first half of 2008, Reis is projecting a \$159 billion total for the entire year, which would be one third of the \$467 billion in investment activity seen in 2007 and half of the \$342 billion spent on commercial real estate in 2006.

"Activity will continue to be slow," Chandan said. "The broad expectation is that lenders

will tighten loan standards and lending at least through mid-2009 and credit will still be tight through 2010."

The multifamily market remains fairly stable because the government-sponsored enterprises, **Fannie Mae** and **Freddie Mac**, have done about 80 percent of the lending for apartments this year. Since the companies are now under federal government conservatorship, Chandan said the main concern is that multifamily lending programs will be modified or reduced as regulators reform Fannie Mae and Freddie Mac.

Apartments saw price appreciation of 56.6 percent nationally between third-quarter 2003 and the peak in 2007, dropping 13.8 percent from the peak to second-quarter 2008, according to Reis. Industrial asset prices increased 70.1 percent and office building prices jumped 78.2 percent from third-quarter 2003 to their peak last year and lost 6.7 percent and 11.2 percent, respectively, of their value since then.

Retail assets gained 85.4 percent in value from third-quarter 2003 to first-quarter 2006 and have lost only 4 percent of their value, according to Reis.

"There is a tremendous flight to quality," Chandan said.

In retail, investors are buying only the best assets because of concerns about consumer spending. Apartments continue to trade at all levels because financing is relatively abundant compared to other property types. For office buildings, capitalization rates are trending up, but Chandan said many sellers are not compelled yet to sell at lower prices.

That could change as fundamentals worsen. For U.S. office properties, vacancy was 13.7 percent in the third quarter, rising from 13 percent in the second quarter and 12.8 percent in the first quarter, according to Reis. Rent growth slowed to 0.1 percent in the third quarter from .8 percent in the second quarter and 1.5 percent in the first quarter.

"The gap is widening between effective rent growth and the expectations in the underwriting," Chandan said. "It's still manageable compared to 2001 to 2002 and the '80s. There's less overbuilding."

Reis is projecting that the national average for office vacancy will peak next year and continue falling through 2012. Chandan also noted that rents have increased 25 percent since 2003, so even if office rents come down 10 percent landlords still have a cushion in their assets.

U.S. apartment vacancy has been trending up all year, reaching 6.1 percent nationally in the third quarter, as condominiums steal apartment renters and tenants double up in one apartment to save rent. Multifamily rents have increased by 1 percent or less year-over-year for each of the first three quarters of 2008.

"It's difficult to raise rents when wages aren't growing," Chandan said.

Rents are declining nationally for retail properties, dropping 0.2 percent in the third quarter after a 0.1 percent decline in the second quarter and 0.1 percent gain in the first quarter. Retail vacancy has grown to 8.4 percent from 7.7 percent at the beginning of the year.

"The capacity of real estate to meet expectations has been undermined," Chandan said.

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