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## **Distress: The Waiting Game**

*By Alyson Grala*

For the third month in a row, acquisitions of office properties increased in July, albeit modestly. However activity remains muted and sales of distressed properties, expected to be the catalyst to re-energize investment, have yet to materialize in earnest. There is no shortage of distress--\$17.4 billion of office properties are known to be in trouble, according to Real Capital Analytics' August 2009 Month in Review report, but lenders are in little rush to foreclose.



**Nicholas Minoia**

Many pundits and the administration in Washington have declared we have hit bottom and better days are ahead for real estate. But residential indicators are generating mixed signals. Existing home sales velocity has risen and the Case Shiller Index released in August points to prices having risen 1.4% nationwide in June.

"Foreclosures continue to rise as residential mortgage delinquencies mount," says Mark Scott, senior vice president and managing director of NorthMarq Capital in Parsippany. "Until a clear bottom has been put in the residential market and consumer confidence continues to rise--the Consumer Confidence Index did in fact rise in August--positive signs on the commercial real estate market remain remote."

Most commercial real estate lenders have yet to admit and realize their losses on commercial real estate and proffer assets to the huge pools of opportunistic buyers waiting on the sidelines. "

Buyers are seeking high returns for taking on risk in today's commercial real estate market as fundamentals remain questionable," Scott says.

And lenders, at risk of adversely impacting their capital base now, are extending and amending loans rather than admitting their losses by foreclosing and selling assets in today's difficult environment.

"You've heard the expression rolling loans gather no moss," says Mark Antoncic, managing member of Greenwich, CT-based Carpathia, which was formed earlier this year as a Tuckerman Group/TriLyn LLC JV to assist real estate investors, lenders and advisors in managing their assets. "Well, that's essentially what's happening today. In most cases, if the banks marked their commercial loans properly today they would be insolvent."

Antoncic points out, "The FDIC is already inundated with assets so it's placed the banks in a holding pattern in order to position itself properly."

In fact, the number of troubled banks rose to 416 at the end of June, up from 305 at the end of March, according to the FDIC. This is the largest number of banks on its problem list since June of 1994, when 434 banks were highlighted. Assets at troubled banks, meanwhile, totaled \$299.8 billion, the highest level since December 1993.

Community banks are having a particularly tough time, says Nicholas Minola, managing partner of Diversified Realty Advisors in Summit. The advisory services group was formed in May to provide a host of services related to workouts, foreclosures and note restructurings.

The real problem banks are having under a mark-to-market concept is that regulators are beginning to move more aggressively against banks, especially on the community banking level. As a result, banks are becoming more aggressive against their borrowers so that they can more quickly address the pressures that have been put on them by the regulators.

"We are seeing a greater sense of urgency right now to resolve loan

issues," says Jonathan Stein, also a DRA managing member. "This brings the workout strategy to the forefront of the process because it can be implemented in a much quicker timeframe than waiting for foreclosure action, which can take 18 months."

Add a bankruptcy to the mix and this could drag the process out by another six months.

There's also a balance between expediency and recovery that needs to be reached by the lenders. "In most cases, the quicker you want an issue resolved, the less you are going to receive in terms of recovery. This is a constant struggle with lenders," Stein relates.

Because of the current regulatory climate, there is more pressure to resolve loan issues quickly, so banks are more open to the idea of granting concessions to borrowers as they move through the workout process. Having said that, if the asset is far along in the foreclosure process, lenders are less likely to grant concessions at the risk of prolonging the process.

There are several types of concessions that lenders may be willing to grant, such as discounted pay-offs or modifications that make it possible for the borrower to pay at a lower rate, lease up the property or make the loan current. "There are many opportunities and it's incumbent upon both the banks and borrowers to be creative to find the most advantageous solution," Stein adds.

While workout strategies run the gamut, some due diligence work is usually necessary. DRA looks at everything from borrower/guarantee documents to financial statements and tax returns to help determine an appropriate course of action.

"Some of these loans are already in foreclosure, but some of them are simply delinquent, which means the term has expired but a demand letter has not been sent out to the borrower," Minoia explains. In certain cases, the firm will even hire a private detective to determine the current status of the property and the borrower.

"We also look at updated title searches to see if there are a lot of liens behind the bank liens," Minoia says. "It may rule out an immediate deed in lieu of foreclosure transaction, which oftentimes we recommend to the banks so that they can quickly get their arms around the collateral, step into an ownership role and sidetrack an 18-month foreclosure process. But if there are a large number of

construction-related liens behind the bank then it doesn't do much good to take the deed since you can't spin it out the back door."

According to David Csontos, executive managing director of FirstService William's New Jersey office in Parsippany, lenders are also providing inducements, such as a reduced principal amount, to their borrowers to repay sub-performing loans sooner rather than later. An unfortunate circumstance in the current market, he says, is that "the loan servicers for the CMBS sector are so overworked with problem loans that good borrowers and loans are contemplating defaulting on their obligations to get the lenders attention and negotiate a workout."