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The Line Reports from the CRE Finance Council Conference: Distressed Asset Investors "Back on Offense"

Posted on **June 16, 2010** by Peter K. McKee, Jr.

Panelists from Brookfield Real Estate Financial Partners, Eastdil Secured, The Blackstone Group, Oaktree Capital Management and PCCP surveyed the state of the distressed asset market and the motivations of buyers and sellers.

So how does the market look?

Eastdil's Matt Borstein said that last year's trades at 30-35 cents on the dollar for senior debt had moved to 80-85 cents for better product this year. "It's a good time to be a seller."

Blackstone's Frank Cohen noted that it wasn't such a bad time to be a buyer either: "It's a good point in the cycle; fundamentals are improving and prices are relatively low for some assets. Early on, we bought up in the debt stack; now we're looking at bigger loans and messier situations as opportunities: more B-Notes and mezzanine positions."

For Oaktree's Keith Gollenberg, there were opportunities, but not the deal flow his firm expected. "An equity gap of \$200-400 billion is looming. It's ok to be a buyer today, but there will be better buys later. Many properties are in deteriorating condition, and the need to fund those capital expenditures will create more sellers."

Bill Lindsay from PCCP felt that the capital markets were a little ahead of property fundamentals: "Prices are a little high."

What about market conditions six months from now? "Waiting is better for buyers," said Lindsay. Borstein observed that good prices have been drawing out sellers. Cohen looked for 2011 to be key for distressed asset opportunities: "Banks by then will have had two full years to bulk up their reserves; they'll be prepared to sell and there will be more stuff to choose from." Gollenberg largely agreed, sensing that banks were more willing to support better properties and liquidate the weaker ones.

Several panelists thought there was abundant capital chasing deals, but there were also differences between sectors. Hotels are attracting attention because of the shared perception that fundamentals are bottoming and getting better. 2010 earnings are likewise expected to show marked improvement. For the office sector, investors see that "bouncing along the bottom," and markets in California, Atlanta, Boston, and Miami won't pick up until job growth returns.

What of investors' expectations? "Last year investors were looking for 20% unlevered returns, but now there's a ton of capital chasing a few deals—we're happy with a 10-12% return for several years and we'll recycle those funds later," said one panelist.

Cohen intoned that everyone had been playing 100% defense since 2008. "Now we've got the ball." Real estate has been under-allocated in most portfolios. Another panelist extended the metaphor: "Investors last year were afraid they were throwing good money after bad. With the emergence of a robust note sale market, there are more pages in the playbook. The market is more stable. The debt capital markets are functioning. Prices have increased."

Brookfield's Andrea Balkan, as moderator, pressed the group for strategies to achieve those 20% returns.

"We haven't seen trades that generate those kinds of returns. If you modify the senior debt to reduce debt service, you're willing to operate the asset and you have a 'value add' strategy, you can get there, but you have to work," said Lindsay. Cohen was more willing to look at purchasing down the debt stack, essentially buying subordinate positions for their "option value." Gollenberg said that what capital has to do today is to get the debt, turn it into equity, and stabilize the asset.

The discussion turned to changes in investor approaches: "Are people getting smarter about what they're buying?"

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The panel said they'd seen some cross-over buyers (investors with core businesses outside real estate) that were chasing yield, but, certainly in highly structured loan structures, there were many traps for the unwary. Control also plays a critical role: "We only buy where we have control," said Balkan of Brookfield's strategy. Loan participations and syndications were not favored investment vehicles.

With the expected flood of CMBS loans transferring to special servicing (20-30% by some estimates), what about deal flow from special servicers? Borstein said that Eastdil was marketing \$1.1 billion in specially serviced loans for LNR, and that the deal would serve as a barometer for other loan pools from special servicers. Said Borstein: "There is a take-out for distressed assets."

Gollenberg pointed to another driver affecting special servicers' motivations. To work out loans on the scale that's envisioned means hiring more people. Liquidating loans is a more lucrative option for special servicers, he said, if (alluding to compliance with servicing standard) it makes sense for the trust. And there's no need to increase staff with a liquidation strategy.

Finally, in response to an audience question, the panel was asked what returns their respective firms were looking for. One answered that their approach was to analyze each deal by looking at a 10 year unleveraged return. On that basis, between 10 and 11% seemed typical, but that outcome depended on a value-add component. What happened to higher return hurdles? "No one wanted to sell at 15% unlevered return levels."

And so, with property fundamentals stabilizing, debt markets functioning and ample capital to deploy, many investors see reason to step up their activities and increase their allocation to real estate. The availability of product seems to be a greater impediment than any overriding concern about the wisdom of recommitting to the sector.