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## The Line Reports from Andrews Kurth's Mid-Year Real Estate Roundtable - Part I: "Trophies and Train Wrecks": Distressed Asset Strategies and Opportunities

Posted on **June 25, 2010** by Peter K. McKee, Jr.

Andrews Kurth hosted its 2nd Annual Mid-Year Real Estate Roundtable on June 22. The panel included Lindsey Wright from special servicer C-III Asset Management, Trey Morsbach of the real estate services firm HFF (Holliday Fenoglio Fowler), Bert Crouch of Invesco, an institutional investor and pension advisor, and Andrews Kurth partner Pat Sargent, who is also the immediate past president of the Commercial Real Estate Finance Council.

Lindsey began the discussion on distressed assets by describing C-III's special servicing portfolio. As the nation's third largest special servicer, C-III has seen a spike in the last two years in loans that have transferred to special servicing. That number is now some 700 loans totaling \$11 billion in special servicing and represents about 10% of its CMBS loans by loan volume. "Loan delinquencies are over 7.5% and on their way to 8%, with no sign of dissipating in the near future." What's behind the surge in transfers? Lindsey explained that most transfers are the result of imminent (rather than actual) default, and typically stem from looming maturities, shortfalls in available refinancing proceeds, or lease renewals where additional capital is needed that the borrower is unwilling or unable to provide. As for the sectors with the highest delinquencies, retail led the way in C-III's portfolio, followed by office, hotel, and multifamily, a trend that also happens to coincide with their loans that are on "watch list" (CMBS loans whose performance is stressed, but is not yet to the point of being transferred to special servicing).

What of markets and asset types that are the most represented by servicing transfers? "Texas multifamily, California multifamily and retail, everything in Florida, and, not surprisingly, Ohio and Michigan."

Foreclosed properties (REO) among C-III's loans have roughly quadrupled from about 22 a year ago to over 80 (and climbing) today. Lindsey attributed that increase at least in part to C-III's willingness to foreclose where the borrower was not viewed as being a part of the solution to addressing the property's management or capital needs.

To balance any perception that C-III was precipitous in favoring that outcome, however, she added that the special servicer resolved about \$800 million in loans last year and was already closing in on \$1 billion in loan resolutions this year, 70% of which involved modifications, forbearance, or extensions resulting in corrected, performing loans that were pushed back to master servicing.

Trey connected the pattern of distressed loan data not to performance, but to markets and asset sectors where there was too much leverage at CMBS lending's zenith, particularly Texas multifamily, and, more broadly, Florida and California. He added that Michigan and Ohio have underperformed for some time.

Bert added another perspective: "CMBS is, by virtue of its breadth, a good cross-section of the commercial mortgage markets, but over 90% of it is fixed rate." Where will the bulk of the distressed market be? It will be in the floating rate loans that were secured by transitional assets without stabilized income. "Look at this in the context of interest rates," Bert continued, "the LIBOR index has historically been about 10 times higher than it is right now, and these properties are still becoming distressed. There are a variety of factors that can shift the data in various ways. Delinquencies would be higher if so many floating rate loans' debt service was not artificially low. CMBS loans that are not really distressed still show up in special servicing statistics (GGP's retail mall-secured loans being the most celebrated examples), the result of IRS changes to REMIC regulations that were intended to encourage loan extensions and modifications. On the banking side, the FDIC's guidance on loan modifications lessened the impetus of banks to mark loans to market at trough-level pricing, skewing the picture of that sector. Total commercial mortgage delinquencies are in the vicinity of 5%, and half of that's with special servicers."

Explaining the misperception created by the REMIC changes in particular, Pat reminded the audience that it's the Pooling and Servicing Agreement that really governs what the servicer can do. "The servicer's duty of care is to maximize proceeds to the securitization trust on a net present value basis. Despite the effect of lowering the REMIC hurdle by permitting

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modification for defaults that were 'imminent' as well as actual, the PSA's contractual hurdle still remains. Some people wrongly counseled borrowers to quit paying. The actual change was not significant, but borrowers were spurred to ask for modifications without considering whether the modification would satisfy the requirements of the PSA's servicing standard. Still, there are cases where a loan modification is arguably in the best interests of the property, as in the situation where the borrower is willing to fund capital improvements for a lease renewal, but a loan extension is necessary for the investment to be justified."

Asked what borrowers should do to improve their chances with special servicers, Lindsey concurred that stopping payments would not get things off on the right foot. "The PSA governs who does what, and you have to go through proper channels, which starts with the master servicer. Define your plan. Substantiate it. Don't expect anything without work. The master servicer will likely talk with the special servicer. These days we're talking on a daily basis. Borrowers should be proactive and bring something to the table."

Asked for his assessment of whether borrowers were, as a panel at a servicer's conference put it, "delusionally optimistic," Trey admitted to being optimistic himself. "We have had liquidity throughout this financial downturn, but people did not like proceeds and price. There are more embedded capital sources now than we have had in the last 10 years. There is a dramatic shift in debt capital availability. It's as if everyone's light switch went on at the same time. Other debt sources were emboldened once they saw that Wall Street had figured out how to regain its footing, and securitization was a viable exit strategy once again. Life companies have been ravenous. Even banks, too, though they were the last to show up. But what's the other side of the story? All that debt capital wants the same thing: trophies and train wrecks. If you have a core asset (a high quality property in a gateway city market with good sponsorship), you can readily get 20 bids for debt at prices that would absolutely astound you. At the other end of the spectrum, capital is lined up for transitional assets, too, but at levels between 300-500bp higher. There's limited but expanding capital options for the middle of the market, which represents about 80% of real estate assets. So if you're an owner of an institutional quality asset or you're buying a transitional asset at a low basis, you've got reason for optimism. For the folks in between, it's a different story."

We'll continue this discussion in our next post.