

# Real Estate Journal

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## The expanding universe of distressed assets: Commercial real estate



Aynsley Catalano of Catalano Associates

We have all been exposed to the "other shoe" theory with regards to commercial real estate. While the current climate suggests that the foreseeable future will be a festival of pain for all classes of commercial real estate, it is also unlikely that there will be wholesale foreclosures either. This column is two-part attempt to show the dovetailing between capital market trends, anticipated workouts and valuation processes as macro-economic forces continue to apply downward pressure on markets. The first segment will address ongoing capital market issues as well as generally accepted theories regarding future maturities. The second segment is more nuanced and outlines some of the challenges facing commercial real estate appraisers as the volume of distressed assets continue to grow.

### Workouts vs. Foreclosures

Most lenders do not treat commercial real estate (CRE) collateral the same as residential R.E. CRE loans tend to be larger, are often collateralized with other commercial property and are more complex in nature. It is estimated that Wall St./CMBS accounted for between 40-50% of all CRE lending between 2005 and Q3-2008. Today, that number is less than 5% (some say zero). Breaking off one bad apple from a CMBS is not as easy as sounds. As an aside, a segment of CMBS "special servicers" lack the capacity to manage or divest of distressed assets in-house, nor the capability to carve out "performing" assets within a tranche. (that may be a topic of an entire other debate). Complicated financial engineering does indeed have its disadvantages. There are no winners in a foreclosure and there is often incentive for creditor/debtor to work together to find a way through the darkness by means of debt restructuring or aptly-named "workout." In fact recent FDIC guidance stated that "prudent CRE loan workouts are often in the best interest of financial institutions and credit-worthy borrowers." When distressed assets are often liquidated between 20-80 cents on the dollar, foreclosure is the absolute last resort. These are just some of the reasons commercial lenders have not taken write downs on the same scale as

residential loans.....yet.

### Exhibit A: Capmark Financial

Enter, or shall we say "exit" Capmark Financial Group (CFG), a re-branded GMAC unit that filed for bankruptcy October 26th. CFG was the 3rd largest CRE lender, servicing or originating \$360 billion in CRE debt. As many CRE lenders struggle and continue to "kick the pile down the road," Capmark's Chapter 11 filing could denote rough sailing ahead for others as well.

Capmarks failure is relevant and provides some anecdotal evidence that portfolios of dysfunctional properties/loans continue to pose a very real threat to the capital market system. Capital markets will continue to strain, with selective lending going forward. Debt structure will be comparatively higher for all but "A" properties and "A" credit borrowers. Distressed collateral will have little maneuverability in terms of re-financing options. The same capital market constraints will also exacerbate any REO sales efforts by weakening buyers' purchasing power. Tight credit policies along with the volume of distressed assets and maturing loans will likely handcuff creditors into the workout route.

While I'm not suggesting appraisers have any insight on lender or CMBS portfolio leadership policy, we could conclude that more distressed assets will be in "workout" rather than foreclosure in upcoming years. While this assertion could be proven incorrect, understanding, managing and valuing distressed assets will be imperative going forward. Continued...

### Part II:

#### Distressed Asset Valuation

In a valuation context, distressed assets can be far more complicated relative to performing, or "stabilized" assets. Complexities include unfinished/damaged improvements, lease-up costs, changing rents/contract renegotiations and possible repositioning of the entire property (if it no longer serves any demand).

When called upon to appraise, consult or advise on distressed assets, the analyst(s) need to quickly recognize the nature of the distressed asset and employ the appropriate methods. In short, that means that the valuation models and techniques should emulate "the market" and its participants.

#### DCF vs. Direct Capitalization

To be more specific, we see an increased need employ multi-year cash flows (DCFs) as opposed to the more common and simple single year, or "direct capitalization" technique. DCFs were developed to account for irregularities in cash flow and we could not think of a more "irregular" time than now.

#### Turning the Dials

All appraisers and analysts rely on a myriad of fact-based assumptions within the valuation. Larger distressed assets with more moving parts require more assumptions, or inputs. The appraiser/analyst should take care to not lean too far one way or another during the course of

the analysis. While this is common sense, it is worth remembering this point especially when many types of distressed assets require complicated modeling.

There are a lot of inputs, or “dials” as we can often call them. The more dials you have turned in the wrong direction results in error. A good appraiser can moderate these dials based on experience.

e.g. estimated market rent for a particular type of vacant property should not be at the upper limits of a range, while simultaneously selecting the shortest absorption period. You can’t turn all the dials in one direction (negative or positive) within a supported range.

#### Types of Value

In some cases, it may be appropriate to estimate several value scenarios for a particular client. Market Value, Stabilized Value and Liquidation Value all have very different meanings and relevance to a particular user of an appraisal. Value definitions extend beyond these as well. Dialogue between appraiser and client should extend to discover the exact purpose of the appraisal in order to establish which value(s) should be developed. Additionally, the client may want to know the value under a few “what-if” scenarios.

#### Owner/Debtor Cooperation

Another hurdle in valuing distressed assets can sometimes be the...shall we say, less than cooperative ownership. The same responsive owner willing to assist in any way necessary by perhaps emailing floor plans and lease abstracts ASAP in 2005, could be the same contact person that at best gives lukewarm cooperation in 2010. Although there is not much we can do if we’re stonewalled, appraisers need to treat some of these meetings with “kid gloves” and are often called upon to “negotiate” the surrender of current information such as lease defaults and renegotiations.

As 2010 quickly approaches, we are all asking the same question.....Is commercial real estate the preverbal “Other Shoe” to drop? Like everything else these days, the answer is both yes and no. Regardless, most of us can agree that those involved in commercial real estate should become comfortable with the analysis, valuation and management of distressed assets.

Aynsley Catalano is principal/manager of Catalano Associates Duxbury, Mass.