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Commercial loan play - Better than the building itself?

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It's no news that commercial real estate is in a slump, and sales are down. In fact, the number of sales which averaged approximately 375 per month in 2009 were as high as 1,100 per month in 2007 at the beginning of the downturn. Prices are down about 40% since the peak in early 2007, now hovering around 2004 levels. (See: Moody Real Commercial Price Index.) Owners have been reluctant to sell on the down side and they are trying to hold on, assuming there's an improving economy.

A few things are now happening that may alter this. First, owners are definitely feeling the strain of holding the properties with rents going down. More importantly, the bank loans on these properties are going into technical default, triggered by the loan to value ratio becoming too high, as value declines. Banks have some choice in the matter as to whether to write off losses now or postpone into a better time frame. However, weaker banks, under the most scrutiny, are beginning to be forced to identify these bad loans, and get rid of them. As a result, we are beginning to see more loan packages going up for sale, many of which will be sold to private investors and vulture funds.

We have recently worked with clients which wanted to buy these loan portfolios at a discounted price. Depending upon the underlying assets, the discount can be as small as 10% of face value or as large as 80%. Clearly, the underlying value of the asset is critical, since by buying the loans, investors know they may have to foreclose at some point.

We have found one very viable strategy which can be a win-win for both loan investor and the current borrower. Suppose the investor can buy a package of loans at a discount of, say, 30%. The lender provides this discount, in many cases, simply to quickly raise cash. If the underlying assets are strong, then the current borrower will probably be able to refinance over the next several years. However, the borrower may well want to refinance now, due to so attractive loan rates, but may be subject to prepayment penalty.

Here's where the strategy can benefit both. The investor/purchaser of the loans, having achieved a discount of 30%, can easily forgive/absorb the prepayment penalties, thus freeing the borrower to refinance now. There may even be enough leeway to slightly discount the principle of the loans. As a result, the borrower is able to go into the current marketplace, perhaps qualify for FHA insured loan at a relatively low rate, invest slightly more equity based upon reduced debt availability, and pay off the investor who bought the loan. The investor makes slightly less profit than originally possible, but at a much faster and more certain pace, and the property owner is able to finance now at lower rates.

This strategy clearly works best on relatively high quality properties. It breaks down when underlying asset value is far below current loan value, and/or the discount received by the investor is not large enough to share some of the benefits with the property owners. It could also fail if the amount federal funds provided to the FHA, or Fannie Mae and Freddie Mac, is curtailed. Currently there is

an unlimited bail-out of the latter two agencies, and speculation that FHA will need the same. For the time being, it is manageable, but with predictions of increasing commercial property failures, and the amount of already failed residential loans, the burden may be too big for Congress to swallow, and the spigots will be turned off. These are complicated issues, but where there are complications there is always opportunity.

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