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Trickle down economics revisited in today's market

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"Reaganomics" was coined in the late seventies to describe Ronald Reagan's domestic supply side economic policies. Simply stated, as tax rates on capital gains, corporate income and other higher tax rates were lowered, more capital would be available to the markets, promoting economic growth at the upper tier, which would in turn "trickle down" to the lower tier.

Supply side theorists point to studies such as that by the Pacific Research Institute, which conducted extensive research in all 50 states and ranked each state based on their free enterprise policies, to further their basic economic purposes. The Institute concluded that personal income grew 31% faster in those states in the top third of the list versus those in the bottom third of the list. More significant was that employment growth grew at a rate of 216%.

Trickle down economics was not without its critics. George Bush, Sr. characterized candidate Reagan's policies as "voodoo economics". John Kenneth Galbraith compared supply side economics to the old horse and sparrow theory: "If you feed the horse enough oats, some will pass through to the road for the sparrows."

But enough of economic policy. What we are witnessing today in the commercial real estate industry is trickle down economics of a different sort that is creating opportunities for risk takers and capitalists.

In the years preceding the Treasury's current stimulus plan, the capital markets became illiquid as investment banks such as Lehman Brothers and Bear Stearns ceased to exist. Lehman Brothers and Bear Sterns and many other large institutions owned interests in many types of investments, including commercial real estate loans. Many of these assets witnessed severe loan delinquencies. A \$190 million dollar securitized loan on the 640 unit Pointe South Mountain Resort in Phoenix, AZ (renamed the Arizona Grand Resort), a \$117 million dollar loan on Loews Lake, Las Vegas, NV, a \$100 million dollar loan on the Dream Hotel in New York, NY and a \$360 million dollar loan on a mixed use complex near Dallas, TX are just some examples of large loans that suffered major delinquencies and were shifted to special servicing to be marketed for sale. Institutions who suffer liquidity issues typically sell these investments at a discount to raise capital. However, many of those loans were packaged in billion dollar pools (some of the listed assets were part of a \$4.2 billion dollar pool originated in 2006). (Crenews.com, March, 2009). Few buyers existed for billion dollar pools of delinquent loans, causing selling institutions to look solely towards large institutions and hedge funds who had access to significant capital.

Institutions who were successful in purchasing these large loan pools slowly began to sort through them, determine which loans were desirable to keep in their own portfolios and which loans would be better to off load. This "trickle down" approach has now allowed smaller institutions and funds, many of which were established with private equity, to enter the game and become buyers. As these institutions and funds seek to replenish their liquidity, smaller pools and one-off loans are being

packaged for sale to all types of investors.

Purchasers of small portfolios, such as Shem Creek Capital, confirm that they have seen a concentration by those capital sources with liquidity towards purchasing existing one-off and small portfolios of loans and noted that the recent narrowing of the bid/ask spread in the market reflects a desire by those sellers to either reduce their overall purchase basis for a portfolio or generate a quick and favorable return on the more stabilized assets.

These statements are consistent with recently reported market activity. A \$9.9 million loan secured by a hotel in San Diego, CA was recently listed for sale as a one off loan. Amcore Bank of Chicago, IL recently marketed approximately \$200 million of distressed loans. This portfolio was marketed unsuccessfully last year so this year bids were accepted on individual loans. A community bank offered a \$38.3 million portfolio for sale in four smaller pools between \$6 million to \$13 million and offered investors the opportunity to bid on any one or more combinations of those pools, and Capital One, holder of a portfolio of \$256.5 million of loans, has divided its portfolio into 14 pools ranging from \$5.5 million to \$37 million dollars and is permitting bids on individual loans in the group. Even loans on so-called "Trophy" assets are being marketed individually. Recently, TIAA-CREF put in play a \$49 million senior mezzanine loan on One Federal St., Boston, Mass.

Smaller target groups have also increased the popularity of loan sales through online auctions. ING Clarion and LNR Partners recently listed \$200 million dollars of loans for sale online and sold \$124 million dollars of those loans through the online auction process. Three hundred registered bidders participated in the auction. Most of these loans were offered in single increments (rather than being pooled) and every offered loan received at least 4 bids; further confirming that purchasers for these much smaller transactions are now actively in the market. (Crenews.com, March 2010).

Many first time purchasers are entering this market looking to increase the meager returns they are receiving on cash deposits. These purchasers must be cognizant of the many traps awaiting the unwary. Purchasers of distressed loans are not for the lighthearted. Financing is often not available in today's lending environment, due diligence is much more limited compared to a typical real estate purchase and purchasers confront a myriad of borrower issues, including possible bankruptcy filings. Understanding the process and identifying target loans, with the assistance of competent advisors, will continue to permit smaller loan purchasers to enter the market and drive the demand for these types of transactions.

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