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CELEBRATING 55 YEARS

Playing our part in curing the mortgage debt hangover

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The commercial real estate lending binge that hit its peak in 2005-2007 has left lenders with an extended hangover. Investors paid peak prices and then overleveraged properties; their loans are now coming due in a market with lower values and tighter underwriting standards. Banks and special servicers now hold nonperforming loans totaling $180 billion which will have to be worked out or sold. Resolution of these distressed mortgages will play out over several years as the loans roll. According to Trepp Analytics, $360 billion of commercial real estate loans mature in 2012 and $370 billion in 2013. In 2012, CMBS loan maturities will total just under $60 billion; maturities in 2016 will exceed $120 billion.

Larger banks with diversified revenue sources and healthy balance sheets have been able to address their problems in a measured, methodical way. Unlike the RTC sponsored transactions of the early 1990s, there have been fewer bulk sales, single loan and small portfolio dispositions have been the rule. Many less well capitalized regional and local banks have not yet been able to take the write downs required to move problem loans from their books, but eventually regulators will force their hand.

This deleveraging presents opportunities for investors willing and able to work through the complexities of problem loans. Because most investors dislike the uncertainty regarding the timing and the cost of gaining control of the asset through a debt purchase, those with the requisite experience can earn significant returns.

Since 1994, Realty Financial Partners (RFP) has invested $940 million in distressed commercial real estate mortgages and properties. We apply debt structuring expertise and real estate skills to gain access to properties and unlock the value of the underlying assets. Because we are willing to untangle "hairy" deals and resolve complicated problems ranging from warranty claims to bankruptcy, we do not bid against typical equity investors. Institutions trying to dispose of problem assets sometimes approach us with deals, knowing that we can work through issues that financial institutions find difficult or inefficient to deal with and would also dissuade other potential property buyers from taking on given their lack of distressed debt expertise.

We recently completed several note purchases in the Boston market, including the purchase of a first mortgage secured by a condo project in Boston and the purchase of a note secured by a suburban residential subdivision. Although we invest in all property types, both of these deals involve for-sale residential housing, which is of particular interest to us at this stage of the cycle.

The former transaction involved the purchase of a mortgage secured by 47 well-located, newly constructed condominiums in downtown Boston. Two thirds of the units in the project had been sold. We negotiated an agreement with the borrower to take control of the management and initiated an aggressive marketing plan. Thanks to effective execution, program sales have exceeded projections, and we expect to substantially beat proforma returns.

The business plan for the recently closed second transaction is similar. Purchase the note, negotiate with the owner to take control of the property, settle creditor claims, resolve homeowner associates issues, and proactively manage the project through construction and sale, taking advantage of the low acquisition cost basis to drive returns. We believe that our investment approach is well suited to this market environment, and we look forward to playing our part in curing the mortgage debt hangover.

David Allen and Michael Walton are founding parters, Realty Financial Partners, Wellesley, Mass.