Lending

Bank Shot

Do you have the right moves to score with lenders' troubled assets?

by Justin Bert

As commercial real estate loan defaults spike to the highest level in 20 years, a seismic shift in control of real estate assets is taking place — from owners and borrowers to lenders and investors. Almost every active provider of real estate investment and development capital is struggling to determine the appropriate management and exit strategy for troubled investments.

Since few lenders are experienced real estate owners, many will outsource real estate functions such as asset management, opinions of value, and financial analysis. This offers commercial real estate professionals a variety of opportunities to provide service on real estate-owned properties.

But first, REO service providers must see the distressed asset world through the eyes of capital providers. Lenders are proceeding with caution as they develop their plans to resolve troubled assets; however, they are under pressure to act quickly to preserve and enhance the value of their REO properties. Understanding the thought process behind lenders' decisions can help commercial real estate professionals tailor their services to the needs of lenders.

REO Checklist

Below are the actions most capital providers must take before making decisions on REO properties and new developments.

1. **Perform a Detailed Legal Review.**
Lenders sometimes engage new legal counsel to review documents to get a fresh perspective on the transaction. Common issues they address include:

- What is the full collateral pledged to the debt?
- Are the building and improvement plans, architectural drawings, trade names, license agreements, and engineering reports all assigned to the lender?
- Are there partnership or LLC interests that are assigned to the lender?
- Are there any rights to repurchase the asset from the original seller recorded against the property and senior to the loan?
- If loan modifications were made, were they agreed to in writing by the guarantor?
- Are there other agreements affecting the property that the lender might want to assume?

2. **Gain Detailed Knowledge of the Asset.**
At this stage, lenders may employ third-party consultants to conduct overall project reviews. A site visit ascertains the project's current status and that of competing projects. If the loan is secured by a development or construction project, several key questions must be answered:

- What is the current status of the on-site and off-site construction?
- What development agreements exist?
- What are the ramifications if construction at the project is shut down?
- Is there a construction stage where shutdown costs are minimized?
- Are entitlements fully secured and, if not, what entitlement issues exist?
- Are there outstanding mechanics' liens?
- What is today's cost to complete?
- What needs to be done to protect the site from waste?
- What are the carrying costs under a mothball scenario?

3. **Evaluate the Borrower.**
Lenders must critically determine borrowers' quality and focus, as well as their ability and desire to continue managing projects. Part of this evaluation should determine not only the borrower's financial strength but also the existing organization's condition.

Another important consideration is whether the borrower adds value to the project. Some lenders rush down the road to foreclosure with no plan or ability to replace the unique management organization that they are in the process of removing. Lenders must determine if there is something unique or hard to replace about the borrower that warrants special consideration in deciding whether to foreclose.

Equally important — and sometimes overlooked — is the analysis of what is needed from the borrower to maximize value. Even if the borrower's qualifications are easily replaced, significant cooperation may be required. The borrower may own or control other assets that are imperative for the operations or development of the collateral.

4. **Develop an Alternate Plan.**
Should the borrower become insolvent or abandon the project, plan B should include pre-foreclosure and post-foreclosure strategies.

The pre-foreclosure plan should evaluate using a receiver. Appointed by a state superior court, receivers are charged with preserving the property and performing the same general responsibilities as the property's owner. A receiver is critical if the underlying asset deteriorates in value or incurs substantial liability from inappropriate management.

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Justin Bert is vice president of Capstone Advisors. Contact him at bert@capstoneadvisors.com.

Can You Make the Team?

Currently, lenders face an abundance of individuals and groups selling asset management and receivership services. In choosing the right team, lenders not only evaluate key employees' individual backgrounds but also assess the stability of the company's platform. Here are some of the questions lenders ask:

- How long has the group been together?
- Does it have experience operating as a fiduciary?
- Does it have current risk management and institutional quality reporting systems in place?
- Do the principals have contingent liabilities that may cause them to prioritize their issues ahead of their clients?
- Do they have experience and connections in the specific real estate sector?
- Is their reputation intact with the other companies that they will need to work with to resolve asset issues?

The FDIC Sale Process

Much of $1.8 trillion of troubled assets sitting in U.S. banks today will be sold through the Federal Deposit Insurance Corp. The FDIC typically sells failed bank assets — loans and real estate owned — through a sealed bid or auction process. Loan portfolios usually are stratified into pools based on various criteria such as location, size, and asset type. Bidder information packages describe the loan, available due diligence information, auction procedures, and bidder requirements, and include an eligibility certification and confidentiality agreement.

Reserve prices for loan pools usually are established as a percentage of appraised value (per FDIC's valuation methodology) of the underlying collateral. An initial deposit of 5 percent is required and the winning bidder must submit an additional deposit. Both deposits total 10 percent of the winning bid amount.

The bidding usually occurs three to four weeks after the sales announcement and availability of the information package. The closing occurs within a short time after the auction or bidding, usually within 20 business days. In rare cases, seller financing and limited repurchase terms may be available.

Most of the purchase information is on the FDIC's Web site (www.fdic.gov) or the linked Web sites of its advisers. Investors are well served by becoming acquainted with the FDIC's Web site. Under the asset sales tab, the FDIC Web site provides well-organized investor information including sales announcements, due diligence information, contact information for the broker or advisers, a searchable database, bidding procedures, contract documentation, and answers to frequently asked questions. Information is

One benefit of using a receiver is the potential avoidance of construction defect, environmental, and lender liabilities. For example, using a receiver to complete and sell individual units in a residential housing project can significantly reduce the lender's exposure to construction defect liability as the seller.

The post-foreclosure plan should include an analysis of what expertise is needed to manage and maximize recovery from the foreclosed loan and a realistic analysis of whether that expertise exists in-house or needs to be obtained from a third party. (See "Can You Make the Team?")

5. **Perform Market Due Diligence.**
This step is essential to gain an understanding of what an asset is worth today — including the value as a loan or an REO asset. This evaluation should consider the loan's value prior to foreclosure as well as the collateral's value as REO after completing the foreclosure process. It also should consider the short- and long-term strategies that could add value or the circumstances that could lead to a decrease in value.

For example, some loans may have a significant amount of bankruptcy risk and, therefore, will be discounted considerably by buyers under a loan sale strategy. In this event, the lender may complete the foreclosure process and sell the collateral as REO with a higher realization. Of course, the lender bears the bankruptcy risk in this scenario. In addition, the lender may determine that it can hold the same asset for six months, spend a modest amount of money to complete the entitlements, and sell the asset for significantly more than it would be worth without the entitlements completed. Alternatively, the lender may determine that a project's entitlements will expire within the lender's expected hold period and may decide to sell the property prior to entitlement expiration.

In conducting the necessary valuation due diligence, the lender should limit its reliance on appraisals, which in today's environment, can vary significantly from current market values. Today's buyers are setting values on a forward-looking basis that differs dramatically from the value used in the recent past. Consequently, lenders must get multiple valuation data points from other sources such as loan sale advisers, property brokers, and distressed-asset buyers.

U.S. Bank Commercial Real Estate Exposure

Bank by total asset size (number of banks)	% of total assets in commercial real estate	% of commercial real estate assets in construction and land loans	Size of construction loans($ billions)
Less than $1 billion (6,861)	28.0	28.8	110
$1 – $25 billion (588)	26.6	30.7	169
$25 – $100 billion (26)	16.1	30.7	71
$100 billion – $1 trillion (19)	5.4	28.1	82
More than $1 trillion (4)	4.5	27.5	91
All banks (7,498)	10.1	29.2	522

Source: Global Market Perspective, November 2009

6. **Implement a Resolution Program Quickly.**
The loan strategy — how to handle the defaulted loan — generally consists of the following four options: forbearance, workout, deed in lieu, and foreclosure.

A forbearance or workout will be employed if the borrower provides the greatest opportunity to preserve and add value. Otherwise a deed in lieu or foreclosure will result, and the lender must develop an alternate plan for managing the asset.

The asset strategy — what to do with the loan/underlying collateral — will have different options and the lender's chosen strategy may change over time as the real estate environment evolves. Generally, the options include:

- sell the loan (immediately or after forbearance/workout);
- use a receiver to complete and then sell the project or note (faster asset control and sheltered liability);
- foreclose the note and sell the asset as REO immediately;
- foreclose the note, manage the REO to add value for near-term sale; or
- foreclose the note, manage the REO to add value, and hold for long-term sale.

At this point lenders must consider the asset's marketability and evaluate ways to add value or minimize uncertainty. With numerous distressed opportunities in the market, buyers focus on the assets that they can quickly understand and evaluate. Providing a complete asset file and a business plan or road map for maximizing value of the asset being sold enhances marketability significantly.

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