

Distressed Assets INVESTOR

Providing Field-Level Guidance on the Acquisition and Disposition of Distressed Assets

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Distressed Loans Are Hitting the Market

Over the next few years, investors in distressed loans will be presented with an opportunity they haven't seen in a while: an abundance of commercial real estate loans collateralized by income-producing property. Significant

BY KINGSLEY GREENLAND such loans are starting to hit the market as a result of the unfolding meltdown in the commercial sector.

How much more is likely to hit the market? Research firm Foresight Analytics recently estimated that approximately two-thirds of the \$800 billion in commercial real estate loans held by banks and maturing between now and 2014 are underwater. To manage that enormous problem, many of these loans will need to be sold.

In the near term, demand for commercial loans backed by income-producing property will likely be stronger than residential and acquisition development and construction loans, which have been the primary products available for the past two years.

Commercial loans on income-producing properties are more attractive for several reasons. First, these loans are less speculative than residential and ADC loans because the cash flows of these properties are still intact. That's not the case when a residential housing project goes under. Distressed loans on income-producing property typically fall far less in value—from par to 70 cents or 80 cents on the dollar. For residential or ADC loans, values can plummet from par to 20 cents to 30 cents on the dollar,

making it easier for banks to absorb the loss in order to move the assets.

Second, commercial loans collateralized by income-producing properties are typically easier to value for investors. Because these loans have an income stream, investors don't need to guess about the absorption rate. If, for example, two retail storefronts go dark in an otherwise fully leased shopping center, it's easier to assume when that space might be occupied. But if a condominium project sees sales dry up completely, it is anyone's guess as to when the market might return.

Finally, commercial loans tied to income-producing property are easier for institutions to sell. The bid-ask spread on such a loan is relatively small. When the bid-ask price is wider or can't be ascertained, financial institutions can't make reasonable judgments about the potential proceeds of a loan sale.

Distressed loan investors will have a wide range of these commercial loans from which to choose by collateral, term, geography and loan-to-value, among other characteristics. Major financial institutions—banks, pension funds, insurance companies and investment banks—will be among the biggest sellers of commercial loans secured by income-producing property. These institutions have already started selling loans of all sizes. The face amount of these loans tends to be above \$10 million.

Another large source of commercial loans backed by income-producing properties will come from community and regional banks. These institutions

have among the largest exposure to commercial real estate of all types and are under intense pressure to reduce their volume of distressed loans. Loans from these banks tend to be smaller, under \$5 million, and represent a good opportunity for investors looking for a particular type of product.

Finally, investors can expect to see a variety of commercial property loans seized by the FDIC from failed banks. Problems with such loans have contributed to approximately 100 of the nation's bank failures, and more failures are likely over the next 12 months.

The good news for distressed debt investors is that it has never been easier to analyze and bid on loans. The standardized legal documents used at an online marketplace also allow the transaction to be closed in weeks instead of months.

For investors seeking distressed loans, the next few years will provide some of the most compelling opportunities to build a diversified portfolio of product that offers both high risk and potentially high reward. ■

The views expressed here are those of the author and not necessarily DAI.



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