

Special Section: Working with REO Assets

Distressed Asset Dynamics

CCIMs bank on their skills to service and sell lender-owned properties.

By Beth Mattson-Teig

Broker competition to service lenders' real estate-owned assets is heating up as traditional leasing and sales activity cools amid the current market slump. Yet landing these coveted listing agreements is no easy task.

Lenders faced with a growing portfolio of distressed commercial real estate assets are deluged by broker calls every day. Oftentimes, the most crucial first step to secure REO business is to understand a lender's strategy for a particular property. "It is imperative that brokers have direct, specific, and local experience with the type of asset that we own, but it is also important for them to understand and buy into our philosophy for owning and disposing of the asset," says Chase Pattillo, CCIM, vice president of REO and special assets at EverBank, an \$8 billion privately held bank in Jacksonville, Fla.

One Strategy Doesn't Fit All

There is no cookie-cutter approach to dealing with distressed assets. Different lenders take different approaches, and those strategies are evaluated on a case-by-case basis. Some banks may be motivated to sell properties quickly to get them off their balance sheets, while others are willing to invest both time and money if that means garnering higher sales prices in the end.

EverBank, for example, is well capitalized and has a relatively modest REO portfolio of about 12 properties valued at between \$20 million and \$30 million. Even though the size of that portfolio could grow tenfold, the bank's solid financial base gives the lender flexibility in developing strategies to maximize sale prices for each property. Depending on the situation, EverBank considers options that range from holding a property until pricing improves to investing in capital improvements to enhance value.

"It is important for us to think proactively about these properties, because we are in such a difficult capital environment," Pattillo says. For example, EverBank foreclosed on a vacant 60,000-square-foot shopping center in suburban Indianapolis. The 6.3-acre property was an older shopping center in a class A location that had been vacated in preparation for a redevelopment that ultimately fell through. Rather than marketing an empty shopping center, EverBank recognized that it could likely generate a higher price by redeveloping the property. The bank is evaluating options that include selling all or part of the property to developers, financing the redevelopment for a new buyer, forming a joint venture, and/or redeveloping the property on its own and selling the project upon completion.

Proven Expertise Is Key

REO properties represent a lucrative and rapidly growing niche for commercial real estate professionals. The volume of distressed properties on the market reached an estimated \$180 billion at the end of November 2009, according to Real Capital Analytics, which tracks properties valued at \$5 million or higher. And just 10 percent of the total, or \$18 billion, has been resolved so far.

Brokers are working hard to get their feet in the doors of lenders and loan servicers to not only land a particular listing assignment, but also establish a relationship for repeat business.

Foremost, lenders are looking for brokers with strong expertise in the local market and property type who can deliver solid price opinions. "It is an extremely, extremely competitive process right now," says T. Sean Lance, CCIM, managing director at NAI Tampa Bay Commercial Real Estate in Tampa, Fla., and president of the firm's Troubled Asset Optimization Program. "One of the best ways to work with these lenders and servicers is to be a specialist, have a defined market, and be successful in your transactions." For example, NAI Tampa has done nine of the last 30 apartment transactions in Tampa in the past 13 months. "So banks understand that we are a recognized leader in that product type," he adds.

In some cases, brokers are joining forces to bring lender relationships and specific expertise together to land assignments. For example, Lee & Associates Commercial Real Estate Services was awarded the listing for an older, 60-seat theater in northern California. The deal required a broker with "boots on the ground" knowledge of the market. Lee & Associates found a local broker that understood the dynamics of the property and worked out a co-listing arrangement. "In that case, the other broker ended up collecting the majority of the fee, and I had a great experience with the REO lender because we got the deal done," says Michael W. Strode, CCIM, SIOR, senior vice president with Lee & Associates in Murrieta, Calif. The firm has provided about 80 price opinions to various lenders in the past five months and currently has 12 exclusive listings.

Receiverships Open Doors

Brokers are deploying a variety of strategies to beat the competition, including leveraging existing relationships, cold calls, and direct marketing. Offering a full menu of services for distressed assets is one way to get an early foot in the door with lenders on what can be a lengthy foreclosure and disposition process.

"Oftentimes, what the lender is looking for is soup to nuts," says Jeffrey Ackerman, CCIM, executive vice president of Investment Properties Private Client Group at CB Richard Ellis in Pittsburgh. Some lenders prefer working with a

commercial real estate firm that can provide a variety of services such as property management, construction, valuation, and strategic advice, while other lenders might only want disposition or property management and leasing.

In 2008 CB Richard Ellis launched its Restructuring Services Group, which now is providing services to about \$2 billion worth of distressed properties. "We're very busy, and that business is definitely starting to grow," Ackerman says. However, the majority of that work right now is consulting and managing distressed assets as part of receiverships. For example, the CBRE Pittsburgh Private Client Group was recently appointed receiver to preserve and protect the land, buildings, and improvements located at Lehigh Valley Crossings in Lower Macungie Township, Pa. The developer had started work on the first building of the 84-acre industrial park before defaulting on its loan, halting construction, and filing for bankruptcy.

Firms that don't have the depth and breadth of services are finding creative ways to team up to deliver the services that lenders want. For example, Scottsdale, Ariz.-based ReCom Global formed about six months ago specifically to pursue business from financial institutions. The company pooled expertise from several managing partners, including Lee B. Farris, CCIM, of Phoenix and Patricia A. Lynn, CCIM, of San Francisco, in the western U.S. that includes development, construction, management, accounting, and brokerage. "There is definitely a need from smaller banks that don't have their own internal staff to manage REO properties," says Sidney Montague, a managing member of ReCom Global.

ReCom recently picked up the receivership assignment for a 27-unit apartment project in Phoenix. ReCom collects a flat monthly fee for the assignment. Although that type of assignment is not a big moneymaker for the firm, the hope is that it will lead to additional business. "The endgame is to dispose of these properties," Montague says.

Research Pays Off

Some brokers try to separate themselves from the pack of brokers chasing REO deals by doing their homework on distressed properties before the news of a foreclosure lands in the local paper.

One strategy that has helped Lee & Associates garner REO business is to focus on banks that have been active Small Business Administration lenders. "We were able to compile a list of all of the banks that made SBA loans in southwest Riverside County, [Calif.], over the last five years," Strode says. Lee & Associates looked at the original purchase prices and then worked backward to find the drop in value and identify distressed assets.

Recovery Rates for Defaulted Commercial Mortgages			
By property type, based on properties \$5 million or greater			
Property	Outstanding balance (in \$ millions)	Number of mortgages	Average recovery rate (%)
Office	1,391.2	22	53
Multifamily	830.7	64	63
Land	370.6	17	45
Development	252.9	6	32
Retail	202.5	15	72
Hotel	115.1	12	65
Industrial	48.2	9	66
Total	3,211.3	145	60

Source: Real Capital Analytics, September 2009

Three years ago, for example, smaller owner-occupied industrial buildings in Riverside County were selling for \$145 to \$150 per sf. Now those buildings are worth about \$85 psf. "At least on paper, the majority of those loans are all upside down in terms of the current loan to value," Strode says. That doesn't necessarily mean that all of those properties are in default, he adds, but if an owner is trying to refinance or sell right now, it is extremely difficult because the majority of those deals were done with about 10 percent equity down, and now values have dropped by more than 40 percent.

NAI Tampa has identified potential troubled loans by reviewing transaction data for sales that occurred between 2004 and 2007 — when investors were paying top dollar and using high leverage to acquire properties. Digging into some of the data on file shows which lenders provided loans on those properties, Lance says. The firm uses that info to tailor its marketing efforts to specific lenders.

Marketing REO Properties

Successful marketing programs stress the fact that the property is distressed or bank owned, simply because that term creates more interest from buyers. "If I put a property on the market today and call it a distressed asset, I would get 25 offers on it," Ackerman says. "If I put that same asset on the market and didn't call it distressed, I would get less than a handful of offers."

The psychology is that REO properties represent a bargain. It is true that the majority of REO properties are selling at prices below market value. Distressed properties are typically selling at 30 percent to 40 percent of values that were established a year or two ago. "Buyers in this market are not looking for just deals, but steals, and REO properties are typically perceived as bargains even if they are priced at market value," says A. Scott Hensley, CCIM, SIOR, a partner at Piedmont Properties/Corfac International in Charlotte, N.C.

Other strategies for marketing REO properties include auctions, sealed bids, or a call for offers where the bids, selections, and closing all follow a specific schedule to expedite the process. "We have different programs depending on what the lender is looking for in order to meet their goals," says Lance of NAI Tampa. "Many of these properties are marketed using traditional methods combined with older methods that are 'new' again, including auctions, mailers, e-mail blasts, trade industry publications, seminars, good old-fashioned pounding the pavement, and phone calls," he adds.

For example, NAI Tampa Bay was selected to exclusively market Cedar Pointe Apartments, a 76-unit multifamily community located in Tampa. The REO asset was approximately 60 percent occupied at the time of foreclosure. The marketing strategy was to bring the property to market with a call for offers deadline of Oct. 31, 2009, to expedite the bidding process and get a sale closed by year-end.

Buyers vary across the board from individual entrepreneurs to public real estate investment trusts. The one thing they have in common is access to capital. Buyers are either coming to the table with all cash to close deals, or they have strong, proven relationships with lenders and are still able to secure financing for acquisitions. "Many of the buyers we are working with today are experienced owner/operators but were shut out of the market over the last few years as the bubble expanded," Lance says. "Other buyers are more opportunistic in nature and they are trying to capitalize on the values in the marketplace and their ability to close when others cannot."

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What's It Worth?

Brokers struggle to value properties in fluctuating market.

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The biggest stumbling block to successfully marketing distressed commercial real estate properties today is providing accurate price opinions.

Brokers are finding that there is plenty of investor money chasing lenders' real estate-owned assets. "The big question is what is the value, because in many instances there are not a lot of data points to establish the sales price," says T. Sean Lance, CCIM, managing director at NAI Tampa Bay Commercial Real Estate in Tampa, Fla., and president of the firm's Troubled Asset Optimization Program. Even an appraisal from six months ago can be very far off the mark, because the market has declined so much, he adds.

The murky valuation issue is partly responsible for the spike in demand for broker opinions of value. Lenders want to get a more accurate understanding of where the property value is at today, and also how long a property will take to sell at a particular price.

Underwriting has changed dramatically. Even replacement cost is no longer the benchmark that it once was. "Investors are not going to buy a property simply because it is 50 percent of replacement cost. Unless there is a clear path to creating income, there will be very few interested buyers," says A. Scott Hensley, CCIM, SIOR, a partner at Piedmont Properties/Corfac International in Charlotte, N.C.

Values are very dependent upon property type and location. For instance, Hensley recently provided a broker opinion of value of \$3.5 million for a vacant big-box retail store in Charlotte. The price was well below the lender's first deed of trust at \$8 million. The original underwriting was based on an aggressive rental rate, low capitalization rate, and a high loan-to-value ratio. All of those factors, coupled with the challenge of finding a replacement tenant, resulted in a much lower value.

More accurate sales comparison data is beginning to emerge as more transactions occur. "But sometimes the gap between where the market price is today and where it was two or three years ago is really shocking for lenders because values have dropped so much," Lance says. "On a broad basis, a lot of values have reset to 2004 levels or even as far back as 2001 levels."

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