

EDITOR'S EDITION

On the Verge of Opportunity

By Jay Rollins

November 2007

Now that the credit crunch seems to be settling in for a longer stay, many real estate professionals are trying to figure out how to profit from this market and credit dislocation.

Capital formation is now occurring with an eye for distressed and illiquid situations. There is a feeling that a wave of distress is coming and many people are trying to position themselves for what may be further opportunity.

This article will explore how capital, sponsors, and brokers can profit from the impending storm. First, some facts:

Residential vs. Commercial

In order to participate in what may be a distressed real estate market, one must separate commercial "Income" assets from "For Sale" assets (homes, land, condos). The dynamics in front of us are very different between Income Producing assets and For Sale assets.

Income Producing Assets (Multifamily, Retail, Industrial, Office, Hotel)

There has yet to be seen any real property level distress in these asset classes. Most of these assets are performing well at ground level. However, there are a few concerns:

1. **Poor exit underwriting on recent value added floating rate transactions:** There is a concern that many of these currently performing loans will not be able to repay their floating rate bridge loans because they were underwritten with "NOI optimism" and low exit cap rates. Thus, the view is that while the property is performing now, it will not be able to be refinanced or sold at a level that will pay off the existing debt.

Opportunity: The opportunity here will not surface for 6-18 months. Most likely there will be "spot" situations, but unless there is a recession or macro event, there does not appear to be a meltdown coming in commercial assets. The distress in most cases will be financial (at the note level) and not at the asset level. We anticipate the projected NOI's will not be achieved, exit cap rates will be higher than underwritten and the floating rate debt will not be able to be repaid. Yet, this will not be a large scale default event, but rather individual "spot" opportunities.

2. **B-Notes on existing paper:** The securitization market has frozen up and the thaw is taking longer than most people thought it would. The reason is that the investors who bought the more risky tranches of CMBS & ABS have been burned. They don't want to go back to the well right now.

Thus, there is a lack of liquidity in the securitized market, which is leading to the sale of paper below its face amount. This will enhance yield, but does not speak to the credit quality of the asset. This is a “Wall Street-centric” problem, as they are holding paper that is now worth less than what they paid for it. There will be losses, but this will be a short window of opportunity to “pick off the Street” as this type of arbitrage opportunity does not last long.

3. **Forced asset/note sales:** There will be some banks, CDO’s and credit companies that due to regulators, accounting, and risk based capital issues, will be forced to sell loans/bonds that have taken a paper write down due to pricing. This will create some opportunity, but again it will be on a spot basis.

Income Producing Summary

To take advantage of commercial market dislocations, capital will have to be in a position to move fast, because the commercial assets are not yet distressed, it’s the paper that has been below what is now considered to be acceptable pricing.

For Sale Assets – A Different Story

For Sale residential (homes, lots, land, condos) continues to be in a free fall. This distressed market is growing, not shrinking. There are numerous distressed points that need to be considered:

Value declines: Land and home values have declined, in some places dramatically.

Large inventory: Builders and developers were caught with a large pipeline of to be completed condos, resort communities, land to be developed, finished lots and homes.

Lack of buyers: Less available financing due to credit underwriting tightening, plus a psychological element combined with the possibility of a recession all leads to fewer buyers.

Less capital in the market: When the credit markets were hot, all asset classes were securitizable. Thus, many For Sale projects ended up in CDO’s and other SIV’s. That party is over and the availability of financing for For Sale assets has dramatically decreased.

Financial Distress & Asset Distress

For Sale assets, unlike commercial, are distressed on two levels:

1. Financial “paper distress”: The value of the paper on the lender’s books has fallen in value.
2. Asset level distress: Many of these assets are no longer performing and the owners have liquidity problems and cannot repay the loans as they are coming due.

This combination will lead to a distressed buying/financing opportunity.

How to Buy and Finance Distressed For Sale Assets

In some ways it is simpler to analyze For Sale assets than income assets, as there are less moving parts. The analysis starts with:

Acquisition Basis: What will the loan/acquisition price be per foot/door/key/acre? All distressed deals start with the basis. Obviously, the new basis needs to be lower than the old basis

The “Built Out” Basis: The next step is to have a budget that can project the costs required to take the asset to a “finished product” stage, which will be more sellable.

Example:

Approved lots to finished lots

Finished lots to homes

Un-renovated condos to fully renovated condos

Carrying Costs: The lender/ investor in distressed For Sale assets is taking a “basis and market bet.” Obviously the market is not good now, so the investor/lender must build in carrying costs until the market recovers. This includes:

- Interest
- Taxes
- Insurance
- Legal fees
- HOA fees
- Cost of sale

Profit: In most cases, the exit strategy for the distressed buyer will be selling to a local sponsor/operator sometime in the future. Therefore the distressed investor must build in a profit component, typically 15-25% of the finished product sales.

- Residual Analysis:** This is the key to pricing a distressed asset (acquisition basis) is being comfortable with your price, knowing that you have factored in:
- Built out costs
 - Carrying costs
 - Entrepreneurial profit

This analysis can be applied to commercial assets (land/pads) but is easier to understand with residential lots.

Example: Solving for the appropriate price to pay for a distressed “paper lot” transaction. Assume a 3,000 square foot home

		<u>P/SF</u>	<u>Notes</u>
Real home price today:	\$500,000	\$166.67	Real value today
Less: Cost to sell the house (6%):	<u>\$30,000</u>	<u>\$10.00</u>	Broker costs
Net home sales value:	\$470,000	\$156.67	
Less: Costs to build the home:	\$300,000	\$100.00	Stick and bricks
Less: Cost to finish the lot:	<u>\$30,000</u>	<u>\$10.00</u>	Lot finishing costs
Net land cost:	\$140,000	\$46.67	
Less: Cost to hold the lot:	\$37,500	\$12.50	3 year hold period (est.)
Less: Entrepreneurial builder profit (15%)	<u>\$75,000</u>	<u>\$25.00</u>	Based on house profit
Equals: Bid price for paper lots:	\$27,500	\$9.17	

Rule of Thumb: Finished lot retail price should be 20-25% of the ultimate home sales price.

Variables of this analysis will include:

1. **Local market conditions:** Market strength is a huge factor. Future population growth, desirability, etc. All things being equal, you would rather make this acquisition in Phoenix versus Toledo.
2. **Approvals:** The closer the product is to full approvals, the better. When the municipality still has a “say” (public hearings, staff approvals), be ready for curve balls and time delays.
3. **Interest:** If the bridge loan is floating rate, an increase in Libor will increase the carrying costs.
4. **Timing of recovery:** If the recovery takes longer than anticipated, the value is improved.
5. **Value of current finished product:** If prices of finished product continue to fall, the analysis is impaired.
6. **Offsite Development Obligations:** These will increase costs.

Where are the deals?

Today these transactions are everywhere:

- Sponsors who need liquidity to keep the deal alive
- Bank loans that are “upside down” on value
- Bank loans that are running out of interest reserve
- Properties in, or going to foreclosure
- Stalled projects looking for more time and more cash
- Properties in bankruptcy
- Loans coming due with complex structures: first trust loans, mezzanine loans, and preferred equity.

There are multiple entry points into this space and much capital today is forming around it. For those with capital, a two-three year view, and an appetite for returns, the tide has turned and your day is coming.



JCR Capital is a direct real estate lender, specializing in value added and opportunistic transactions.

JCR Capital customizes each transaction to fit the client's needs, which may include; pricing, proceeds, structure, flexibility and speed.

Financial Products

- Bridge Loans
- Mezzanine Loans
- Preferred Equity
- Small Balance Equity
- Large Balance Equity

Asset Classes

- Office
- Multifamily
- Affordable Multifamily
- Industrial
- Land
- Land Development
- Condominium
- Retail

Geography

- United States