distressed assets

Troubled asset area has been one of the strongest growth areas in the comm'l. marketplace in 2009

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It is opportune that in this mid-year review, I am able to describe a market segment in bullish terms, but for the past 6 months I have seen an uptick in the business of distressed asset acquisition and investment. In fact, the troubled asset area has been, in my opinion, one of the strongest growth areas in the commercial real estate marketplace in 2009. Assets have become distressed due to above-average vacancy rates, inability to refinance existing debt, depletion of reserves, and disrepair. While these assets are now more affordable, the resources, including sources of capital funding needed to acquire, rehabilitate and reposition these assets have become scarcer and more difficult to secure. Specifically, underwriting requirements have been considerably strengthened, equity requirements are uniformly higher, cross-collateralization (even over-collateralization) is more likely, borrower credit quality and asset values have weakened, and financial institutions are generally leery to fund projects in a declining value environment. I wrote several articles this past year focusing on the theme that although these are difficult times, there are valuable opportunities to be had out there, and I would like to use this review to convey a strategy to overcome the funding difficulties that many distressed deals are currently facing.

I have been working with developers, managers, and investors seeking to acquire distressed multifamily residential properties, distressed commercial, industrial, office, flex, and hospitality assets, as well as investors seeking to acquire the devalued securities, mortgages, notes, or other commercial paper secured by these distressed assets. While traditional means of financing an acquisition of distressed assets are difficult in the current credit market environment, I have guided operators through a strategy that includes successfully completing a private equity offering into a fund-type entity that will utilize its assets to acquire, rehabilitate and reposition distressed assets for cash flow and residual proceeds. These ownership entities have a greater chance of obtaining financing on more favorable terms than individual or corporate borrowers, and such entities are also able to occupy a more preferable position as a buyer of distressed assets due to the fund's capitalization.

Although we may bounce around the bottom for a time, the June 30, 2009 Case-Schiller Report indicated an improvement in the residential market. On the commercial side, we are still enveloped in the quagmire of a slower and more gradual decline. Understandably, therefore, the lending community is apprehensive about funding projects in this time period of uncertainty. The fund or pooling-of-interest transactions that I am working on seek to acquire assets using equity contribution amounts of 25-30%, thereby neutralizing institutional fears regarding declining values. These deals provide allowances for funds to be allocated toward rehabilitation and repositioning of the property so as to take advantage of the post-rehabilitation appraisal of the property at a more favorable valuation and create a forced appreciation factor that fuels returns.

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Clearly, these transactions are not for the faint-hearted, and due to the valuation imbalance carry large upside potential with a correspondingly large risk factor. A distressed asset transaction is complex and challenging in that the properties are often bank-owned, in a state of disrepair that is sometimes unlikely to be fully determined or understood at the time of purchase, have depleted reserves, and there is usually limited access to quality due diligence when dealing with a bank-owned property managed by an out-of-state asset manager. Site inspections and testing, as well as a dearth of warranties usually commonplace in transactions of this kind may also be absent.

Nevertheless, this is a strong and growing market segment capable of engineering a steady recovery.

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