

Dissecting the Distress: Debt & Equity Update



Momentum ...At Last?

IT WOULD SEEM THE TREASURY DEPARTMENT'S long-awaited Public Private Investment Program, finally unveiled in March, would be the answer to Chip Larson's dreams. Larson is president of Home Equity Partners, a San Diego-based company that was recently formed to purchase troubled mortgages. Over the next 12 months he aims to invest between \$150 million and \$200 million.

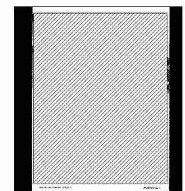
By Erika Morphy

PPIP's intention is to purchase troubled or legacy assets currently rotting away on the balance sheets of US financial institutions. It's expected to generate \$500 billion of purchasing power, with the potential to expand up to \$1 trillion, through a combination of private capital and some \$75 billion to \$100 billion of Troubled Asset Relief Program funding. This will be leveraged with debt guaranteed by the FDIC and

the New York Federal Reserve Bank. The debt-to-equity ratio could be as high as six to one. While that's not the ten-to-one ratio that some had been anticipating, it's still respectable leverage, especially in this market.

But Larson says he is finding viable investment opportunities in the private sector without the execution of PPIP. In the early part of the year, trading of these securities had all but ceased, partly due to the expectation that the government would be purchasing them. Now good deals are coming to market, he reports.

The economic recession and credit crunch has battered the commercial real estate sector. That said, there are still investment opportunities and financing, albeit limited to the strongest prospects, which can be had. Life goes on, in other words—even if it's life in survival mode. To be sure, these spurts of activity have been lackluster, in part because the




capital markets have been waiting to see what the government will do.

The PPIP remained frustratingly vague at the beginning of April. But from the details that have been provided by Treasury Secretary Timothy Geithner, it's becoming clear that the government—either by accident or

despite the programs. Larson notes that last month several institutions began pricing securities in which he wants to invest at reasonable rates. One of the reasons, he believes, is that the market has relinquished hope that the government would provide an ideal exit strategy for holders of these assets.

Investor interest in AAA-rated tranches of CMBS, meanwhile, has picked up considerably in recent weeks as prices rose by some 10 to 15 basis points. NewOak Capital, a New York City-based advisory and asset management firm, attri-



The government has finally colored in the black and white outline to its toxic debt plan. Will that be enough to jumpstart the capital markets?

design—will not supply the floor that many sellers had hoped.

This is not necessarily a bad thing. Some in the market believe that anticipation of the government's involvement was hindering what little activity might have occurred. This is not to say that government action in the form of the Term Asset-Backed Securities Loan Facility, TARP and PPIP was unnecessary or even dangerous. Clearly, the market is struggling under the weight of toxic debt.

Greg Leisch, CEO of Delta Associates in Alexandria, VA, notes that distressed real estate debt went from \$25 billion in December 2008 to \$50 billion in February. If that rate continues, the financial system will buckle under the load of non-performing assets. Leisch, who is also a principal of a newly formed consultancy called the Distressed Asset Recovery Team, has his concerns about the PPIP, but is cheering on the program. He wants it to succeed—by June.

That, of course, assumes Treasury will fill in the missing blanks soon. It's not a given that it will. Even after the expanded version of TALF launched at the beginning of March, Treasury continued to refine it, expanding the types of collateral to include securities backed by floor-plan debt, vehicle fleet leases, loans and leases for business equipment and those secured by mortgage servicing advances. Yet, more specifics are needed.

The commercial real estate industry, for instance, has fiercely lobbied Treasury to expand loan terms to five years from the current three. Without that change it's unlikely the facility will be used to support CMBS purchases, at least on a wide scale. The \$4.7 billion in loan requests made under the first round, which closed toward the end of March, were disappointing. But a true, comprehensive assessment of these government programs may not be possible until well into the third and fourth quarters.

Meanwhile, the markets are showing small signs of activity—some of it in response to the government initiatives, some of it

butes this rally to the inclusion of vintage CMBS in TALF and PPIP. Indeed, the firm advises that TALF securities may be an excellent opportunity for institutional investors, since some of the credit quality distinctions could translate into very attractive yields.

Some observers say, though, market movement can be explained by something far more fundamental than the hand of the government, namely that the bid-ask spread is narrowing. It's this gap that had previously kept the market from moving towards recovery, says Mark Gibson, executive managing director in Holliday Fenoglio Fowler's Dallas office. Lack of liquidity is not the main problem, he says, although it is an issue. The US economy has tanked, with some five million jobs lost and residential and commercial valuations plummeting.

"The faster people deal with that, underwrite it and come to some kind of price agreement, the faster transactions will come back because there is liquidity there."

Foreign investors, equity and institutional funds, to some degree, are still waiting on the sidelines to invest, Gibson says. "The problem is, real estate is no longer a competitive asset." He continues, "Find me the best trophy asset in Washington, DC, for instance, and then discount it by 30% to 40% from its asking rate. I will have you 10 offers backed by funding within a week."

There are signs that the market is settling on a price floor for first deeds of trusts on residential properties, Home Equity Partners' Larson says. It's nothing definite yet. Still, there have been large trades that sold as low as 20 cents on dollar and as high as 75 cents on the dollar, he reports. But the bid-ask spread does appear to be narrowing. The bid range, as this is written, seems to be between 30 and 45 cents. The ask range is between 50 and 75 cents.

For his part, Spencer Garfield, managing director at Hudson Realty Capital, a New York City-based real estate fund manager that focuses on discounted debt acquisition, reports signs of "capitalization by sellers in terms of price." Throughout the end of 2008 and into 2009, the bid-ask gap was seemingly insurmountable, he says.

Buyers were taking into account the worst-case scenarios in rent, occupancy levels and economic distress. Indeed, in some cases last year, potential buyers were not discounting deeply enough to match economic conditions. Sellers, for their part, had no real pressure to sell and figured they might as well hold onto their assets until the worse-case scenarios materialize. Garfield can't pinpoint why a shift has occurred—only that it has.

“We looked at an asset held by Lehman Brothers shortly after its bankruptcy and the price guidance was in 80% of par range. The price talk for that same asset today is closer to 50% of par,” he points out. “I would say there is anywhere from a 10% to 40% swing in favor of buyers in terms of price expectation from sellers.”

Even land—one of the more difficult asset categories to value even in stable times—appears to be heading for some sort of price equilibrium. Fairfax, VA-based land broker Fraser Forbes is launching a financing arm this summer, inspired by a belief that prices are approaching the point where investors will be ready to step up and buy, CEO Rich Samit says.

Seconding Gibson's point about liquidity, he says there is a sufficient amount of equity waiting to fund these transactions. Specifically, Samit says that Fraser Forbes can place its hands on some \$5 billion to invest in land parcels up and down the Eastern Seaboard.

Of course such money will be aimed at the strongest borrowers and best prospects. However, after a year of credit entrenchment and economic downturn, borrowers' finances and project fundamentals have been seriously weakened. For this group, without a doubt, financing is unavailable. At the same time, the industry is bracing for the tidal wave of CMBS debt that will begin to roll over this year. The CMBS market is obviously not going to refinance it; it will have to be eked out from existing sources or go into default.

Still, borrowers—even those that previously relied on the CMBS market—are scrapping by. Lenders, for instance, are becoming increasingly amenable to allowing borrowers to buy back their debt at a discount, often at large markdowns, Jones Lang LaSalle managing director Wes Boatwright says. Some are even willing to waive yield

maintenance for borrowers that can pay off a loan.

Private equity is also available for qualified borrowers—but at a price, of course, Boatwright continues. The terms can be downright onerous, with LTVs close to 80% and interest rates topping 10%, in some cases. But for property owners that want to restructure, such funds provide a good stopgap, he says.

Then there are the foreign investors, who are expected to step up their allocations in US real estate this year. A recent survey by the Washington, DC-based Association of

Foreign Investors in Real Estate found that foreign-based investors plan to increase lending by 54% globally and 58% in the US. Equity investors anticipate an increase in investment activity by 40% globally and 73% in the US.

There are already some signs that foreign investors are following through. In Washington, DC—the city rated most likely to be the recipient of such funds—JBG Cos. recently secured \$100.5 million in three-year financing for 1101 K St., a 310,825-square-foot office building. The German bank Helaba replaced Bank of America's construction loan with adjustable rate financing.

Life insurance capital is also available, but at unknown allocation levels. Indeed, identifying which insurers are still active in the market has become a favorite guessing game for the industry. Clearly, many have scaled back, but the major providers are still lending, Steve Sakwa, a Banc of America Securities-Merrill Lynch Research Analyst, says. However, many have been very coy about stating their intentions. "They have not come out and said they are or are not going to lend," he says.

Much of the capital available will go to refinance new loans, Sakwa says, which limits funding for new projects. But, he says, "Insurance companies and banks don't want to take back performing properties just because the new LTVs and property valuations have put an asset under water."

So life insurance companies are changing terms or requiring borrowers to pay more debt. Indeed, most borrowers can expect continuing support from their life financier. The only question is whether they will have to put in more money or whether they will receive proceeds at all. Not that such solutions are painless for borrowers. In many cases, Sakwa says, a borrower may have been planning to place expected proceeds elsewhere, including on debt that may be coming due for another project. But in this market, any financial solution—including the government's PPIP—will be equal parts pain and relief. ♦

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