



Opportunities and obstacles

Debt delinquencies, foreclosures, bankruptcies still loom large in the US real estate market.

Stephanie Schwartz-Driver reports on debt coverage at the AFIRE conference

The debt situation is a defining force in the US institutional real estate market, one that presents either opportunities or obstacles to most key players. The breadth of the situation was made apparent in a session at the 2010 Association of Foreign Investors in Real Estate (AFIRE) conference in New York City in early February.

The scene was set when moderator Sebastian Kaufmann, partner in law firm King & Spaulding, presented some familiar but still amazing statistics: there is around \$2.5trn (€1.83trn) of commercial real estate debt outstanding, and over the next three to four years, around \$500bn of that will be coming due.

Delinquencies in commercial mortgage-backed securities (CMBS) are still rising. At the end of January, delinquencies were at 6%, according to Fitch Ratings, up from 4.7% at the end of December 2009. However, nearly 70% of this increase was due to Extended Stay America's move to delinquent status, which pushed the hotel delinquency rate up to more than 16%, from 9% in December. Office delinquencies were at 3%, retail reached nearly 5%, and multi-family topped 8%. At the same time, construction loans have reached a default rate of around 50%.

Two landmark bankruptcies have shaken the industry to the core. General Growth Properties, the second-largest US mall operator, filed for chapter 11

bankruptcy last April, facing \$25bn in debt that was coming due in the short term. The firm had a complex organisational structure, broken into hundreds of subsidiaries and special purpose vehicles (SPVs). Not all subsidiaries and SPVs filed for bankruptcy protection; at the same time, the case allowed some still-solvent SPVs to file for bankruptcy. This case showed, according to Barry Green, director of Goulston and Storrs in Boston, that "bankruptcy-remote is not bankruptcy-proof".

Extended Stay, which operates more than 650 hotels in the US and Canada focused on long-term guests, filed for chapter 11 bankruptcy in June 2009, when its assets of \$7.1bn were exceeded by debt of \$7.6bn. Extended Stay's first mortgage, of \$4.1bn, was carved into about \$3.5bn of CMBS; the remainder of the debt was in a mezzanine loan, which was also tranching. Resolution of the Extended Stay bankruptcy thus is seen as a test for the way other CMBS delinquencies might play out.

Representing the lenders, Daniel Vinson, managing

director and head of transaction operations and capital markets at Eurohypo's US operations, stressed that "in a low interest rate environment, there are a lot of options for both borrowers and lenders". Eurohypo's own lending was focused on core, in addition to a lot of development lending. "Most borrowers want extensions, and we will always work with a borrower that is willing to put in additional equity," he said.

Vinson's experience as a lender willing to negotiate shows that big capital stacks have become a problem. It is the complex relations between lenders that are presenting an obstacle. He explained that some of the biggest issues have been with co-lenders. "Half of our work-outs have been agency, and there have been multiple side-show strategy plays: B-note holders want to avoid defaults because they lose control; A-note holders posture that they want default so they can be bought out at par."

At a certain point, there is a day of reckoning, said Vinson, because the loan will go into default if the parties cannot agree, and nobody really wants that. "Ultimately the posturing subsides and people reach a deal," he said.

"A borrower cannot keep control without putting in more equity," said Green. "But usually bankruptcy is not the first thing the borrower will think of – the process is too complex and too costly." Vinson agreed: "Bankruptcy is not a great experience for a lender, but it is worse for a borrower."

The tipping point is whether the borrower is able to meet expenses on a property, said Peter Baccile, vice-chairman, JP Morgan Securities. "As soon as the lender has to reach into its pocket, that's when foreclosure looms."

Baccile noted that around 10% of all CMBS have moved to special servicing. With CMBS, the process is more cumbersome and difficult. Leverage is higher than with whole loans, and the CMBS structure means that there is a lack of flexibility. This may result in "a tidal wave of assets heading toward special servicers," said James Lee, former CEO of developer OPUS East. (OPUS East filed for chapter 7 bankruptcy in 2009 and Lee left the company. Chapter 7 bankruptcy focuses on liquidation, as opposed to chapter 11, which focuses on restructuring.)

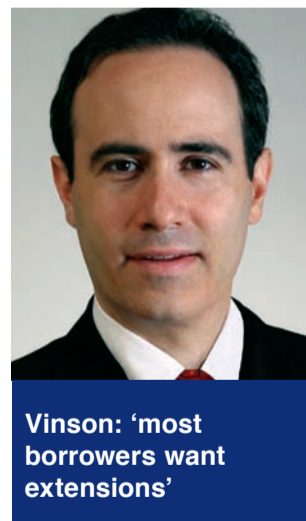
Whether the special servicers will be able to handle the workload coming their way might be an issue. "At the beginning of the cycle, the special servicers were like deer in the headlights. They were not staffed up at all," said Vinson. "But now, they have hit their stride and have been moving quickly."

In order to avoid bankruptcy and foreclosure, lenders are in an 'extend and pretend' mode as much as possible. "Most lenders would rather not foreclose on an asset," said Baccile. "The best outcome is keeping the existing owner in place." He sees one solution:

"There is a lot more money around today than there was in the early 1990s – now the solution is to sell the loan." Secondaries represent a growing investment opportunity for those firms able to afford the disciplined due diligence required, as well as the low success rate in bidding.

In current market conditions, there is a big distinction between high- and poor-quality properties. Core properties are eminently saleable, and lenders are also more willing to renegotiate on high-quality properties. However, poor-quality properties will be forced into the system quickly.

This is limiting the kinds of loans that are on the secondary market as well. Opportunity funds looking to buy real estate loans want 11-15% unleveraged returns. But, Vinson said: "Why would I sell the loan at a 15% return, when I can extend the loan, or foreclose and sell the building?"



Vinson: 'most borrowers want extensions'