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Investing in Distressed Assets

By Mark G. Dotzour

Distressed assets are investments that are in trouble. Some euphemistically call them investments "with a story." In business lingo, a distressed deal is an investment that "has hair on it."

In a typical investment, an owner borrows money to purchase a property or business. Sometimes owners borrow from several lenders, ending up with second mortgages from mezzanine lenders, who offer short-term, interim loans to make up for lack of equity. If the investment works, all the loans get paid and the owner makes a profit.

But if it does not work out, lenders do not get paid and they foreclose on the real estate loan or force the business into bankruptcy. At that point, the lender becomes the owner of the property or business.

Because lenders generally are not prepared to operate businesses or buy and sell real estate, they sell these assets at steep discounts, sometimes for pennies on the dollar. Usually, the risks of investing in distressed properties are so high that investors demand high returns.

Origin of Distressed Investments

Distressed assets take many forms, from a 2,000-lot subdivision with a golf course whose owners defaulted on a $100 million loan, to a small business with three industrial buildings and an office building that defaulted on a Small Business Administration (SBA) loan.

When the economy is strong, few businesses default on their loans, so few real estate foreclosures occur. From 2003 to 2007, private equity funds had billions of dollars to spend, but distressed investment deals were scarce.

In June 2007, however, when Bear Stearns closed two hedge funds it sponsored, the situation changed dramatically. This early tremor spooked the credit markets, and 30 days later, funds for risky investments virtually vaporized. The credit markets locked up. As the magnitude of the credit crisis became more apparent, the availability of credit for virtually any purpose disappeared.

Many business and real estate investments are funded by short-term loans that must be refinanced every few years. When the credit markets froze, these investors were doomed. Loan defaults are expected to skyrocket in 2010, resulting in a large number of distressed properties.

Investors interested in distressed assets may choose from defaulted business loans, commercial real estate mortgages, SBA loans, credit card loans and student loans. At a 2009 Distressed Investment Conference in New York City, several speakers commented that all investments are distressed today.

A representative from a bond rating agency said that junk-bond default rates are at 4 percent but could skyrocket to 16 percent before the end of 2009. This means that 16 percent of the riskier businesses in America could fail this year.

Three issues are causing the increase in defaults: lack of credit at any price; poor underwriting standards that generated business loans that could never be repaid; and the number of strong businesses financed with short-term loans that will be unable to refinance their loans.

Buying Opportunities Ahead

So how do professional investors view commercial real estate loans as a potential investment in 2009? The overwhelming consensus is that commercial real estate prices could fall dramatically in the next few years and that a significant number of commercial real estate loans will default, leading to foreclosure. This will produce "once in a lifetime" investment opportunities in the next few years.

Many commercial real estate properties purchased in 2006 and 2007 were bought at exorbitant prices based on future rent projections that were not realistic at the time. Now that those rent projections clearly are not coming to pass, property owners will not be able to service the debt.

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Even solid investment properties are not immune in the current lending environment. Many lenders are not willing to extend existing loans, and few will make new real estate loans. Therefore, owners of fiscally sound properties who are currently paying their loans could be subject to foreclosure because they cannot refinance those loans when they come due.

Many professional investors expected commercial property values to fall by 30 percent or more from 2006–07 prices, when buildings were sold at cap rates lower than at any time in U.S. history. Properties that sold at an 8.5 percent cap rate in 2002 sold for a 5.5 percent cap rate (or lower) in 2007. Prices are likely to continue to fall until cap rates get back to historic norms.

Suppose an investor bought a building for $1,818,181 in 2006 with a 5.5 percent cap rate. It generates $100,000 net operating income (NOI) per year. Two years later, rent levels are unchanged, and the NOI is still $100,000. However, buyers are no longer willing to accept a low yield and demand a cap rate of 8.5 percent. They offer only $1,176,470 for the same building, meaning the property value has declined by 35 percent in just two years.

If an investor purchased the same building in 2007 with $118,181 in equity, borrowed $1.2 million from a life insurance company for the first mortgage, another $300,000 through a second mortgage and $200,000 in mezzanine debt from a private equity fund, the investment has $1.7 million in debt. Selling the property at the higher cap rate (a sales price of $1,176,470) means the equity is completely wiped out. So are the mezzanine loan and the second mortgage loan. Those investments become worthless. Only the first mortgage holder will be repaid.

How much would investors offer the owner for the equity? Nothing. How about the mezzanine debt interest? Nothing. How much would they pay for the second mortgage? Nothing. But they might pay the first mortgage holder $1.1 million to buy the underlying mortgage and effectively become the property owner.

What About Tomorrow?

What are the implications of this for commercial real estate in Texas and the rest of the country?

Expect cap rates to return to 2002–03 levels, which were normal rates of return before the bidding frenzy that occurred in 2006–07. Cap rates probably will not go higher than 2002–03 levels, when the country was in the throes of a recession, job growth was nonexistent and rents were falling.

At that time, financing terms were at historical norms. Lenders were maintaining reasonable underwriting standards and requiring equity in the deal.

If cap rates return historical norms, price declines are likely to occur in the big cities where "hot" or "smart" money drove prices through the roof. In the secondary and tertiary markets of Texas, price declines could be much less, or negligible, because easy money never entered those markets in the first place. Watch for a sizable increase in foreclosures of commercial properties in Texas and throughout the nation beginning in 2009 as banks refuse to renew loans or demand additional collateral on existing loans. As banks sell off the foreclosed properties, prices will drop. Initial declines could be substantial.

Owners of commercial real estate in Texas who do not have to sell should stay on the sidelines and wait for the firestorm of foreclosures to dissipate. Once the selling pressure subsides and the distressed properties are purchased, prices could rebound significantly. Commercial real estate buyers should get back in the market as soon as prices realign with 2002 valuation levels.

With another 13 million people moving to Texas in the next 20 years, many investors will be looking to make smart investments in the state's bright future.

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THE TAKEAWAY

Commercial foreclosures should increase in the remaining months of 2009 as banks refuse to renew loans or require additional collateral on existing loans. As the banks sell off these distressed assets, prices will decline substantially. But once the bulk of these assets are sold, prices should rebound.

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