



## Wait Training

Vulture investors sit on the sidelines in wait for good buys, but how many and when they come are the real questions.

By **Sharon Simonson**

**F**or the last year investors have anticipated a wave of foreclosed and distressed commercial properties. Billions of dollars have been raised in expectation that the Great Recession would deliver the sweetest commercial real estate opportunity in a generation. As the new year begins, the question arises: Will 2010 yield the hoped-for goods?

To be sure, the Bay Area has seen high-profile failures affecting prestigious names: Morgan Stanley, Hines, CalPERS, MacFarlane. But against other U.S. markets, the financial distress has been minor. San Jose ranks last among 51 cities measured by dollar volume and proportion of distress, according to Real Capital Analytics. San Francisco is 45th on the same scale.

Company failures, with the exception of San Francisco's Lembi Group, have not rendered masses of troubled properties to market. Even multiple regional bank collapses driven by commercial real estate have not thrown up volumes of property distress. San Francisco's Pacific National Bank, taken over by the FDIC on Oct. 30, and United Commercial Bank, which failed Nov. 6, both lent heavily on Bay Area commercial real estate. But neither has thrown up piles of distressed properties. (UCB had 12 at the beginning of October; Pacific fewer than five, Real Capital reports.)

Pacific was a lender on the high-profile Watergate complex in Emeryville, now in receivership and effectively up for sale. But the bank also helped finance construction of millions of square feet of speculative office and housing development in Silicon Valley, much of it available for months and not well occupied. Yet none of it had fallen into distress ten months into the year, according to Real Capital.

Whether conditions will hold is another question. Asked what might force the train from its tracks, the most likely answer is time. "The longer

the stress is in place, the more things will break down," said Scott Robinson, co-director of the REIT Center at New York University and a 15-year veteran of real estate finance with experience in investment banking including debt securitization and syndication.

Lenders will tire of loan restructuring and lose confidence that certain borrowers will survive. As time passes, property revenue will decline as more leases expire and tenants secure lower market rents or fade away. Property income will fall below debt service. Strapped borrowers might feed the beast for a time but ultimately will give in. In the words of a San Francisco expert who specializes in property-note sales: "Blend and extend will end."

But Robinson and others are not persuaded that the treachery will finally throw up the distress volumes that capital anticipates. "I am not entirely convinced there will be a wave of foreclosures," said Kenneth M. Fox, San Francisco managing director of capital markets for Cohen Financial, a national real estate capital-services company. "None of the opportunities has gone retail yet. I get a list every week from a bank that is offering assets. It is all junk: land, non-performing commercial properties, broken condo deals. I don't spend my time looking for investments" there.

More distress has failed to materialize in part because the government has intervened so heavily in the marketplace, propping up banks with capital infusions, Robinson said. That has allowed banks to show borrowers deference. Commercial real estate has gotten time. The net effect, everyone hopes, is that fewer properties will fail, carried by the extra months through the storm, then allowed to soak in some economic recovery before regulators turn the screws. Of course, that is exactly the opposite of what today's eager opportunistic investors want to happen.

As the year closed, the Federal Financial Institutions Examination Council issued new guidelines directing bank examiners on how troubled commercial real estate loans should be treated. The guidance on its face is permissive. The Examination Council represents all major U.S. banking regulators: the Federal Reserve System, the Federal Deposit Insurance Corp., the Office of Thrift Supervision, the National Credit Union Administration and the Office of the Comptroller of the Currency.

In what may be one of the greatest strokes of unintended regulatory irony ever, the guidelines stipulate that lenders may carry incomplete commercial construction projects on their books at collateral values consistent with the rents and income that the finished project should produce, not

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managing director of debt advisory services,  
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at current or as-is value. The treatment is suspiciously close to the pro-forma lending practices that bankers embraced during the go-go days, now viewed with askance. "It is interesting. The guidelines suggest that it is possible to restructure a loan based on expectations of future property performance," said Gregg J. Loubier, a partner and expert on real estate finance with law firm Allen Matkins. "Lenders have been roundly criticized for making loans in the recent past based on what many people believed were optimistic assumptions about leasing expectations that in many cases have not materialized."

Loans also can be considered performing even if the collateral value has fallen below the loan balance. That was not true in the past, said Richard Caldwell, former chief credit officer at Pacific National.

"It's not carte blanche to keep everything in the performing category, but it's very much distinct from the current regulation, a material deviation, in my view," he said. "Banks were not able to keep overleveraged loans in the performing category in the past. It affects their loan-loss reserves."

The guidance helps banks to minimize required loan-loss reserves in other ways, too. "Historically, bank examiners didn't look at [borrowers'] global cash flows available to repay debt. So if a borrower were repaying with something other than the cash flow from the asset, the loan was non-performing," said Michel Kapulica, a partner in Assurance and Advisory Business Services for Ernst & Young LLP in San Francisco. The new guidance lets lenders determine if a loan is recoverable based on borrowers' general ability to pay and to classify the loan accordingly.

The guidance also encourages lenders to divide troubled loans into A and B pieces, which also cuts required loan-loss reserves. If a borrower

is able to service a portion of the debt, that piece would continue to be considered fit, while only the B piece would be classified as troubled debt, Kapulica said

Still, he and others are not convinced the changes will much prevent the distress from seeping in. "A large number of borrowers just don't have the global strength to pay off on over-leveraged deals," he said.

Researchers at Deutsche Bank also predict that the worst is yet to come. "... [Commercial real estate] exposures will lead to hundreds of billions of dollars in real losses and many hundreds of [bank] failures," Richard Parkus, the bank's head of commercial real estate debt research, forecast this fall. U.S. banks are exposed to \$1.81 trillion in construction, land development, core property and multifamily real estate loans. The largest group of banks, those with assets of \$25 billion or less, are most at risk. They are heavily exposed to construction loans, half of which are expected to default. They also have failed to set aside sufficient loan-loss reserves. As to the theory (or hope) that time will reduce pain, Deutsche Bank is dubious: "Improvements in rents and vacancy rates are also extremely unlikely to be sufficient to materially affect the scope of the problems."

For Joseph Franzetti, managing director of debt advisory services for Cohen Financial in Chicago, now may be the deceptive calm before the storm. Franzetti works for commercial property owners to restructure and modify existing debt. Servicers in the commercial mortgage-backed securities market are overwhelmed, he said. Bankers are next, he believes. "You can try to kick the can down the road, but if a loan has real cash-flow problems, it's hard to run away from those."

Those, he said, are real losses. ■

