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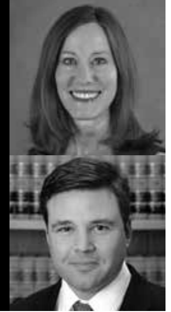
Buying Opportunities; Avoiding Disasters



Buying distressed debt secured by commercial real estate is all the rage. Billions of dollars have been raised for this investment model with the idea that the wave of CMBS maturities from loans originated during 2005–2007 would turn into defaults and high-yielding opportunities. However, widespread distress did not materialize as expected due to appreciating real estate values and low interest rates. This lack of investment opportunity could push these investors into a reckless buying flurry to deploy capital in 2018. In fact, private debt dry powder levels remain near all-time highs and, as of September 2017, totaled $214 billion. Of those funds, approximately $70.7 billion is targeted for distressed debt.[1] Yet, with the October 2017 CMBS delinquency rate at 5.21%[2], or $25 billion, it appears there is nearly a 3:1 ratio of capital to distress CMBS debt.

The risk, however, is that few of these investors are set up to do the required due diligence (much of which may need to be done on a moment's notice) in advance of a distressed acquisition. And those who are prepared, in many instances, may not know what to review. Too few buyers know what they are buying before buying it. Too often, critical aspects of both legal and non-legal due diligence that need to be done up front prior to making a distressed acquisition are overlooked, even by the most experienced of debt buyers.

Below we highlight 10 of the more common mistakes acquirers of distressed commercial real estate debt make when going through the due diligence process. Review the list of common mistakes set out below and take heed. Buyers should do their homework up front — to maximize gains and to mitigate buyer's remorse. Sometimes, there is a reason a buyer's bid is the best bid.

The Basics

Buying distressed debt is not new. With the benefit of multiple financial crises, the market has evolved and created a more efficient solution for investors to acquire pools of non-performing loans using on-line due diligence rooms and document images followed by an on-line auction or bid submission process. This is the foundation for today's buying and selling: a bid and ask market. Today's investors have on-line access to data-rooms instead of rows of banker's boxes. The gig economy has created hundreds of on-the-ground inspection resources. And, there's nothing like Excel to run a model instead of the HPC12.

With all of the information available through a login and portal, due diligence, both in terms of the real estate and any potential legal issues, should be a snap. That being said, without knowledge of what to look for, mistakes (and costly ones at that) can be made. Purchasers of distressed assets do not want to come to regret the price paid for a distressed asset after the fact based upon a fact that could have easily been discovered prior to closing on the acquisition. Do the work up front — and know what to look for — prior to jumping into the distressed debt acquisition pool head first.

Ten Common Mistakes

Below is a summary of what is important, what to watch for and some of the more common mistakes made by even the most experienced professionals acquiring distressed real estate assets:

The real estate. Regardless of the discounted purchase price, the underlying real estate is the primary source of recovery for any commercial real estate loan. If this is not the starting point, don't start.

- Mistake #1: Not running a foreclosure search with a reputable title company. Do not cut corners. The hundreds of dollars spent running a foreclosure search at the outset can save tens of thousands of dollars later. Identify judgments that may impact a potential foreclosure action. Make sure that there is no dispute as to the selling lender's priority position as lienholder on the property. Do not assume the seller has correctly identified (or has rights to) the underlying collateral, including access and parking — review surveys and other documents that may be provided as part of a foreclosure search to confirm. A thorough foreclosure search at the outset can prove invaluable.

- Mistake #2: Not reviewing leases and the rent roll. Ground leases, property leases and REAs may have unusual clauses and resets impacting the value of the real estate, transfer provisions (including rights of first refusal) and consequently the timing and source of recoverable funds. Do not underwrite an asset based on hearsay and market-speak — think about the bankrupt retailers that were considered creditworthy even five years ago. Step back and think about the underlying business model of the tenant coupled with regulations and the tenant's general business model and overlay that on the underlying lease. Will the tenant be able to support the lease and, if not, what happens to the rest of the tenants at the property once one tenant leaves? Take the time, read the leases. All of them.

- Mistake #3: Not understanding special assessments and local municipalities. Buyer beware. Today's rising property values have brought forth a well-anchored party to the transaction — the underlying municipality. The local government has decided to capitalize on the wealth creating special assessments, tax value resets and other revenue generating opportunities. Also, if the buyer's model includes a foreclosure and subsequent reposition of the collateral, make sure that is not going to be an issue with the municipality. The local municipality may have a different agenda — including unique zoning or other laws that prevent subsequent property owners from executing a real estate business plan after taking title. The buyer may be seen as an outsider and as a source of capital — after all, the buyer bought a $15 million loan, and therefore it must have substantial resources.

"The underlying ground lease contained a provision that required all subsequent buyers of the real estate to pay a 6% transfer fee, upon each transfer, including a transfer by foreclosure. This significantly increased the transaction costs to the lender on the $20 million loan."
– Asset Manager

- Mistake #4: Not understanding the status of litigation. Is a foreclosure action already in process? If so, then counsel should be engaged to review the litigation file to see if there are any issues that may cause the foreclosure process to take longer than anticipated. Real estate recovery laws are driven by the property laws of the state and the venue of any litigation matters in terms of timing. Experienced foreclosure litigation counsel should be able to provide advice to the buyer around litigation benefits and detriments in one forum versus another (e.g., is this a borrower friendly venue? If so, re-think the acquisition or, at a minimum, the pricing for the acquisition). Time is money — identify the litigation pitfalls and make sure the chain of title to the loan is clear and recorded.

- Mistake #5: Receiverships. Getting a receiver in place may be the quickest way that the buyer, as the debt acquirer, can start generating revenue from the loan. But the laws in various jurisdictions vary as to whether a lender is entitled to a receiver and the powers a receiver may have, including distribution of net operating income prior to a resolution of the lawsuit. Experienced foreclosure litigation counsel will be able to advise its clients on receiverships in a particular jurisdiction and how long it might take to get a receiver in place and what that receiver may (or may not) be able to do once in place. Receivers may collect rent while a foreclosure action is pending, and that rental revenue stream may come into consideration when trying to price the purchase price for the loan. However, receivers can also make recommendations to the court to pay past-due amounts, improve the property and use debt (receiver certificates) or net operating income to make those improvements.

- Mistake #6: Not knowing or seeing the property. While free, Google Earth is not a substitute for the time and value of a site inspection. Many commercial real estate professionals have an unusual ability to remember a site once they have seen it. And, once there, it is hard to forget how hard (or easy) it is to find or access the property or the invaluable experience of sitting in the deli as chatty tenants grab a snack. Google Earth rarely has a hard time finding the real estate and does not eavesdrop on tenants in the deli.

- Mistake #7: Not knowing the default. Make sure that it is clear how the underlying loan came to be distressed, and if there are any potential lender claims that pre-date the borrower's default. Not all defaults are created equal and not all buyers will have bona fide purchaser status. Short payment defaults can, in many jurisdictions, be cured under state law, which may quickly get the buyer back to holding a performing loan (which it may not want if, ultimately, the desire is to own the real estate). Also, older defaults could present statute of limitations issues if the prior lender did not act upon the default soon enough. The courts generally do not look favorably upon a lender operating outside the loan documents when it comes to disbursements or response times to borrower requests. The buyer inherits the history and only knows what the seller shares in the due diligence vault, which generally does not include historic emails between borrower and lender, assuming there is a communication trail.

- Mistake #8: Not knowing the customer. Yes, that's right, the customer. This is a two-fold inquiry. First, who is selling the distressed loan and what is their reputation? This is critical, and do not hesitate to ask why might the seller be looking to unload the debt, especially in states that offer a short-term non-judicial foreclosure. Approach this with a critical eye. The second part of the inquiry is who is the ultimate borrower? The principals behind the commercial real estate are people. They are investors, owners, and operators with households, commitments, college tuition to pay and retirement accounts. They are beneficiaries of inheritances or property holders because of divorce (i.e., emotional). They are trying to make money — yes, money — i.e., the same goal as the lender. Knowing the borrower and the borrower's track record may allow a buyer to capitalize upon its investment sooner. Does the borrower have a history of being litigious? If so, add time and costs to the model. Do the principals have any assets other than the subject property that the loan purchaser may be able seize upon in the event there is a personal guaranty? If so the loan purchaser may want to factor this into pricing, as there may be more than just the underlying asset for recovery.

- Mistake #9: Not reviewing the lender's loan file, if it is available. State and Federal laws are continuing to move to a more neutral (read: compassionate) venue. The CFPB and other agencies, are designed to improve and document the lender (yes, the note buyer is the lender) and borrower interaction, making sure there is fair treatment. What is fair is not at the discretion of an asset manager servicing a portfolio [read: 15-20 loans, multiple pieces of collateral under each loan and in varying stages of collection] of non-performing loans. The buyer should consider the servicing history and liability it may be inheriting when acquiring a non-performing loan; consider the borrower's efforts to repay the loan and communicate with the prior lender; and consider the emotional history behind the property's ownership. It is rare that a lender does not prevail in its recovery efforts, but it is a time and expense that must be evaluated, and one or two bad loans can easily blow an Internal Rate of Return or Multiple.

"I have a wife and two daughters and would be remorseful if I did not [sincerely] compliment you on that magnificent piece of jewelry."
– Asset Manager

- Mistake #10: Not reading the loan documents. Read the loan documents, all the loan documents. This is where the right counsel makes all the difference. Read the covenants, the non-standard provisions buried in the loan agreement, mortgage or guaranty. Ensure that there is not some inconsistency within the terms of the loan documents that may make it difficult to move a foreclosure action forward. Make sure that the lender is in possession of the original loan documents, in particular the original promissory note, as that in many jurisdictions is the operative document to transfer. Make sure that the loan documents provide for the appointment of a receiver. Make sure that the prior lender is not charging a usurious rate of interest. Make sure that any default notices that the lender has sent to the borrower comply with the requirements of the loan documents (otherwise, after acquisition the buyer may have to re-send the notices and start the foreclosure or collection process again). Find out what state(s) law governs the documents — the property's state, the lender's state, the guarantor's state. It's not economical to be in multiple courts trying to enforce rights and remedies.

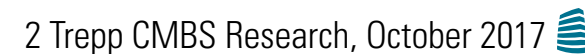
> **"Don't worry, you'd never be able to afford it."**
> **– Principal**

The Closing

We have outlined some of the more common factors that are pre-bid identifiable due diligence items associated with buying distressed debt. Yes, there are many more, and those factors may make for interesting conversation. Ideally, the buyer, having done its due diligence, is on the secured side of that conversation, having identified and priced buying hurdles prior to closing on a distressed loan secured by commercial real estate.

1 Preqin's Private Debt Quarterly Update Q3 2017

2 Trepp CMBS Research, October 2017



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