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How to Succeed With Distressed Properties

By Steve Bergsman

Distressed property remains a fairly generic term referring to real estate that was originally purchased with debt, but for one reason or another, payments have stopped and the borrower has either defaulted on the loan or is in such a financially precarious position that default is imminent.

It's true that thousands of commercial properties are in distress and that there continues to be a massive amount of real estate in the default pipeline. But more interesting is the observation that individual markets, and real estate professionals in those unique metro areas, have responded differently so as to be able to move those defaulted assets to new, more stable owners.

In some cities, SIOR professionals are reporting a predominance of receivership situations; others are citing an increased amount of end-user purchases. There are even some markets where either owner-finance (good for brokers) or forbearance (bad for brokers) has risen to the fore.

However, before one can arrive at those individual market responses, there are still a few important practices that need to be initiated just to get buyers and sellers prepared for the existing and sometimes exasperating transaction environment, no matter where a proposed deal arises.

The key to accomplishing a transaction these days is valuing property correctly, not such an easy practice in a swirling, slippery downturn.

Kenneth Reiff, SIOR, a managing partner with Cassidy Turley BT Commercial in Sacramento, likens pricing to catching a falling knife, and he takes a three-prong approach: Find whatever comps (comparables) are available, but recognize there really aren't many that are useful; figure current asking rents of comparable buildings and extrapolate an appropriate cap (capitalization) rate; and find competing properties for sale.

"You need to be ruthlessly clear-eyed and clear-headed about the direction you want to go. "

"You need to look at what the competing properties are in order to get your property to a proper basis," reiterates **George McCutchen, SIOR, CCIM,** an industrial specialist with Grubb & Ellis/Wilson/Kibler in Columbia, South Carolina. "There are few comparables out there and many of them are not good. Appraisers try to pull it together, but an appraisal won't be as good as saying, 'We have this other building in the market priced at $6 million. In order to sell yours before that one sells, you need to be better priced.'"

The last argument is an extremely strong one. So many commercial properties have been sitting empty and for sale for more than a year, two years, even more, that when that singular buyer comes around, you need to snag him or her because it could be another year before the next buyer comes.

"We sold a 28,000-square-foot warehouse earlier this year that had been sitting on the market for 18 months," says McCutchen. "When someone came along who was interested, we got the deal done at 60 percent off peak price."

"If you set an unreasonable expectation, you are not going to be successful."

That all leads to a second three-step dance, Reiff adds. "You need to get the borrower (or bank) to accept reality in regard to pricing, find a buyer willing to step into the current market, and then keep everyone together while hoping the market doesn't shift even more."

In Tampa, **Edward Miller, SIOR, CCIM,** managing director and principal with Colliers International, along with his partner, Dee Seymour, another SIOR member, closed on three buildings in July and another earlier in the year. "We only take on things that will sell. We have a 100 percent track record of selling things we take. If you set an unreasonable expectation, you are not going to be successful."

Miller's secret sauce in the very depressed Tampa market is first to focus on existing properties that are well positioned for manufacturing or bulk distribution. And secondly, he says, the seller has to understand the true value and possibilities of the building in question.

"You need to be ruthlessly clear-eyed and clear-headed about the direction you want to go and indicate that clearly to the seller; otherwise you set the wrong expectation at the beginning of the relationship," Miller says.

What's reality in Tampa? Answer: 50-60 percent off peak pricing.

"We are beginning to see transactions again," says Miller. "We are seeing more buyers, typically end-users, and sellers who are willing to adjust the sale price to the market."

End-User Predominance

Things are not good in Tim Ruffin's town, Reno, Nevada. **Tim Ruffin, SIOR, CCIM,** is senior vice president at the Reno office of Colliers International, and he looks around at a city with an unemployment rate above 14 percent and an office building market at 22 percent vacancy. Yet, he feels fortunate because he has been able to move property, one recent closing and two more buildings in escrow.

"The people that are buying now are end-users who want small buildings and are paying cash," he says.

Even making those deals were tough because they were on properties taken back by banks. But like Miller in Tampa, Ruffin believes the only way to survive is to be somewhat ruthless. "We don't take listings unless the sellers use our numbers; otherwise it will waste both our times," he says.

A lot of banks try to go to market with an older appraisal, which is no longer relevant as markets move so rapidly. "Once we secure the listing, we expect the bank to go to the market at real value," he says. "If they go to the market with the old appraisal, the property will sit and lose opportunities."

Going to market at real value is the key, because he cautions, "If you misprice your property today, you will only chase down value."

Echoing Ruffin in Reno, **John Stacy, SIOR,** president of J.P. Stacy & Co. in Prairie Village, Kansas, a suburb of Kansas City, reports, "The only properties that are trading in this market are those that are used for business." In other words, it's a cash-in-hand, end-user market in the Kansas City area as well.

Nevertheless, Stacy has been working with an investor who has been involved in non-Kansas City deals, one of which was an office building in Michigan that sold at 50 percent of peak.

"You have to understand what the market conditions are [at the location] where the property is. You have to do your homework," says Stacy "I worked with another SIOR in Michigan, a guy that I had a lot of confidence in. Still, if the bank doesn't come forward, nothing will happen. This particular bank initially wasn't as cooperative in the beginning as they were at the end. But, cash speaks. Throw in cash and say you'll close in 30 days and people will listen."

In fact, that deal was a short sale. "We bought it for much less than what they had it on the market for and less than what was owed," Ruffin notes.

Working With Banks

The good news is that a number of regional banks have come around to the concept that it is better to actively sell off their portfolios of foreclosed properties and take the lumps now rather then wait around hoping the market will stabilize in the near future. In fact, better times for commercial real estate could be a long time coming.

Zion Bancorporation in Salt Lake City has turned to a local company, Innovision Property Group, to help them sell assets across the country.

"Zion has taken a proactive position in writing down balances and getting properties into the market at actual prices," says **Michael Jeppesen, SIOR, CCIM,** Innovision Property's

Contributing SIORS


Michael Jeppesen, SIOR, CCIM


George McCutchen, SIOR, CCIM


Edward Miller, SIOR, CCIM


Kenneth Reiff, SIOR


Tim Ruffin, SIOR, CCIM


John Stacy, SIOR

president. "They have asked us to go through their entire portfolio and get a new competitive market analysis for each property. We have hired the most qualified brokers in individual markets and demonstrated that we are getting the best information available to make sure we don't leave money on the table."

Zion assets are going to market with prices that can move a property in 60 to 90 days, Jeppesen adds. "If banks are willing to take a hard look at their assets, hit the market priced right and with the best broker in every market, properties are moving."

The Colliers International office in Memphis, Tennessee, has also worked with a regional lender, First Tennessee Bank, to sell off assets.

"The key for us on this distressed stuff is getting all the information," says **Andrew Cates, SIOR,** a vice president with Colliers International. "When we have the information, we can quickly get to the closing table instead of trying to find someone who no longer works for the company to get old reports. It's the biggest challenge. Our job is to figure out all that information and put it in a location where we can use it when trying to sell a property."

Equally important, Cates adds, is to do the research on the buyer because the seller wants to know the buyer is the right person with whom to do business.

Different Metros, Different Lender Responses

The Denver commercial real estate market has stayed relatively healthy compared to other cities, but the banks remain cautious, and when properties do go back to lenders, the overriding approach is to be as flexible as possible.

Paul Kluck, SIOR, a vice president with CB Richard Ellis in its Greenwood, Colorado, office, gives this example as to how banks are working with defaults. "I sold a building about seven years go to a customer and then the economy went sour and so did his business. He got into a position where he could no longer make payments on his loan," Kluck recalls.

The customer had paid $1.7 million for a property with the mortgage at $1.5 million. With his business and the economy going bad, the property was no longer worth the value of the mortgage.

"It was a Small Business Administration loan, so the bank went to the borrower, who is my client to discuss the situation," Kluck says. "The client told the bank, 'You can take the property back and kick me out, or you can let me occupy the property while Paul (Kluck) tries to sell it.' I told the bank the property was now worth $1 million or less. The bank said they would leave my client in the property while I put the building on the market."

The key point here, says Kluck, is that "lenders are realizing it's better to leave the borrower in place in the buildings to continue to maintain the property so it doesn't lose value."

That's a different approach from what **Paul Fogel, SIOR, CCIM,** has been seeing as a vice president with the Karbank Real Estate Co. in Kansas City, Missouri. Fogel had a manufacturing client that had bought a building in 2006 for $1.8 million with a loan of $1.4 million, so the client had $400,000 worth of equity in the property. Fogel, following the client's request, first put the property on the market for $2.2 million, then dropped the price to $1.8 million and finally to $1.4 million. An offer came in at $1.1 million.

The offer obviously was $300,000 less then the client owed on the building. The client pleaded poverty, saying he didn't have the $300,000 to make up the difference.

"I said there are a lot of people in Kansas City that are just like you; they owe more on their building than it is worth. But you have one big advantage—You have an offer," Fogel says. "My advice is to take the offer to the bank, which is no longer your adversary; it is now your partner."

The bank's response was, sign the contract and we will forgive the gap.

"The bank didn't want to foreclose because the minute that happens, the offer at $1.1 million drops down to

$900,000 or $800,000," says Fogel. "The banks are realizing the seller is the one qualified to get the most money for the property, and they are deciding on a case-by-case basis whether they will forgive the borrower the difference."

Out in Orange County, California, **Stan Mullin, SIOR, CCIM, CRE**, a principal with Newport Beach-based California Real Estate Receiverships, reports an increase in receiverships, which is good business for brokers.

In Orange County a lot of developments are broken but not busted. Office buildings are functioning with tenants, but they are not providing enough income to pay expenses, mainly mortgage debt, and finding a lender to do a refinancing is near impossible. The banks don't want to take the property back; instead, they put it into receivership.

Think of receivership as a stage just short of the bank taking title.

"When a property is put into receivership, brokers get hired not only to take over the leasing but also to sell the asset out of receivership," Mullin explains. "The lenders, whether they be CMBS, life insurers, credit unions, or banks, don't want to take title and have to deal with all the intended liability that comes with it."

Borrower Strategies

In some markets, the borrowers, not the lenders, are taking the initiative to move real estate to a new ownership position.

The Boise, Idaho, commercial real estate market has been very hard hit by the recession. "I've been doing this for 32 years and this is the worst downturn I've seen for such a lengthy period of time," says **Gary Buentgen, SIOR, CCIM**, a principal in Boise-based Intermountain Commercial Real Estate.

Even with the property market in such turmoil, Buentgen is concluding two sales, and he was able to find a buyer for both buildings because he convinced the owners to finance the deals. The buyers were end-users.

"It is an easy sell if the owners don't have debt against their properties," Buentgen explains. "As primary lenders, they are in the driver's seat and they get to charge more for the loan than the buyer would have received from a bank."

Buentgen adds, "If we know it is a strong buyer, we can get personal guarantees. As long as there is a traditional down payment of 20 percent or more, the seller feels comfortable that the buyer has enough skin in the game to meet the obligations of the debt."

That borrower ploy is a bit different from the ones **Tom Hill, SIOR, CCIM**, of Tom Hill Realty & Investment in Waterbury, Connecticut, has been experiencing lately.

One of Hill's clients was underwater on a five-acre lumberyard with a 20,000-square-foot building on it. The lawyer for the client asked Hill to accompany them to court, where they were going to ask for an extension.

"They were asking the court to hold off foreclosure for a year and give me time to sell property," Hill explains.

It's a good strategy, says Hill. "I do the owner a favor, preserve the listing, and, if there is no foreclosure, I still have an opportunity to sell the property."

These requests come in fairly often, Hill notes. "It's happening more and more. Some banks know they will never get paid, so they are starting foreclosures or turning the properties over to receivers. Other banks are extending the loans. And cities do not want to take over the properties even if taxes aren't paid. They don't want to be responsible for the operations of the properties."

Contributing SIORS

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