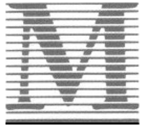

Opportunities in a Workout Environment

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Over the next two to three years a substantial percentage of the commercial real estate balance sheet in the U.S. and Western Europe will need to be restructured. New capital will be required to accomplish this, and providers of that capital are in a position to enjoy very attractive returns.

Pricing at the peak of the cycle was fueled by abundant leverage, and property level debt was frequently excessive, often with the help of creative Wall Street structuring. In a near-zero LIBOR environment, the majority of these loans (excluding construction loans) may continue to perform for some time, but at the earlier to occur of maturity and the time when the property needs capital, the chances of default are high. Whether the default happens at or before maturity, the problem is a lopsided balance sheet, and it needs to be corrected before the property can be refinanced, sold or in many cases even properly maintained. For this to happen, the property needs to be recapitalized with a healthy and sustainable amount of debt, and the inherent loss of value needs to be absorbed by the owner, the lender, or most often a combination of the two.

The mechanism for achieving this recapitalization and the opportunity for new investors to profit from the transaction differs by the type of entity that holds the loan and by the individual institution. Banks and similar lenders such as life companies, are constrained in the choices they can make by regulators, the extent to which they have the capital to absorb the loss and, to a growing degree, staffing. CMBS lenders have different constraints related to tax and other specific rules underlying the securitizations.

Bank and Other Balance Sheet Debt

As the cycle unfolds, there will be a full range of opportunities from lenders that will likely include sales of foreclosed assets, loan sales and restructurings. This may ultimately include bulk sales, particularly of the assets of troubled institutions. At the moment, most banks are managing their loan books without aggressive foreclosures, so loan sales and restructurings are now the more common outcomes and are increasing in volume.

If a bank does not wish to pursue a foreclosure, and has the capital to absorb the full loss, the simplest execution is to sell the loan at a discount, either individually or in a pool. For sub-performing loans (i.e., those that are likely to default in the future) and non-performing loans, prices are likely to reflect a substantial discount to both replacement cost and the expected value of the property when the real estate recession ends.

Opportunistic investors have a range of choices for participating in and benefitting from this process:

1. Acquire the whole loan from the bank and pursue a workout with the borrower. The workout generally has one of the following outcomes:
   - *Discounted payoff*: The borrower puts up or raises sufficient capital to pay off the loan at an amount less than the full amount of unpaid principal balance but sufficiently greater

than the price the acquirer paid to the bank to generate an attractive return to the holder. In this case, the loan purchaser avoids both the process of foreclosure and any real estate related issues that need to be addressed.

- _Foreclose and own the asset_: In cases where the loan holder and the borrower cannot come to terms on a discounted payoff, or the borrower is unable to raise the capital required for the payoff, foreclosure or a deed in lieu of foreclosure can be pursued. Should this action be taken, the investor will have to deal with any property related issues but will also have the potential to capture the full value of both property enhancements and an ultimate recovery in market values.

2. Finance the “gap” between the cost of the whole loan purchase and the amount of a new first mortgage financing that can be obtained from a traditional lender (life insurance company, Fannie/Freddie, etc.) plus whatever supplemental capital the asset may require.

3. Provide the full amount needed to buy the loan in the form of a new first mortgage within a new capital structure that includes funds to maintain the asset.

Some investors will only want to own the most senior portion of the new capital structure at returns that are currently in the five to seven percent range. We believe the 50%-75% loan-to-value portion of these new capital structures, with expected returns in the mid/high teens, provides a more attractive risk/reward scenario given the very conservative level of new senior debt and current valuations. Indeed, many of these positions may be *created* by buying the whole loan and financing it through the sale of a senior participation, or “A” note, often to a life insurance company or to a TALF-financed investor. These may also be created by financing the whole loan directly on balance sheet which, if conservatively structured—non-recourse, long term, no mark-to-market—can also be attractive.

There are many variations on the above themes, including solutions for banks that are able to tolerate some, but not all, of the implied capital loss. For example, a lender can choose to extend the term and/or reduce the remaining principal amount of an existing loan, essentially converting a sub- or non-performing loan into a new performing loan. This is likely to be done in tandem with an equity infusion by the existing borrower or a new third party investor whose money may have priority rights to cash flows, even over all or a portion of the senior debt. Some bank/borrower discussions are currently envisioning the bank splitting its loan into a new, “right-sized” first mortgage with the remaining portion of the loan converted to a mezzanine loan.

Regardless of which of the above structures is employed, opportunistic new investors have three basic risk/return positions from which to choose in these restructurings: (i) junior debt at a very attractive basis that is likely to perform to maturity and generate a fixed (typically mid/high teens) coupon; (ii) 100% ownership of the property; or (iii) a position between the debt and equity (either mezzanine or preferred equity) in which the investor is likely to earn an attractive fixed return (at the moment roughly 20%) and may also have senior rights to cash flows and participate in the expected recovery of property values.

There are clearly risks in investing in a distressed environment and certain skills are required to execute successfully. It is easy to talk about a “loan to own” purchase of a note, but few managers have both the expertise to work through the financial maze (note purchase, foreclosure, potential bankruptcy, etc.) and the property expertise to restore to health a property that has likely been neglected for an extended period in a difficult operating environment. Even managers that do have the

skills to accomplish their program must utilize a financing structure that provides sufficient term such that the new investor does not wind up in a second workout before the market recovers.

Securitized Debt

CMBS lenders do not have the regulatory or capital issues faced by banks; at the same time, special servicers are constrained by the restrictive tax and structural rules. Therefore, while we expect a similarly high percentage of CMBS loans to default (vis-à-vis bank loans) the range of opportunities to participate in a workout of a securitized mortgage will likely be narrower than with loans held by a bank. Given the size and fragmentation of the bank mortgage market, as well as the wider range of structural possibilities the bank market offers for an opportunistic investor, we expect CMBS opportunities will represent a relatively modest portion of the distress opportunity over the next two to three years.

As special servicers (already overwhelmed) work through the growing backlog of delinquent and defaulted loans, we expect to see opportunities to buy whole loans and foreclosed properties.

In addition, we believe that the CMBS sector will remain very illiquid and volatile. As defaults rise over the coming quarters, we expect to see attractive investment opportunities in inefficiently priced bonds from time to time (particularly at times when government sponsored programs, such as PPIP, are on the sidelines). Managers that have the ability to underwrite each underlying loan and the related real estate collateral in a large portfolio will be well positioned to capitalize on these opportunities.

Conclusion

Property values are severely depressed and are likely to remain so for at least the next couple of years as workouts play out. However, we believe that they will ultimately recover, and investors that participate in these recapitalizations will have the opportunity to earn outsized returns in any of the above risk/return approaches. Regardless of what drives the restructuring, the window of opportunity to benefit from the workout of distressed debt has opened and is expected to expand greatly over the next 24-36 months. Tenacity, diligence and patience remain critical for those looking to participate in and benefit from the progression.

- David Sherman, President and Chief Investment Officer

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