

Distress Tests

Demand Rises for Strike Forces to Tackle Troubled Properties

By Paul Rosta

The explosive growth of troubled assets is a well-known phenomenon of the commercial real estate downturn, but the echoes of that explosion reach beyond the obvious stakeholder groups of borrowers, lenders and investors. Today's conditions are also creating a once-in-a-generation demand for property managers skilled and nimble enough to handle properties that are in bankruptcy, in foreclosure or financially delinquent. "I think that this is a great opportunity for people to really home in on this challenge," said Mike Kent, president of FirstService Real Estate Advisors' real estate management services group. So far it has been easier for assets to fall into distress than it is to climb out of it; as of early March, Real Capital Analytics Inc. tallied more than \$207 billion worth of properties as distressed, only \$47.6 billion of which have regained stability.

Among geographic regions, the West presents property managers with the greatest opportunities to take on properties in a state of extremity. More than 2,400 assets valued at \$56 billion were counted as distressed in California, Arizona, Nevada, Washington, Oregon and Hawaii, according to Real Capital Analytics. In second place is the Southeast with 2,268 distressed properties valued at \$37.7 billion. Given the souring of retail during the recession, it comes as no surprise that the sector accounts for an industry-leading \$41.6 billion in troubled assets.

A distinct capital markets trend is further shaping the demand for distressed asset services. To this point, lenders have been far more

reluctant to take possession of distressed assets than they were in previous cycles, particularly during the savings-and-loan crisis a generation ago. So far, \$27.3 billion worth of properties have fallen into the category of "foreclosed" or "real estate owned"—a significant volume, to be sure, but only a trickle compared to the larger pool of distressed assets. Lenders have any number of incentives these days to avoid taking on problem properties. Foreclosed properties are a tough sell in an already unforgiving transaction market; although REO inventory expanded by \$8 billion during the fourth quarter of 2009 alone, lenders managed to unload only \$2 billion worth of distressed properties.

tions and property upgrades is also limiting the potential market for foreclosed properties.

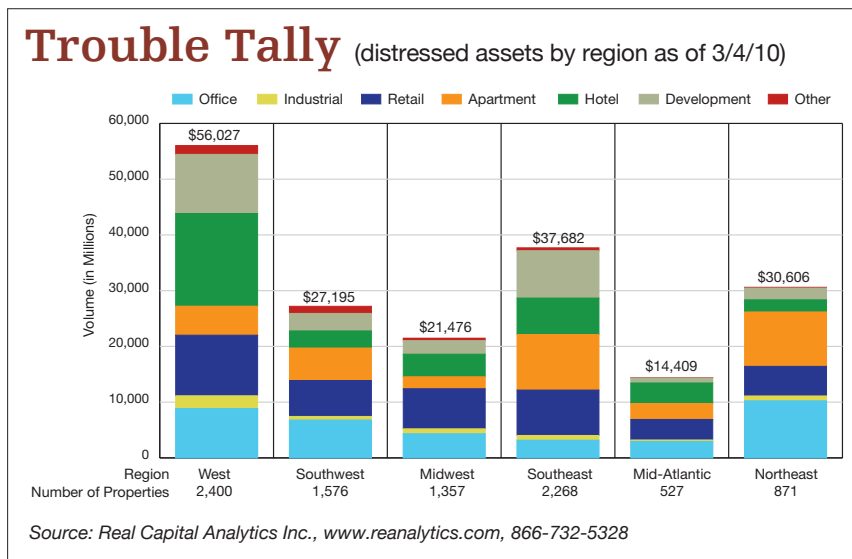
But lenders are finding alternatives. "Special servicers are getting receivers appointed rather than foreclosing simply because they can rework and re-write the loans to provide seller financing," explained Roland Freeman, president of Capital Consultants Realty Services. "A foreclosure and subsequent sale would require outside financing, which is simply not available."

Who's the Boss?

Although the basic tasks of property management remain the same for assets in an extreme condition, the property manager will carry them out in a different way. "To me, the No. 1 priority is you have to know who you're working for," said Randy Woodbury, vice president of property management firm Woodbury Corp. and the Institute for Real Estate Management's 2010 national president. Those potential stakeholders can range from a private owner and investor to a lender, an insurance company or a court of law. "Every one of those situations will probably bring to the party a different priority and a different goal," Woodbury added. In some cases,

a lender that has foreclosed on the property will decide to liquidate it as soon as possible. Those lenders typically want to invest only enough capital to allow an asset to tread water until it can be sold.

Given the challenging investment sales market, another option is sticking with the property for at least the medium term, until prices rise



A shortage of experienced personnel also makes taking ownership of troubled assets unattractive. "Sometimes, lenders can't digest the properties that can potentially come their way," noted Todd Robinette, senior vice president & regional manager for Jones Lang LaSalle Inc.'s Northern California property management services. And the scarcity of financing for acquisi-

[Property Management]

and acquisition financing becomes more readily available. A third, probably rarer possibility for high-potential properties is holding on to the asset for several years with an eye toward a long-term turnaround.

Whatever the client's goal, most scenarios involving distressed assets carry a common thread: the requirement to assume management of a property and rapidly stabilize it. In most cases, a crack team of experienced professionals must take on unknown conditions—while the clock is ticking. “You have to have everything completed in two or three weeks,” explained Kent. “Your knowledge has to be equal to what the prior team's was.”

In many cases, the property manager will report to a court-appointed receiver, often an attorney or other professional who specializes in stabilizing troubled assets. However, a number of property managers also have extensive track records as receivers. Not surprisingly, these are in increasing demand. Ben McGrew, president of Managewest Inc. and a qualified receiver since the 1980s, is currently serving in that role on more than 20 properties comprising about 1 million square feet of office, retail, industrial and multi-family space in California.

Whatever the scenario, managers brought in to handle properties on the edge must expect to encounter problems of all shapes and sizes. “We're looking for something to jump out of the woodpile at us, and something does almost every time,” said McGrew. Many of those issues stem from the daily battle for survival that the property owner has been waging for months or years. It is not uncommon for property managers to discover months of unpaid utility bills, so one of the first tasks for distressed properties is to negotiate with those for extensions or settlements in order to keep the property's lights turned on and maintain other essential services.

A borrower's struggle for survival may also have unintended consequences. An owner that is struggling to keep up with utility bills is much more likely than a typical property owner to put off maintenance that affects security and safety. As a result, the property manager must rapidly assess the physical condition of the property and figure out whether lapses in maintenance have created a breeding ground

for a fire, accident or other mishap for which the manager's client would be liable.

Development projects represent a significant portion of distressed properties nationwide—nearly 1,200 properties valued at \$27.7 billion, according to Real Capital Analytics—and they present a unique set of headaches. “Banks are taking on properties that don't have any history of operations,” Kent noted. Where the developer leaves behind no projections for revenue or operating expenses, the property manager is then tasked with quickly coming up with estimates.

Both new and existing assets can be plagued not only by inadequate cash flow but efforts to skirt the law. “In one portfolio of buildings, the borrower was doing a lot of work without pulling any permits and the work they were doing was not up to code,” reported Robinette. That owner converted storage spaces in an apartment complex into illegal and potentially hazardous multi-family units. The owner of another property taken over by Jones Lang LaSalle had received 100 percent acquisition financing from a foreign lender, skimmed the rents, failed to pay utility bills, insurance and taxes—and then fled the United States.

A Firm Hand

In addition to taking stock of accounting issues and assessing physical condition, property managers must tend to the distressed property's tenants. Worried tenants must be kept informed and reassured that the interim management team has matters under control. “Any time there's a transition, you have to be above and beyond in communication,” Kent contended. “Overkill will be a blessing. Uncertainty creates chaos.” He recommended ensuring tenants are clear on the expectations and goals of the transition. If the lender's plan is to liquidate the property as soon as possible, the manager should make sure the tenants know that another change in ownership is on the horizon.

When the owner of a distressed asset decides to hold it for more than a few months, the property manager has the mandate to develop a strategy for the medium term, if not for the long term. Although many distressed-asset situations call for the strike-team approach, other skills are needed when the owner's goal

is to stabilize the asset for a longer-term or medium-term hold. The urgency required for initial stabilization then extends to other responsibilities, such as backfilling vacant space. “You can't be a reactive manager or owner or receiver in a distressed marketplace,” noted McGrew. Comprehensive, up-to-the-minute market knowledge is vital to keeping the property competitive and pulling in new tenants, he explained: “So many distressed properties are coming online, there could be a new one today that wasn't on my comp sheet.”

Even against unfavorable market odds, patience and resourcefulness can help restore a property to stability. A community center owned by diversified real estate services firm Rector Phillips Morse Inc. took a one-two punch in late 2008 and early 2009 when a national big-box retailer and a grocery store departed within months of one another. Although it was vital to backfill those spaces and generate revenue, the right combination of tenants was equally important, said Ron Goss, president of RPM Management Inc., the company's property management affiliate, and IREM's president-elect. By the third quarter of 2009, RPM had leased the vacated spaces to a church and a call center.

Perhaps the hardest questions to answer about demand for distressed asset management services are when the need will peak and how much it will involve. Several factors may yet help soften the impact on lenders and borrowers—in particular, an accelerated economic recovery in 2010 and 2011 could provide a sound rationale for lenders to extend loans for properties with a genuine shot at a turnaround. Although the number of foreclosures has been relatively low so far, many veterans speculate that lenders cannot keep kicking the can down the road indefinitely. “I think that in 2010 to 2012, that situation will come to a head,” said Mez Birdie, director of retail investment services for NAI RealVest. “You can only ‘pretend and extend’ so long.”

Whether the pace of foreclosures remains a steady trickle or finally turns into the long-awaited flood, it is clear that demand for managing distressed properties will remain a fact of life.

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