

Assessing Distressed Property

HOSTED BY FIAAO

PRESENTED BY:

WILLIAM “TED” ANGLYN, MAI, CCIM

Assessing Distressed Property Agenda

3:00 p.m. – 3:15 p.m.	Introduction and Overview
3:15 p.m. – 3:30 p.m.	Current Events and Trends
3:30 p.m. – 3:45 p.m.	Capital Market Considerations - Value Impacts
3:45 p.m. – 4:15 p.m.	Valuation Considerations – Revenue and Vacancy Impacts
4:15 pm – 4:30 pm	Valuation Considerations – Expense Issues
4:30 p.m. – 4:45 p.m.	Valuation Considerations - Development Properties
4:45 p.m. – 5:00 p.m.	Closing Comments – Have We Overstated the Problem with Commercial Real Estate

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Further, the general principles and conclusions presented in this text are subject to local, state, and federal laws and regulations, court cases, and any revisions of the same.

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Acknowledgements

Program Developer

William “Ted” Anglyn, MAI

Anglyn Property Advisors, LLC

PO Box 71144

Marietta, GA 30007

Tanglyn@anglynproperty.com

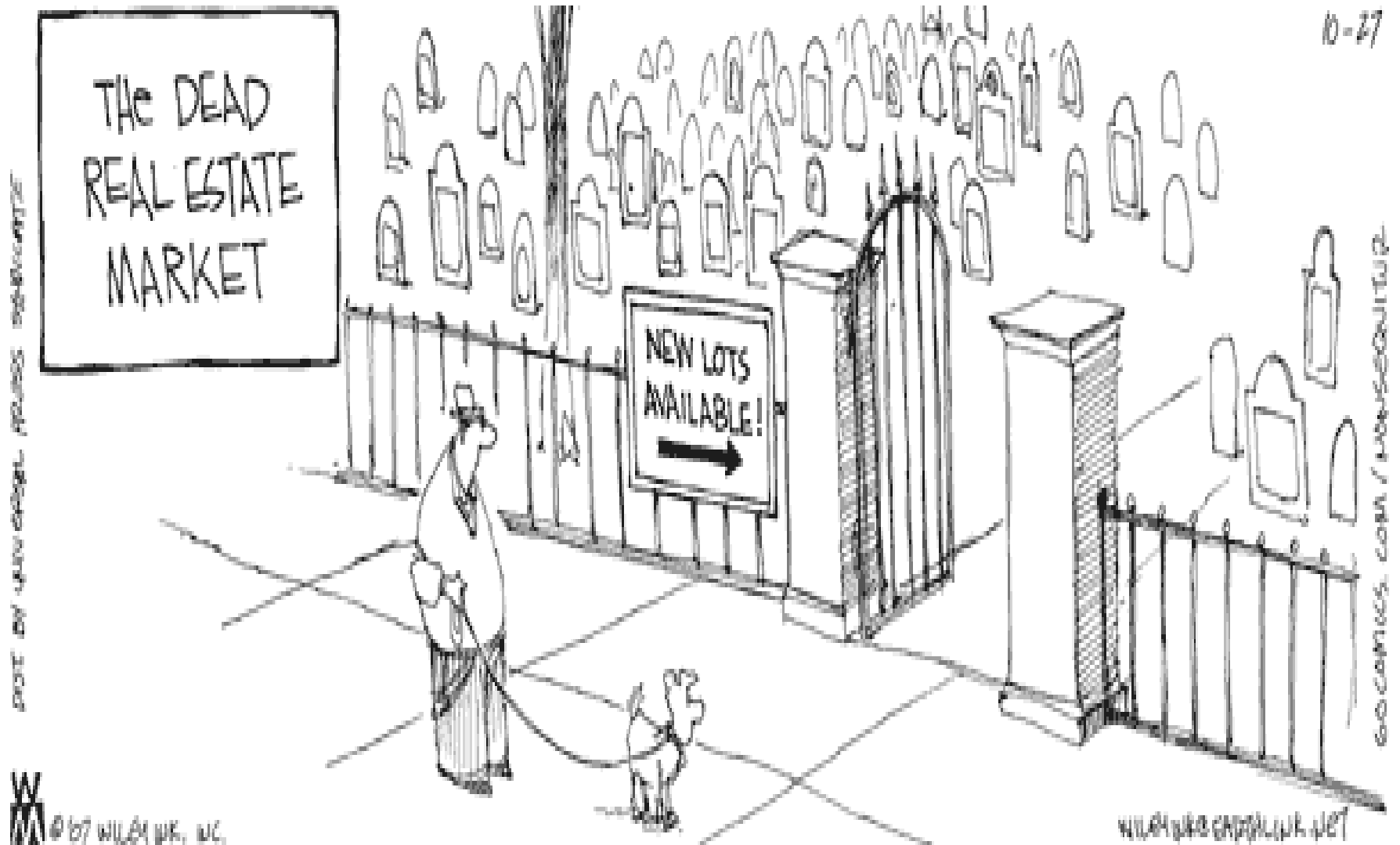
(770) 289-4500

www.anglynproperty.com

Program Objectives

- Discuss Current Issues and Trends
- Discuss Distressed Valuation Considerations on:
 1. Revenue (Income Forecasts)
 2. Expense estimates (holding costs)
 3. Capitalization Rate forecasts
- Explore how Capital Markets (debt and equity) affect Commercial Real Estate
- How to Analyze Development Properties

Subdivision Development



Key Definitions

- As Is Market Value
- Liquidation Value
- Distressed Real Estate
- Entrepreneurial Incentive

Liquidation Value

Liquidation Value may be defined as the most probable price which a specified interest in real property is likely to bring under all of the following conditions: *[key points]*

- Consummation of a sale will occur within a **severely limited future** marketing time specified by the client.
- The buyer is acting prudently, knowledgeably and typically motivated.
- The seller is under **extreme** compulsion to sell.
- The buyer is acting in what he or she considers his or her best interests.
- A limited marketing effort and time will be allowed for the completion of a sale.

Source: Dictionary 4th Edition

Liquidation Value

Most lenders are currently using 90 days for marketing time. Big debate today about how Liquidation Value is being reported.

Distressed Definition

- Distressed Real Estate
 - In general, distressed real estate represents those properties suffering from higher than typical vacancies.
 - Properties where effective rents or prices have declined significantly in order to attain lease-up or sale.

Other Key Definitions

Entrepreneurial Incentive:

- A market-derived figure; represents what entrepreneur expects to receive for his or her contribution to a project;
- The difference between the total cost of a property (cost of development) and its market value (property after completion);
- Also called entrepreneurial reward.

Problems & Causes

Supply & Demand

- Market Issues
- Capital (Debt & Equity) Availability
- Property Specific Issues
- Ownership/Management Issues
 - Incompetent
 - Undercapitalized

Part 2 – Current Events and Trends

Objectives – Part 2

- **Valuation Considerations**

- **Impact of Housing Downturn**

Valuation Considerations

- Issues are two-fold:
 - Valuation Methodology (e.g. derive overall rates from Band of Investment versus from sales; review historic sales trends when similar market conditions prevailed, etc.)
 - Valuation Influences (e.g. NOI Impacts , lack of sales, Bid/Ask gap, lack of capital)

Valuation Methodology

Methods market participants are using for
Capitalization Rates with lack of Sales:

- 1) Band of Investment
- 2) Investor Surveys
- 3) DCR Method

BAND OF INVESTMENT TECHNIQUE

2007

<u>Source</u>	<u>Ratio</u>	<u>x</u>	<u>Rate</u>	<u>=</u>	<u>Wtd. AVG.</u>
Debt	80.00%	x	5.50%	=	4.40%
Equity	20.00%	x	8.00%	=	<u>1.60%</u>
					6.00%

BAND OF INVESTMENT TECHNIQUE

2010

<u>Source</u>	<u>Ratio</u>	<u>x</u>	<u>Rate</u>	=	<u>Wtd. AVG.</u>
Debt	60.00%	x	8.88%	=	5.28%
Equity	40.00%	x	12.00%	=	<u>4.80%</u>
					10.08%

Note

- Based on this simple depiction, cap rates have increased over 67% {68%} since 2007. The real result is that many sellers have taken their properties off the market and are not selling unless under undue pressure (loan balloon or some other debt/equity constriction).
- www.cushwake.com/sonngold/

INVESTOR SURVEYS

- Positives and Pitfalls

- The DCR method is $R_o = DCR \times R_m \times M$ (% Mtg)
- -- R_m = Mortgage Constant
- -- M = Mortgage Percentage (say 75%)

Valuation Influences

Depending on the severity of the distressed market conditions, participants scrutinize investment decisions with the following type analysis:

Valuation Influences

Depending on the severity of the distressed market conditions, participants scrutinize investment decisions with the following type analysis:

- Actual Income in place versus pro-forma NOI
- More Incentives (sales and or rent concessions)
- Lower rent growth forecasts
- Longer lease-ups/sell-outs forecasted
- Higher Yield Requirements/Higher Overall Rates
- More Cash Required (all cash in some cases)

Part 2 – Impact of Housing Downturn

- Home Inventories – Highest in 12 years
- Builder Losses Continue to Compound
- Builder Bankruptcies are increasing
- Bank CRE concentrations are elevated
- Home Foreclosures are at 30-year high

Part 2 – Impact of Housing Downturn (Cont'd)

- Unsold homes/condominiums pose competition for apartments
- Household credit conditions have weakened
- Foreclosure sales representing greater percentage of home sales
- Home Equity Lines being compromised from both value decline and lender constrictions

Part 3: Capital Considerations

Objectives:

- Explore Debt and Equity Sources
- Explore changes in Capital Trends
- Underwriting Standards: Discuss changes that are occurring
- Loan Term Patterns: Review how debt parameters have affected amount of equity and equity returns.
- Interest Rate Forecast/Implications: Explore implications of interest rate increases.

DEVELOPER MANTRA

- WILL BUILD WHEN:

- there is _____ Cash Flow
- there is _____ Cash Flow

- WILL NOT BUILD WHEN:

- There is _____ Cash Flow

DEVELOPER MANTRA (Instructor)

- WILL BUILD WHEN:
 - there is **Positive** Cash Flow
 - there is **Negative** Cash Flow

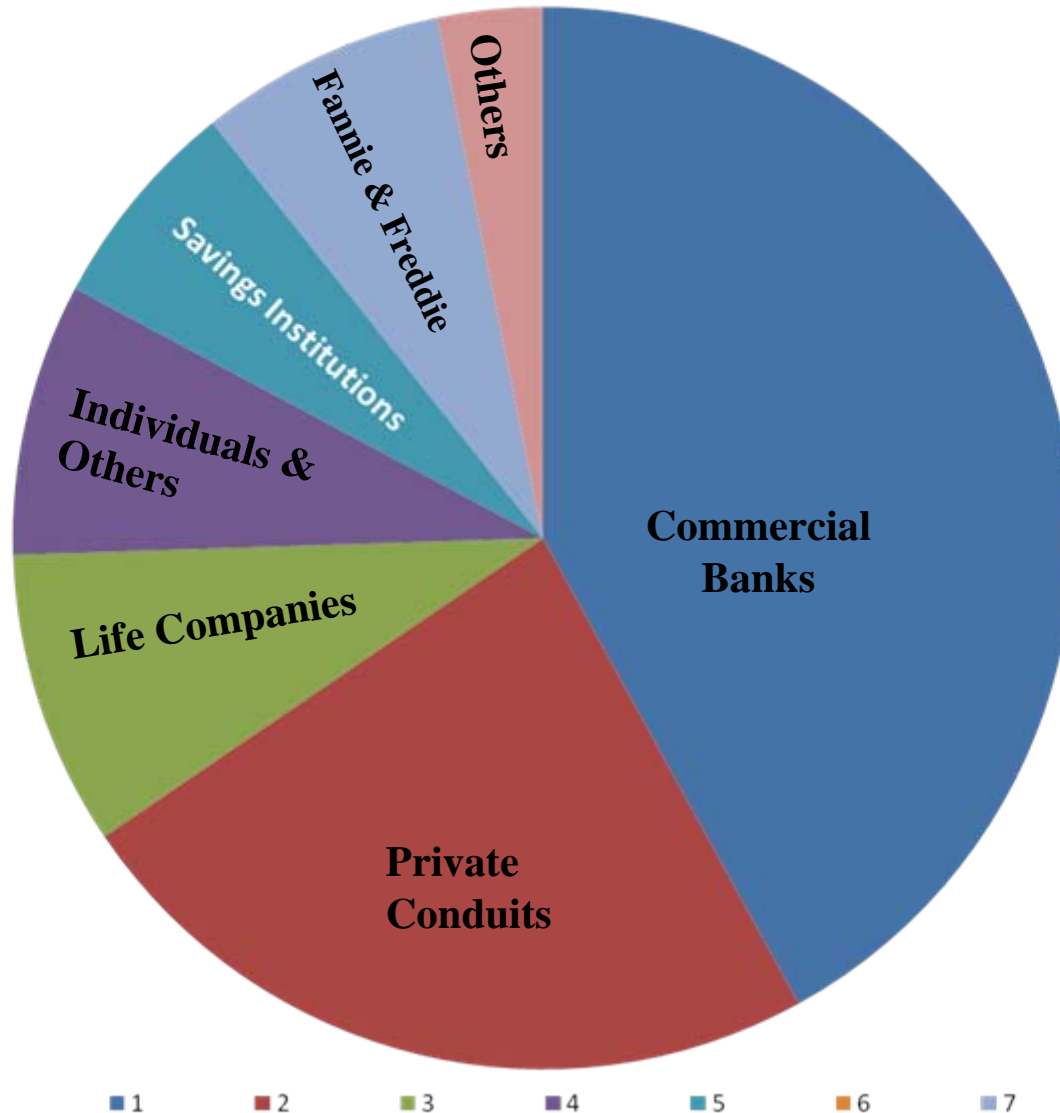
- WILL NOT BUILD WHEN:
 - There is **NO** Cash Flow (No Debt or Equity)

CAPITAL SOURCES

- Six Primary (Traditional) Sources (\$3.5 T):
 - Commercial Banks
 - Conduits
 - Life Insurance Companies
 - Individuals and Others
 - FNMA/Freddie Mac
 - Savings Institutions

Source: Federal Reserve Board, Statistical Summary, March 2008. FNMA/Freddie Mac includes both mortgage pools and direct agency loans. Individuals and Others include mortgage companies, real estate investment trusts, state and local credit agencies, state and local retirement funds, noninsured pension funds, credit unions, and finance companies.

Capital Market Pie Chart



NON-TRADITIONAL CAPITAL SOURCES

- Private Equity
- Hedge Funds
- Seller-Financing

Equity Sources of Capital

- Private Equity (Individuals included)
- Pension Funds
- Life Insurance Companies
- Commercial Banks
- Real Estate Investment Trusts
- Limited Partnerships
- Tenant-In-Common (TICs) groups
- Government Agencies
- Private Funds (International and Domestic)
- Public and Private Companies

Equity Sources

- Equity Capital Considerations
 - Typically require higher returns than debt sources
 - Influenced greatly by market perception
 - Often have longer term perspective
 - Debt use perspective varies greatly
 - Until recently, equity capital was very deep and growing significantly in the past five years due to superior risk-adjusted returns.

CAPITAL TRENDS

- Debt and Equity has become increasingly difficult to secure.
- Debt Sources are changing. CMBS debt is not available for most transactions after dominating until the middle of 2007.
- 3 CMBS offerings in late 2009 – hiatus for roughly 2 years
- \$20 Billion anticipated for 2010

Part 3: Underwriting Standards

- Underwriting standards are far stricter.
 - Lower LTVs (50 to 60% versus 75 to 80%)
 - Higher DCRs (1.35 x versus 1.10)
 - Increased Financial Covenants
 - Higher use of Recourse (Full or partial recourse)
 - Much greater focus on Tenant Credit and Turnover
 - Actual NOI used versus Proforma NOI

Loan Term Patterns

- Loan Terms have changed:
 - Higher spreads
 - Often floors (minimum rate required) are used
 - Swap spreads versus purely loan spreads over the 10-year Treasury
 - Less optionality provided to borrower
 - Minimal to no I/O (Interest Only)
 - Faster Amortization
 - Greater Demand for Escrows

Part 4: Valuation Considerations

1. Review Revenue Considerations
2. Discuss Vacancy Considerations

Revenue Considerations

- Distressed Real Estate is Typically Characterized by a Decline in the Property's Rental Revenue
- Contract Rent versus Market Rent

SLIPPAGE/LEAKAGE

Slippage and leakage represent the foregone reimbursement revenue when management does not collect expense reimbursements stipulated in the leases.

Slippage/leakage exists for two reasons:

1. Management Election

Or

2. Management Incompetency

Vacancy Considerations

- Actual Physical Vacancy
- Functional Vacancy
 - Nonfunctional or Non-leasable Space
 - Space the Market Does Not Find Attractive
- Retail Space too Deep to Attract an Alternate User
 - Build an Interior Wall
 - Demolish the Rear Portion
 - Lease “As Is” with Essentially No Rent on the Excess Space (Sometimes referred to as “Dungeons” or “Dead Space”)

Vacancy Considerations with Distressed Real Estate

- Forecasting Vacancy
 - Subjective
 - Objective Through Cycle Analysis
 - Stabilized Vacancy Should Be Higher
 - Include Downtime Between Leases
- What happens to Utility & Janitorial Expenses When Vacancy Goes Up?
 - Increase at CPI?

Vacancy Considerations

■ Stabilized Vacancy vs. “As Is” Vacancy

Consider:

- “As Is” Occupancy: 50%
- Stabilized Occupancy” 90%
- Occupancy Improvement Needed to Reach Stabilized Occupancy: 40%, not 50%
- The forecast in occupancy improvement should bring occupancy to “stabilized” occupancy (a 50% improvement would equate to an inherent 100% occupancy).

Collection Loss Considerations

- Collection loss often increases in times of property distress. Several Questions:
- How many evictions in the past year?
- How many tenants are 30/60/90 days late?
- How much bad debt - last year's statement?
- Has collection loss increased or decreased recently?
- How is collection loss reported ?

Part 5 – Expense Considerations

- Fixed Expenses
- Variable Expenses
- Reserves for Replacements
- Capital Improvement Considerations

- Expenses/Holding Costs on Development Properties

Operating Expense Considerations

■ Fixed Expenses

- Real Estate Taxes May Decrease for a Distressed Property
- Insurance Expense
 - May Increase Significantly for a Distressed Property or may be unavailable
 - Risks Associated with Vacancy
 - Self-Insured Anchor Vacates

Operating Expense Considerations

- Variable Expenses

- Utilities and Janitorial Expense Should Decrease on distressed real estate:
- But How Much?
- Management Expense Often Decreases
- Fixed Minimum?
- Leasing Commissions May Increase
- Leasing Bonuses!
- Advertising

Other Expenses

- Reserves for Replacements
- Capital Improvements
- Holding Costs on Development Properties

Holding Costs on Development Properties

There can be holding cost associated with development properties. These holding costs typically include:

- Taxes on unsold inventory
- Insurance (typically minimal)
- Sales Costs
- Completion costs for uncompleted units
- Association Dues (if applicable)
- Management (of property and association)
- Profit

Part 6 – Valuation Considerations

Development Properties

Bulk Value Concept

Retail Pricing Support

Discount Rate Support

Bulk Value

- Value Via Discounted Cash Flow Analysis
- Value Via Comparable Sales

Bulk Value Scenario

- The valuation scenario employed in subdivision valuation and other appraisal problems in which a group of properties are evaluated under a bulk sale scenario

From Glossary of:

Subdivision Valuation, by Don M. Emerson, Jr. MAI, SRA, published 2008 by the Appraisal Institute

Bulk Value

- In subdivision analysis, *bulk value* is the market value of a group of lots to one purchaser.

From Glossary of:

Subdivision Valuation, by Don M. Emerson, Jr. MAI, SRA, published 2008 by
the Appraisal Institute

Discount Rate

- Investor Surveys (often 20 to 25%)
- Band of Investment
- Built-up Rate
- Provisions for Profit

(line item expense or part of discount rate)

CLOSING COMMENTS

- Are Appraisals overstating the problem?
- Are appraisals useful tools or too conservative?
- What is the useful life of an appraisal?