WORKOUT STRATEGIES FOR DISTRESSED PROPERTIES

by
C. DEAN SPERANTSAS
B.S., FINANCE, ECONOMICS; GEORGETOWN UNIVERSITY
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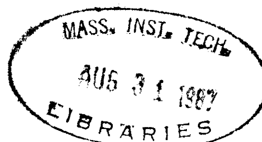
Signature of the author________________________
C. Dean Sperantsas
Department of Urban Studies and Planning
July 31, 1987

Certified by________________________
Lawrence S. Bacow
Associate Professor, Urban Studies and Planning
Thesis Supervisor

Accepted by__________
Michael Wheeler
Chairman
Interdepartmental Degree Progam - Real Estate Development



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ABSTRACT

This thesis attempts to answer the question of "How to salvage distressed real estate properties?"

The thesis arrives at the following conclusions: the existence of distressed property loans can be traced to the historical cyclicality of the real estate development industry; the entry of highly-liquid, undermanaged and newly-deregulated financial institutions into the real estate development industry; the artificial stimulus to investment provided by the tax laws; and macroeconomic changes.

The problems faced by distressed properties are caused by a lack of market demand due to forseeable circumstances such as unsophisticated market analysis or inattention to demand, and unforseeable changes in demand during the development period. Alternatively, property distress may result from financial, marketing or property management factors.

Financial restructuring of properties must secure adequate time and money for a turnaround. Time is required for the property to be absorbed by the market, to be renovated or repositioned. Money buys time. The equity investor wields significant negotiating power in distressed property acquisition and refinancing due to his willingness to accept risk. In exchange for investment of equity funds, the lender may provide forbearances. Specialized mortgage instruments such as the cash flow mortgage can be structured to suit the particular needs of the distressed property.

Marketing strategies for distressed properties rely heavily upon product repositioning; competitive pricing and broker relations. Property management works in tandem with the marketing strategy in maintaining cash flow during the recovery period and securing new tenants.

Thesis supervisor: Lawrence S. Bacow
Title: Associate Professor
Urban Studies and Planning

ACKNOWLEDGEMENTS

Interviews were crucial to the completion of this thesis. The author benefited from counsel and the forthright information provided by over 40 industry experts across the United States. While several of those interviewed will, at their own request, remain anonymous, the author would like to thank all those individuals who gave of their time and effort to explore the under-researched area of workout properties.

The author would particularly like to thank Professor Lawrence Bacow, the thesis advisor. As a thesis workout specialist, he guided this project from inception to completion.

CHAPTER ONE :

THE FORCES WHICH CREATED ONE OF THE LARGEST PEACETIME LOSSES OF CAPITAL IN U.S. HISTORY

Why are real estate markets across the United States replete with vacant real estate projects of every kind? Why do states, from Florida to California and Alaska to Hawaii, report an oversupply of apartments, office buildings, retail shopping plazas, hotels and many other types of property? The reasons are complex and indicative of the tremendous changes to which real estate and real estate capital markets have been subjected in recent years.

The scale of losses attributable to distressed real estate is illustrated by the frailty of the savings and loan industry, a major source of capital for the real estate development. The Federal Savings and Loan Insurance Corporation ("the FSLIC") is on the verge of bankruptcy [1]. The FSLIC has a negative net worth of $6 billion and loses $10 million per

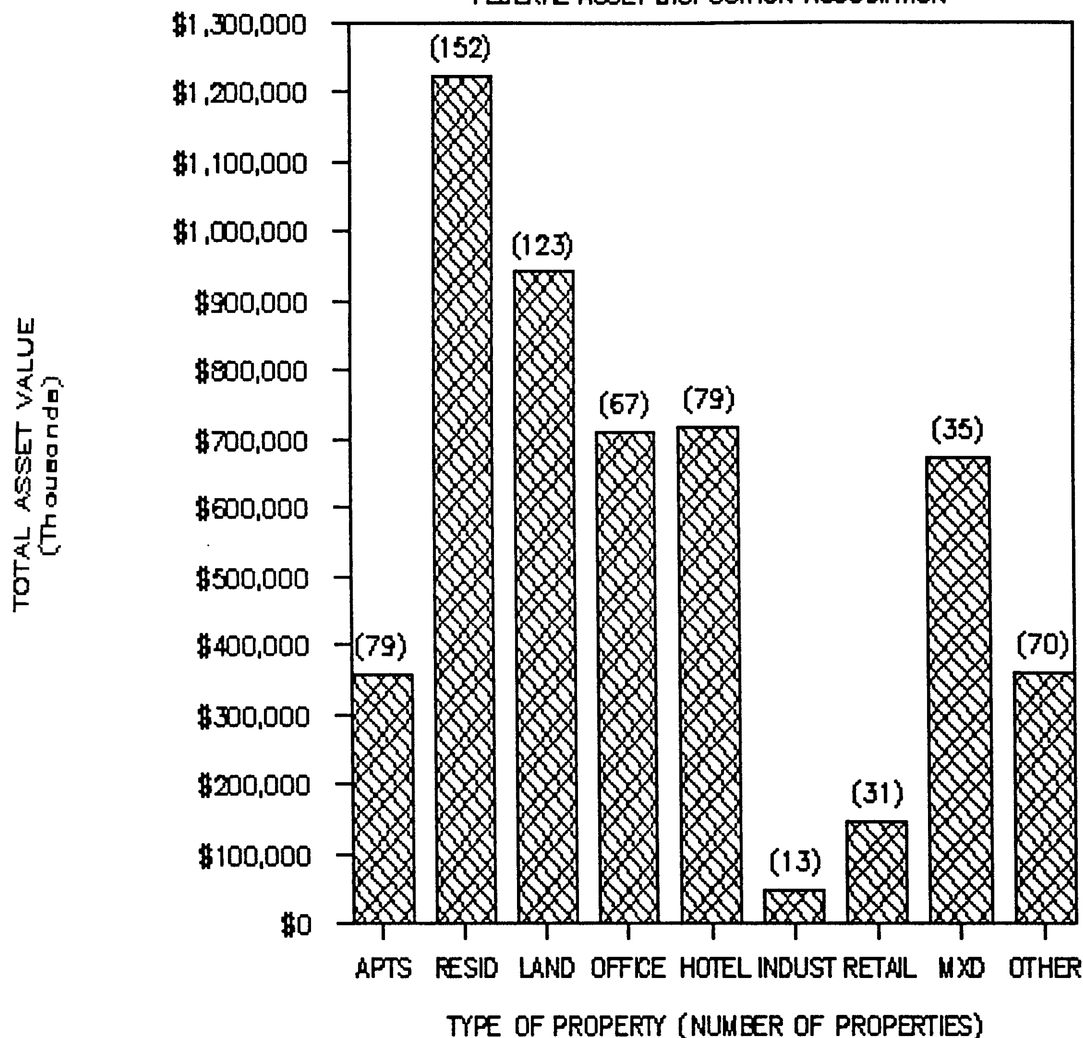
day. Proposals for a recapitalization of between $5 and $15 billion are currently before the Congress [2]. The FSLIC has assumed control of 44 savings and loans, with total assets exceeding $49 billion [3]. More than 450 savings and loans are technically insolvent. Some industry experts estimate that savings and loans may require $25 billion in capital infusions during coming years, in order to survive [4]. Since 1982, banks and savings and loans have reported over $10 billion in real estate-related losses [5]. Not all of lender's loan problems are traceable to real estate. Many suffered from ill-fated loans to the energy and agriculture sectors. Yet, the total amount of non-performing, reposessed or delinquent real estate loans held by commercial banks and savings and loans as of March 1986 exceeded $60 billion [6].

The upheaval in real estate can be traced to four main reasons: the historically cyclical nature of the real estate development industry; the over-supply of capital and uneven quality of management expertise at newly-deregulated lending institutions; the stimulus to investment offered by the availability of tax deductions for the ownership of real property; and economic shifts, on both a regional and macroeconomic level.

Cyclical Nature of the Real Estate Development Industry

The real estate industry has historically been plagued with a "boom and bust" mentality. The United States real estate market is the only market in the world where the majority of building takes place *in anticipation* of future demand, rather than to fulfill *existing* demand. Developers respond to a perceived demand for a certain type of real estate. They tend to initiate projects with insufficient regard to competition from potential new projects. Supply of certain types of real estate is more price-elastic than demand. For a given a change in price, developers tend to offer proportionately more space on the market than consumers demand [7]. Projects tend to feature long "lead" times between project initiation and project completion. Circumstances such as competitive supply can change significantly during these lead times. This phenomenon is often referred to as the "pipeline" effect. For these reasons, supply of real estate can exceed demand. The result is "overbuilt" markets. Excess supply of real estate can take months, or years, to be absorbed by a market, imposing significant carrying costs on owners. As space is gradually absorbed, and vacancy rates go down and rents increase, developers inititate new projects. The cycle of markets attempting to return to equilibrium begins anew. Real estate is an industry in continuous disequilibrum. [8]

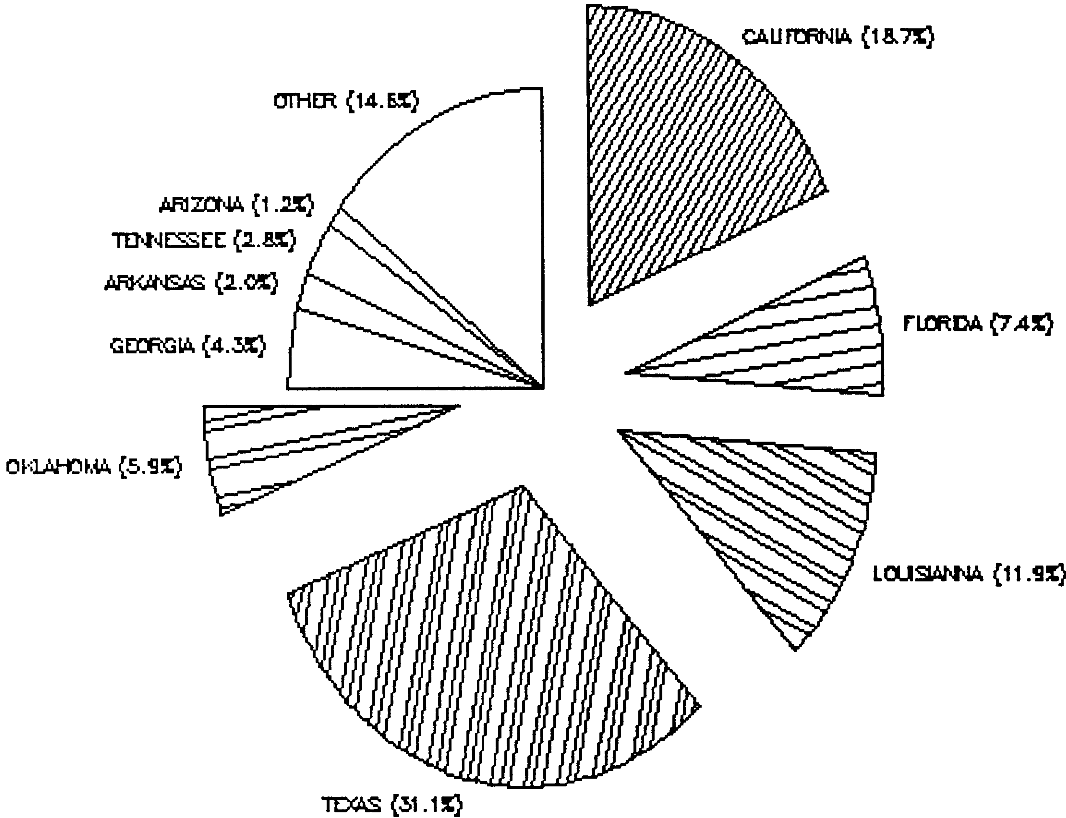
WORKOUTS BY PROPERTY TYPE



Source: Federal Asset Disposition Association, as of July 10, 1987. Data are for "Participation Loans", those loans with a minimum prinicipal amount of $2 million which involve an institution in receivership or in the govenment's Management Consignment Program. Some workout loans may be attributable to difficulties encountered by the lending institution rather than by the real estate. "Residential" includes single family homes, condominiums, and Planned Unit Developments. "Land" includes both improved and unimproved land. "Office" includes rental office space and office condominiums. "Hotels" includes conventional hotel space, time shares and restaurants.

DISTRIBUTION OF PROPERTIES BY STATE

FADA—JULY 10, 1987



Savings and Loan Managers Venture into Real Estate Development

Prior to 1980, the real estate industry moved in seven-year cycles. The financial system provided a measure of discipline to the industry. Federal government intervention ("Regulation Q") limited the rate of interest payable on depositor's savings and loan accounts. As interest rates rose, depositors withdrew their funds to place them in other, higher-yielding financial instruments ("disintermediation"). Disintermediation reduced funds available for lending. When this happened, lenders' underwriting criteria became more conservative. The resulting reduction in the supply of credit would limit new development. Reduced development lead to a reduction in the supply of excess space [9]. This pattern has been forever altered by the deregulation of financial institutions (Depository Institutions Deregulation and Monetary Control Act, "DIDMCA", of 1980). Financial institutions of every type (commercial banks, savings and loan associations, insurance companies and pension funds) now compete for savings. These institutions operate on the difference between their cost of funds and their interest income, (the "spread"). As the institutions' cost of funds rise, they must earn higher yields on their capital.

Frequently, institutions have become equity investors in projects in order to satisy their need for higher yields. Thus, deregulation contributed to a flood of capital into the real estate industry in the early 1980's, particularly into the development of new property. As new capital competed for real estate development projects in which to invest, supply of space inevitably outstripped demand.

One of the more notable effects of DIDMCA was the unprecedented influx of capital into real estate development from the savings and loan industry ("thrifts") [10]. The traditional expertise of thrifts lay in the the financing of the nation's housing production and ownership. Prior to 1980, regulation and tax incentives combined to keep the vast majority of thrift assets (loans) in residential mortgages. With the elimination of these incentives, savings and loans ventured into the lucrative, but risky, commercial lending arena. Thrifts enjoyed a competitive advantage against commercial banks due to their ability to make loans without requiring a downpayment. Moreover, federal policy encouraged the conversion of mutual savings banks into stock corporations. This conversion had the desired effect of increasing thrifts' capital. It also had the unintended effect of massively increasing liquidity, because each dollar of thrift capital could be leveraged into $30 of assets [11]. Additional liquidity emanated from the development of the

mortgage-backed security. Mortgage-backed securities allowed thrifts the opportunity to liquidate their existing portfolios of single-family mortgages onto the secondary market, thus making reserves available with which to fund new loans. As a result, thrifts became more aggressive in pursuing deposits and lending to commercial projects [11].

Unfortunately, the transition from residential to commercial lending was not accompanied by a concomitant increase in the supply of managerial talent with expertise in commercial lending. The transition occurred virtually overnight for thousands of thrift institutions across the country. Managerial staff tended to be compensated on the basis of fees generated by loan production. Earnings and stock prices of financial institutions were determined by their ability to secure fees from loan commmitments. While fees provide an observable measure of performance, the quality of loans made is much more difficult for outside investors to determine. Further exacerbating the situation was the lack of real incentives on the part of depositors to contol the managerial excesses of thrifts. The lack of risk associated with FSLIC-insured deposits allowed depositors to seek out the highest yields without regard to safety. Savings and loan associations negotiated equity interests in projects. Lenders evaluated properties with an ownership mindset, tending to be more willing to invest depositors' savings in

risky projects. Management made decisions to commit funds to often ill-conceived projects, with predictable results [12].

When thrift managers reached for a source of reassurance for their ill-fated decisions, in the sea of commercial lending uncertainty, the appraisal industry was often there. As many as 25% of the 3,200 federally insured savings and loan associations suffered from faulty appraisals between 1983 and 1985 [13]. The appraisal industry tolerated imprecise rules governing the valuation of proposed projects and the varying competency level of the many thousands who hold themselves out as "appraisers". Cases involving the preparation of fraudulent appraisals lead to a further erosion in appraisal industry credibility.

Economic Recovery and Tax Act (ERTA) of 1981

The Internal Revenue Code has historically provided a non-economic stimulus to real estate investment. The code effectively subsidized financial returns from real estate by permitting paper losses from real estate investment to be used to shelter ordinary income from other sources. Tax benefits were created through deductions for interest payments made on non-recourse real property loans, accelerated depreciation of buildings, and income tax credits for investment in certain types of property. This subsidy

made many otherwise-marginal development projects attractive. As investors exploited the rules, another stimulus was added for supply to outpace demand [14].

Sponsors of real estate limited partnerships ("real estate syndicators") quickly organized to exploit the increased tax benefits offered by ERTA in 1981. The real estate syndication industry grew from $1.5 billion in placements in 1979 to over $10 billion in 1984 [15]. The most popular vehicle for distributing tax benefits from ownership of real property is the limited partnership, which allows complete passthrough of tax benefits to the partners. The syndicator would acquire a property and distribute the benefits through the limited partnership vehicle. With the use of this subsidy, the syndicator was able to offer often unheard-of prices for real property. Builders and lenders eyed these tax benefits and initiated projects which might otherwise have been marginal, on a pre-tax basis. The market became driven by the ability to sell the product rather than the user's demand for occupancy.

Macroeconomic and Regional Shifts

Real estate has been affected by changes that were difficult to forsee, in both the macro economy and some regional economies. Inflation, which had ravaged the United States

economy during recent years, was being treated as a permanent element of the U.S. economy. The general expectation was that inflation would continue. In net terms, real estate tends to benefit from unanticipated inflation. The benefit to real estate is due to increases in rents which increase the value of property. Many real estate executives reasoned that increases in the value of their property would proceed unabated, along with inflation. They reasoned that real estate loans would be supported by increasing rents and high values. Moreover, future principal and interest payments would be made in less-expensive, inflation-ravaged dollars.

As supply expanded, demand nationally grew less quickly. Certain regions have actually experienced deflation and a reduction in demand for real estate. The reduction in demand for space was most prevalent in regions dependent on oil and gas or suffering economic downturns in undiversified economies. The office sector benefited from a rapid shift from assembly-oriented manufacturing plants to office buildings in the 1970's and early 1980's. Reduced growth in demand for office space has reflected a slowdown in this shift. The unforseen reduction in demand left projects wanting for tenants.

The number of distressed properties would be much greater, were it not for a reduction in nominal interest rates. The

prime lending rate has gone from a peak of 21 percent in January of 1981 to 8.25 percent in July of 1987 [16].

Summary

The multi-billion dollar loss of capital facing United States lending institutions was brought about by the historial cyclicality of the U.S. real estate industry; the entry of highly-liquid, undermanaged savings and loans into the industry; the stimulus to investment offered by tax incentives; and macro-economic shifts. As supply of real estate exceeds demand and projects are unable to pay their debts, who pays the price? The dangerously simplistic assumption is that the financial institutions absorb all losses. It is society which ultimately pays for massive loan losses. Banks and thrifts can absorb losses representing only a small fraction of their assets before they reach insolvency. Insolvent banks and thrifts leave their failed real estate projects in the hands of government insurance agencies, resulting in large, ongoing taxpayer subsidy. Insolvency creates burdens and risks for thousands of depositors, investors and employees.

The failure of real estate projects also tends to exercise downward pressure on property values in the localities of the failed projects. An unsuccessful project in an area lends a stigma to the neighborhood. The failed project can also taint the market for similar properties.

****

This thesis will explore strategies for salvaging distressed properties. The methodology followed includes interviews with industry experts in an attempt to determine the immediate cause of failure of particular properties. A typology of problems affecting distressed properties is developed. The thesis describes a range of strategies for salvaging properties employing financial, marketing and property management skills. Case histories are analysed to determine how distressed properties are created and how stategies can be implemented.

For the reader's convenience, the male pronoun will be used throughout the thesis to indicate both male and female gender

of the subject. The thesis adopts the perspective of the new investor in distressed properties. The investor is assumed to not have been instrumental in the development of the distressed property. The names of the participants and facts related to the case studies have been changed, where requested by those involved.

FOOTNOTES TO CHAPTER ONE

[1] "How the White House Lost Its Big Bank Battle", The New York Times, July 12, 1987

[2] "How the White House Lost Its Big Bank Battle", The New York Times, July 12, 1987

[3] "The Wright Man to See", Newsweek, June 29 1987

[4] "The Wright Man to See", Newsweek, June 29 1987

[5]"Empty Buildings: Severe Deflation Hits Commercial Properties in Many Areas of the United States", Wall Street Journal, September 4, 1986

[6]"Empty Buildings: Severe Deflation Hits Commercial Properties in Many Areas of the United States", Wall Street Journal, September 4, 1986

[7] "Market Analysis for Real Estate (Lecture Notes)", graduate level course offered by Professor William Wheaton, Center for Real Estate Development, M.I.T.

[8] "Real Estate Market Outlook", Lecture delivered by John McMahan, McMahan Associates, San Francisco, California, Center for Real Estate Development, M.I.T.

[9] "The Return of the Grave Dancer", Samuel Zell, Real Estate Issues, Fall/Winter 1984

[10] "Empty Buildings: Severe Deflation Hits Commercial Properties in Many Areas of the United States", Wall Street Journal, September 4, 1986

[11] "The Return of the Grave Dancer", Samuel Zell, Real Estate Issues, Fall/Winter 1984

[12] "Loose Lending: Texas Savings and Loan Disasters are blamed, in part, on freewheeling style", Wall Street Journal, July 13, 1987

[13] Only three percent of the 300,000 people reviewing property values for financial institutions are accredited by the Society of Real Estate Appraisers or the American Institute of Real Estate Appraisers. "Malpractise in Real Estate", Forbes, June 29, 1987.

[14] "The Return of the Grave Dancer", Samuel Zell, Real Estate Issues, Fall/Winter 1984

[15] "Real Estate Syndicator's Shift", Profile of Arthur J. Halleran, Chairman, Winthrop Financial, The New York Times, June 25, 1987

[16] Federal Reserve Board Bulletin

CHAPTER TWO: TYPOLOGY OF PROBLEMS FACING DISTRESSED PROPERTIES

A distressed property ("workout") is a property which is in default on the terms of the loan which it secures. Default is frequently occassioned by nonpayment of principal and interest.

Upon default, the lender may use its lien against a property to bring about *foreclosure* for lack of contractual compliance. Foreclosure results in an offering of the property for sale to the public. The lender may bid for and purchase the property. If proceeds of the foreclosure sale are insufficient to satisfy other lenders, more junior liens against the property are eliminated. *Bankruptcy* offers a haven for debtors, in that it forestalls action by the lender. Bankruptcy may be used to stay a foreclosure. Alternatively, a borrower may voluntarily offer to the lender or a third party a *deed in lieu of foreclosure*, forfeiting

the rights of ownership. [1]

Workouts result either when a property suffers from insufficient demand or when reasons unrelated to demand bring about property distress.

I.Market Demand

Insufficient demand may result from forseeable circumstances such as inadequate market analysis during project planning or excessive optimism; or from an unforseeable change in the market during the development process [2]. Lack of market orientation is often manifested in such symptoms as inappropriate design, poor choice of location, or pricing above what the market will bear.

Market studies with significant shortcomings are often used to justify the decision to develop a property. Distressed properties often lack a proven market need. Market studies frequently focus either on supply or demand, resulting in a one-sided analysis. They rely upon trendline forecasts, which ignore the existence of short- and long-term economic cycles and their effect on real estate. Trendline forecasts fail to adequately consider the structure of the local economy. Local market areas are often treated in market analysis as though they were independent of the metropolitan

area of which they are an integral part. Inadequate consideration is given to the importance of location by failing to study potential acceptance of the project and its competitors by consumers through spatial preference studies. In analyzing supply, consideration is rarely given to competition from potential, as-yet unannounced projects [3].

Errors of a procedural nature are also common in market analyses. Such errors include inadequate consideration of potential competition from subleases; inadequate scope of the study; and use of erroneous information, such as employing "asking" rather than "taking" rents, use of gross rather than net absorption or use of poor comparables [4].

The developer and (or) the lender may choose to disregard market demand. Excessive optimism of the sponsors of a project is often related to their fee-based compensation. Executives often have strong incentives to initiate a project regardless of demand. When the developer earns a fee to develop and the lender earns a fee to lend, there is little incentive for restraint, particularly when the true underlying capital risk is being borne by a federal insurance agency.

Real estate projects may also suffer from unforseeable adverse changes in the market during the long lag time

between project initiation and completion. Demographic changes, such as the closing of a military base in a town with an undiversified economy, may reduce the demand for a real estate product. Changes in lifestyle patterns or macroeconomic factors reduce demand for space. The drop in the price of oil significantly affected demand for real estate in Texas, Louisianna, Oklahoma and Colorado. Economic recessions in the Central and South American economies have affected the demand for condominiums in South Florida. In "steady state" circumstances, an appreciating dollar leads to a marginal reduction in demand for real estate in markets dependent upon foreign investment [5].

II. Other Factors

Distressed properties also result from financial, marketing and property management considerations.

Financing

Insufficient demand or other adverse circumstances result in the need to draw upon capital to survive an adjustment period, until the property can become self-sustaining. Money buys time. If capital is not available, the project runs out of time and the property becomes distressed [6]. Insufficient capitalization is symptomatic of distressed

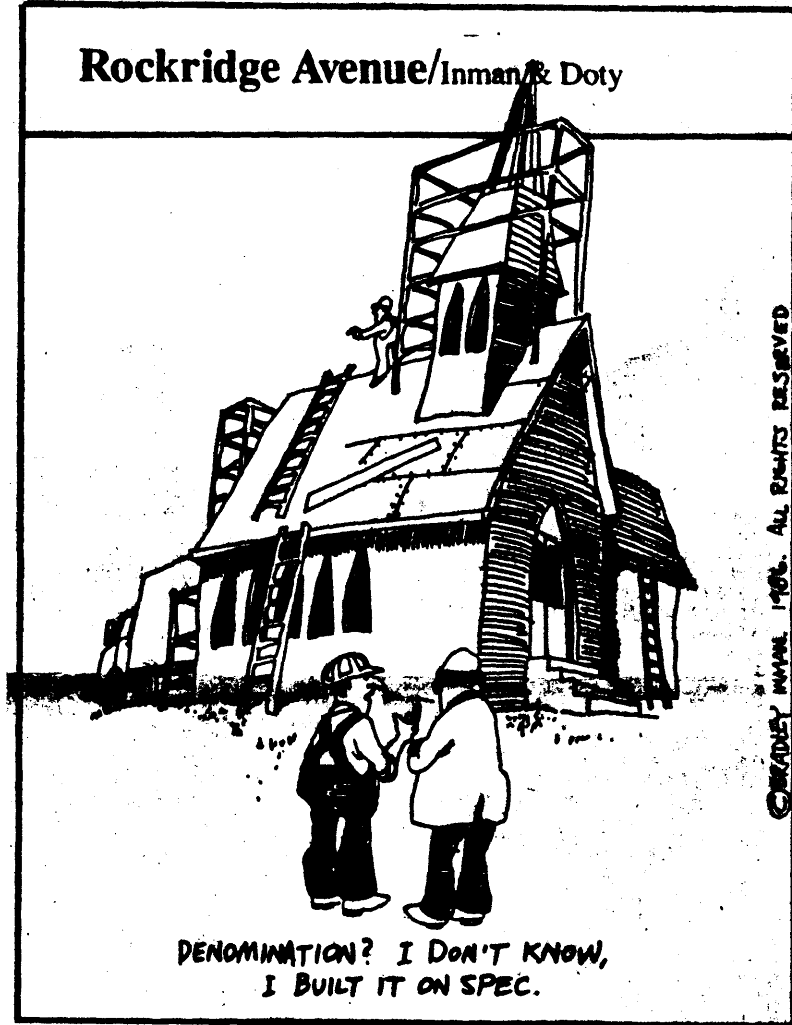
properties. The financial structure underlying a project often implicitly assumes stability or improvement in markets over time. Contingencies are frequently not anticipated in structuring financing. Developers frequently do not have access to adequate capital resources with which to cover contingencies. The financial institution approving a construction loan may fail to adequately fund the project. Lenders may naively underfund costs legitimately related to the real estate development project. "Soft" costs such as interest payment reserve, marketing costs and operating deficits during the market absorption period may be underfunded, in the name of "conservative" underwriting [7].

Lack of thoroughness or negligence in lender loan practices and developer procedures may expose the institution, the developer and the project to additional risks. The lender may agree to fund a loan before all municipal and environmental approvals necessary to legally develop the property are in hand or before all appropriate consultant's studies have been submitted and reviewed. The lender may fail to verify that construction is proceeding on time and within budget prior to disbursement of funds [8].

A real estate development project may be jeopardized by cost overruns. Project complexity may exceed the developer's construction monitoring capability. Costs may exceed budget

for such reasons as a work stoppage by labor unions, problems relating to soil conditions, significant change orders, an increase in construction loan interest charges due to rise in market interest rates or a contractor's inability to perform for the agreed-upon price. Delays in project completion due to securing of approvals, environmental permits or other reasons may also exhaust capital resources. Securing of approvals can result in delays of several months and can result in the imposition of additional carrying costs on the project [9].

Some distressed properties result from fraud or theft on the part of one or more of the parties involved in the project. A banker may accept bribes in exchange for influencing the decision to lend on a project. A developer may employ construction loan proceeds for purposes unrelated to the project. A dishonest property owner may remove operating revenues from the property, leaving inadequate funds with which to meet debt service obligations [10].


Rockridge Avenue/Inman & Doty
DENOMINATION? I DON'T KNOW,
I BUILT IT ON SPEC.
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Marketing and Property Management

The developer may not have the requisite skills, staff or experience or may be negligent with respect to accomplishing crucial development tasks. The property may suffer from a poor marketing effort during the market absorption period due to inappropriate market positioning or inadequate use of marketing channels. Property management may not be responsive to tenant needs [11].

Occassionally, properties become entangled in difficulties encountered by the lender and become workouts for reasons unrelated to the property itself. The workout may result from an inability or unwillingness of the lender to perform. The institution may commit to a loan and then renege on its commitment due to capital, corporate, merger, acquistion or regulatory problems. Multiple lending institutions involved in the loan participation may enter into a dispute which causes the job to come to a halt. Alternatively, the property may become distressed due to borrower violations of agency restrictions in the credit agreement. Such violations may include an insufficient current ratio on the borrower balance sheet. The owner may cross-collateralize property, resulting in foreclosure when some properties encounter

difficulties. Tax reform may make investors indifferent to a project, jeopardizing developer credit. Borrower problems resulting in the creation of distressed property need not be related to the property. Analysis of such "workouts" is outside the scope of this thesis [12].

Summary

Distressed properties come into existence due to lack of market demand for the space or problems associated with financing, marketing or property management.

A distinction can be made between forces underlying the creation of distressed properties which are forseeable and those that not forseeable. We are more able to manage risks for which some degree of advance knowledge exists. However, real estate development is characterized by long "lead" times for completion, complexity of construction, reliance on the performance of diverse parties and other uncertainties. Not all real estate-related risks are knowable in advance. "Force Majeure" risks such as war, extraordinarily severe weather, economic shifts and labor stoppages provide examples of changes that are not forseeable. In "steady-state" circumstances, these risks will always lead to a certain number of workouts in the real estate industry. A certain amount of risk is inherent in the real estate development

process and helps to account for the above-average returns generated by real estate development.

Finally, workouts are seldom brought about by the existence of a single risk. Real estate casualties tend to result from the convergence of a number of correlated risks. Careful analysis of workout situations reveals that several circumstances tend to converge in undermining the property, with a particular circumstance often acting as catalyst [13].

NOTES ON CHAPTER TWO

[1] "The Workout Game: Managing Non-Performing Real Estate Assets", Stuart M. Bloch, Esq., Executive Enterprises Publications Co., New York, N.Y.

[2] Interview with Larry Levey, Chief Financial Officer, Hall Financial Group, Inc.,Dallas, Texas., July 1987. Interview with Jim Bertelsen, Asset Disposition Group, Continental Illinois National Bank, June 1987. Interview with Jack Sangunett, President, Sangunett and Associates, Alexandria, Virginia, June 1987

[3] "Market Analysis for Real Estate (Lecture Notes)", graduate level course offered by Professor William Wheaton, Center for Real Estate Development, M.I.T.

[4] Interview with Richard Scott, Principal, Aldrich, Eastman and Waltch, July 1987. Some of the criticisms leveled against market studies may also be leveled against real estate appraisals.

[5] Interview with Jack Sangunett, President, Sangunett and Associates, Alexandria, Virginia, June 1987. Interview with Jim Bulloch, Vice President, Citibank, New York, N.Y. Interview with Eduardo R. Arellano, Vice President, Senior Corp., Miami, Fl., June 1987. Much foreign investment in U.S. real property is motivated by a desire to secure a "safe haven" for foreign capital and is not exclusively influenced by currency fluctuations.

[6] The relationship between "working out" a distressed property, money and time is explored in more depth in Chapter Three, herein.

[7] Interview with Jack Sangunett, President, Sangunett and Associates, Alexandria, Virginia, June 1987.

[8] Interview with Mark Jennings, Workout Loan Specialist Oldstone Bank, Oldstone Development Corporation, Providence, R.I., June 1987. See also the "Outlet Mall Case Study", herein.

[9] Interview with Jack Sangunett, President, Sangunett and Associates, Alexandria, Virginia, June 1987. Interview with Andrew Siwulec, Senior Vice President, York Associates Bethesda, MD., July, 1987. Interview with Mark Jennings, Workout Loan Specialist, Oldstone Development Corporation,

Providence, R.I., June 1987. See also the "Outlet Mall Case Study", herein.

[10] "The Workout Game: Managing Non-Performing Real Estate Assets", Stuart M. Bloch, Esq., Executive Enterprises Publications Co., New York, N.Y.

[11] Interview with Eduardo R. Arellano, Vice President, Senior Corp., Miami, Fl., June 1987. See also case study, "Miami Vice: Repositioning and Competitive Pricing in the Miami For-Sale Housing Market", Chapter Four, herein.

[12] Interview with Jack Sangunett, President, Sangunett and Associates, Alexandria, Virginia, June 1987. See the definition of "workout" adopted by this thesis in the introduction to Chapter Two.

[13] "The Workout Game: Managing Non-Performing Real Estate Assets", Stuart M. Bloch, Esq., Executive Enterprises Publications Co., New York, N.Y.

CHAPTER THREE :

PRINCIPLES OF RESTRUCTURING FINANCING FOR DISTRESSED PROPERTIES

Distressed property turnaround strategies involve a combination of three basic elements: *time; money;* and *skill.* The objective of the refinancing strategy is to secure time and money for the property.

Time

Time is required in order for the property to be absorbed by the market. Time is also needed in order to renovate or reposition the property. The objective in structuring distressed property transactions is to secure the maximum amount of time within which to add value, at the lowest cost. In this sense, financial structuring for distressed property resembles a real estate option contract. At a given cost, the longer the investor can control the property, the more

likely he is to be vindicated in his belief that he will profit due to property appreciation. The workout investor seeks to harness the power of time [1].

Money buys time. Money is required to fund operating deficits over the market absorption period, capital improvements and to pay for marketing costs.

The workout investor's challenge is to secure additional funds with which to buy time and salvage the property. The additional funding must be secured in spite of a lack of income from the property with which to make debt service payments in the traditional manner.

Money

The incremental costs and expenses associated with salvaging distessed properties must be anticipated in structuring distressed property financing. Distressed properties may require additional capital for renovation, operating deficits and marketing costs [2].

The need for additional improvements to the property is common in workouts. Distressed properties frequently require renovation in order to satisfy a new market [3]. Owners of properties on the verge of foreclosure have been known to

massively substitute or delete materials in an effort to avoid the loss of their property [4]. Unscrupulous borrowers divert funds from their loans to other purposes. Costly tenant improvement allowances may be required in order to attract tenants [5].

A property with few tenants will nevertheless demand substantial cash resources in order to cover operating expenses. Occupancy of a property and operating expenses are not well-correlated. A time lag exists between the point where a tenant agrees to rent a space by signing a lease and the point where he occupies the property and actually begins to pay rent. Real estate taxes, insurance, maintenance and other fixed expenses comprise a large share of total property operating expenses for many properties and must be funded regardless of the total occupancy level of the property [6].

Loss of tenants ("shakeout"), tends to occur in distressed properties during the market absorption period. The loss of existing tenants tends to prolong the market absorption period and contribute to operating deficits. Tenants may be lost due to dissatisfaction with the distressed property. Tenants may be evicted due to the their loss of discipline in meeting lease obligations [6].

Distressed properties demand extraordinary marketing

expenditures in order to overcome a tainted reputation in the marketplace. Marketing, promotional and property management personnel costs are high for distressed properties relative to other properties [6].

Funding for the extraordinary needs of a distressed property is secured from a combination of equity funds, unsecured loans, a purchase money mortgage, senior and junior mortgages. Equity funds represent the most "patient" capital in the financial structure. In contrast with debt, common equity is not accompanied by a legal obligation to make current interest payments.

Equity

The new equity investor wields significant bargaining power in loan restructuring negotiations. The investor's willingness to invest his capital toward resurrecting the lender's troubled property represents a powerful negotiating tool. The equity investor's bargaining power emanates from his willingness to accept risk. Equity protects debt by standing first at risk. New investment of equity allows the existing debt to be restructured. Without new equity investment, the lender owns the property. Without new equity, the lender's loan on the property effectively becomes the equity: it earns no current interest and is the first

capital at risk.

The investor's negotiating objective is to secure lender forebearances in the form of capital and time to contribute toward the property's recovery. The investor is motivated by an anticipation that markets with excess supply will experience a reduction in construction. Should reduced construction result in less supply being offered on the market, prices would increase and he would stand to gain. The investor will also benefit from tax benefits associated with interest payment deductions and net operating losses deductible against future income ("NOL carryforwards").

While the lender wishes to minimize a reduction in the amount owed on the loan (the "writedown"), lender motivations are not all financial. The lender may have regulatory, legal or public relations motivations in concluding a transaction. The lender may seek to bring about interest income from the loan so as to be permitted to classify the loan as a "performing" asset. The lender may seek to sell the property within a specified time so as to satisfy regulatory requirements. He may seek to salvage a distressed property so as to avoid the glare of negative publicity [7].

Both the lender and the investor must render a judgement as to whether their respective anticipated rewards from the

property will justify their patience and investment of capital over the holding period [8].

Debt

The second source of funds for the workout effort is the existing lender. The lender may inject new loan funds into the property. The property gains time to recover by shifting existing loan repayment obligations from the present to the future. Existing debt is converted into more patient, quasi-equity capital. The lender may restructure existing loan terms including the term, amortization and interest payments.

The lender will resist reductions in the principal amount owed. He will seek to structure a transaction which will allow him to recover his investment. The loan repayment term must be extended to provide adequate time for property recovery. The investor will therefor seek to avoid mortgages with a relatively short term, such as bullet loans. The term may be extended for a fixed period or can become a function of achievement of certain property performance levels, such as a minimum loan-to-value ratio [9].

The investor seeks to restructure loan payment obligations to coincide with realistic expectations of the property income

stream and thereby avoid default. Concessions as to amortization of principal have a relatively small impact on current debt payments. If *current* interest payment obligations exceed project income, equity reserves will eventually vanish.

The interest rate ("pledge rate") and current coupon rate need not be the same. The pledge rate can exceed the coupon rate. The difference between the stated rate of interest and current interest payment (the "pay rate" or "coupon") is accrued. Reasonable care must be taken to avoid an excess of interest *accruals* over project equity.

The viability of the project must not be threatened by potential increases in variable interest rate payment obligations. Rate sensitivity may be minimized by sharing interest rate burdens with a joint venture partner; hedging capital costs in the interest rate futures market; or setting lower and upper boundaries on variable interest payment obligations ("floors" and "caps") [10].

Other Loan Provisions

Other issues likely to arise in loan negotiations include participation or conversion rights and personal liability. In exchange for concessions, the lender may request the right

to participate in the proceeds of sale above the mortgage amount, if any. Alternatively, the lender may seek to have the right to convert his secured, debt interest in the property into an equity postion.

Personal liability and cross-collateralization for loans on distressed properties are avoided by investors. Occassionally, guarantees may be offered on potential property operating deficits, up to a specified amount [11].

The challenge facing the workout investor is to determine the degree of reward which he must secure in order to justify his investment in the risky project. The investor must also assess what concessions he can secure from the lender.

ALTERNATIVE MORTGAGE INSTRUMENTS

By combining the above degrees of freedom, mortgage instruments can be structured so as to answer the particular needs of a distressed property.

Cash Flow Mortgage

The objective of the cash flow mortgage is to avoid borrower default for non-payment of interest. The property pays debt

service equivalent to *available* cash flow. Cash flow mortgages have no pay rate. The difference between available cash flow and the pledge rate accrues against the principal amount. Thus, the loan principal amount may actually increase from year to year ("negative amortization"). Alternative cash flow priorities may be arranged. The cash flow from the property may be divided ("stripped") so as to assure both the lender and investor a cash return out of available cash flow.

An accrual-basis borrower may fully deduct interest equivalent to the full pledge rate in computing his federal income tax liability, if the lender recognizes equivalent interest income [12] [13].

Accrual Mortgage

The accrual mortgage differs from the cash flow mortgage in that the accrual mortgage features a coupon rate, creating a fixed payment obligation. The cash flow mortgage pays interest only if cash flow is available from operations [14].

Zero Coupon Mortgage

The Zero-Coupon mortgage ("zero") is similar to an accrual

mortgage, with a pay rate of zero. All interest on the zero accrues and is compounded over time. The lender may demand a premium over current market rates on a zero to compensate for additional risk. Participation in the proceeds of sale above the mortgage amount may be demanded, particularly if the zero is subordinated to a more senior mortgage [14].

Participating Mortgage

The Participating Mortgage offers the borrower a below-market rate of interest in exchange for a percentage of operating income and (or) proceeds of sale above the mortgage amount ("residual value").

The benefits of the participating mortgage to the borrower tend to be in the form of short-term cash-flow. The participating mortgage becomes much less advantageous to the borrower over time. At some point, interest payments become equivalent to market rates at the time of mortgage origination. Beyond this point, the project must make market interest payments in addition to being obliged to surrender a percentage of the residual [14].

Wrap-around Mortgage

The wrap-around mortgage is added to the existing mortgage on

the property. It typically features a pledge rate which is above the pledge rate on the existing mortgage and allows the borrower to realize additional funds by borrowing on the property. The lender profits from the difference in debt service between the existing mortgage and the wraparound. The wrap-around mortgage satisfies the borrowers' need for additional financing and debt service relief [15].

Fixed and Variable-Rate Mortgages

The above mortgage instruments can be structured as either fixed- or floating-rate instruments. The pay rate may be staggered, beginning as low as zero and gradually moving upward over time. Floating-rate interest payments can be determined by a variety of indices. The intervals at which the interest rate is to be adjusted and the maximum adjustment in the rate between intervals and over the life of the loan are negotiable [15].

A mortgage which combines features of the above instruments may be employed with distressed properties. While the above descriptions are meant to be illustrative, new instruments are continually devised [16].

The investor will optimize value from the transaction by placing project benefits in the hands of those who value them most. Parties to distressed property transactions have different yet complimentary needs. Parties may differ with respect to their federal income tax exposure, cost of funds, measure of value (book vs. market), and risk preference. For example, pension funds tend to be attracted to assets whose returns correlate positively with inflation, to match against their inflation-sensitive liabilities. They are therefor interested in extending variable-rate mortgages and in real estate equity investments [17].

Salvaging the Midland, TX Office Building

The financial restructuring of a distressed 50,000 sq. ft. office building in downtown Midland, TX. illustrates a strategy for providing both adequate *capital* to fund operating deficits during the market absorption period and *time* for recovery. The total project cost was $6,000,000 and the developer secured $5,000,000 in takeout financing. With an occupancy level below 50 percent, the property suffered from a mismatch of revenues and expenses. The lender foreclosed when the developer became unable to fund operating deficits and capital costs. The workout investor developed a

strategy for adding new "patient" capital to the property. The new capital structure succeded in minimizing fixed payments over the property holding period [19].

The investor determined that the property itself was fundamentally sound. However, he was concerned about the future availability of long-term funds in the capital markets. The property was projected to generate cumulative deficits of over $1,500,000 over a seven- year holding period. *How could the property be saved ?*

In analysing the acquisition, the workout investor assumed that increases in rental income would occur only due to increased property occupancy and property upgrading. No increases were assumed to occur for such other factors as market improvement or inflation. The investor based his decision to invest upon value, not on expectations as to market improvement. Expenses were assumed to remain stable. Leases on the building are "Triple Net", calling for full passthrough of expense increases to the tenant. Debt service payments on the existing first mortgage had to continue.

Capital Structure

The investor agreed to provide $500,000 in new equity funds for the project. This amount represented the total

investment to be made by the equity investor. These funds were to be used to cover project operating deficits. The lender initially requested that these funds be applied toward principal amortization. The investor staunchly resisted this request. The investor insisted that new funds be injected into salvaging the distressed property, which ultimately might enable the lender to achieve a return of capital. The first mortgage continued to be fully serviced.

The lender agreed to fund a second mortgage of up to $500,000 above the investors' equity investment on a non-recourse basis. The second mortgage proceeds were to be applied toward tenant improvements on space which had not been leased. Interest would be paid on the funds actually disbursed.

Additionally, the lender agreed to make an amount of $750,000 available for further operating deficits and capital improvements on an unsecured basis. Interest on the unsecured loan was accrued. Interest payments and principal amortization on these funds would be deferred for a twenty-year term.

Recapitalization

All debt on the property would become due and payable at the

end of the twenty-year term. The property would be recapitalized with a new loan from the lender. The principal amount of the new first mortgage loan will be the sum of the $5,000,000 existing first mortgage loan, the $500,000 second mortage loan and the principal and accrued interest on the $750,000 loan. The new loan would be fully amortized over 29 years, with maximum annual interest payments not to exceed $549,000 per year.

The structure allowed the loan on the Midland office building to once again become a performing asset by generating interest income. The lender avoided having to increase his loan loss reserves to allow for a loan writeoff. Confidence in the abilities of the investor was key to the lender's willingness to disburse further funds on the property. The prospect of significant future gains existed for the investor. Should even a marginal improvement in the general rent levels occur in the local marketplace, the property would generate enormous gains. Adequate funds are available to cover projected deficits during the market absorption period. The structure assured the availability of permanent loan proceeds in the future. The structure eliminated concerns relating to interest rate risk upon refinancing. By guaranteeing a maximum annual debt service payment in the future, the investor hedged against future interest rate risk. Caution was taken by the investor to assure that

accrued interest and other loan obligations did not exceed reasonable expectations of the future property value. The investor always asks whether anticipated appreciation will be adequate for the property to repay loans plus accrued interest.

Summary

Distressed property turnaround strategies involve a combination of three basic elements: time, money and skill. The financial structure of a distressed property seeks to provide adequate time and money resources with which to salvage the property. The workout investor seeks to harness the power of time so as to perform product renovation and repostioning and achieve market absorption of the property. Money buys time. Money is required to fund operating deficits, marketing costs and renovation expenses. Equity investors have significant bargaining power to negotiate forbearances from the lender due to the investors' willingness to accept risk. While the investor maitains the flexibility of not becoming an owner of the distressed property, the lender is the de facto owner of the distressed property. Mortgage instruments can be structured to answer the specific needs of distressed properties.

The investor seeks to structure an agreement which is

predicated upon *current* revenue and expense figures (value), rather than *expectations* of future performance [19].

There are threee determinants of the capital structure of a transaction. This chapter has addressed the *preferences of the parties* involved and the *type of transaction*. The investor must also incorporate the status of the capital markets into the analysis. In a volatile world, no optimal capital structure for distressed properties exists. One must monitor equity and debt pricing in the capital markets on a daily basis to determine the best course of action [20].

NOTES ON CHAPTER THREE

[1] Interview with Richard Scott, Principal, Aldrich, Eastman and Waltch, July 1987

[2] "The Grave Dancer", Samuel Zell, Real Estate Review

[3] See "Product Repositioning", Chapter Four, herein.

[4] "The Grave Dancer", Samuel Zell, Real Estate Review

[5] "The Workout Game: Managing Non-Performing Real Estate Assets", Stuart M. Bloch, Esq., Executive Enterprises Publications Co., New York, N.Y.

[6] "The Grave Dancer", Samuel Zell, Real Estate Review

[7] Interview with Jim Bulloch, Vice President, Citibank N.A., New York, N.Y.

[8] "Structuring Complex Real Estate Transactions (Lecture Notes)", graduate level course offered by Professor Lawrence S. Bacow, Center for Real Estate Development, M.I.T.

[9] "The Return of the Grave Dancer", Samuel Zell, Real Estate Issues, Fall/Winter 1984

[10] Interview with Richard Scott, Principal, Aldrich, Eastman and Waltch, July 1987

[11] "The Grave Dancer", Samuel Zell, Real Estate Review

[12] "Financing Real Estate Under Tax Reform", seminar conducted at Center for Real Estate Development, Massachusetts Institute of Technology, by Robert Nessen, Attorney, Fine and Ambrogne, Boston, Mass.

[13] Interview with Andrew Siwulec, Senior Vice President York Associates Bethesda, MD., July, 1987

[14] "Financing Real Estate Under Tax Reform", seminar conducted at Center for Real Estate Development, Massachusetts Institute of Technology, by Robert Nessen, Attorney, Fine and Ambrogne, Boston, Mass.

[15 "Financing Real Estate Under Tax Reform", seminar conducted at Center for Real Estate Development, Massachusetts Institute of Technology, by Robert Nessen,

Attorney, Fine and Ambrogne, Boston, Mass.

[16] "Hall American Center Associates (Corporate Newsletter)", "Hall Olivetree Associates", Hall Financial Group, Dallas, Texas, June 30, 1986

[17] Interview with Richard Scott, Principal, Aldrich, Eastman and Waltch, July 1987

[18] Adapted from "The Grave Dancer", Samuel Zell, Real Estate Review

[19] "A chat with Michael Milken" Forbes, July 3, 1987

[20] "Structuring Complex Real Estate Transactions", graduate level course offered by Professor Lawrence S. Bacow, Center for Real Estate Development, M.I.T.

CHAPTER FOUR :

MARKETING STRATEGIES FOR DISTRESSED PROPERTY

Marketing efforts for distressed properties are more intensive than those required of other properties. The marketing strategy for distressed properties rests on the premise that the property has typically has become known as a troubled property in the marketplace. Successful distressed property marketing relies upon positioning of the property to suit an identified market need, competitive pricing and real estate broker relations.

Product Repositioning

Real estate products that have failed to attract a market often require repositioning. Product repositioning entails orienting the product to address the needs of a group of potential new users or to alter perceptions of the property held be a group of existing users. The repositioning is accomplished by effectively re-manufacturing the product to

serve a new market. Additionally, a property may adopt a new name so as to shed a negative market identity.

A comparative assessment must be performed of the distressed property in relation to the local marketplace. Space configuration, amenities, and other property attributes must be compared with competitive properties. For example, distressed apartment complexes should be compared against condominiums and single family homes, against which apartments compete. The key elements in selling or renting residential space are square footage and life-style. Lifestyle is determined by the amenities and services offered by the residential complex. Lifestyle considerations can overcome price competition from other facilities [1].

Case Study: Is There a Doctor in the Area?: Repositioning The Mid-Western Office Building

A professional office building in suburban Chicago, Illinois illustrates the need to reposition the distressed real estate product to meet a new market. A money-center bank made a construction loan on a mid-size office building, the first post-War office building proposed in the town. The developer's concept was to attract tenants by asking less-than-premium rents for first-class office space in a suburb which lacked virtually any modern office buildings.

The principal local employers were a university and hospital. The developer proceeded to develop the project without sensitivity to the market, which did not feature an abundance of potential users for conventional office space. Results of the leasing effort were disappointing. Few tenants responded to solicitations. The property was unable to meet debt service obligations and the lender foreclosed. A specialist in salvaging distressed property assessed the alternatives. He identified a previously unrecognized source of demand: medical professionals associated with the local university hospital. A multi-million dollar refurbishment was performed to meet the specialized needs of these professionals. Floorplans previously designed for large users were subdivided into many smaller offices for individual physicians' use. Plumbing was extended to the new offices and necessary individual washbasins were added to each. Success was achieved by remanufacturing the product to serve a newly redefined market need. The repositioned property was fully leased.

Pricing

Competition becomes the key determinant in establishing rents (or prices) for distressed properties. Project cost or total indebtedness are relatively minor considerations in determining pricing strategy. Unleased or unsold space in a

market represents inventory. In a stagnant or declining market, the key to salvaging distressed property becomes the ability to lease or sell the existing inventory at current rates. The rent structure of a distressed property must be lower than that prevailing for comparable properties. Lower rents provide an inducement for sale of the inventory. Reductions in price can bring about a significant increase in demand [2].

A major element of any leasing effort will be to retain existing tenants. Aggressive rates may be offered in the crucial effort to maintain an income stream from the property. In some cases, existing leases are destroyed and lower rents offered in exchange for extending the lease term. Offering of equity in the project to tenants may be warranted in some circumstances [3].

Competitor's costs are a key consideration in determining competitive rent structure. If an exisiting competitor's cost basis is lower than that of the investor in distressed property, the competitor may potentially outbid the investor for tenants. If future competitors can build a similar product while incurring significantly lower costs of land and construction, they will enjoy an advantage [4].

In structuring tenant inducements, the workout investor seeks

to fulfill an unmet market need [5]. Tenant inducements may be utilized to increase the property's competitive position. Creativity can assist in meeting tenant needs while staying within project budget. For example, distressed Texas apartment complexes frequently offer travel and entertainment inducements to renters. Travel and entertainment have the disadvantage of offering an exhaustible, one-time-only inducement to the tenant to sign a lease. Creative investors in distressed Texas apartment complexes offer appliances such as microwave ovens or fans. These permanent amenities enjoy the advantage of being available as an inducement to both current and future tenant prospects [6].

"Free rent" periods are generally avoided by experienced workout investors. The correlation between receipt of free rent and tenant default on lease obligations is noticeable. Preference is given to structuring leases with a below-market net effective rent [7].

Case Study: Rocky Mountain High: Altering Pricing Structure for the Denver Office Building

The case of the suburban Denver office building serves to illustrate the effectiveness of competitive pricing in securing tenants. The 250,000 square foot "Town Square"

office building owned by the State Employees' Pension Fund was fully preleased upon construction in 1982 to creditworthy petroleum concerns. A regional recession was subsequently brought on by the precipitous drop in oil prices. As leases expired, tenants closed or consolidated offices in new locations. By 1986, the building lay entirely vacant.

The pension fund implemented a competitive pricing strategy to re-lease the space. The strategy focused on securing a major, anchor tenant who would add legitimacy to the building in the local marketplace. A trained, full-time leasing agent was hired to concentrate exclusively on the leasing of the building. The agent identified a construction-services company which occupied 125,000 square feet in a neighboring building under a lease with two years until expiration and a rental rate of *$24.00*. With comparable office space in the depressed market leasing for *$18.50*, the agent structured an offer calling for an initial rental rate of *$17.00*, on a ten-year lease. The rental rate would "step-up" annually beginning in year two, in increments of $1.00, until reaching $26.00 in 1996. The insurance company would pay $3 million toward the tenant's existing lease obligation. Signing a lease with the construction services firm added significant momentum to the leasing effort, making a simpler task of securing other users. Smaller tenants were attracted to the building over the course of the following nine months, at

below-market rental rates. One half of the lease commission was paid to brokers on the very day that the lease was signed, with another half paid on the date of occupancy. Competitive pricing succeeded in securing tenants for a completely vacant building in a depressed, oil-dependent region. The leasing effort resulted in an occupancy level in excess of 90 percent.

Promotion

Marketers rely heavily on direct-contact promotional practises in the extraordinary leasing effort required by distressed properties. While traditional real estate media campaigns employ signs, mail, newspapers, billboards, radio and television advertisements, distressed property marketers often rely on telemarketing and canvassing competitive buildings. A key link in the promotional effort for distressed properties is the real estate broker.

Securing the support of the best people in the local real estate brokerage community is the focus of the marketing campaign. A fundamental marketing consideration is that of "Who represents the product at the point of sale?" [8]. In many markets, prospective tenants work with a real estate broker (or "locator") who tends to specialize in certain market niches. It is imperative that the leasing broker be

an individual with established relationships with quality tenants [9].

Frequent contact and meetings with brokers allow the investor to maintain his property at the forefront of broker awareness. Members of the brokerage community also respond favorably to social events organized to increase awareness of the property. Frequent contact also yields an opportunity to secure market intelligence with which to maintain a competitive rent structure. Continuous monitoring of marketing results is important in attaining marketing objectives. While brokers provide a valuable introduction to prospective tenants, the workout investor must be continuously, personally involved in the leasing process [9].

The workout investor can gain increased broker attention by offering a commission structure in excess of market norms. The procuring broker may receive a full commission, with the cooperating broker receiving a half commission. Payment of commissions is made promptly upon signing of the lease in order to maximize broker cooperation. Sales and leasing contests aimed at brokers can add a sense of urgency to leasing campaigns and accelerate the market absorption period. The workout investor may offer rewards in exchange for procurement of a qualified tenant prospect requiring a minimum amount of square feet within a set time period [9].

A full-time leasing agent for the property can facilitate prospective tenant identification. Market absorption can be significantly augmented through intensive training of professional personnel in management, leasing and selling skills, such as showing space and closing lease transactions [10].

Case Study: "Doing Things Big": Auctioning Texas Condominiums

The auction of a 220 unit condominium complex illustrates how creative approaches to promotion can achieve sales in an inactive market. A savings and loan association funded the construction of the "Las Brisas" condominium complex in Houston in 1985. The developer sold 160 units. The regional economy unforseeably deteriorated during the market absorption period due to a drop in oil prices. Sales took longer than anticipated. The developer came to believe that the units could "not be sold" and promoted the units ineffectively. The developer exhausted his capital. The savings and loan foreclosed. A workout specialist was brought in to implement a sales strategy.

The specialist planned an auction sale for the units. An advertisement was placed prominently in the local newspaper

stating the address of the property, that "only" 60 units remained and that all the units would be sold "this weekend". Prospective purchasers were asked to bring their previous year's tax return. Upon arrival, visitors were greeted with information indicating the limited number of available units. They were issued entry passes of various colors Only those visitors in posession of a pass of a certain color were permitted to make an offer. Those in possession of a qualifying pass were immediately asked to express their preference of unit. Purchasers were offered a below-market financing rate of 6.0 percent, immediate qualification for financing and no closing costs. Credit agencies and loan processors were available on site to process loan documents. With a total cost of sales equivalent to 4 percent of sales proceeds, all 60 units were sold in one weekend, with another 90 "backup" contracts on hand.

Direct, creative promotion resulted in sales by creating a sense of urgency. Peer pressure was created by the presence of many other interested buyers, compelling visitors to make on-the-spot offers. "Unsellable" condominium inventory in a depressed real estate market was sold in its entirety in a single weekend.

Case Study: Miami Vice:
Repositioning and Competitive Pricing In the
Miami For-Sale Housing Market

The case of a Miami, Florida condominium complex illustrates how a combination of competitive pricing and product repositioning salvaged a foreclosed for-sale housing project. An inexperienced developer constructed a 231 unit, 20-story condominium complex on Miami's prestigious Brickell Avenue in 1975 with a construction loan from a Real Estate Investment Trust. Despite a healthy local housing market, the developer failed to secure significant sales. The project encountered financial difficulties. The Real Estate Investment Trust holding the construction loan foreclosed when construction was approximately 85 percent complete. An outside workout investor was brought in to propose a turnaround strategy for the property. Should the property be sold in bulk to one purchaser, resulting in a possible writedown for the REIT? Or, could units be marketed individually, allowing the REIT to recoup its investment? [11]

The investor's analysis revealed that the product was not thoughtfully conceived. The condominium development offered neither the space nor the lifestyle crucial to residential real estate marketing. Units tended to be small in relation to other properties on the market. The swimming pool had

been constructed near the street and lacked any privacy. The 100 parking spaces were inadequate to serve the needs of 231 owners. Many condominium units had views on the parking lot. Characteristically, the tennis court had been built with an east/west orientation, in violation of the norms of the game.

Pricing of the units had created an inequality. With all units priced similarly, units on upper floors with southern exposure onto beautiful Biscayne Bay had sold first. Few sales has occurred on sides of the building with less-desirable exposure. Prices were high in comparison to comparables.

In repositioning the property, the workout specialist added a landscaped buffer between the swimming pool and the street. He erected a parking superstructure over the existing parking lot. He added a new tennis court with a north-south orientation on top of the parking superstructure. Placement of the attactively landscaped tennis court atop the parking structure preserved space and simultaneously added attractive views onto an amenity area for many condominium units.

New prices were established without relation to total project cost or outstanding loan balance. Pricing strategy was modified to offer an incentive to purchasers of units with inland views. The incentive took the form of a $20,000 (10

percent) price differential between bay- and inland- facing units.

A previously-lacking lifestyle feature was added to the marketing effort. An emphasis on recreation and the outdoors life permitted the condominium to be marketed as a community offering a "club" lifestyle. Recreational features and amenities were accentuated. The emphasis on the outdoors tended to de-emphasize the small size of the condominium units.

Initial construction of the project had cost $14 million. The refurbishment effort cost $3 million. With gross sale proceeds exceeding $21 million, the lender realized a profit of $4 million. Competitive pricing and a remanufactured product succeded in revitalizing the property.

Property Management

Property management efforts work in tandem with the marketing repositioning strategy. Property management is instrumental in bringing about additional revenues through tenant retention. Clean, neat buidings are important in securing new tenants and maintaining existing tenants. Maintaining tenants preserves property cash flow and thereby offers the property additional time to recover. The property manager in

a distressed property turnaround serves to maintain the physical appeal of the property, to initiate a tenant-relations campaign and to build community acceptance of the distressed property [12].

The property management firm can significantly reduce property operating expenses by appealing real estate tax assessments and concentrating occupancy of buildings. Buildings purchased at a significant discount or with below-market financing can appeal to the real estate tax assessor to base the assessment on the purchase price rather than on the original cost. Property managers can control where space in a facility is occupied. By concentrating partial tenancy in certain parts of the property, other parts can be closed, reducing occupancy costs [12].

A successful property management strategy for distressed property relies on the choice of quality property managers. The investor's objective must be to secure the best property management staff available. Professional, aggressive, market-oriented younger property management and leasing firms with experience in workouts are the most appropriate [13].

Owner involvement in monitoring and overseeing the property management effort should be continuous and intensive. Distressed property turnarounds require quality

upper-mamagement time. Management requirements are typically traceable to physical defects of the property and to eradicating possible problems with tenants. Management of a distressed property can demand two to three times the management attention required by a conventional property, over an extended time period [14].

The investor in distressed property should not accept the open-ended financial responsibility of completing construction. The nature and degree of the work involved in completing a project is unpredictable and costly. Even the most experienced construction executive cannot accurately predict the construction requirements of a partially-constructed project. The original lender must agree to accept an open-ended financial commitment with respect to completion of construction. Inspection of the property prior to acquisition is advisable. Developers may go to great lengths to conceal omissions and substitutions of materials [14].

The combination of a management and leasing team is most appropriate for a distressed property. Leasing agents tend to have a relatively short-term interest in the tenant and the property. Once compensated for securing a lease, they can quickly loose interest in a tenant. By combining the

property management and leasing functions, leasing agents gain the long-term perspective of the property managers. Combining leasing and property management also permits a cross-subsidization, with substanitial leasing commissions helping to compensate for more meager management fees. Management and leasing firms are often offered incentive compensation when managing distressed properties, with above-average fees paid for attaining results in tenant retention and leasing [15].

SUMMARY

Successful distressed property marketing relies upon positioning of the property to suit an identified market need, competitive pricing and real estate broker relations. Property management works in tandem with marketing in achieving a property turnaround.

The individual investor in distressed properties has an organizational advantage over institutional holders of competitive properties. The individual can move more swiftly and can make creative decisions independently, rather than await the approval of committee. This flexibility acts to counteract the institutional advantage of capital [12].

NOTES FOR CHAPTER FOUR

[1] "The Return of the Grave Dancer", Samuel Zell, Real Estate Issues, Fall/Winter 1984

[2] Interview with Richard Scott, Principal, Aldrich, Eastman and Waltch, July 1987

[3] "The Grave Dancer", Samuel Zell, Real Estate Review. Interview with Duke Woodward, President, Wayne Duddlesten, Inc., Houston, Texas, June 1987

[4] "The Return of the Grave Dancer", Samuel Zell, Real Estate Issues, Fall/Winter 1984

[5] Interview with Richard Scott, Principal, Aldrich, Eastman and Waltch, July 1987

[6] Interview with Larry Levey, Chief Financial Officer, Hall Financial Group, Inc., Dallas, Texas, July 1987

[7] Interview with Duke Woodward, President, Wayne Duddlesten, Inc., Houston, Texas, June 1987

[8] "Structuring Complex Real Estate Transactions", Arthur J. Halleran Jr., Chairman, Winthrop Financial Associates, Lectute at Center For Real Estate Development, M.I.T., Spring 1987

[9] Interview with Richard Scott, Principal, Aldrich, Eastman and Waltch, July 1987

[10] Interview with Duke Woodward, President, Wayne Duddlesten, Inc., Houston, Texas, June 1987

[11] Adapted from interview with Eduardo R. Arellano, Vice President, Senior Corp., Miami, Fl., June 1987

[12] "The Return of the Grave Dancer", Samuel Zell, Real Estate Issues, Fall/Winter 1984

[13] Interview with Richard Scott, Principal, Aldrich, Eastman and Waltch, July 1987

[14] "The Return of the Grave Dancer", Samuel Zell, Real Estate Issues, Fall/Winter 1984

[15] Interview with Richard Scott, Principal, Aldrich,

CHAPTER FIVE:

SUMMARY AND CONCLUSION

The multi-billion dollar loss of capital facing United States lending institutions was brought about by the historical cyclicality of the U.S. real estate industry; the entry of highly-liquid, under-managed savings and loans into the commercial real estate industry; the stimulus to investment offered by tax incentives; and macro-economic shifts.

Distressed properties come into existence due to either inadequate demand for the product or due to risks associated with financing, marketing and property management. Inadequate demand may be traceable to unsophisticated market analysis, inattention to demand considerations, or a change in demand during the development period.

A distinction can be made between forces underlying the

creation of distressed properties which are forseeable and those that are not forseeable. We are more able to manage risks for which we have some degree of advance knowledge. In "steady-state" circumstances, these risks will always lead to a certain number of workouts in the real estate industry.

Real estate casualties tend to result from the convergence of a number of contributing reasons.

Distressed property turnaround strategies involve a combination of three basic elements: time, money and skill. The financial structure of a distressed property seeks to provide adequate time and money resources with which to salvage the property. Time is needed for repositioning of the property and renovation. Money buys time. It funds operating deficits and costs associated with product repositioning such as tenant improvements and renovation. The equity investor has negotiating leverage in structuring financing due to his willingness to assume risk in order to salvage the lender's property. Specialized mortgages answer the particular needs of distressed properties. In a volatile world, no optimal capital structure for distressed properties exists. One must monitor equity and debt pricing in the capital markets on a daily basis.

Successful distressed property marketing relies upon

positioning of the property to suit an identified market need, competitive pricing and real estate broker relations. Product repositioning in the marketplace essentially amounts to remanufacturing the property. Property management and marketing interact in achieving a successful property turnaround. Property management increases tenant retention, improves the image of the property in the community and reduces operating expenses. Property management is dependent upon the selection of quality managers. However, there is no substitute for direct, continuous owner involvement.

The individual investor in distressed properties has an organizational advantage over institutional holders of competitive properties. The individual can move more swiftly and can make creative decisions independently, rather than await the approval of committee. This flexibility acts to counteract the institutional advantage of capital.

Ultimately, workout strategies are not radically different from strategies for well-managed development of successful properties: structuring financing to realistically match the anticipated property operating income; positioning the property in the market to serve an existing market need at an achievable price; promoting the property aggressively through marketing channels, particularly the brokerage community; and employing professional, motivated property management aimed

at tenant service, all coordinated by the intense, personal involvement of the owner. The property that was not effectively developed initially must, in essence, be re-developed correctly by the workout specialist.

Many opportunities exist in this sector for the disciplined, skillful investor who allies himself with patient capital.

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BIOGRAPHICAL NOTE

The author, Costas (Dean) Sperantsas, attended Georgetown University in Washington, D.C., graduating with honors in Finance and Economics in 1982. Upon graduation, he was employed by the New York investment banking firm of Morgan Stanley & Co., in the real estate division. He later was engaged in multifamily and industrial development in Florida. He has published articles on real estate topics in English and Greek.

The author intends to devote time, as principal, to working out distressed properties.