OPPORTUNITIES IN DEBT AND BROKEN PROJECTS

Broken projects are not all alike. Sometimes the right customers seek the right property at the right time.

Just about every day, **Matthew Cravey, SIOR, CCIM**, president of Cravey Real Estate Services Inc. in Corpus Christi, Texas, drives past One Shoreline Plaza, the South Texas city's iconic, twin-tower office building sitting in a picturesquely perfect location.

One day a local reporter said to Cravey, "you, of course, agree with the old real estate axiom, 'location, location, location,'" and Cravey, thinking of One Shoreline Plaza, which had suffered through two foreclosures in its history, shook his head, "no, I believe in location, location, timing."

LOCATION, LOCATION, TIMING?

"One Shoreline is absolutely gorgeous, won prizes for its design and sits right on the shore looking out over the bay and the port," says Cravey. "If location was so great why did One Shoreline get repossessed two times? The answer is: it failed for a lot of reasons, including too much debt at the wrong time."

The sad fact is, with the onset of the Great Recession, many of the buildings that went back to lenders were not bad properties, in fact, they were good buildings with what turned out to be really bad loans.

> "Not all broken properties are broken in the same way. Some are truly distraught or obsolete. Others are structurally modern and attractive, but the financing may be morbidly unsound. But if you have a vision and capital there is opportunity."

Those toxic debts were once good performing loans, but when the real estate market collapsed, suddenly all that paper was underwater. Borrowers and banks had to get rid of bad debt and properties tossed into the market devalued very quickly.

Many of these, like One Shoreline Plaza, were very good properties that needed either better management, an infusion of capital, and/or tender loving care.

"The first owner of One Shoreline Plaza was the developer, and he got caught with too much debt," Cravey recalls. "The next owner did great with the property, but flipped it. The next group put too much debt on it and they lost it. The newest owners came in with just enough debt to not overburden the property."

Today One Shoreline Plaza is finally getting the rent levels projected when the building was built in the 1980s. The property is cash-flowing and occupancy is rising.

"It's the timing," says Cravey, "because on top of better management, the Corpus Christi economy is booming. We have $15 billion in plants being constructed due to all the natural gas being developed."

Cravey's company is doing the leasing on the building, which at one point saw vacancies drop to 68 percent. Today it's at 88 percent.

Back in 2009 and 2010, when the Feds began to audit every bank, they came to the conclusion fairly quickly that a lot of real estate loans did not meet threshold requirements in terms of loan-to-value, reports **Nathan Anderson, SIOR, CCIM**, managing principal with Lee & Associates in Kansas City, Kan. "When the Feds came in, they realized the margins were no longer there and told the banks to get rid of the loans; but when you are telling every bank in the country the same thing, there was a snowball effect. Values declined rapidly."

The quickest way to unload the loans was to sell the paper. Shrewd investors with cash realized the good value in these deals and bought the loans for $0.30 to $0.50 on the dollar.

As the debt market stabilized, around 2011 investors began buying not just the paper but the real estate itself. They were able to do that in volume because the banks would loan the investors the capital to do so. As a result, the underperforming loans were moved to the other side of the ledger as performing loans.

"We had an investment group that acquired from a bank a $1.5 million asset, which at one time was worth $3 million," says Anderson. "The bank financed the deal with an 85 percent loan-to-value."

Everyone except the original investor won: the buyer got the property cheaply and with a good LTV loan, while the bank moved the loan from non-performing to performing.

Currently, Anderson is working a building where the owner passed away and the real estate went into receivership. The investment group buying the property will pay 50 percent of what it was worth before the recession.

When asked if there were a lot of these kinds of deals still in the Kansas City market, Anderson responded, "we are a diversified, second tier market. We don't get large swings in value. We still have a few projects out of whack on the non-performing side, but most of that is land."

There are good prospects for brokers in busted properties or broken debt, but one has to be smart about the opportunities.

Todd Kamps, SIOR, CCIM, a principal with the Kwekel Companies in Grand Rapids, Mich., offers this example. Back in 2005, he sold a 30,000-square-foot, Grand Rapids office building to a Michigan investor. At the time, the building was leased, stable and had been for many years. Then bad things happened. First, a tenant with a 15,000-square-foot lease departed, followed by a tenant who had an 8,500-square-foot lease.

Kamps was able to find small tenants to fill some of the space, but by the time the recession hit, the banks wouldn't finance improvements to the building. Meanwhile, the value of the building dropped precipitously and eventually went through a short sale.

Kamps continued to look for tenants and one prospective company had a need for about 6,000 square feet. The building was in its target area. Kamps suggested the company find a partner and buy the building instead of just leasing, which is what happened. The building was then re-appraised and new debt replaced the old. Another tenant took space and now the building is 100 percent occupied.

Again, think of it as good timing. Although the property was a B-building, nothing new had been built in the area for years and the Western Michigan economy over the last 18 months got stronger. Expanding companies needed more space.

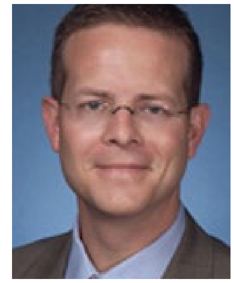
In the older Ohio manufacturing belt that extends north from Cincinnati, **Norman Khoury, SIOR, CCIM,** a senior vice president for Colliers International in Cincinnati, Ohio, has sold and leased properties that were broken, not due of debt overload, but because of the most basic of all corporate departures: building obsolescence.

Fortunately for Khoury, he made the acquaintance of Stuart Lichter and has successfully concluded a couple of deals for him. Lichter is the president and chairman of Industrial Realty Group LLC, a company that focuses on the adaptive reuse of commercial and industrial real estate.

"What Lichter looks for are surplus corporate properties that have been on the market for some time, or large projects that are functionally obsolete," says Khoury. "There is generally not a lot value for those older, large plants, but Lichter has the capital and ability to make the land useful again."

In one of the two deals Khoury brokered for Lichter, IRG bought an old Delphi automotive brake campus that included a 500,000-square-foot manufacturing plant and a 60,000-square-foot office building. Lichter then tore down the buildings, cleaned, and graded the property. He then sold it to a truck stop developer.

contributing SIORs



NATHAN ANDERSON,
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SIOR, CCIM

GABRIEL SILVERSTEIN,
SIOR

"It was a blighted, old building right off an interstate interchange," says Khoury. "There is quite a lot of distribution near there and the area was in desperate need of more space for truckers."

Perhaps the most noteworthy Lichter deal in Ohio involved a former GM manufacturing facility in the city of Moraine. The 4.5 million square-foot facility sat vacant for a long time and then was sold at auction to IRG.

Lichter is in the process of splitting the building in half and selling 1 million square feet of space to the Chinese company, Fuyao Glass Industry Group Co. Ltd. – the largest Chinese investment in the state. The remainder of the property will be multi-tenant.

Lichter acquired the GM plant in the heart of the recession, and Khoury asked how he was able to make the purchase. As Khoury recalls, Lichter told him: "the equipment was still there and I used that as collateral for a loan, so initially it wasn't really a real estate loan. The banks were able to move it to a different side of the ledger so the project could happen. As I began leasing, I put a short-term real estate loan on it. As it leases up, I'll put additional debt on."

THREE KEYS TO SUCCESS IN ADAPTIVE: REUSE, RESOURCE, VISION AND FINANCIAL ACUMEN

Angelic Real Estate, a New York real estate investment banking advisory and brokerage firm, has been very active in the market for broken properties over the past half-decade and its president, **Gabriel Silverstein, SIOR,** president of Angelic Real Estate in New York, N.Y., had some incisive comments to make about that market.

"Early in the recovery, the biggest challenge was the bid/ask spread, where the holders of debt or REO property, namely lenders, were seeking substantially more than the properties were worth," Silverstein recalls. "While properties were readily available, they weren't trading because of the spread."

That has all changed as the market has aggressively come back to close the gap.

"Both sides of the equation have tightened up to the point where, for the most part, we are seeing just about everything that becomes available ultimately trade," he says.

THIS DOESN'T MEAN THINGS ARE EASIER

In the traditional auction process, the potential buyer gets access to a "data vault," in short, whatever hard information about the real estate the seller has, but the lenders that are now sellers often don't have this data.

"They may not have the historical financial background or even copies of everything," says Silverstein. "This has been the biggest challenge going through deals."

Usually in the auction process, the buyer can access information ahead of time, and after winning an auction, makes a bid with at-risk hard money. "Now you don't have the traditional period of time to validate what you assumed," says Silverstein. "Therefore, as a buyer you are taking more of a risk because you don't know everything and the lender (seller) didn't give you the data it should have given you."

SILVERSTEIN HAS THREE CAUTIONS FOR BUYERS OF BROKEN PROPERTIES BEING SOLD BY THE FINANCIAL SIDE OF THE INDUSTRY:

- The big institutions that are trying to buy distressed properties aren't good at talking to the tenants before they buy. It's amazing how, after talking to tenants, you learn there are a lot small things that aren't expensive that you can do to right that ship and make tenants happy. Tenants often feel neglected in busted properties and the moment someone walks in their door, they will flock to them.

- Be cautious of the unknown. Any building that has been in a distressed situation for many months, probably has suffered from "under-doing the maintenance" and sometimes that is not easy to make up. We have seen catastrophic failures in building systems simply because the systems were neglected for too many years in the receivership process.

- If you have never bought properties from a lender, you will be surprised at what will end up in a purchase contract. Often lenders refuse to make the kind of representations and warranties in a contract the traditional seller makes for the marketplace. With most lenders, it's take-it or leave-it.

Ultimately, the biggest problem with distressed property deals, which are essentially value-add plays, is that the market is flooded with buyers.

"Pricing is so competitive it is hard to feel that you have gotten a good deal," says Silverstein. "The best way to reverse that feeling when buying from a lender is to take on the risk of a property with 'hair on it,' so you can end up getting to the return you're after."

ABOUT THE AUTHOR: *STEVE BERGSMAN is a nationally recognized financial and real estate writer. For more than twenty-five years, he has contributed to a wide range of magazines, newspapers and wire services, including the New York Times, the Wall Street Journal Sunday, Global Finance, Executive Decision, and Chief Executive.*