

Distressed Assets INVESTOR

Providing Field-Level Guidance on the Acquisition and Disposition of Distressed Assets

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NOTE BUYERS

Real Estate Meets The Paper Chase

True real estate people want to own buildings and property, but they're finding that they often have to buy up debt as a means to that end.

For real estate people who want to get their hands on hard assets and do something with them, distressed assets illustrate the maxim that you can't always get what you want, at least not right away. Getting your hands on

bricks and mortar, in the world of distress, often means having to grab some paper first. As founding partner and managing principal Larry Kestin of New York City-based Glenmont Capital Management puts it, "Even investors who want to own property are required to pursue such assets via the debt."

Among those who want to own property is Sycamore Urban Properties of Irvine, CA. "We want the real estate," says Dan Flynn, vice president at Sycamore. The company has acquired distressed assets through both REO and note purchases, but in all cases, it's trying to get to the bricks and mortar. "We buy a note with the intent to take the property," Flynn says. "We are developers by background; our intention is to get to the real estate."

One of the reasons Sycamore and others find themselves buying paper to get to real estate is that lenders, in general, have shown a preference for disposing of distress via note sales rather than REO. In a nutshell, lenders are doing this because they're getting note-sale prices that are close to REO

values while avoiding the risks, headaches and time-consuming procedures involved in foreclosing. Lenders "want to stay out of the chain of title and all the liabilities that go along with it," Flynn says.

It's no wonder that lenders want to stay out of the chain of title and dispose of the assets without foreclosing if they can. Jay Hiemenz, CFO of Phoenix-based Alliance Residential, points out, "Depending on the state you're operating in, the risks and timing to foreclose can differ greatly." When lenders can sell notes, it's the note-buyers who are facing those risks.

And those risks can be formidable. Kestin of Glenmont Capital points out that, in some cases, the buyer of a note "might be able to compel a deed directly from the borrower in a matter of weeks and at a fairly nominal cost." On the other hand, he adds, certain situations can involve a lengthy and costly foreclosure process that may even include a bankruptcy filing, significantly increasing the time and, certainly, the cost to acquire the title. These are just some of the risks lenders avoid and note-buyers take on in note sales.

A borrower bankruptcy is exactly what happened in one of Sycamore's note purchases. "Fortunately, the bankruptcy worked out well for us," says Flynn. "When we bought the note, the bank that was selling it had already

filed a notice of default, so we immediately continued with that process." When the borrower filed bankruptcy, Sycamore had several factors working for it. "One, we had an excellent bankruptcy attorney and two, we were able to make a very clear, obvious case that the best appraised value of the property was significantly less than what the borrower owed." The case was processed quickly, with the bankruptcy judge converting the Chapter 11 into a Chapter 7 liquidation. "We were able to take the property back within six months of buying the note, which is very quick when a bankruptcy is involved," Flynn says.

Nonetheless, he advises that anyone contemplating a note purchase should build in some potential delays and expenses into their underwriting. "You may have to build in \$50,000 to \$100,000 of legal costs, or even more, before you are able to take back the property," he says. "It could be a six-month to 12-month process, depending on whether and how much the borrower fights."

Considering the potential pitfalls of buying notes, buying already-foreclosed REO "is a simpler and cleaner process," Flynn says. Considering that the risks are lower when buying REO, investors who want the bricks and mortar might be expected to eschew the paper for buying the actual real

estate directly via REO. But there is another side to that coin. "Since REO is simpler, there will be far more competition from bidders on REO than on note sales," he says. "Less competition is one of the advantages of note acquisitions."

Sycamore has found three levels of competition, in general, in the assets it pursues. One is REO that is 100% completed and ready for someone to simply step in and operate it, which can attract dozens of bidders who drive up the price. Next is REO that requires a substantial amount of work to complete, which attracts fewer bids capable of taking over a partially built project and finishing it. The third is note acquisitions, where the buyer pool dwindles even more because fewer bidders are equipped or inclined to take on the task of foreclosing.

Alliance Residential's Hiemenz also cites differences in the pricing and level of competition for REO versus note sales. Hiemenz explains an REO purchase in most cases "provides far greater access to the asset and the subsequent ability to perform more in-depth due diligence regarding the purchase." A note purchase, by contrast, generally provides little opportunity for typical real estate due diligence, such as lease-file audits, physical evaluation, third-party testing and reports, not to mention the ever-present possibility of the aforementioned borrower bankruptcy.

Nonetheless, Hiemenz says, his company "has been more successful with the purchase of notes or short sales, rather than going through a bidding process" on REO. "If we are able to assess and understand the risks, the benefits associated with the lower basis are worth the risks" of buying notes, Hiemenz says. "The key is to assess the level of risk and get paid for taking that risk"

Kestin of Glenmont Capital provides a similar assessment. Despite the risks and "an additional level of complexity" in buying notes, "investing in non-performing loans secured by real estate can be an effective means by

only at REO, then mathematically you are going to have fewer opportunities than someone who is willing to look at notes too," Flynn says. "That's why we've done both."

The notes that Sycamore has ac-

Loan Market Shifting



Source: FDIC

which an investor can acquire assets at a discount to the market and do so in a less-competitive environment," than bidding on REO, he says. Note buyers really need to know what they are doing because a host of factors come into play, including geography. "If the loan being acquired is guaranteed by solvent principals and located in a non-judicial foreclosure (deed of trust) state, the path to title should be faster and less costly. Conversely, where there are no guarantees and the property is located in a judicial foreclosure (mortgage) state, the risk of a more costly and lengthy path to title exists," Kestin says.

Ultimately, those who want to get their hands on bricks and mortar have to look at both REO and note purchases, according to Flynn of Sycamore. "If you are willing to look

quired have been on incomplete condo projects, which plays to the company's strength as a developer. "In these projects, there is much more of a value-add opportunity," Flynn says. By contrast, someone buying a fully leased, 100% completed REO property "will be buying at a very low cap rate, and there will not be a lot of upside," he says. Sycamore and the buyer of that low-cap property may have different strategies, but they do have one thing in common: They're not after paper, they're after real estate. ■



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