

Fed, financiers can't Kick The Can forever

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Remember Kick The Can? Ever play this great game when you were a kid? You missed out? No worries. If you are real estate banker or commercial real estate owner, you have a chance to play it again yourself.

However, if you are an investor in commercial real estate looking to make a killing in the \$1.4 trillion of real estate debt coming due through 2012, this is going to be a very painful game to watch.

The FDIC has quietly issued a ruling essentially enabling banks to classify real estate loans that have spotty debt service coverage or whose property values have fallen below the loan balance as "performing." With commercial real estate values down in some places as much as 40%, this is a true leap of faith on the part of the federal government, which is hoping that by keeping these loans in the performing column banks can "kick the can" farther down the road until the economy and private real estate values reflate.



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The FDIC is quietly trying to avoid a replay of the early 1990s when the creation of the RTC resulted in deep-discount pricing of real estate loans and assets. As a result, banks are "pretending and extending," keeping the loans on their books in their "held to maturity" accounts - and as such are not required or incentivized to mark them or bring them to market and sell them. If they did, the banks would look insolvent and nobody, especially the Feds, want this to happen.

The banks ARE moving some very small loans and selling them at deep discounts, and as we have seen from recent investments, these can be bought attractively and quickly. But the big stuff, the larger troubled loans, are just being held for now. Meanwhile, with most bad loans focused in regional banks, the FDIC has already implemented a playbook for keeping the increasing number of bank failures from impacting the economy by having them taken over by larger banks.

However, with only 22% of commercial loan defaults coming from bank loans, there is more to the story. Today, nearly 54% of all current commercial real estate loan defaults are in the CMBS sector (commercial mortgage-backed securities) - that is, not loans held at banks but rather loans that were made mainly by other financial institutions and then securitized.

So, is this the path to successful vulture investing? Unfortunately, there is can-kicking here, too. As the loans mature or go into default, there is no clear picture of how things are going to play out except that there will be a lot of delays before these loans are sold at market due to the structure of these loans.

Once a CBMS deal fails to pay off or goes into default, the deal administration is transferred from the master servicer to the special servicers, and three problems pop up. First, under the agreements that govern the loan, the special servicers have very limited powers to adjust the loan, forgive it, or sell it. They can only do things that have no net negative effect on the loan.



Second, most of these players also have a B piece of the deal, which means they are in the first-loss position, so even if the deal matures and they are not paid off, they are HIGHLY incentivized to extend - because without the extension they lose their position entirely.

And, finally, most of the agreements give the special servicers a number of years to resolve the issues, so again we have stalemate.

Meanwhile, the investors in the senior bonds, which are the most protected from a value and cash flow perspective in the securitization, would love to foreclose and own, so they can often go to war with the special servicers, and with no adult in the room, sometimes only a bankruptcy judge can figure it out.

More and more of these will deals mature in 2010, 2011 and 2012, so this only gets worse, with special servicers and borrowers attempting to postpone as long as possible, hoping that the economy will recover enough to minimize the damage. But, the bottom line is that eventually these deals will get written down and sold, with asset types most exposed to the markets - like hotels - going first, and property types like CBD office with longer lease terms going later.

So, have patience and watch the game. There may be a few cans to pick up yet.

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