

InterChange Alert



Distressed real estate: knowing when to sell

In the current market, should a potential seller hold or fold? For real estate companies, one of the biggest challenges is deciding whether to hang on to a money-losing commercial property or to sell it at a deeply discounted price.

The decision is risky, nerve-wracking and complex. Methodical analysis is called for, requiring robust financial modeling and realistic market knowledge. The current and future cash position of the company must be determined. The company needs to understand its level of debt, when it comes due and what it costs. Most difficult for the company will be to try to determine the value of each asset. Critically, the company must consider its entire real estate portfolio - not just look at a single property.

Transaction paralysis

Despite signs of a nascent macroeconomic rebound, the commercial real estate sector still faces tremendous obstacles to its own sustained recovery. One symptom: paralysis in the deal space. In the first three quarters of 2009, US real estate transactions volume fell by 67% and dollar value declined by 73.5%, compared to the same period in 2008. Globally, the value of commercial real estate transactions fell 53.7% for that time frame versus one year earlier.

The only properties being sold now are those purchased with nonperforming loans and high-end, one-of-a-kind trophy or foreclosed properties. While differences between buyers and sellers are becoming less pronounced than they were at the peak of the global crisis, the sides are still far apart. Buyers, expecting a rash of commercial properties to flood the market, await a further fall in prices.

Given buyers' market power, how should a potential seller think through the exit decision? Ultimately, the purpose of the sale will be to raise cash, so it's important to clearly understand the company's cash needs. The potential seller must assess not only the future cash projection of a distressed property or even each property in the portfolio but also the company's cash position as a whole - on both an operating and an asset level. To that end, the company should utilize a rolling 120-day cash flow budget that will illustrate its actual liquidity position every month.

Assessing cash needs

When determining cash flow, potential sellers need to find the cash shortfalls and understand their negative impact. Which properties are sucking the most cash out of the company and dragging down the good assets? After identifying those vampire assets, owners should work through various possible options. Leasing is one option, for example - but many markets have 20% vacancy rates, making new leases difficult. Only when such options are exhausted, can the verdict to sell be appropriately reached.

Key to assessing cash needs is identifying the level of debt to be serviced for each asset, when it is coming due and the cost. The more equity a company has in an asset, the better the owner's ability to weather today's market conditions. With greater equity, the cash the asset throws off can be used to meet unexpected capital expenditures.

Another consideration is the type of outstanding loan on the property. A recourse loan allows the lender to legally pursue the property owner for the amount owed even after taking the collateral for a property. A nonrecourse loan only allows the lender to collect the collateral. While a property owner would certainly want to work with the lender in either case, the incentive to create a schedule to pay off a recourse loan is greater since more is at stake. If cash-strapped, the owner would need to sell that property or others to pay the lender what was owed on the recourse loan.

Valuation challenges

Key to determining whether and what to sell is the worth of one's assets. But when valuing property in today's volatile market, appraisals done even six months ago are of little use. In today's uncertain economy, difficulties in forecasting abound. Every element that goes into a financial model must be assessed more closely than ever before with less room for error.

The goal for the owner is to determine whether the asset's value over a specific time period will likely be greater than the cost of holding it. To get there, owners must attempt to calculate net income for the property over the next few years and how long it will take for the property to bounce back. That calculation depends on realistic market assumptions, appropriate capitalization rates, updated business models and of course - location, location, location.

With highly-leveraged assets, when the property is worth less than the debt, the owner needs to consider the current capitalization and occupancy rates and what a buyer would pay for the cash flow stream. While the property may be throwing off cash, it may still be worth less than the debt and the owner will have problems if the lender comes to "remargin" a loan that was bought at the peak of the market cycle. In that case, the property owner must ante up additional cash when the equity in the loan is insufficient to meet the interest payments - and may have to sell to raise the money.

Portfolio analysis

When deciding whether to sell, commercial real estate owners must consider the cash position, cash flow and cash needs of all holdings, not just of the distressed property. It may be that the troubled asset cannot be refinanced on its own, but can be as part of a larger portfolio. If contemplating a turnaround effort for one property, the owner needs to consider the cost of this investment to the entire business.

Most relevant, perhaps other assets can be sold at a profit that will cover some of the troubled asset's debt or bail out the company. Indeed, it is the portfolio's most stable properties, those with high occupancy rates and good cash flow, which are the best candidates for sale when cash is needed. To be sure, the decision to divest comes with its own set of complicated issues. The competition for buyers in today's market makes sell-side due diligence increasingly important.

There are considerable tax ramifications around the sale of a real estate property that must be considered. It is imperative that the owner understand the taxable events that surround major loan modifications and plan decisions around these issues. To have considered everything else and then to forget the tax impact could be a very costly mistake.

Whether a company can afford to keep the property or should sell is not only the owner's decision to make. Owners should consult with their bankers. Working with the original lender is usually far better than alternatives such as taking on a partner, which usually requires paying high mezzanine financing rates. Lenders are increasingly giving borrowers "room to breathe" by waiving financial covenants, modifying existing credit facilities and extending maturities. Banks, however, are also becoming more open minded about owning or taking full control of properties where borrowers have gone bust. Typically, the banker will run a cash flow forecast for the specific property and consider debt service obligations before approving refinancing, turnaround strategies, prospective sales or other solutions to distress.

In such an uncertain environment, property owners need robust analysis and modeling to be able to make sound decisions. Having the greatest possible market knowledge is a critical factor in deciding whether to hold or fold.

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