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How to Navigate Distress in the Commercial Real Estate Market

BY SHLOMO CHOPP NOVEMBER 29, 2023 11:32 AM

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In the ever-evolving cycles of commercial real estate, distressed periods present challenges and offer unique opportunities. Over my two decades in this dynamic industry, I've donned the hats of borrower, lender and investor. I've learned a lot of important lessons along the way through success and failure. In analyzing the current commercial real estate market, here's what borrowers need to know and where savvy investors can make their mark.

The scars from the 2008 financial crisis still linger in our collective memory. During that period, the predatory practices of residential mortgage lenders ultimately exposed vulnerabilities in our financial system. Now, 15 years later, we find ourselves confronting similar issues, albeit this time primarily on the CRE side of the equation.

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Distressed assets in the CRE market encompass a diverse array of properties. While some of these assets face inherent challenges — like brick-and-mortar retail's battle against e-commerce or offices adapting to remote-work trends — all share a common challenge: being indexed to low yields in a rising rate environment.

At the heart of many of these issues lies the complex world of commercial mortgage-backed securities (CMBS). These vehicles, while designed to mitigate and package risk, often make the unwinding or working out of a distressed loan a herculean task. The unexpected challenges posed by events like the COVID-19 pandemic were tackled only by pushing the boundaries of what was considered the norm in this space.

CMBS loans are known for their competitive interest rates and accessibility, even for borrowers with less-than-stellar credit. However, beneath the surface of this seemingly attractive financing method lies a labyrinth that can ensnare the most diligent borrowers. Cash can become trapped, defaults can arise, and significant fees can mount — even on an otherwise healthy asset.

The pandemic further exacerbated these issues. Lockdowns, bankruptcies and lease terminations wreaked havoc on property matched the all-time high of 10.32 percent recorded in 2012 — a number we may see once again.

Special servicers play a crucial role in the CMBS landscape. When a borrower defaults on a CMBS loan, the loan is handed over to a special servicer, whose primary responsibility is to either find solutions or initiate foreclosure. Crucially, these servicers operate in the interest of bondholders, often capitalizing on defaults to collect fees — with no obligation to the borrower. Unfortunately, most borrowers lack the know-how, vision and expertise to prevail in the face of these complex loan agreements, having ceded negotiating power when the loan was made.

While some may argue that CMBS issues are isolated, I believe the opposite. These securities are held by all types of financial institutions and funds. As the bonds' interest rates are lower than market rates, they may be worth less than their face value, potentially causing these balance sheets afloat, but this could change with defaults. These issues also extend beyond CMBS to any loans made at low interest rates, which are now potentially worth less than face value.

Despite the complex challenges of the distressed CRE market, there are unparalleled opportunities for those armed with the right knowledge, experience and strategic vision. The proprietary investment strategies we are employing extend beyond traditional real estate investment. We generate and leverage unique insights into the yield-sensitive bond market with a goal of transforming it into tangible real estate ownership.

There has been a surge in investor demand for distressed assets. Large private equity firms have raised multibillion-dollar funds, making it a challenge to compete with them for larger on-market deals. However, real estate operators can leverage their expertise to identify and develop off-market deals that can be brought to these firms as strategic partners.

The dynamic landscape is undoubtedly daunting. To truly recognize opportunities in 4-D, and capitalize on them, requires knowledge of the nuances of distress, the market power dynamics, the intricacies of complex loan agreements, distressed workout minefields, and, of course, foreclosure proceedings. Challenges conceal hidden, albeit complex, gems of opportunity.

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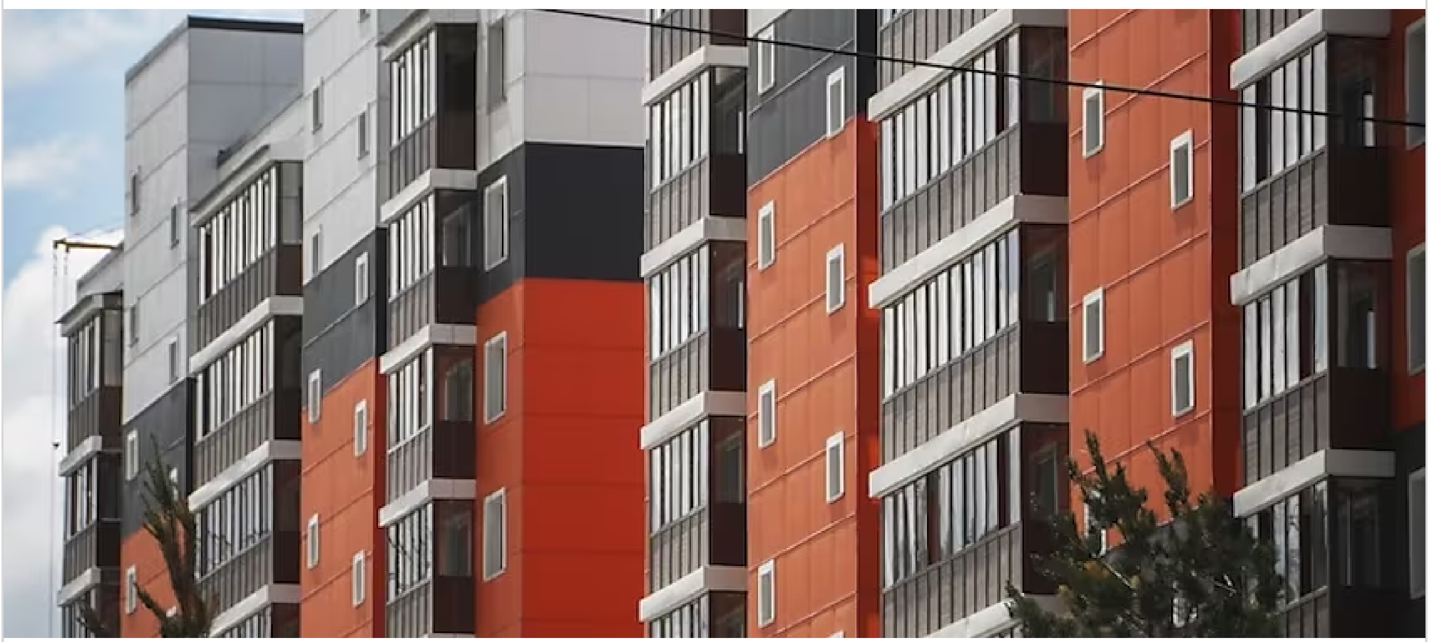

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