Distressed Asset Borrowers: To Sell or Not To Sell

Assessing the Many Options and When a Sale is Optimal

By Emily Fu

For the past six months, in the world of commercial real estate the term "distressed asset" is like Lord Voldemort in Harry Potter. You can just feel that dark force creeping through.

Distressed assets in commercial real estate refer to properties or real estate investments that are facing financial difficulties or undergoing a period of distress. These difficulties typically arise when the property owner or investor is unable to meet their financial obligations, such as mortgage payments, property maintenance costs, or other debt-related expenses. Distressed assets are often in danger of foreclosure, bankruptcy, or other adverse outcomes.

If it's a war, office and retail are the two major battlefields right now. However, in each asset category, many matrices could affect the distress level. The situation of functional obsolescence varies depending on the market and the potential uses. The options for borrowers can vary from replacing the property manager or maintenance team to repurposing the current property.

When it comes to distressed assets, selling the property is not the only option, and many times not the best option. One of the reasons is that the sponsors may or may not generate enough proceeds to cover the balance that they have on the project. That's why it's worth looking into other options before you sell.

Can I get a discount?

"They [Borrowers] could go to the lender and ask for some relief on the loan – forbearance or reduction in the principal or split it into an AB note where the B is an accrual announced so they don't have to continue to pay the interest today," explained Matt Reidy, Moody's Analytics' director of Commercial Real Estate Economics. "They could approach the lender about getting additional capital from the lender to make building improvements."

Many borrowers would come to the lender and ask for a discount on their existing loan. But if that's how they start the conversation, many times lenders would say no, according to Michael Cohen, managing partner at Brighton Capital Advisors in Charlotte, who has over 25 years of experience in restructured finance. "You need to have a plan and convince the lender that you are the best person to do it. You're doing homework for the lender," said Cohen. "First, you have to show the lender you've tried everything and exhausted all your remedies. And two, you have to prove that with the current market condition, even if you put money into it, you're never going to reach that value."

"The lender is not the enemy," said Shlomo Chopp, managing partner at Terra Strategies, a real estate advisory firm that specializes in distress. "The market's the enemy. You need to explain this to the lender. You can help them."

Are we on the same page?

With a list of options available, sometimes it's not about what you communicate, it's how you communicate.

"I think there's this massive disconnect between borrowers and lenders," said Chopp. "The biggest issue that borrowers have is that the most important thing when you take a loan is your rate and proceeds. But the most important thing when you have a problem is going to be the rest of the terms of the loan document," said Chopp.

"Structured finance is structured to give you more proceeds at closing. That's why you like it. That's why you don't like it," said Chopp. And it turns into a "pick your poison" situation. "You can either take more money today and hope everything goes well or take less money. The flexibility is just how it works," said Chopp.

"We have a lot of borrowers calling up and wanting to have a discussion as if we have a relationship. There is no relationship in CMBS lending," said Cohen. To him, the unique nature of CMBS differentiates it from other forms of financing. "In CMBS, no loan is the same and no one has come up with a programmatic solution yet," said Cohen.

"The biggest leverage that a borrower has is the fact that the underlying collateral is worth less," said Chopp. "It's not that you're a fighter. You have a good lawyer. It's that the collateral is worthless because the lender then will potentially go to you and say, 'What are you giving me that's worth more than the collateral?"'

To solve the problem of distress, building that bridge between borrower and lender is the first step.

Giving back the keys is not that easy

With the current turbulence in the market, even some of the industry's most prestigious names are struggling to refinance formerly performing properties and weighing the option to hand back the keys to underwater office buildings to lenders.

"The biggest mistake that borrowers are having is to let the property go to special servicing and let them handle it," said Cohen. "Giving back the keys is not as easy as saying 'Here's the keys, I'm walking away!'" he added. There could be potential liability, including personal recourse and tax liability when it comes to loan foreclosures.

For special servicers, taking back the key may not be the best option either. In order to preserve the property and investment, if the loan could go back to performing through some kind of modification or extension, sometimes it can the best outcome for most of the parties involved.

What's coming?

"The market overall is healthy, occupancy is good and the rents have been reasonably strong and growing," said Reidy. From talking to several bankers, Reidy's team at Moody's found that a lot of them have been very proactive about addressing issues before they become obstacles.

"We had more than one bank say that they were already looking at loans that could potentially be issued out through the end of 2024 and contacting those borrowers today to say, 'What steps should we start working on to make sure that when we're over six months or a year from now, when your rate resets or when your loan comes due, to make sure that that we don't have issues and you don't become distressed,'" said Reidy.

In a sense, the broader economic circumstances intensified the stress level. "The banks haven't really changed their loan-to-value requirements or debt service coverage requirements," said Reidy. Due to the fact that interest rates are going up, borrowers have to have more money to service coverage. While banks haven't actively tightened their underwriting standards, the change in interest rates is tightening. It's more difficult today to qualify under those terms.

"With any distress situation, it's really a matter of looking at the different ways that you think you might be able to maximize the future value of the project," said Reidy.

Alternatives to Selling Distressed Properties

Selling distressed properties is one way to address financial difficulties associated with these assets, but it's not the only option. Depending on the specific situation and goals of the property owner or investor, there are several alternatives to consider:

Loan Modification	extending the loan term, reducing interest rates, or temporarily suspending payments
Refinancing	consider refinancing if equity remains and the owner's creditworthiness allows
Leasing or Renting	consider leasing or renting if the property is vacant or underutilized
Joint Ventures	partnering with an investor or developer who has the resources and expertise to address the property's issues
Debt Restructuring	negotiating with creditors or exploring debt consolidation options
Property Rehabilitation	investing in necessary renovations and improvements
Rent-to-Own Agreements	establishing a steady income stream and a path for tenants to eventually purchase the property
Loan Workouts	gradually repaying the arrears or negotiating a settlement
Government Assistance Programs	pursuing programs or grants available to help avoid selling
Real Estate Crowdfunding	inviting multiple investors to participate in the rehabilitation or acquisition of the asset