



Tim Foley for Barron's

Distressful Opportunities

By STEVE BERGSMAN

GELT FINANCIAL, A SMALL REAL-ESTATE LENDER based in Southampton, Pa., recently bought the \$190,000 mortgage on a five-unit Trenton, N.J., apartment building for \$175,000. The property had an estimated value of \$475,000, but the borrower was slow making payments and the lender decided it would prefer to sell the mortgage, rather than badger the owner, month after month.

The new note-holder offered the owner a deal: If he made regular payments for the 36 months and refinanced for 36 months, he would pay zero interest. What's the catch? Gelt already had locked in a profit by buying the \$190,000 note at about an 8% discount. And if the borrower, despite the easier terms, nonetheless defaulted, Gelt could take control of a property worth almost a half-million dollars.

Gelt is one of many firms that have found a lucrative niche in the property market, investing in distressed debt on commercial real estate -- office buildings, shopping centers, industrial structures and apartment buildings. It's an approach that has considerable advantages over direct purchases of equity interests in problem real estate. And Gelt has steadfastly stayed in this market even through the 1990s and after the turn of the millennium, when there were scant opportunities, thanks to low interest rates and rapid property appreciation.

Now, however, restless investment money is expecting a rise in troubled commercial mortgages. Years of easy loan underwriting, including high ratios of debt to equity, combined with higher interest rates suggest that a day of reckoning for marginal properties may be nearing.

For example, New York-based Hudson Realty, a real-estate "opportunity" investor -- one that seeks out troubled properties -- has put together three funds that include purchases of distressed debt. In the past two years, Hudson has bought \$120 million of troubled real-estate loans. The thinking, explains Spencer Garfield, a Hudson managing director, is that over the next few years loans will come due that were originated in 1996-1997, when Wall Street issuers of commercial mortgage-backed securities were particularly aggressive. "The market fundamentals are not so good now," says Garfield, "so some borrowers are going to have trouble getting out of these loans. We expect them to sell at a slight discount."

Palisades Financial, based in Englewood Cliffs, N.J., is launching a \$200 million fund that will include distressed real-estate debt. Says David McLain, Palisades' chief investment officer, "When you see lenders putting more than 90% loan-to-cost on projects, you

realize there is no downside protection. In the past, lenders built downside protection into funding, but that went out the window the last couple of years."

Hedge funds have entered the market with enthusiasm. One is GoldenTree Asset Management, which has formed a joint venture, called GoldenTree InSite Partners, with Tom Shapiro, a former managing director at Tishman Speyer Properties. InSite will look for total returns in the mid-20% range on its investments.

To be sure, opportunistic investors may be salivating too, soon. Right now, there is scant evidence of widespread weakening in income-producing real estate. According to the Federal Reserve, charge-off and delinquency rates on property loans hit all-time lows in 2005. Realpoint Research, an arm of GMAC, shows delinquent balances on commercial-mortgage-backed securities declining from January through September 2005, with an October uptick due mostly to Hurricane Katrina damage. Similarly, Fitch Ratings' CMBS delinquency index dropped to 1.19% in October, from 1.57% in January.

Patty Bach, Fitch's senior director in the firm's CMBS group, is near-term optimistic for commercial-mortgage-backed securities, but her company's 2006 Outlook expresses concern: "In existing floating-rate transactions, as interest rates rise, loans exercising extension options will be at greater risk, and borrowers will have more difficulty refinancing fully leveraged loans."

The Bottom Line:

Investing in distressed-property loans can offer more options for a generous payday than directly purchasing underperforming properties. But too much money could be chasing too few deals.

Apartment complexes may be especially vulnerable. Heading into the end of 2005, loans on multifamily dwellings accounted for 31.3% of Fitch's delinquency index, way ahead of the second-place office sector's 18.9%. Realpoint attributed 38.9% of October 2005 CMBS delinquencies to multifamily loans, more than double second-place office at 17.3%. The troubled condominium market could add to apartment-owners' troubles as speculators are forced to put condos on the market as rentals, giving multifamily projects unwelcome competition.

INVESTORS LIKE DISTRESSED REAL-ESTATE DEBT because it is a way to gain control of properties at a discount. And debt offers more flexibility than direct purchases of properties.

"When you buy distressed real estate, you have one exit: Fix it up and sell at a profit," says Hudson's Garfield. "When you buy distressed debt, you have more options: Make a new loan to the borrower and allow him or her to perpetuate the existing business plan; go through the foreclosure process to get control of the property; or allow the borrower to make a discounted payoff." Traditional lenders like banks are particularly loath to pursue the last option because of the precedent it tends to set.

One of Palisades Financial's early distressed-debt deals were two loans it bought from a Japanese lender that had spent four years in court fighting with a defaulting borrower. As an entrepreneurial investor, says Palisades' David McLain, the firm was able to change tactics and "monetize the investments in nine months."

According to Scott Tross, a Newark-based partner with the New York law firm Herrick Feinstein and an expert on foreclosure law, the big money for distressed real estate debt is coming from hedge funds. "They are the largest buyers and have an insatiable appetite for the product," he observes. "Investors in hedge funds demand handsome returns and distressed debt is one vehicle that has the potential to deliver such returns."

That, in itself, could pose a problem for investors. Jack Miller, Gelt Financial's president and founder, frets that the field has become crowded: "Paper is much harder to come by and prices are expensive. There are more buyers, and now hedge funds have gotten into it."

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