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More Distressed Debt Coming to Market

For buyers of distressed whole loans, more opportunities—perhaps a lot more opportunities—are on the way. With the economy improving, many sellers are looking to offer all kinds of distressed

loans.

BY KINGSLEY GREENLAND Financial institutions and other lenders are likely to sell everything from underperforming commercial real estate to consumer and small business loans in the second half of 2010.

More product is coming to market for several key reasons. First, equilibrium is returning to bid-ask spreads. In the depths of the recession, many transactions never occurred because buyers and sellers often found themselves too far apart on price. A support level for prices is emerging as the underlying collateral is stabilizing. Second, with the economy picking up, sellers are aggressively disposing of troubled loans. Many are racing to get healthy first and take advantage of the strategic options available to companies with strong balance sheets.

Third, buyers have pent-up demand for distressed debt, particularly commercial property loans. A significant amount of capital has been raised over the past 18 months, but it has remained on the sidelines because there haven't been enough opportunities to deploy capital.

An April sale conducted for the US Department of Housing and Urban Development illustrates the strong demand for distressed commercial loans. A \$306-million portfolio of mostly

nonperforming multifamily loans sold for 48% of the unpaid principal balance, with an average of eight bids per asset.

In looking at the inventory about to come to market, commercial debt is likely to be among the most plentiful in both the short and intermediate term. For the remainder of 2010, loans secured by retail and multifamily properties are likely to be in the greatest supply, followed by debt secured by office and industrial properties. This will represent a significant shift from the primary product for sale over the past two years, namely acquisition, development and construction loans.

The commercial property loans to be sold in the second half of 2010 won't be nearly as discounted as the acquisition, construction and development loans, which often sold for pennies on the dollar. Many of the commercial loans coming to market are generating at least some income and carry higher values as a result.

Over the next four years, \$1.4 trillion worth of CMBS will mature. As much as half of those loans are under water and will present distressed debt investors with a wide range of opportunities. Investors should expect more competition for distressed loans because significant capital has been raised and is ready to enter the marketplace.

Along with the capital raised for opportunistic investment, newly freed up funds from loan resolutions will increase demand for loans. Lenders are resolving troubled loans at a faster pace than they were over the past few years. In some parts of country, borrowers who previously had

no refinancing options are now able to obtain financing to facilitate discounted payoffs. As investors pare down their portfolios, they are redeploying this capital and turning to the secondary loan market to help rebuild their portfolios.

Investors can also expect tighter spreads. In April, the credit curve shifted downward and flattened modestly, with spreads on lower credit quality paper falling more so than higher quality paper. The five-year, triple-A spread tightened by 17 basis points to 2.4% during the month. April was the eighth consecutive month that the triple-A spread has narrowed; spreads are at a level not seen since just before the collapse of Lehman Brothers. The 10-year double-A and A spreads dropped significantly more, with the double-A spread tightening by 592 basis points and the A spread tightening by 692 basis points. April was the third month in a row these two spreads tightened.

With the availability of better-priced product and a growing amount of capital pursuing it, buyers of distressed loans should expect a robust wave of market activity. ■

The views expressed here are those of the author and not necessarily DAI.



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