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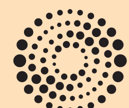

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Loan Purchases: Lenders and Investors Weathering the COVID-19 Economic Downturn to Find the Other Side of the Rainbow

*Michael J. McCarthy, Peter David Ballance, and Albert M. Singer**

With the pandemic lingering on and the economy continuing to struggle, it is certain that the rate of commercial real estate loan defaults will continue to rise. The authors of this article discuss the perils and opportunities in the COVID-19 real estate market.

As the COVID-19 pandemic continues to take its toll on the country and on economic markets, commercial real estate is feeling a significant impact. A growing number of tenants of all types are failing to pay rent, property owners are watching cash flows and asset values decline, property valuations are becoming difficult to determine, and lenders and servicers are seeing a growing number of borrowers that are unable to satisfy the financial obligations under their loan documents.

Some of these borrowers may be unable to refinance loans that are approaching maturity or approaching the end of agreed upon forbearance periods. Lenders and servicers may not be willing to extend forbearance periods or meaningful workouts may not be viable given property cash flows or valuations.

For many of us in the commercial real estate industry, this is reminiscent of the Great Recession. However, one key difference is that even the most thoughtfully-underwritten real estate loans secured by desirable properties are vulnerable this time, and the rate of loan defaults is increasing.

Background

The CARES Act provided limited payment forbearances to certain multifamily borrowers of federally-backed mortgage loans. Banks, life insurance companies, real estate investment trusts ("REITs"), and other commercial

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real estate lenders and servicers have prophylactically offered short-term forbearance options to borrowers who are unable to meet their financial obligations.

For many borrowers and lenders, however, these initial forbearance periods have, or will soon, expire. With continued uncertainty about tenant occupancies in multiple classes of properties, low or non-existent demands at hospitality properties, severely impacted cash flow, capital calls on debt funds and lending REITS, and COVID-related disruptions in the commercial mortgage-backed securities market, many lenders and servicers will be unwilling (or unable) to extend these forbearances or to make any meaningful modifications to the loan documents.

The road to recovery may be many months and in some sectors, such as hospitality, years long. The long recovery time may be a factor some lenders rely upon to sell their debt instruments. Lenders may be eager to quickly sell loans secured by properties with longer recovery periods, but they may be willing to wait for incremental improvements in the economy to sell loans secured by more stable property classes at higher prices.

With the results of the recent election and the roll-out of COVID vaccines, lenders may not have to wait as long as they originally thought for a recovery (except, perhaps in the hospitality or retail spaces). As such, lenders may decide to restructure existing debt, or if they are willing to sell, may not do so with a large discount.

Opportunities

Even in this uncertain market, opportunity exists. Lenders have the opportunity to clear their books of non-performing loans, generate liquidity and avoid the hassle and expense of loan workouts, receiverships, foreclosures and potential litigation. Real estate debt funds that are facing redemption calls may be forced to sell their non-performing debt in order to quickly raise capital to satisfy such redemption calls.

There is also opportunity for cash-flush real estate investors that have been waiting for a dip in the market to occur. With funds in hand, many investors are eager to purchase distressed and defaulted loans at a bargain price, often with the ultimate goal of gaining control of the underlying borrower or property through foreclosure or deed in lieu of foreclosure. For such an investor, it can be a win-win proposition.

If the real estate and the loan recover, the investor will benefit from debt service payments on a loan amount that is greater than the investor's investment, and it will earn a potentially significant premium when the loan is paid off.

If the loan continues in default, the investor will be able to exercise its rights and remedies under the loan documents and ultimately become the owner of the property.

Business and Legal Issues

In both bull and bear markets, there are a number of complex business issues, legal documentation decisions, and due diligence matters that buyers and sellers should consider before closing on the purchase and sale of a real estate secured loan, mezzanine loan or loan participation interest.

Sellers should always conduct due diligence

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on potential buyers to make sure they have the wherewithal to close and they should hire competent legal counsel to protect them from unwanted post-closing liability.

Buyers should undertake a complete due diligence review of the underlying loan documents and loan file and review all aspects of the real estate itself; particularly in light of the fact that many loan sales are "as is, where is." In doing so, buyers should consider the typical items, including financial statements, leasing reports, title documents and policies, surveys, estoppel certificates, environmental reports and property condition reports.

Buyers should also undergo a thorough analysis of the bankruptcy and other litigation risk associated with the borrower, any loan guarantors and the property.

Valuation Issues

During the Great Recession and in prior downturn markets, determining the value of underlying real estate assets could be accomplished with relative ease based on data from prior recessions, assumptions regarding continuing tenancies and the availability (or lack) of equity in the market.

However, one significant difference between the debt sales that closed during the Great Recession versus the current market will be the difficulty in determining the value of the underlying real estate assets. The pandemic and the resulting stay-at-home orders have detrimentally affected tenants across the full spectrum of businesses in a way that has not occurred in prior downturns. As a result, sophisticated loan buyers and sellers must undertake a thorough analysis of the current tenancies at a property, including rental payments and delinquencies, rent forbearances or modifications, tenant credit worthiness, and tenant bankruptcy risks.

Buyers should also be on the lookout for litigation commenced by borrowers to evict tenants or pursue lease guaranties. This is especially important for buyers who ultimately want to own the real estate and will therefore inherit those lawsuits and their inherent risks and costs. All of these tenant-related risks can drive down the market value of the real estate and the loan, and the difficulty for the parties is in their determination of how much.

One result of the difficulty in determining property values, will be a corresponding difficulty in placing a price tag on the sale of the debt. Sellers and buyers may be at odds when it comes to the purchase price of real estate loans and the price may also be driven by the number of potential buyers in the market.

Many new opportunity funds have formed since the Great Recession and they have liquidity to deploy, which may result in a bidding war for many of the same debt sales.

Timing Matters

In addition to the typical due diligence considerations, sellers and buyers should examine how the timing of exercising remedies can affect the marketability and desirability of a particular loan.

For example, a buyer looking to own the underlying property may be particularly attracted to a loan where the seller has virtually completed a foreclosure because the buyer can close on the purchase of the loan, then immediately complete the foreclosure and step into ownership of the property. In so doing, the

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buyer can sidestep certain bankruptcy risks and hopefully avoid any need to deal with the original borrower.

Alternatively, if a seller has not yet taken any action on a defaulted loan, the buyer will need to formulate a plan for what to do after acquiring the debt. Things that should be considered are whether a receiver is necessary, the timing and cost for completion of a foreclosure, and whether there are any borrower bankruptcy risks or other litigation risks.

In addition, if the capital stack includes mezzanine or subordinate debt, a potential buyer may want to strategically acquire the defaulted mezzanine loan as the foreclosure process under the UCC can potentially be completed in a much shorter time frame than a mortgage foreclosure under state law. In such an instance, the buyer will need to carefully analyze any intercreditor arrangements between the lenders to fully understand and appreciate the rights of each lender.

Conclusion

With the pandemic lingering on and the economy continuing to struggle, it is certain that the rate of commercial real estate loan defaults will continue to rise. Lenders are weighing the need to sell off bad loans and investors are assessing their willingness to take on the risk inherent in a loan purchase, and at what purchase price.

What is certain is that the purchase and sale of distressed debt will become a thriving industry, as it was in the Great Recession.

Opportunities abound for lenders to reset and for smart investors to acquire highly desirable properties for pennies on the dollar, but any successful transaction will require business savvy and legal acumen.

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