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Distressed? Don't Overlook Due Diligence

By Carrie Rossenfeld
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Attendees gathered at the ACRE of Southern California luncheon to gain insight on distressed real estate.

ORANGE COUNTY, CA—Investing in and acquiring distressed commercial real estate assets via note sales is not to be done blindly or without understanding the risks involved. So said speakers at a recent Association of Corporate Real Estate Executives of Southern California luncheon in Long Beach, CA, who pointed out both the opportunities and pitfalls within this subcategory.

The panel, moderated by Carson Faris of Western Bay Group, emphasized that investors who purchase bank notes who should be knowledgeable in many facets of real estate. To mitigate risk, investors should understand applicable state and federal real estate laws, loan documents, borrower and tenant risk; environmental conditions; and entitlement rights. Faris said that the most important thing for any investor to understand when purchasing a note is that he is purchasing a lender's position, not real property.

Meanwhile, panelists—which included state court receiver and principal at Coreland Cos. Pat Galentine; Bob Roades of Union Bank's special assets division; Adam Weissburg of Cox Castle Nicholson LLP; and Matt Beck of Beck & Co.—warned that buyers interested in pursuing bank-note purchases should not overlook a borrower's rights or real estate fundamentals.

"When considering a purchase, the very first step I take is to look for the local experts," said Beck, who specializes in the purchasing of notes and environmentally distressed assets. "I gather as much information as I can from local brokers or management teams that can give me information I might not receive from the bank. Before I make an offer, I perform extensive due diligence on the property, the loan documents and the relationship between the lender and borrower."

Galentine, who specializes in rents and profits receiverships of distressed commercial real estate properties throughout California, added that he's seen buyers get caught up in the value of the note without ever taking a close look at the state of the asset. "If there is a receiver in place, buyers need to take a very hard look as to why that is. There could be environmental or structural issues, or you might not have the access you need to the property or tenants because of the dispute."

Roades commented that banks don't automatically pursue a note sale to resolve a nonperforming loan. "Banks have options. They could elect to accept a discounted payoff in connection with their borrower's short sale or refinance of the property; they could elect to restructure the loan to enhance the likelihood of the borrower being able to repay the loan; or they could choose to foreclose and sell the property themselves."

Roades added that small banks, which may not be well staffed to manage and sell foreclosed commercial real estate, and banks of any size that may be under pressure from regulators or stockholders to reduce nonperforming assets quickly are more likely to conduct note sales.

Weissburg said a lender looking at real estate will do a cost-benefit analysis and decide if it is worth the time and brain damage to hang onto the loan and foreclose on the property. "They will then turn to their relationships with people who are selling; then, they must be equipped to understand quickly what they are getting into as closings typically happen within 10-15 days."

Luncheon attendees questioned how to best compete for notes of distressed assets, and panelists emphasized the importance of relationships. They pointed out that relationships start with a phone call to a lender and, if nurtured correctly, can lead to a long synergistic relationship. All participants agreed that building the right team is the key to purchasing a note successfully and achieving positive results.

On the residential side of distressed, GlobeSt.com reported earlier this week that US bank-owned properties sold during the first quarter of the year had been bank-owned for an average of 226 days when they sold, a 34% increase from the average of 168 days in the first quarter of 2013, according to Irvine-based RealtyTrac. States with above-average time to sell REOs included Texas, Michigan, Minnesota, Colorado and Georgia, the firm reports.