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INSIDERS OUTLOOK

Distressed assets and the mysterious V(alue)

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In any distressed asset — or any asset at all — lenders and borrowers alike use the term "loan to value", or "LTV."

The "V" holds the real mystery here.

The mysterious "V" — the true value — is like truth itself. Everyone has his or her own opinion of the truth, just as everyone has his or her own idea of an asset's value.

Lenders can end up with a truly distressed asset by calculating an incorrect true value in their LTV ratio. Entities lending on an asset with too high a loan-to-value ratio, will soon be out of the money. If a lender loans at an LTV of 80 percent, and the true value of the asset is incorrect, that lender could soon be under water.

Entities that have lent funds on an asset heading into default must first truly understand the asset's value. But they must distinguish between "as is" value versus *potential* value.

Banks largely focus on "as is" value. If the value is there, the bank will eventually get its money back. If the value is incorrect, the bank takes a loss and hopes to offset it through gains from other transactions.

There's another way. Banks can think like developers when they examine an asset to calculate its true value.

Who's going to buy this property next? Why are they interested? What needs to be done to the property? What will the buyer do with it? Are there risks? What will the buyer make on the purchase?

Buyers of "distressed" assets think like developers, viewing such transactions as money-making opportunities. By leveraging their skills, capital and creativity, they intend to turn a profit.

However, lenders usually aren't involved in developing or repositioning real estate. They lack the time and personnel to implement transactions like developers do.

But banks can avoid losses on a bad loan by joining forces with entities that do think like developers, and who can collect defaulted debt and deal with sometimes unscrupulous borrowers.

Many deals went sour in the early 1990's, so some banks adopted this approach by establishing entire units focused on revitalizing distressed assets.

Today, defaults are less prevalent. Banks may dispose of only one or two assets per year, which doesn't warrant creation of a dedicated workout team.

Lately, creative bridge equity investors — like Palisades Financial – have adopted a new "value-added" model allowing lenders to share in the upside.

Under this approach, workout firms purchase the "distressed" debt from a lender at a discount of 10-20 percent below the asset's market value (there's that "V" again!). The workout firm then puts up additional capital, applies appropriate management expertise, and maximizes the return on that asset.

Once the workout manager receives a return on its capital, it shares the ex-

cess proceeds with the original lender. Lenders thus recover more of their "distressed" loan than if they had simply sold the debt "as is."

Calculating the mysterious "V" becomes more complex when the asset is partially built.

In these cases, the lender must consider not only construction costs required to complete the project, but also whether the job can be completed with the same development and construction team. Under these conditions, loan documents must affirm that all construction contracts and subcontracts can be assigned to the lender at the lender's option.

If the existing contractor is capable and can provide a fixed price to complete the project, it becomes easier to quantify completion costs.

The situation gets more difficult when the borrower is also the builder. Now, no third party can be relied upon to complete construction.

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In these cases, prime subcontractors become extremely important. For instance, a building's with half-completed plumbing must use the existing plumber, because a new subcontractor won't certify prior work. This is also true for electrical, mechanical, structural, or virtually every other significant trade. It's not impossible to substitute a major prime subcontractor, but it always adds risk to the equation.

Lenders dealing with partially built projects must also note all existing pre-sales or pre-leasing, collateral damage, existing lawsuits, liens and other special situations.

When determining the mysterious "V," lenders shouldn't mistake a "distressed" loan for a permanently "distressed" asset.

Somebody will make money. Virtually every asset eventually falls into the hands of a capable developer who can make it perform to its potential. Lenders must decide whether to take a loss now, or take a chance at making full recovery...and then some.