Commercial Vegas Falling? Real Estate Investor Opportunities?

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Market & Economic Conditions

Commercial defaults are on the rise. Hotels have been the hardest hit. Falling consumer spending, and rising consumer debt loads evidenced by the national trend of 1.4 million bankruptcies expected in 2009 (ABI), threaten the stabilization of commercial properties.

Nevada/Vegas: With saturated inventory, room prices falling, visitors in decline, and additional inventory still coming online (5900 rooms (CityCenter / Aria Resort & Casino opening Dec. 16, 2009 (Huffingtonpost.com 11/30/09)), top line revenue, bottom line profits and other key financial indicators of commercial properties must be monitored. As more commercial delinquencies come online, with less supply of affordable (refi or replacement) debt, along with soft valuations and higher loan-to-value ratios, greater the opportunity may present itself for investors. With fewer consumers spending, operating incomes generally deteriorate resulting in lower NOI, which negatively impacts the Debt-Coverage-Ratio.

"The distribution of negative equity is heavily skewed to a small number of states as three states account for roughly half of all mortgage borrowers in a negative equity position. Nevada (66 percent) had the highest percentage with nearly two-thirds of mortgage borrowers in a negative equity position." (August 13, 2009 Summary of Second Quarter 2009 Negative Equity Data from First American CoreLogic). According to Table 1 of that report entitled Negative Equity by State, Nevada's "Loan-to-Value Ratio" is "115%", "Negative Equity Share" is "65.6%" and "Near Negative Equity Share" is "68.9%."

A National Situation: Almost half of U.S. homeowners with a mortgage owe more then their properties are worth. [Deutsche Bank AG, Aug. 5 (Bloomberg)]. The percentage of "underwater" loans may rise to **48 percent**, or **25 million homes**, as prices drop through the first quarter of 2011. The percentage of underwater loans may rise to **90%** in the fastest appreciation states like California, Florida and Nevada. [Karen Weaver, Ying Shen, analysts in New York at Deutsche Bank; Jody Sheen, Bloomberg]. According to the WSJ (Aug. 5, 2009), "Nearly 10% of owner-occupied homes now have mortgage debt with loan-to-value ratios of at least 125%, and roughly half of those homes have mortgage debt with loan-to-value ratios of 150% or more. The rising share of homeowners without equity and the foreclosure crisis continues to be the biggest storm cloud facing any possible economic recovery, says Mark Zandi, chief economist at Moody's Economy.com. "That such a high proportion of homeowners are underwater is testimony to the severity of the foreclosure crisis and the risk that it still poses to the broader economy," he said. To date, most foreclosure-rescue efforts have focused on lowering monthly payments by reducing interest rates, in part because the housing crisis began with mortgages that were resetting to higher payments. But the looming negative-equity problem could put more pressure on policymakers to come up with a modification plan that includes reducing loan balances, and not just lowering interest rates. "The modification plans that they have in place … will become increasingly ineffective as more homeowners fall deeply underwater," says Mr. Zandi. Unsurprisingly, the negative equity issue remains most severe in the sand states. Some 40% of owner-occupied homes in Nevada are underwater, followed by Arizona (37%), California (33%), and Colorado (31%)."

According to the "Summary of Second Quarter 2009 Negative Equity Data from First American CoreLogic, August 13, 2009, nearly one-third of all mortgages are underwater or more than $3 Trillion of property is at risk of default. The report also indicated that "More than 15.2 million U.S. mortgages, or 32.2 percent of all mortgaged properties, were in negative equity position as of June 30, 2009." By state, the report revealed that California has 2,937,160 in Negative Equity Mortgages (42.0%), and 3,197,670 in Near Negative Equity Mortgages (45.7%). The report summary also stated that:

> The aggregate property value for loans in a negative equity position was $3.4 trillion, which represents the total property value at risk of default. In California, the aggregate value of homes that are in negative equity was $969 billion, followed by Florida ($432 billion), New Jersey ($146 billion), Illinois ($146 billion) and Arizona ($140 billion). Los Angeles had over $310 billion in aggregate property value in a negative equity position, followed by New York ($183 billion), Miami ($152 billion), Washington, DC ($149 billion) and Chicago ($134 billion). (emphasis added)
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> The top five states' negative equity share was 47 percent, compared to 25 percent for the remaining states. In numerical terms**,** California (2.9 million) and Florida (2.3 million) had the largest number of negative equity mortgages, accounting for 5.2 million or 35 percent of all negative equity loans. Ohio (862,000), Texas (777,000) and Arizona (706,000) were also ranked among the top five states with the highest number of negative equity loans. "Negative equity continues to be the dominant driver of the mortgage market because it leads to foreclosures in the event a borrower experiences some kind of economic shock such as a job loss, illness or other adverse situation. Given that negative equity did not increase this quarter and home prices declines are moderating or flattening, we may be at the peak of the negative equity cycle. However, until negative equity recedes and unemployment declines, mortgage risk will continue to be very elevated," said Mark Fleming, chief economist for First American CoreLogic.

Debt-Coverage-Ratio (DCR) –

> DCR is expressed as Debt Coverage Ratio = Net Operating Income (NOI) Divided by Annual Debt Service (ADS)

A DCR closer to 1.0 reveals less income before debt service and trouble brewing. A property with a DCR below 1.0 does not have sufficient income to pay the mortgage; a DCR above 1.0 has excess income to service its debt, to that extent. A DCR ratio of 1.25% has income before debt service that is 1.25 times greater then the debt service. That property would produce 25% more net income then required to service its mortgage debt.

Workout Trends

Recent reports (11/09) show liquidation was the most prevalent resolution device used. However, recent new tax regulations have opened the way for early default resolution discussions for loans not in default but in risk of imminent default. However retesting of collateral values after modification or lien release have become the issues in determining whether the loan will continue to be 80% "principally secured" by an interest in real property. If valuations keep falling, liquidation will remain the solution of choice, however, loan assumptions, modifications, changes of nonrecourse to recourse modification / assumptions and forbearance agreements (for several months) pending take-out financing package approvals should also see more play.

New Tax Regulations Allow Early Default Negotiations

With billions if not trillions at stake, commercial mortgage resets have arrived. Only recently on 9/16/09 did commercial owners get the green light for early resolution workouts; when still current. On September 16, 2009, TD 9463 (26 CFR Parts 1 and 602) took effect and TD 9463 expands the list of permitted exceptions under Section 1.860G-2(b)(3) to include

> (1) changes in collateral (i.e.: nonrecourse to recourse), guarantees, and credit enhancement and
> (2) clarifies when a release of a lien on real property securing a qualified mortgage does not disqualify the mortgage.

Negative Tax Consequences

Generally, when a lien is released or a mortgage is modified in whole or part, a 100% tax may be assessed for violation of the REMIC requirements, or on the gain realized from the disposition of the prior obligation, or on the income from the prohibited transaction (from the modified obligation).

Although these final regulations (TD 9463) resolve and clarify many issues for Modifications of commercial mortgages held by Real Estate Mortgage Investment

Conduits (REMICs), the IRS and Treasury will review the comments received as of November 14, 2009 and issue final regulations based upon that review or determine whether additional guidance may be appropriate on Modifications of Commercial Mortgage Loans Held by an Investment Trust (Notice 2009-79). At the Fitch MBS Conference in NYC (9/15/09), it was reported that, special servicers are seeing select short extensions or discounted payoffs. Short extensions were defined as 1 year or less, only to allow time for the borrower to seek foreseeable financing. The servicers are considering whether the impairment is temporary or permanent. If it is financially impracticable, it is likely to go to liquidation. Borrowers who can pay but are not willing, are more likely sent to liquidation. Borrowers who are in trouble and able to cure the temporary impairment are likely to obtain some limited extension to obtain financing or face liquidation. However, Borrowers should have a realistic plan in place with steps underway. Borrowers should contact the lender/servicer before default or before reasonably foreseeable default to afford the servicer more chances of fashioning a workout plan without invoking unnecessary costs, fees, or regulations. One tool used to advance this business judgment is found in the final regulations (TD 9463). The regulations conclude its position to the following key issues in part as follows:

1. The Lien Release Rule - The final regulations clarify that a release of a lien on real property that does not result in a significant modification under §1.1001-3 (***for example, a release or substitution of collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan***) is not a release that disqualifies a mortgage loan, so long as the mortgage continues to be principally secured by real property after giving effect to any releases, substitutions, additions, or other alterations to the collateral. Similarly, the final regulations clarify that a lien release occasioned by a default or a reasonably foreseeable default is not a release that disqualifies the mortgage, so long as the principally-secured test continues to be satisfied.

To satisfy a lender (in a modification), the borrower may have to enhance the value and quality of the security for the loan (collateral) by adding, replacing or pledging other assets as collateral. Examples may include substitute collateral that consists of other real property, or Government Securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a–1)); Stripped bonds and coupons. The term "qualified mortgage" includes stripped bonds (1286(e)(1) and stripped coupons (1286(e) (2) and (3)) if the bonds would have been qualified mortgages.

2. The Requirement to Retest the Collateral Value - Generally, regulations require that an 80-percent test of the fair market value of the property be satisfied at origination, contribution but not after the start-up. Section 1.860G-2(a)(1) of the regulations provides that an obligation is principally secured by an interest in real property if the fair market value of the real property that secures the obligation equals at least 80 percent of the adjusted issue price of the obligation. TD 9463 states in part:

To ensure that a modified mortgage loan continues to be principally secured by an interest in real property, the IRS and the Treasury Department continue to believe that it is appropriate to retest at the time of the modification. Accordingly, the final regulations retain the retesting requirement, but amend the proposed standards for satisfying the principally secured test as described in section 3 in this preamble. In addition, to provide a more flexible standard for changes that do not decrease the value of real property securing the mortgage loan, the final regulations provide an alternative method for satisfying the principally secured test. For these types of changes (***for example, a change from recourse to nonrecourse, or vice versa***), the final regulations provide that a modified mortgage loan continues to be principally secured by real property if the fair market value of the interest in real property that secures the loan immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the loan immediately before the modification. This alternative test is consistent with the general rule that a decline in the value of collateral does not cause a mortgage loan to cease to be principally secured by real property. The final regulations provide an example to illustrate the application of this alternative method for satisfying the principally secured test. The final regulations also require retesting with respect to a lien release that is not a significant modification for purposes of §1.1001-3 (for example, a ***release of real property collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan***). Here as well, the principally secured test is satisfied if either the 80–percent test is satisfied based on the current value of the real property securing the mortgage or the value of the real property collateral after the modification is no less than the value of the real property collateral immediately before.

If the loan docs allowed the release of certain property securing the loan, such as a ground lease, pad, or parking lot, when the borrower reached certain predefined lease-up goals, or valuations, as long as the fair market value continued to meet the 80% "principally secured" test immediately after the release, the loan would continue to be a qualified mortgage. In cases where the valuations were lower, and the post-release valuation was below the 80% "principally secured" test, it would not be permitted under the regulations.

3. The Appraisal Requirement - TD 9463 in pertinent part states: In response to these comments and to make the retesting requirement more consistent with the current rules for satisfying the 80-percent test at the startup day, the final regulations provide that the principally-secured test will be satisfied if the servicer reasonably believes that the modified mortgage loan satisfies the 80-percent test at the time of the modification. The final regulations provide that a servicer must base *a reasonable belief upon a commercially reasonable valuation method*. The final regulations set forth a nonexclusive list of commercially reasonable valuation methods that can be used by servicers for retesting purposes. These same commercially reasonable methods can be used under the alternative test to establish that the value of the real property collateral immediately after the modification is no less than the value of the real property collateral immediately before it.

4. Changes in the Nature of an Obligation from Nonrecourse to Recourse - TD 9463 states: The final regulations clarify that changes in the nature of an obligation from *nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse)*

are permitted so long as the obligation continues to be principally secured by an interest in real property.

In the event the borrower elects a pre-defined assumption right (contained in the loan documents),but the lender is not comfortable with the credit, it may require a recourse guaranty. This change from nonrecourse to recourse is permitted so long as the obligation continues to be principally secured by an interest in real property.

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