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Opportunities Open Up for Investors Looking for CRE Distress

There will be 3,600 distressed deals during the next two years from which to choose.

By Joseph J. Ori | July 20, 2023 at 08:48 AM

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Investing in distressed CRE assets in 2023 and 2024 will be the key to earning high returns on capital in the real estate industry. What is different about this distressed cycle is that most of the lenders are not foreclosing and taking title to the CRE assets, managing, and leasing them for a few months and then selling the properties. They are more likely to sell the note/mortgage rather than foreclose on the property. Like a lot of industries including hotel management, technology manufacturing, food delivery and ride-sharing, lenders prefer to be "asset-light" concerning large and complex CRE assets. This presents a unique and interesting opportunity for astute distressed investors, who are experienced in acquiring mortgage notes secured by commercial property and in the arduous foreclosure and bankruptcy process, which may follow, to obtain a clean title to the property. Distressed investors should be raising capital right now to take advantage of the upcoming plethora of defaulted CRE loans.

CRE distress and defaults in this cycle will be caused by the following issues:

1. Higher interest rates and the inability of the borrower to refinance at these higher rates
2. A reduction in occupancy, revenue and NOI and inability for the borrower to cover the current debt service on the property
3. Mortgage loan and covenant breaches

4. Inability to make required payments and escrows under the note and mortgage
5. Higher and in some cases prohibitive costs to eliminate interest rate risk from floating rate loans with an interest rate swap or collar
6. A significant decline in the value of the property
7. A reduction in the occupancy of the property and loss or bankruptcy of major tenants

With all the above issues currently affecting about 2.0% or $90 billion of the total CRE loans outstanding of $4.5 trillion, there is a great opportunity for distressed investors to contact the various CRE lenders and seek to acquire the note and mortgage on the property at a significant discount. If the average defaulted loan is $25 million, there will be 3,600 distressed deals during the next two years from which to choose. Since today's distressed investors are accepting higher risk by buying the note/mortgage and then going through the foreclosure process, which would normally be done by the original lender, the discount on the loan paper has to be an additional 10%-15% than if the property was sold by the lender as a foreclosed asset.

For example, an office building that was valued at $100 million, with $70 million in debt at 5.0% interest only and 95% leased in 2019, is now 70% leased and worth $70 million. The NOI at purchase was at a 4.5% cap rate or $4.5 million but is now down to $3.2 million and less than the annual debt service of $3.5 million. The borrower has defaulted on the loan by missing the last three months of payments and in discussions with the lender has been unable to restructure the loan with a lower interest rate, deferred payments, or a loan paydown. The lender does not want to foreclose on the property and hires a CRE brokerage firm to sell the note/mortgage. Since potential distressed investors have to go through the foreclosure and possible bankruptcy process which in some states could take years, they will need an additional discount on the note of at least 10%-15% or a price of $59.5 million to $63 million for the $70 million loan. This represents a 37% to 59.5% and 85% to 90% discount on the original property value and loan amount, respectively. If the borrower does not tie up the distressed investor in bankruptcy, then the investor will foreclose or get a deed in lieu of foreclosure. The investor now owns the office building at the above deeply discounted price and will reap any occupancy and higher rent benefits as the local office market recovers and valuation increases as interest rates are lowered.

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