

## DISTRESSED DEBT MARKET TAKING SHAPE...

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Goldman Sachs polls its investors regarding a proposed shift in focus for its \$15B fund, moving from private equity to distressed debt buys. Goldman Sachs wants to allocate \$4.5B of the remaining \$9B in the fund for distressed properties as well as make more debt and equity purchases that will total about 10% to 25% of the total fund. It might be more than a coincidence that Goldman, despite wanting to exit the TARP program ASAP, made the distressed debt announcement to its investors two weeks before Treasury Secretary **Timothy Geithner** announced P-PIP. The two parties have been cozy with Goldman being one of the firms hired to manage parts of TARP. Goldman will use \$1.5B of the fund to buy out the debt for firms Goldman owns. No word on when or what it will buy, although don't expect the entire \$4.5B on real estate, as there is plenty of corporate debt the investor may pick up.

King Penguin gets into the game with the hiring of two employees specifically for its distressed asset and debt fund. The focus of the fund will be to buy in the five boroughs of New York City, but it may expand outside The Big Apple if a deal makes the cut. For King Penguin the debt buy is a means to an end. The company would rather own properties than hold loans and looks at properties in the \$1M to \$5M deal range. A distressed debt buy for King Penguin would go like this: buy the debt off the bank for 30 cents to 60 cents on the dollar, acquire the asset for less than replacement cost, add value, hold for six to eight years, then sell, expecting a 20% IRR; wash, rinse, repeat. King is confident the property values and distress opportunities will present themselves in the next year. Look for the company to pick up properties in the four food groups as well as residential and self storage.

Office investor and manager Parmenter Realty jumps into the distressed debt foray with a \$500M fund of its own. While the fund focuses on the asset side, don't be surprised if, like King Penguin, some debt is bought up as an avenue to acquiring properties. Parmenter likes to invest about \$10M to \$30M on properties valued from \$15M to \$70M, so expect it to attack similar sized properties in primary and secondary markets.

## RETAIL EQUITY TURNS SELECTIVE

Equity players head back to the store and pick up retail properties where recapitalization and joint venture opportunities present themselves. Equity providers have remained fairly quiet on the retail front, as confidence in the sector has been reduced to grocery-anchored centers. Still, those with capital find themselves in position to take advantage of borrowers falling just short of cash when doing their own refinancing and acquisition. Investors and equity firms **Phillips Edison**, **Rockwood Capital** and **NDC Capital Partners** spy a chance to infuse capital and form joint ventures with those needing liquidity in their retail projects.

Many equity players look at each retail niche much like a consumer views them in terms of necessity. Grocery-anchored properties have the best chance of being picked up by equity players, because they hold the essentials of families. Plus, during times of recession, the tendencies of the average consumers are to cook more home meals, thus boosting grocery revenues. After that, power centers, especially those with discount retailers like Big Lots, Costco or Walmart, will garner the most interest.

At the bottom of the pile are regional malls and upscale lifestyle centers where the focus is on non-necessity buys. These properties are going to need to be in more affluent areas or already well-capitalized if an equity player is going to come in and drop cash. If the regional mall is in a secondary or tertiary market, equity investors will be more selective, making a move only if the borrower already has a lender lined up. Of course, if there is a distressed asset on a primary market, equity players and JV opportunists may see a deal too good to pass up.

All involved will keep an eye on increases in vacancy rates and any decline of rents throughout the country. Vacancies have steadily increased to 7% nationwide, with markets like Arizona, Nevada and Michigan feeling the biggest pinch. Surprisingly, California markets hold steady but the state is in need of capital, meaning some opportunities may present themselves out West. Of course, all parties will expect rents to start coming down, perhaps by as much as 5% nationwide, with regional malls feeling the biggest pain.

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**STRAIGHT FROM THE MARKET***(Deals done within the past 90 days.)*

Type of Loan	Location	Lender	Amount	Rate	Fee	Term	Amortization	Loan to Cost/Value
Apartment Acq.	New York	Bank	\$3.25M	5.5%	Par	5 yrs.	30 yrs.	54% LTV

Details: Apple Bank for Savings closed on two four-story walk-up apartment buildings with fully-leased ground-floor retail on the Upper West Side of Manhattan, N.Y. The 90%-leased B+ buildings, originally built in 1900, have been updated periodically over the years, and are not official historic structures. The conservative LTV and 1.72 DSC are in the range of normal for Apple, as they favor lower leverage debt for their portfolio. Even in Manhattan, one need look no further than some of the former trophy holdings of Harry Macklowe to know that no market is bullet-proof. The upside for borrowers is that the tight underwriting comes with an attractive rate. The five-year loan also comes with a five-year extension option.

**LIFE COMPANIES AND COMMUNITY BANKS SQUARING OFF?...***Continued from Previous Page*

John Hancock has never been aggressive when it comes to its lending practices, and in today's market it doesn't have to be: borrowers come to them. Since its platform starts at \$5M, most competition from banks comes when loans land in the \$10M to \$20M range. After that point, the LC takes charge. With expectations for VP **Jeff Packard** to do \$1B to \$2B this year, the smaller space doesn't bother the lender too much. It's expecting a good year, doing loans in the upper ranges, given they have the ability to get to \$150M, at which point they may syndicate with other LCs. LTV runs the gamut from 50% to 70% with rates ranging from 7% to 8.5%. If the property is retail, leverages sink lower to a 60% max. Terms run from seven to 10 years. John Hancock also looks to buy notes.

**DISTRESSED DEBT MARKET TAKING SHAPE**

The Fed's move into distressed asset and debt markets in March shadows moves by players big and small to focus on opportunity investments. And while companies like **Investcorp** and **Goldman Sachs** expect to make a killing in the sector, don't be surprised if other companies known for ownership like **King Penguin Properties** and **Parmenter Realty Partners** swoop into the distress debt buying game as a means to acquire properties.

One dollar amount you'll hear repeated ad nauseam in the coming months will be \$500M. Why \$500M? It's the minimum total that investors looking to manage funds in the Public-Private Investment Program (P-PIP) must raise. While the Troubled Asset Relief Program (TARP) was originally designed to take bum loans off bank books, that idea was scrapped shortly after all the big banks signed on the dotted line. So now P-PIP is the true toxic asset removal program. When the program was originally announced, two other factors were necessary to join the P-PIP party: \$10B in assets under management and a history of investing in legacy assets, the new handle for CMBS and other asset-backed securities and troubled loans. The plan had been conceived with an investor needing to meet all three in order to manage funds under the program. The cool reception the plan received however, as well as the fact that it left all but a few players out of the game, has the Fed revisiting the requirements.

Since \$10B is a number only national banks, larger life companies, investment banks and hedge funds can reach, and the experience requirement can be interpreted by the Fed any way they choose, the "easiest" route to P-PIP involvement is to build a \$500M war chest. On the other hand, to invest in the troubled assets, an investor must only demonstrate some acumen and bring some equity to the table.

But not everyone will participate in the government program. Businesses with interests in making money off the real estate, and not interest on the loan, will be looking at picking up distressed debt in order to grab the properties. Even if they can't eventually acquire the property, either through missed payments or making a bid, these guys will get paid and make a profit.

Falling in line, Investcorp announces its newest \$500M fund to pick up real estate-related debt in the U.S. Investcorp's Managing Director **Khalid al-Rumaihi** isn't looking for distressed paper that's completely fallen off the map, but a more reasonable 50 cents on the dollar. The asking price may put pressure on other investors looking to buy distressed assets as properties, since their asking price is closer to 30 cents on the dollar. Investcorp definitely fits the bill for two requirements: its \$500M fund and \$13B in assets, although the fund's serious entry into the distress game is recent. The hedge fund lost \$511M so far from the recession. But this new fund, coupled with its \$1B mezzanine fund, shows that the hedge fund is not going away anytime soon.

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