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Intel. Type	ABS
Countries	USA
Intel. Grade	Strong evidence
Intel. ID	1360425
Topics	CMBS Commercial Real Estate

12:55 **Lenders, investors seeking to leverage distressed note purchases**

Story

In the past year, in a sign that distressed commercial real estate financing is gaining momentum in this cycle, a handful of firms have created groups that lend to distressed CRE debt buyers.

In February, **Madison Realty Capital** was in the market to purchase a USD 5.7m mortgage on a 45,000 sq ft industrial property in Long Island City, but chose instead to finance the eventual note-purchase borrower with a USD 3.75m loan. It was the first time Madison financed a distressed debt purchase, said Josh Zegen, managing member and co-founder of the firm.

Lending to distressed note buyers sometimes offers better risk-adjusted returns than directly acquiring defaulted loans, Zegen said. “Sometimes there are too many people chasing certain debt purchase deals,” he said. “If we can’t hit the returns that we would like in terms of pricing on the direct buying of non-performing debt the alternative is for us is to finance note buyers, so we’ve been active on both sides.”

More than USD 1.7trn of commercial real estate debt is scheduled to mature in the next five years, and there’s not enough capital to refinance the loans – many of which were made during the boom years of real estate finance, said Jay Rollins, founder of **JCR Capital**.

Institutions are now exiting their positions on these loans and recouping what they can, pumping the market full of distressed debt, and investors are attempting to ratchet up their returns by adding debt to what have mainly been all-cash purchases. However for a while there was a dearth of leverage available.

Filling a gap

That’s the void **Doral Bank** aimed to fill when it created its note financing group less than a year ago, said Doral’s chief investment officer Tim Zietara.

“There is this consistent flow of assets that are being generated from the banks and other institutions and people are only able to buy them all equity,” he said. “Returns tend to be decreasing as competitors bid for these pools, therefore getting leverage in any way is very helpful in getting investors’ targeted returns. There is a big demand for this kind of financing.”

Distressed note financing often resembles bridge financing in structure with terms under three years and a rate in the high single-digits if the borrower brings about 50% cash to the table, Zietara said.

Financing distressed notes is attractive to shops such as Madison not just because of the yield grab, but because if the borrower stops paying it initiates a process by which Madison can eventually take over not just the note it financed, but the collateral backing that note, according to Zegen.

"So if you think about it I passed on the deal at USD 5.3m dollars, but if I financed the note at 3.75% and the borrower, the note buyer, stopped paying me, I'd be able to get to that same mortgage that I passed on for USD 5.3m at a USD 3.75m purchase price," Zegen said.

Madison will often lend up to 80% of the cost with a rate between 9% and 12% plus a 2bps origination fee, he said.

Of course, the lending pool for distressed notes has remained shallow with good reason. Financing distressed notes adds a second level of risk since there are two sets of collateral, and therefore the due diligence required can pose a hefty opportunity cost.

Due diligence also takes time, and that can be an issue for potential borrowers who want to close a deal quickly and need certainty that the leverage will be there when they make the note purchase.

From the lender's perspective, distressed financing is an asset management intensive business, Zietara said, and the back office infrastructure to do this type of financing is a big commitment.

Rollins said his firm, which has been financing note purchases since 2010, is most active in the USD 5m to USD 25m space because there's increasing competition for larger loans.

John Garth, managing director at **Pembrook Capital Management**, said doing deals less than USD 5m isn't really a good use of his time.

Pembrook provides financing for note purchases in the USD 5m to USD 20m range. The firm financed its first note purchaser about a year ago, and has closed two more deals within the past couple of months, Garth said. All three deals were USD 12m to USD 15m loans, with between 65% and 80% LTCs and rates between 10% and 14%, he said.

"There's a fair amount of work that goes into financing a note purchase," he said. "The folks that are going to be the most inclined to do it are going to be groups like ours that have a certain amount of capital that needs a certain type of return."

by Joe Ragazzo

Source Debtwire