THE DISPOSITION MARKET FOR LARGE PORTFOLIOS

by Brian Furlong

Since 1991 a market in portfolio dispositions has been established. To understand the current market for disposing of large portfolios and to anticipate future changes, it is important to understand how and why today's market evolved. This article discusses the development of the current marketplace, and when and when not to use various disposition strategies.

Today's market developed from the boom market of the 1980s, which gave way to the bust of the late 1980s and early 1990s. During the worst period of the national real estate market bust (around 1991), investment capital fled the market en masse. This created a demand vacuum which, in turn, created great investment opportunity. Many of today's most prominent methods to dispose of large portfolios (bulk sales, securitization, auction sales) developed to induce new forms of capital for investment in a real estate market with more sellers than buyers.

The Boom Period

At the beginning of the 1990s, many major financial institutions in the United States found themselves holding an excessive number of commercial real estate mortgages and equities. These assets were dropping in value, yet their demand was so thin, it was all but impossible to sell them.

Most of these assets were acquired during the heady 1980s. That decade began with sky-high interest rates and a shortage of real estate in most markets. By 1982, interest rates began a long pronounced decline, and a major development boom was on from coast-to-coast. By mid-decade property values had appreciated greatly mostly because of the drop in interest rates along with a flood of investment capital, both debt and equity, which entered the markets to pursue the high returns previously experienced.

By mid-decade, new development was outpacing the capacity of the growing economy to fill the space, and vacancy rates in many markets reached post-war highs. However, so many capital sources were plying the real estate markets in search of opportunities to place debt and equity that property values continued to rise even in the face of too much vacant space. Investment demand had become uncoupled from the underlying property market conditions. Lenders from coast-to-coast scrambled to meet high origination targets by lending on projects which they hoped would outperform the dismal general market conditions.

***Brian Furlong** is a senior vice president of Landauer Associates in New York. Landauer is a full service real estate consulting firm which advises and assists clients in disposing of and acquiring commercial real estate and mortgage assets, individually and in portfolios.*

In most markets (and even longer in California), the late 1980s found construction lenders continuing to originate loans in large volume. Outstanding construction loan balances continued to swell for a few years after originations began to decline, since construction lenders had made multi-year funding commitments to cover both hard and soft construction costs inclusive of interest during the construction period. Because the construction lenders had made these multi-year commitments extending into the early 1990s, they could not scale back their construction loan receivables for some time even after they realized that many of their projects were not feasible.

Many of the banks had been relationship lenders. These relationships turned out to be for naught when times got bad, since the loans were non-recourse. Many borrowers decided they did not want to support construction loan relationships which would not be needed until new financing was feasible.

The Bust

During 1989 and 1990, the extent to which real estate was oversupplied began to be understood by most domestic lending institutions. The Resolution Trust Corporation (RTC) had been formed, and congressional estimates of the cost to bail out the thrift industry were reaching hundreds of billions of dollars. The Bank of New England had to be bailed out by taxpayers, and this triggered an audit by the Office of the Controller of the Currency (OCC) and others of real estate loans from other major regional and money center banks. As a result of the OCC audits, the new lending window slammed shut in early 1989 at all major New England banks. The audits resulted in stiff penalties in the form of high reserve requirements tied to bank construction loan holdings. When the OCC expanded its audits to banks in the Mid-Atlantic region and elsewhere, new lending also ceased abruptly in these locations.

The chill was on. In conformance with the new regulatory pressure, banks which previously had extended loans for underleased properties without a permanent loan takeout, began to declare the loans under default because it was clear that the market would not support the debt service requirements. Insurance companies noted the deteriorating market conditions and the new conservatism at banks, and they too drastically reduced their allocations for commercial real estate lending. Credit corporations, which made participating or second-lien loans, were near the first lines of loss when debt service coverage and values eroded. They, too, stopped lending. Foreign banks, which stepped up their lending at the peak of the market in the late 1980s, realized their big mistake and closed up shop. All major sources of funds stopped lending in rapid succession, and a liquidity vacuum resulted.

The loss of liquidity in the debt markets was matched by a loss from real estate equity sources. Those who had relied on leverage to support their acquisitions were out of the game due to the lack of available loans. Unleveraged investors had no clear motive for investing, since assets were clearly declining in value and most tax benefits to losses had been eliminated in late 1986. Pension funds tried to reverse their previous trend of increasing investments in real estate, but this proved impossible since the fund managers could not find a market for their properties at the par carrying value of the funds.

Many owners tried unsuccessfully to market their properties in the early 1990s. The drop in achievable market value, below carrying value, often was seen as too great. Many owners who had explored the markets decided they would prefer waiting out the real estate bust rather than sell. But some owners had to sell, including the RTC which had committed to Congress and the public it would maintain a certain pace of asset dispositions. The RTC started out by selling individual mortgages and real estate equity assets. However, they could not achieve the desired pace of dispositions using individual sales. The people who previously had bought individual S&L-quality investment properties often were severely weakened by their prior real estate investments. They could not raise the equity or debt monies necessary to buy RTC properties. Furthermore, the price the RTC could legally accept for individual assets was tied to appraised value, and these often were too high for a sale. Appraisers were overestimating the values, because they relied on property sales from prior times. They had not fully adjusted their values to reflect the decline in investor liquidity.

Creating Demand In A Time Of General Illiquidity

With virtually all the traditional providers of real estate capital on the sidelines, the RTC had to try new methods to dispose of their assets. They started to get rid of their assets in bulk, offering them in blocks large enough to entice major opportunistic investors with ready access to funds from sources other than traditional real estate capital providers. The money to be invested would be raised by consortiums of wealthy individuals, the capital base of major investment banks and capital market sources such as the commercial paper sales of the General Electric Credit Corporation. Many of the people who would invest in the RTC pools of real estate and mortgage assets did not have extensive experience in commercial real estate from prior investments. However, they were experienced opportunistic investors who knew that the best time to buy was when most investors had fled a market. Excess returns were available to those who bought low when existing owners were desperate to sell.

At the start of the 1990s, the RTC sold assets in bulk by selling entire thrift institutions. Their assets were mostly real estate and mortgages, so the buyers of these thrifts were able to make an opportunistic asset play while also gaining control of a financial institution which might someday have a going-concern value. These thrift institutions were sold with RTC supports against the downside risk to the investors, yet the investors could achieve huge gains if the thrift's real estate and mortgage holdings went up in value. Major financial players, such as William Simon, the Bass Brothers and Lew Ranieri, knew a good deal when they saw one, and they reaped hefty profits from their early, privately negotiated purchases of RTC-controlled thrifts.

The Rise Of The Commercial Mortgage-Backed Securities Market

Prior to 1991, most commercial mortgage-backed securities (CMBS) were backed by single assets or small pools of assets. Credit ratings for pooled transactions often were dependent on the use of credit support from highly credit-worthy third parties, such as AAA-rated monoline insurers. Those who provided the outside credit support, including first loss letter of credit, performed their own analysis on the likely incidence of loan default and the severity of related losses. The risk of loss for those who bought rated debt was greatly diminished by the fact that the providers of the credit support had pledged they would absorb much of the expected loss on the underlying mortgage loans, even in scenarios where the underlying loans performed quite poorly. As a result of the risk mitigation from credit support, CMBS offered for sale received strong investment grade ratings, such as single-A or better. Bond buyers did not have an appetite at this time for much default risk, so bonds rated below single-A generally were not offered.

During 1991, the RTC decided it would tap the CMBS market to sell large blocks of mortgage assets. However, as of early 1991 the CMBS market, backed by large pools of mortgages, was immature and thinly traded. The RTC had a huge inventory of assets for disposal without a ready market. The RTC had to create a market.

When the first RTC CMBS issues were sold, buyers insisted on much higher spreads for CMBS bonds with a given credit rating relative to more established types of securities with the same rating (such as a corporate or a government bond). The high spreads were necessary to sell the bonds because:

- Bond buyers were uncertain of the accuracy of the rating opinion for CMBS, since the agencies had little experience with large commercial pools.
- The real estate markets seemed to be in a downward spiral of uncertain duration created by very weak property market fundamentals and a dearth of investor demand and funds available by lenders.
- So much money previously had been lost in commercial real estate, even by market experts such as the Reichmanns of Olympia & York, there was a general aversion to any investment backed by real estate.
- Many of the potential bond buyers knew little about real estate and had little experience in buying CMBS. They were largely dependent on the underwriting and structuring expertise of the investment bank structuring the CMBS deals, the rating agencies and other intermediaries and service providers in the securitization process. The bond buyers had to be brought up the learning curve on the process of underwriting and structuring CMBS transactions if they were to increase the effective level of demand for the CMBS assets and reduce the spreads demanded for uncertainty.

The RTC jumped-started the CMBS market by:

- Selling cheap where they sold CMBS tranches at high spreads relative to their ratings, while at the same time providing large cash reserves and other credit support mechanisms. This allowed the rating agencies to establish suitably conservative ratings for the various tranches of the CMBS issues.
- Rating agencies, due diligence contractors, investment bankers, loan serving firms and others were able to go to school on the first RTC pooled deals. They refined their underwriting methods with these deals and, in turn, started to educate bond buyers on the asset class and how it is underwritten and structured. The RTC provided a steady stream of large-pool CMBS transactions, which allowed the key firms in the CMBS field to staff up with good people. New companies were attracted into the field.
- The RTC started with the simplest property type to underwrite, multi-family, the property type with which many bond buyers were most comfortable. The RTC started with performing loans rather than non-performing loans, again because the performing loans are easier to underwrite and are an easier sell to bond buyers who were cautiously entering the market.

Market Demand Expands
Based on the first performing multi-family CMBS transactions, the market began to gain some depth of demand, and the rating agencies, investment bankers and others involved with formulating the transactions gained valuable experience which could be used to expand the market. Transactions, including loans on property types other than multi-family, began to appear. Rating criteria were developed for non-performing loans, and the first non-performing pools of loans were rated and sold. Gradually, but steadily, spreads tightened between CMBS bonds and corporate bonds with the same rating. Market acceptance of CMBS was increasing, and buyers were beginning to emerge who would purchase CMBS tranches with higher ratings of risk in pursuit of higher returns. Bonds with a BBB rating began to be issued routinely and sometimes the tranching occurred even down to the BB and B level. The development of a market for higher risk bonds meant that the amount of equity, cash reserve or other credit support in a transaction could be greatly reduced and that the issuer of a CMBS did not need to retain as much risk as before. As the market developed for non-investment grade bonds, CMBS could be used to finance a higher loan-to-value.[1]

The CMBS market has become an increasingly efficient, less costly source of financing as the impediments fell away. Rating agencies have become more adept at rating risk, and investment grade bond buyers have become more comfortable with rating agency opinions. Bond buyers for all grades of real estate securities have grown in number, and competition has driven down spreads.

During 1991 and 1992, the RTC accounted for the great majority of the CMBS issues and most of the innovation in developing this product type. During 1992, the private sector institutions began slowly increasing their volume of activity in this market. By 1993, the RTC was scaling down its pace of new issuance, since most of its inventory had been worked through. Private institutions, including solvent banks and insurance companies, and entities which had purchased assets in bulk, picked up the slack left by the receding RTC. Pricing in the CMBS market had become attractive to the private sector issuers, because of the reduced spreads needed to sell CMBS and a large decline in the general level of long-term interest rates in the bond markets. The CMBS market had a record year for origination volume in 1993, and a strong pace of issuance has continued into 1994.

Securitization works best for assets which have a strong current cash flow. Generally, rating agencies look for a diversified asset pool with diversification by property type, location, management and other factors which affect mortgage performance. When securitizing a pool of assets, it is generally best not to have more than 10% of the pool comprised of one asset. Multi-family, industrial and retail properties tend to be treated best in a securitization, while office and hotel properties are, on average, underwritten more harshly. For some properties, a rating agency gives less credit for a possible upswing in cyclical market conditions than would the buyer of the property. For example, buyers of Midtown New York office buildings recently have been placing high bids relative to current cash flow under the assumption that rents will spike in Manhattan during the next few years. Rating agencies would be disinclined to reflect a rent spike in their underwriting. Therefore, an owner of a New York office building looking to cash out of its investment is better advised to sell the property on a retail basis than include the asset in a pool destined to be securitized using a CMBS.

Rating agencies base their analysis primarily on the ability of the underlying properties to support debt service. They analyze cash flow, and they give little credit to any premium which may exist in the value of a property not directly connected to the property's capacity to generate cash flow. For example, a rating agency will not give credit to a premium in value due to the special appeal of a property to an owner/user. Nor will a value premium be recognized due to a buyer pricing the asset using a percentage of replacement cost or a floor value per square foot of the asset. Many major office buildings can be sold with the pricing based on some method other than discounted cash flow analysis, but the rating agency underwriting models will not recognize these premiums to value, because they do not help the property generate additional debt service coverage.

In sum, mortgage securitization has become a great way to raise low-cost debt on many asset types. However, it may be best to leave certain large properties and other properties with strong upside potential out of a debt securitization if the maximum available cash is sought on the disposition. It is also necessary to have a large enough transaction so that front-end costs connected to the securitization do not represent too high a proportion of the funds raised by the bond sales. Typically, pooled-asset CMBS transactions tend to be $50 million or more.

Bulk Sales
The second vehicle used by the RTC to dispose of large pools of mortgages and owned real estate assets have been bulk sales. As with CMBS, bulk sales by the RTC became a major phenomenon in 1991. Again, the first product type to be disposed of was multi-family. The first RTC assets were sold

very cheaply in bulk for many of the same reasons the first pooled-asset CMBS transactions carried high returns to the investors. The real estate markets were in disarray in 1991, and there was so little capital in search of major real estate transactions, that the assets had to be sold cheap to induce demand.

The market for assets sold in bulk strengthened during the same time period as did the CMBS, in large part as a result of the CMBS tightening. As cheaper CMBS financing became available, for an ever-higher loan-to-value, bulk buyers raised their bids for the bulk assets.

Many of the early buyers of assets in bulk were able to realize large returns. These returns were received by various methods including financing out, sales of individual properties which had been bought cheaply in bulk, and through receipt of new capital into their investment ventures. When it became clear that large returns could be made in bulk acquisitions, the established buyers were flooded with new investment capital and many new entities entered the market in search of acquisitions. Sellers started to achieve much better prices on the assets they sold, because so much more money became available for acquisition and the underlying real estate property market conditions had reached bottom and were beginning to improve. As with the CMBS market, the RTC at first was the dominant seller. In 1993, the private sector overtook the RTC, and now most deals originate from banks, life insurance companies and thrift institutions.

Since many buyers will look to the securities markets to finance their acquisitions from a bulk sale, buyers may pay less for assets which do not fit well in a CMBS. Buyers of large pools of assets in bulk often do not have much time to spend underwriting each individual asset. With strict time constraints, there is a tendency to use global assumptions in the pricing analysis whenever possible. Unusual upside potential is often overlooked by buyers when their analyses is global. For example, a global assumption that rents will grow at a flat rate may be too conservative in some markets where a detailed analysis of local economic and rental market trends would indicate a rent spike is likely. The quick analysis forced on bulk buyers by limits of time and due diligence budget also may inhibit them from uncovering methods to work out troubled properties. Therefore, the best way to realize the full upside potential of particularly promising properties may be to sell the properties individually to buyers who will not treat the properties in a global fashion.

Auctions

Real estate auctions have been around for a long time. Historically, auctions have been used by sellers looking to sell quick, such as in tax or debt foreclosure sales or for particularly hard-to-sell properties. For example, auctions were used to sell vacant headquarters-type office buildings in remote locations and highly specialized vacant factories.

During the recent real estate downturn, auctions gained a new legitimacy as a quick way to sell commercial property.[2] Early on during the recent real estate bust, the RTC and many private lenders found it so hard to sell assets through traditional brokerage sources that they turned to auctions. The assets sold at auctions generally were troubled by the weak real estate markets, but in many cases they were otherwise good, functional and attractive. These sellers decided that, with a proper marketing program, it was possible to get the best prices for properties using an auction sale.

Various types of auctions are utilized, including the outcry auction, which is a live or telecast event similar in format to an art auction; the electronic auction where bidding takes place via a computer network or by telephone with the bidding process tracked on a computer network; and the sealed bid sale where bids must be mailed to a central point by a set day.

Bidding in any auction format takes place on a certain date, so the bidders know they have to mobilize their efforts to develop a bid that is ready by the specified day This is a good way to induce bids from people who might otherwise delay or procrastinate if the asset was being sold by a traditional negotiated sale process without a clearly understood and enforced termination date.

Where many assets are for sale, the preparation of the selling materials to buyers tend to be standardized in order to take advantage of economies of scale. All bidders for a given asset receive or are given access to a common set of due diligence files and selling materials. This makes it more practical to deal with many more potential bidders. It is in contrast to the sale of an asset through traditional brokerage channels where information often is developed and distributed to each bidder on an as needed, customized basis.

Typically auctions make heavy use of mass media to advertise the sale. This may include advertisements in local real estate publications and the Wall Street Journal, electronic notices about the sale over Telerate or other electronic medium, or other methods such as mass mailings. It is now common to group large numbers of properties for simultaneous sale in a single auction event where bids are placed individually on a property-by-property basis. These assets may include mortgages or real estate equities contributed by one seller or multiple sellers. In grouping many assets together, a critical mass is created which attracts attention to the sale.

Marketing resources also are pooled, so the sale event can be broadly advertised to the buying public.

Auctions have become an accepted, mainstream disposition method. It has become clear to many sellers that, when properly managed, an auction can maximize the competition among potential buyers for a property. More competition among bidders raises the transaction price. Auctions are a particularly good method for assets left out of a bulk disposition, because an individual sale will result in better pricing. This may include very large assets which because of their large size would cause the pool to have less than an acceptable level of diversification. Some office and hotel properties also do well in an auction sale versus a pool sale. This is particularly true if they have strong upside potential or if they would trade with a value higher than the results of a cash flow analysis. Assets with value related to their prestige, rather than their cash flow, also could receive a better price if sold by auction rather than in a pool disposition. Examples are prestigious resorts or golf courses.

Equity REITS

In contrast to the paralysis that hit the marketplace for commercial real estate sales during the recent real estate bust, an active and liquid market was retained for equity REITs. REIT prices declined as early as 1987, and they experienced a large aggregate decline by 1991. Because REIT values were marked down so far so early, they had great appreciation potential from the low base of values they had reached. Equity REIT buyers concluded that the decline in share prices which took place during 1987-1990 was sufficient to make REITs a good opportunistic investment choice with strong current returns. REIT prices boomed during 1991, 1992 and early 1993. Appreciation slowed by mid-1993, because current returns had declined substantially due to the run-up in price and because the market began to reach saturation due to a flood of new issues.

The boom had been fueled by investors attracted to current returns from the REITs which exceeded returns from alternative investments in a low and dropping interest rate environment, and by the rates of appreciation realized. Some institutional investors have been attracted to REITs as a securitized method of investing in assets backed by real estate which has more liquidity than most non-securitized channels for real estate investment. Equity REITs are one of the principal methods for partially disposing of an owner's investment in a large portfolio. Many owners have raised substantial sums of equity capital through a REIT origination and used some of this equity to retire debt carried at an interest rate which was above market.

Most entities which form REITs retain the management responsibility and often a sizable equity stake. Buyers will look carefully at the strength of the proposed management and the protections in place against management/shareholder conflicts of interest. Assets generally will be priced based on income in place, so the assets should have high current cash returns. The portfolio also should be large enough so fixed-cost origination fees are not prohibitive. Curently, most REIT originations are well above $50 million.

Conclusion

The real estate investment market bust of 1989 created a demand vacuum by 1991. Vacuums are unnatural, and they tend to be short-lived. In response to particularly enticing investment opportunities, buyers eventualiy came forth to fill the void. By the onset of 1994 many buyers were actively sourcing deals, both for pool and individual acquisitions. Pricing has tightened for dispositions using mortgage-backed bonds, bulk sales, auctions and REITs. Noting the renewed vigor in the investment markets and improvements in the supply/demand balance of the underlying rental markets, many traditional lenders once again are making loans. Increased liquidity across the board has resulted in higher prices irrespective of the selling technique, including individual negotiated property sales. If the economy continues to grow, we can look forward to good times in the real estate business for the next few years.

REFERENCES

1. When the market for CMBS was limited to bonds with a strong investment grade rating, loan-to-value ratios in a CMBS financing were lower than the loan-to-value rating achievable on loans from institutional lenders. The rating agencies estimate that a typical insurance company loan, newly originated, has a level of default risk roughly equivalent to the default risk on a BBB mortgage-backed bond. Once the CMBS market developed for bonds rated below BBB, CMBS became a financing option which allowed for higher loan-to-value ratios than has been the historic norm for insurance company loans.
2. Although auctions typically involve sales of individual properties, many individual assets or small pools of assets can be sold to separate buyers at one auction event taking place in one day. An auction event, therefore, can be seen as a portfolio disposition channel.