Feature

Getting Real Estate Workouts to Work

Written by:
Robert Steinberg
CRG Partners Group LLC; Fairfield, Iowa
rob.steinberg@crgpartners.com

Developers, builders and lenders are currently inundated with properties to sell from failed real estate developments. Frequently, these developments are in less-attractive second- and third-tier locations where values have fallen precipitously, foreclosures are rampant and growth is stymied. Recovery of losses in these circumstances is a daunting challenge; however, acceptable recoveries can be achieved. Getting real estate workouts to work requires effective strategic planning that is fact-based, tactical and avoids a number of pitfalls that are not intuitively obvious. This article first describes the optimal approach to developing a strategic plan in a real estate workout and then covers the four most frequently made mistakes in implementing such plans.

Devloping an Optimal Strategic Plan


Robert Steinberg

Setting a strategy for workouts of distressed real estate has become increasingly difficult due to the economic downturn, fluctuating and mostly declining real estate values, and lack of clarity about whether values have hit bottom. The following methodology has proven useful in developing the fact-based approach necessary to determine the optimal strategy.

Market Assessment

The first step in developing an optimal recovery plan is understanding the market and forecasting how it may change over the workout period. Data must be obtained on a national and regional basis and for specific counties and developments. Questions that must be addressed include:

- *Foreclosure impacts:* Expected volume of foreclosures over the period, likelihood of fire sales post-foreclosure, proportion over the period of lender—as compared to nonlender-mediated sales.
- *Timing impacts:* Expected sales velocity of properties, holding costs for properties and expected changes over time.
- *Government regulation:* Impacts of tax, environmental, mortgage and buyer-assistance policies and programs.
- *Pricing variables:* Expected value changes, value of existing construction vs. cost of new construction, value of as-is vs. as-completed prices, and wholesale compared to retail market prices.

About the Author

Robert Steinberg is a managing director at CRG Partners Group LLC in Fairfield, Iowa. He has served as a special advisor to the RTC and numerous national real estate associations, and has led complex real estate workouts.

Foreclosures and Lender-mediated Sales

Foreclosed property almost invariably sells for less than nonforeclosed property. The price reduction can stem from the negative taint of a foreclosure, lenders' willingness to sell at a lower price to get the properties off the books or high carrying and holding costs that force lenders to take the hit earlier rather than later. Lender fire sales depress property values across a surprisingly large area of adjacent structures or land. Appraisers are unable to treat even occasional the foreclosure sales as outliers because they cannot tell whether property values have bottomed out or how many foreclosure sales will occur in the near future. A forecast of future foreclosures and the likelihood of fire sales must be made and updated periodically, even though such forecasts are difficult and unreliable.

Sales Velocity and Holding Costs

Analysis of sales velocity is critical to a real estate workout plan for distressed properties. Pricing of real estate affects velocity, and management must evaluate the incremental benefit of higher prices when such prices will likely result in slower velocity and longer holding times. Holding costs include taxes, insurance, utilities, maintenance, administrative costs and money that could be obtained from cash now as opposed to later. These costs can be offset by renting the units, although rentals will increase administrative and maintenance costs. On the other hand, rentals may create cash flow, which is attractive to the investor buyer pool. To make a rational decision on pricing, market research must be conducted at minimum on:

- property tax rates in various locales, as well as how reductions can be achieved and at what cost;
- insurance rates and whether they can be reduced through agreement values, monthly resets and/or other mechanisms;
- expected maintenance costs based on neighborhood crime rates; and
- rental rates and costs associated with rentals such as property-management fees and administrative costs.

Government Policies and Programs

The initial market forecast must include an assessment of current and future government regulations and its impact on property values. With government revenue sources drying up as tax bases diminish, local governments may look to property taxes to increase revenue by refusing to reduce the assessed value of real estate or raising property taxes. In some cases, for example, property taxes have increased even when the true value of property has fallen by as much as 50 percent. Lenders have also discovered that government entities are increasingly seeking payments on letters of credit to fund property development and community improvement, even when the work secured by the letter of credit has been completed. The true cost of a real estate workout must be updated based on changing government regulation and policies.

Realizable revenue from a real estate workout must also be continually reviewed in light of any future government actions. Buyer-assistance programs, in which sellers are permitted to help borrowers with closing costs, or newly enacted tax credits should help prop up real estate values. These proposals must be carefully reviewed and tracked in order to have the best shot at accurately forecasting values.

Pricing

Pricing of properties is determined, at the outset, by comparables in an area. Many real estate brokers can perform simple broker price opinions to estimate property values. In addition, some companies can obtain in-house expertise to provide such analyses. Detailed formal appraisals, albeit expensive, can also be used to confirm pricing.

Yet, appraisals and assessments in today's market, regardless of whether they are formal or informal, are highly unreliable, and it must be recognized that comparables provide only the first step in a pricing assessment. As noted, factors such as velocity, holding costs and current and future government regulation must be considered when setting a price. In addition, it is critical to think about value sustainability; for example, a house may have a value of $200,000 now, but it will be unable to sustain that value because a lender will soon be fire-selling comparable units nearby, diminishing property values in the neighborhood.

Pricing takes on added complexity for partially-built structures and lots. A discount should ordinarily be made when forecasting sales of partially-built structures, either as-is or as-completed, given the execution risk factors, loss of warranty protection and devaluation that results when any product is unfinished. In the current market, lot prices—particularly those of a large number of vacant lots in larger subdivisions—are at highly depressed levels. These are ordinarily purchased by builders, but many builders lack the resources to buy, build or sell the properties.

Ownership and Feasibility Assessment

After conducting a review of market data, the next step in the analysis is to conduct a review of the legal issue of the ownership of particular properties and the business assessment of the feasibility of development and completion of the unfinished properties. Lenders are sometimes surprised to learn that they do not stand in a priority position on the property as contractors or other lenders have first-position rights, or the title otherwise contains defects that prevent or inhibit closing on the property. The earlier these ownership issues are discovered, the more likely an optimum recovery will occur.

Even if the ownership structure is as anticipated, there may be numerous impediments to developments. While in some cases prior management failed as a result of external market conditions, more often failure can be attributed to a lack of attention to details. Often, a real estate workout reveals that the anticipated development is a pipedream because of zoning, environmental or other constraints. Again, the earlier this information is unearthed, the better.

Alternatives Analysis

Based on the detailed market evaluation as well as ownership and feasibility assessment, a strategic alternatives analysis can be developed. An optimal approach is to develop a comprehensive financial model of various alternatives or scenarios, and then provide a qualitative risk assessment based on key assumptions that underlie each scenario. Key variables/assumptions that must be made on a per-unit basis over the period include:

- price of wholesale, bulk or one-off retail;
- net sales costs of real estate commission, unpaid property taxes, unpaid association fees, appliance concessions, etc.;
- ownership dates, if properties will be foreclosed;
- properties that will be subject to foreclosure and timing, as well as cost of same;
- sales dates, *i.e.,* velocity;
- securing dates;
- construction dates;
- holding time and costs;
- carrying costs; and
- administrative costs.

With assumptions clearly delineated, net proceeds can be projected for a quick sale, an as-is sale and an as-completed sale.

Quick-sale Alternative

The quick-sale alternative will ordinarily yield the least sales revenue and the lowest costs. In a quick sale, the owner assumes current market value for the sales prices, obtains a net sales cost based on a percentage and assumes minimal construction, holding and administrative costs. Typically, a large percentage of the portfolio is sold on a bulk basis to an investor rather than on a retail basis to homeowners or future occupants.

As-is Sale Alternative

Under the as-is sale alternative, the owner seeks to sell property primarily on a retail basis with minimal construction costs. When the owner has a significant holding of lots and partially-built structures, this alternative may be expanded to include construction costs; however, for modeling purposes, it is anticipated in this alternative that management will complete partially-built homes and build models on lots only after locating a buyer. Such workouts inherently take more time, but will almost invariably yield more revenue than the quick-sale alternative. Whether such a strategy yields more net proceeds will depend on costs and expenses attendant to a longer workout and the time value of money.

As-completed Sale Alternative

The as-completed alternative anticipates that the owner will make significant expenditures to complete properties prior to sale and build models to sell lots on a retail basis, generally without an identified buyer. This alternative requires the most expenditures and the longest period of recovery for construction dollars expended. In addition, because properties are sold entirely on a retail basis, the timeframe for completion of sales in this scenario is the longest and the administrative and holding costs are the highest. Whether completing all properties will actually yield the highest return will depend on the level of distress of the subdivision and property values within and near the subdivision. This approach typically yields the maximum revenue from units because they are being sold in optimal form and at the highest overall recovery level.

Best Practices for Implementation of the Strategic Plan

An optimal strategic plan will only yield optimal results if appropriate tactics are employed to implement it. There are four simple tactical rules that should ordinarily be followed to optimize value in real estate workouts.

Rule 1: Earn the Trust of Your Agent

The success of a real estate workout is frequently determined by the effectiveness of the real estate agents that have been retained. While work for real estate agents has declined, the fact that a real estate agent has won a new listing does not mean that they will be motivated to sell, particularly if they believe the owner has an unrealistic assessment of their property value, will be unable to make timely decisions or otherwise lack clarity on their workout strategy between sell and hold. The owner and workout lead must earn the trust of their agent and support their selling effort, if they expect the agent to be effective in selling the property.

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Rule 2: Pricing Is More Important than Appearance

Price and ease of buying are the drivers. Because of the amount of inventory on the market, pricing that is even slightly higher than the real market level can be costly. In certain depressed areas, correct pricing will yield multiple offers while pricing that is as little as 10 percent too high may yield no offers.

Real estate workouts require a sophisticated analysis of the numerous variables that will affect value and net proceeds to be realized.

Buyers' perceptions that they are getting a bargain price and that the sales process will not get hung up in a lender-approval process are the most critical variables in getting properties sold. Contrariwise, inexpensive cosmetic efforts, let alone construction activities, may not yield a return on investment because prices in some areas simply will not rise above certain levels. In fact, such improvements can be counterproductive because they may drive the price to a level (to recover the additional cost) where the potential buyer no longer perceives the price as a bargain. The owner's focus must be on pricing and closing the deal, rather than on cosmetics or construction.

Rule 3: Marketing Must Use Channels Available and Avoid a Perception of Distress

Distressed property is often marketed in a manner that undercuts its value. Distressed properties frequently look distressed in marketing materials because real estate agents may be assigned many distressed properties and fail to create effective video tours and photos. Even more astounding is the fact that without appropriate guidance, many real estate agents for foreclosed properties will note on the MLS, without further explanation, that the property is subject to lender approval (which other agents and buyers will interpret as a signal that getting approval for a sale may take months). In today's market, failing to properly market the property will certainly depress sales. In addition, owners and agents must agree on a detailed, Internet marketing plan and ensure implementation.

Rule 4: Systems of Accountability Are Critical

In real estate, employees and agents are generally unfamiliar with the systems of accountability used in other business ventures. For example, detailed sales pipelines are not ordinarily used in real estate sales, but they are an absolute necessity, particularly in more complex workouts. Resistance to this type of accountability can be expected. Accordingly, reporting requirements for real estate agents should be part of the listing agreement so that a sales pipeline can be updated weekly, and should highlight the amount of inventory, listed properties, verbal agreements, written offers, purchase agreements, properties in the closing process and properties that have been sold. Properties not yet saleable, either because there is no model from which to sell lots or partially-built structures, or a completed property is rented, should also be tracked. Projections of when such property is anticipated to become saleable should also be made, so that the salespeople have sufficient inventory to meet sales goals.

Conclusion

Real estate workouts require a sophisticated analysis of the numerous variables that will affect value and net proceeds to be realized. Unless the restructuring professional has conducted such analyses, confusing and ineffective strategies and models are likely. An effective workout of a large real estate portfolio requires a detailed market analysis, review of ownership/feasibility issues, analysis of net proceeds to be garnered from various alternatives and a quality evaluation of benefits/risks of these alternatives. It is critical to develop the fact base for a strategic plan from the outset of a workout and update it as circumstances evolve. In addition, with respect to tactics, it is imperative that the workout professional take into account the four key rules for real estate workouts discussed in this article. Adopting these approaches, particularly when numerous properties must be sold, is essential to optimizing recovery. ■