

Distressed Real Estate: Acquisition Fundamentals and Capital Sources

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STATE OF THE MARKET

- Overall economy is getting stronger, but CRE market is not
 - Defaults are skyrocketing
 - Huge expected spate of maturity defaults
- But, this CRE recession will likely be different:
 - More cooperative borrowers
 - CMBS lenders behave differently
 - Regulatory motivations are different
 - Borrowers may capitulate sooner as no easy solutions exist
- Why has the expected flood of distressed CRE transactions not occurred?

ALTERNATIVES METHODS OF BUYING DISTRESSED REAL ESTATE

- Short sale purchase from Owner
- Buy note and foreclose or acquire by deed in lieu of foreclosure
- Buy real property through receivership
- Buy real property at foreclosure sale
- Buy REO from foreclosing lender
- Public/private partnership alternatives

FORECLOSURES IN GEORGIA

- Non-judicial
- Roadmap
 - Confirm existence of default
 - Accelerate loan
 - Advertise foreclosure once per week for 4 weeks preceding first Tuesday in any month
 - Appoint receiver?
 - Public auction on courthouse steps
 - ▲ Lender can credit bid
 - ▲ Buyer must have cash at foreclosure sale
 - No redemption rights
 - Confirm sale to establish deficiency
- All subordinate matters, including leases without SNDAs, may be wiped out

ALTERNATIVE #1: SHORT SALE

- Sale by Borrower with Lender agreeing to discounted pay-off
- Lender may cut break to third party Purchaser, rather than Borrower
- Full ability to perform due diligence
- PSA with contingency related to Lender consent

ALTERNATIVE #2: BUY NOTE AND FORECLOSE

- Discount from FMV of real property to address Purchaser's costs and risk
- Due diligence issues depend on Borrower cooperation
- Limited Lender reps as to note
- Risks
 - Costs
 - Bankruptcy
 - Defenses by Borrower

ALTERNATIVE #3: BUY NOTE AND ACQUIRE BY DEED IN LIEU OF FORECLOSURE

- Voluntary conveyance by Borrower in exchange for covenant not to sue
- Subordinate matters are not extinguished
- Full due diligence

ALTERNATIVE #4: PURCHASE REAL PROPERTY AT FORECLOSURE SALE

- Third party Purchasers RARELY buy at foreclosure sales
 - Limited ability to perform due diligence
 - Cash at foreclosure sale
 - Financing difficulties
 - Difficulty in obtaining title insurance
 - Lender's advantage inherent in credit bid
- Agreement with Lender in advance?
- Can Lender finance the bid?

ALTERNATIVE #5: PURCHASE THROUGH RECEIVERSHIP

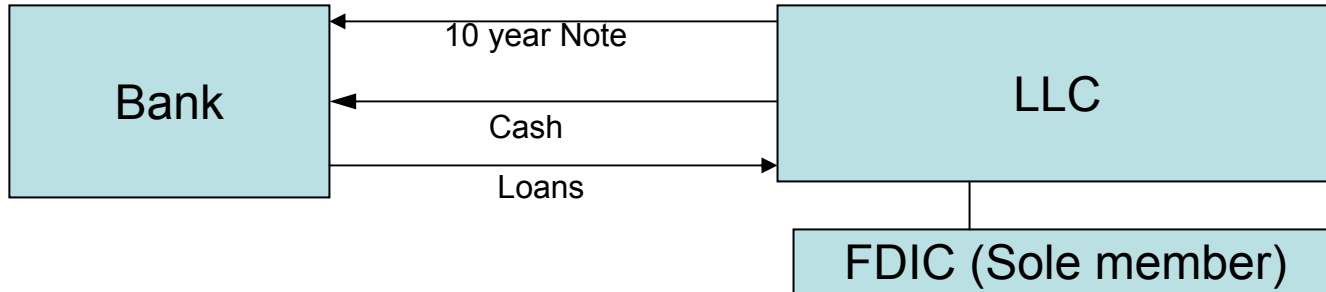
- Lender avoids becoming part of chain of title
- Lender control through receivership
- Requires cooperative Borrower as Borrower must sign deed
- Application to CMBS mortgage transactions

ALTERNATIVE #6: PURCHASE REO FROM LENDER

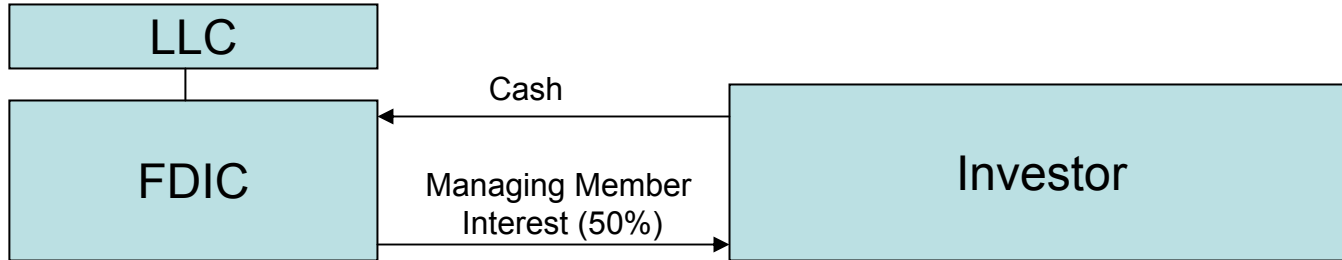
- AS-IS
- Full due diligence
- Equity kicker to avoid embarrassment
 - Hope Note-A/B Note
 - JV

PPIP: PUBLIC PRIVATE INVESTMENT PROGRAM

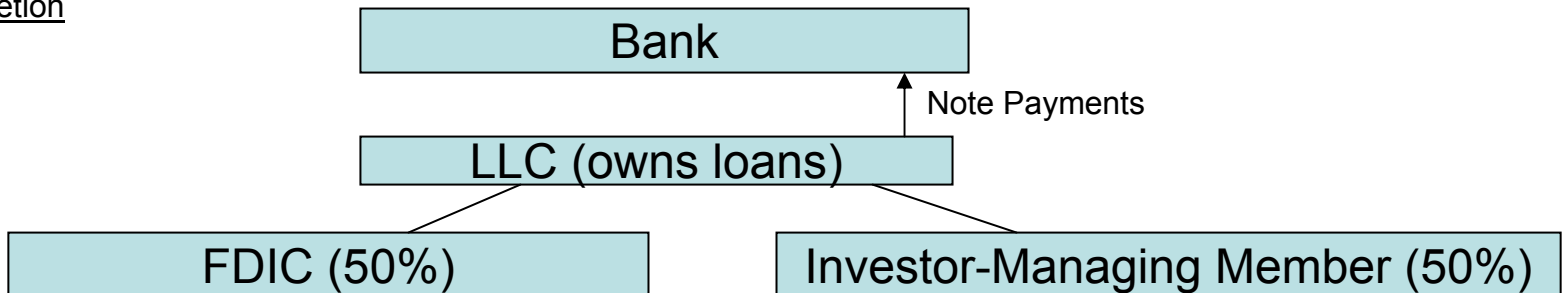
1. Step 1



2. Step 2



3. Completion



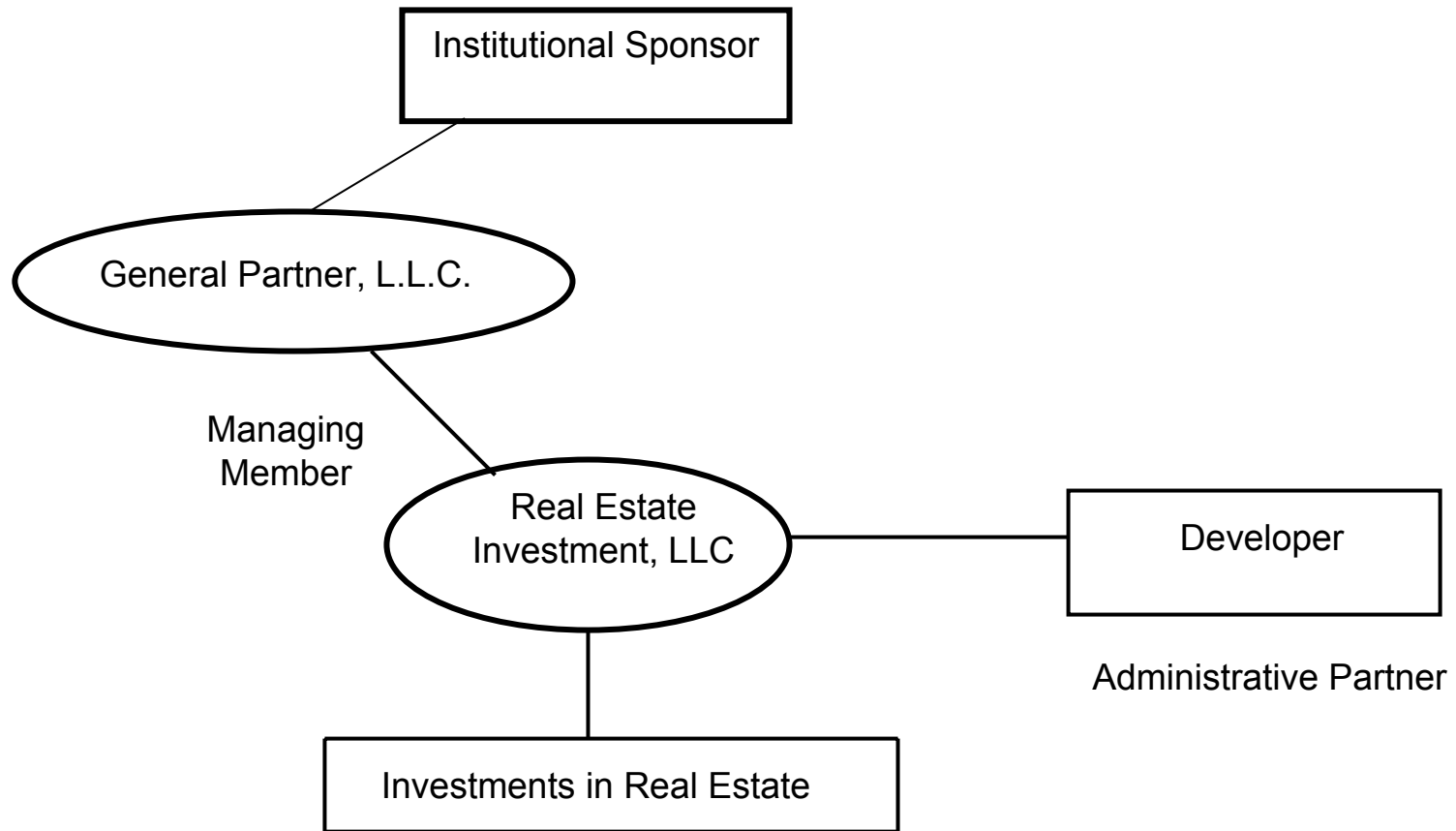
PPIP: PUBLIC PRIVATE INVESTMENT PROGRAM

- Transaction summary (FDIC-Investor partnership)
 - Bank sells loans to LLC and takes back 10 year note guaranteed by FDIC (leverage can range as high as 6:1)
 - FDIC sells managing member interest in LLC to investor after public bid
 - Managing Member is loan servicer and manager (50 bp fee)
 - Cash waterfall provides some current return to investor in addition to loan repayments (loan fully amortizes)
 - Limitation on bulk sales early in term without FDIC approval; otherwise Managing Member controls foreclosure/workout/sales decisions
 - Any required additional capital to be provided by investor member

SOURCES OF EQUITY FINANCING

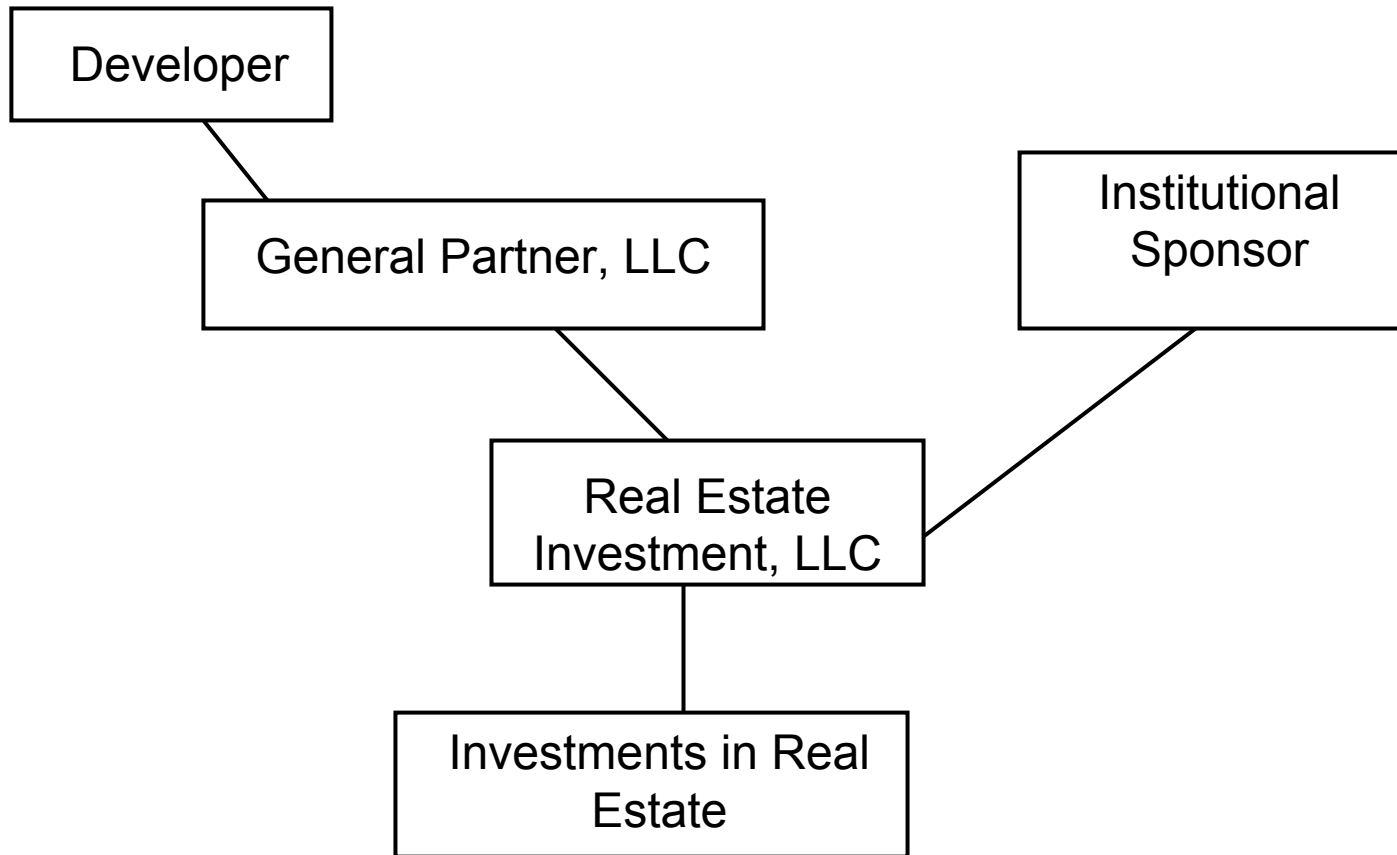
Background: Typical Private Equity Structures

A. Private Equity Investor as General Partner



Background: Typical Private Equity Structures

B. Developer as General Partner



Typical Terms of Private Equity Investment

- A. Discretion on Every Investment (not a discretionary fund)
- B. Exclusivity Provisions (and exceptions)
- C. Reimbursement of Expenses
- D. Carried Interest
- E. Management Fees

A. Discretion on Every Investment (not a discretionary fund)

- Stated Investment Criteria
 - Provide Private Equity Investor with deal list
 - Staged approval process:
 - Preliminary Package May Include:
 - description of property
 - outlining acquisition strategy
 - preliminary acquisition budget
 - preliminary operating plan
 - proposed permitting schedule
 - proposal economic projections
 - list of critical path items

A. Discretion on Every Investment (not a discretionary fund) (Cont'd)

- Final Approval Package May Include:
 - updates to preliminary package
 - environmental analysis
 - title analysis

B. Exclusivity Provisions (and exceptions)

- Anything Within Investment Criteria
- Prohibition on developer and its affiliates from owning or operating property that constitutes competing property (i.e. type geographic area)
- Exclusions:
 - Previously owned properties
 - Properties expressly rejected
 - Specific negotiated properties
 - Outside scope of competing business
 - Provision of brokerage executives unrelated to ownership and operation
 - 3 passes and exclusivity goes away

C. Reimbursement of Expenses

- Strict Limitations
 - Annual Operating Plan and Budget Approval Process
 - Expenditures Authorized in Accordance with the Approved Annual Operating Plan and Budget
 - Emergency Expenditure Exception

Approval required prior to reimbursement of expenses and costs incurred in connection with investigation or acquisition

Carried Interest

The Carried Interest is a share of fund net profits allocated to the Developer that is disproportionate to the Developer's capital commitment to the fund

Range of Carried Interest Rates

- Occasionally, the carried interest rate is contingent upon performance
 - Example: Carried interest rates is 20%, unless the IRR to Limited Partners exceeds 25%, in which case carried interest rate is 30%

E. Management Fees

- Calculated on:
 - Unreturned Capital Contributions
 - Assets under management
- Range: .5% to 1%

Private Equity Factors For Investment



Typical Fund Capitalization

Capital Committed by Investors:	90 - 95%
Capital Committed by Developer:	5 - 10%

BROKER'S PERSPECTIVE

- Fred Roddy of CBRE

LENDER'S PERSPECTIVE

- Guy Guthrie of United Community Bank

THANK YOU

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Sutherland Panel

What is the Size of the Problem?

- Outstanding real estate loans = \$3T
 - Banks: \$1,540B
 - CMBS: \$675B
 - Insurance companies: \$285B
 - Other: \$500B
- Maturities next 4 years
 - \$1.3T scheduled
 - Estimated \$500MM+ unscheduled

- CMBS in the past decade grew from \$14B in 1995 to \$230B in 2007
- CMBS facilitated the large majority of permanent fixed rate CRE loans
- Allows largest pool of capital in the world, the “risk-averse” capital, to access CRE

As of Q2 2009, bank exposure to “commercial real estate” loans consisted of

- \$534 billion of construction and land development loans
- \$1,055 billion of core commercial real estate loans
- \$220 billion of multifamily loans

68.4% of all Loans are Real Estate Loans

\$143 b in Net Real Estate Loans

1-4 Residential \$70 b

Commercial \$36 b

C&D Land \$32 b

Multi- Family \$2 b

Farm \$2 b

\$4.6 b in Loss Reserves

Scale of Assets vs. Percentage of CRE

Global Securitization Research

In exploring bank's exposure to commercial real estate, we use the following sized-based groups

Group	# of Institutions	Aggregate Assets		Construction Loans		Core CRE Loans		Multifamily Loans	
		Bal (\$ Bil)	% of Total	Bal (\$ Bil)	% of Total	Bal (\$ Bil)	% of Total	Bal (\$ Bil)	% of Total
1-4	4	7,415	42	91	17	179	17	61	28
5-19	15	4,849	28	69	13	155	15	26	12
20-50	30	1,837	10	83	16	150	14	39	18
51-97	48	706	4	56	10	93	9	19	9
> 98	7445	2,772	16	236	44	477	45	74	34
Total	7,542	17,579	100	534	100	1,054	100	219	100

Group	Total Assets (Range)	Bank Type
1-4	\$1.28 - \$2.25 trillion	Global Banks
5-19	\$130 - \$890 billion	Large regional banks
20-50	\$25 - \$130 billion	Medium-sized regional banks
51-97	\$10 - \$25 billion	Smaller regional and larger community banks
> 98	< \$10 billion	Community banks

Deutsche Bank 

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How Many Will Fail?

Global Securitization Research

Expected losses as a percentage of Tier 1 capital suggests CRE *alone* could trigger many bank failures

Expected CRE Losses As % Of Tier 1 Capital	# of Institutions	Total Assets (\$ Billions)
0-10	1,759	10,005
10-20	1,107	3,082
20-30	907	762
30-40	815	719
40-50	616	608
50-75	953	910
75-100	356	276
> 100	283	345
Total	6,796	16,706

Source: Deutsche Bank, Intex, SNL Financial

- CRE related loan losses could potentially be quite high for a large number of banks, particularly regional and community banks

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Turning Japanese?

- In the 1990s the Japanese government allowed assets to sit on banks' balance sheets
- Doesn't today's relaxation of mark-to-market rules by the U.S. government facilitate the same effect?
- Both sought to preserve specific companies instead of optimizing the outcome for the economy
- Japan's lost decade (or two) at least had low interest rates. With massive U.S. deficits we are unlikely to be so fortunate

The residential market began its slowdown in 2006. The national builders started selling their inventory in 2007. There was some speculative land purchases in early 2008 and that ended by summer of 2008. From summer 2008 to summer 2009, there were virtually no sales.

Residential and CRE Markets Cycles

Where were we in the cycle when the financial collapse occurred? In September 2008, residential land was nearing a time of recovery, it had been in a down cycle for over a year. Then the bottom fell out. The CRE markets in September 2008 were slowing but unemployment was at 5% and things were holding together with some submarket exceptions, condos and strip center retail.

The two cycles that had diverged in the early 2000's have now found themselves coinciding again. Both markets are employment dependent. Will housing recover substantially without employment? I don't think so. We are artificially stimulating the housing market with tax credits which props up the bottom but it does not create organic growth.

It is here and now. For developers there is nothing to build. For brokers, there is little to sell. For investors, there is difficulty in raising funds and no debt. How much more of a bottom can there be?

- For Developers
 - Asset “value add” services and acquisitions
- For Brokers
 - Figure it out yourself
- For Investors
 - You will have to make fewer bets and be more diligent. The early opportunities will require more of your cash. There is no more “perfect leverage” in this part of the cycle.

- 2010
 - Business numbers will be better than 2009. Watch the employment numbers.

- 2011
 - First year of recovery. Not v-shape, not U shaped but “hockey-sticked”.