

# A Message from the Chairman: Robert A. Knakal

(212) 696.2500 x7777 [rknakal@masseyknakal.com](mailto:rknakal@masseyknakal.com)



## If You Think the Distressed Asset Cycle is Over, Think Again!

Recently, I heard a panel of four sales brokers speaking about the sale of distressed assets and they were basically saying that as an investment strategy it was over. Clearly, appropriately leveraged assets are doing well, but over-leverage is still with us.

Private lenders, banks and special servicers have been aggressive sellers of distressed loans and REO properties that they had foreclosed on. In 2009, and more so in 2010, there were hundreds of these distressed assets sold. The activity began to slow in 2011 as banks had dealt with, what were, the majority of their problem loans. Servicers were focusing on workouts and, while they have asked for hundreds of broker opinion of values, "BOV", they were not selling as aggressively as the banks had.

However, the pace of distressed sales is picking up again and this should come as no surprise.

Let's face it; the economy is lumbering along at a very sluggish pace. With the amount of fiscal and monetary stimulus the government has pumped into the economy, GDP growth should be around 7 percent to 8 percent and it is moving at only about 2 percent. Job growth, on a national basis, is still disappointing. In fact, everyone who was so excited about the 200,000 jobs "created" in January clearly do not know how that number was derived. The government projected that 2.9 million people lost their jobs in January of 2011 (an annual post holiday phenomenon) and projected that only 2.7 million people lost their jobs in January of 2012. Their conclusion, based upon these projections, was that 200,000 jobs were "created". Not exactly confidence inspiring.

True, the rental markets for both commercial space and residential units is getting much healthier and we are seeing tangible increases in these rental levels. However, in New York, the real estate tax policy has been so abused that taxes are rising at about the same rate that revenue is increasing. I have many clients complaining that the top line has grown by 10 percent to 15 percent over the past couple of years but net operating incomes are essentially flat. This dynamic does not provide additional cash flow to cover the debt service which would be necessary to refinance over-leveraged assets.

Our real estate tax problem also seems to be, remarkably, limited to New York. Last week, I attended a great commercial real estate conference in Miami which was organized by my friends at Bisnow.

I met several of the top commercial real estate owners from across the U.S., each of whom own millions of square feet within their portfolios. These portfolios consisted of a wide range of property types including office, retail, residential and hotel. I conveyed the dilemma here of a relatively healthy market (compared with other cities across the nation) but a tax burden that is really beginning to take its toll.

The owners from across the country described various states of positive trends in fundamentals, however, none pointed to real estate tax policy as a cause for concern. An exception was one owner from Texas, who complained that taxes were skyrocketing in Houston as real estate taxes had risen to about 10 percent of gross revenue in some cases. When I told him the percentage in New York was approaching 30 percent, he almost fell over.

The New York market currently has a fairly high rate of shadow distress, in which properties have negative equity positions, yet positive cash flow. Moreover, the most distressed loans were made in 2007 when values were the highest and loan-to-value ratios were at their most aggressive. These loans are now maturing and the early feedback has been startling. Of the 5-year January 2007 loans which matured in January of 2012, just 29 percent were paid off. The balance of these loans, 71 percent, are in one form of default or another. The February numbers are not in yet but the expectation is for similar performance and these trends are expected to continue throughout the year.

We are also seeing banks which told us six months ago that all of their problems were behind them, calling for BOVs on loans that have slipped into distress. Servicers have also been increasing their request for BOVs recently as some of the loans that have been in default for years are beginning to turn into REO. All of this leads to one conclusion; distressed assets have been with us for years, are with us now and will continue to be with us for at least another year or two.

A stylized, handwritten signature in black ink, appearing to read 'R. Knakal'.

*You can read Mr. Knakal's "Concrete Thoughts" articles for the Commercial Observer at [www.commercialobserver.com/topics/concrete-thoughts](http://www.commercialobserver.com/topics/concrete-thoughts).*