Distressed Assets
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# Private Equity's Sideways Entrance

**As more private equity players align themselves with special servicers, the industry can expect to see more deals and a more regimented approach to pricing**

BY ERIKA MORPHY

Whether distress commercial real estate investors realize it or not, the various companies that C-III Capital Partners LLC is acquiring represents a milestone for this part of the industry. It is easy to see why the message—that is, growth in distressed asset transactions is coming—might be lost. After all, New York City-based C-III is intent on building out a diversified, full service real estate company.

However, the bottom line for distressed asset investors is indeed that C-III and other private equity-backed funds are acquiring special servicers and their assets and bringing complementary business lines to the table while they're at it. They reason they're moving into this space is because they see the business, and the fees they can generate from it, as finally poised for growth.

Not that the industry is moving wholesale in this direction. Some companies are charging ahead full force toward this model, while others are approaching it from different angles. C-III, for the moment, appears to be the most aggressive of all these firms.

The company launched itself into the commercial real estate world with the March 2010 purchase of the institutional debt-fund management and loan servicing businesses of Centerline Capital Group, also based in New York. City Since then, C-III has moved into the mortgage origination, investment sales and title insurance arenas—and special loan servicing, when the company acquired the special servicing and CDO management businesses of JER Partners this past August. In a statement issued at the time of the acquisition, C-III noted that McLean, VA-based JER was the named special servicer for $35.5 billion of commercial property debt, of which about $4 billion was under active management.

Other investments of note: In June 2011, C-III announced it

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— David Tobin, Mission Capital

would acquire Princeton, NJ-based NAI Global, which runs what is reportedly the largest network of independent commercial real estate firms worldwide. The deal has not yet closed; it calls for NAI to operate as a separate company under its current management. It has also been reported, by GlobeSt.com, that Andrew L. Farkas, C-III's CEO and the former founder and CEO of Insignia Financial Group, has agreed to buy a stake in Grubb & Ellis. Most recently, in mid-November, C-III acquired two multifamily property management businesses: Carrollton, TX-based US Residential Group and Pacific West Management, based in Irvine, CA.

New York City-based Fortress Investment Group's recent acquisition of Rockwood Advisors, a deal that aligns the New York City-based Rockwood's investment sales platform with Fortress' special servicing unit, CWCapital Asset Management, is another industry example. Berkadia Commercial Mortgage has established an in-house brokerage team, for its part, and LNR Partners, headquartered in Miami Beach, has launched its own loan advisory group, Archetype Advisors.

Taken as a whole, these are important signs of where the industry is headed, says Sandy Monaghan, managing director of the Capital Markets Group at Cushman & Wakefield, based in New York City. "The timing of their pursuit of these brokerage firms and special servicers is in some ways an indicator that private equity players believe there will be more distressed sales transactions—hence more sales transaction fees," he says.

*"For many years, special servicing was a loss mitigation department based on the premise that if you buy below investment grade, you should be able to control the workout."*

— Michael Carp, Berkadia Commercial Mortgage

That is good news for distressed investors, who have been waiting for a more regular flow of transactions ever since the start of the crisis. For other players—the Jones Lang LaSalles, which have been edging into this space as well—it is not so good.

"These companies may not have the opportunity to represent C-III in as many asset sales as they may have had in past," Monaghan explains. "It would be one thing if the company were just building an internal platform, small in scale. C-III would still need to leverage itself into third party-brokerage platforms. But with these acquisitions, it can execute transactions now without them."

This shift in players, however, could mean more to distress asset investors than just a steadier flow of deals from which to pick, says David Tobin, principal and co-founder of Mission Capital Advisors in New York City, a loan-sale advisor that works with Boston-based CWCapital, among others. "The verticalization of special servicers results not only in an increase in transaction activity, but also in better recovery for bond holders," he says.

Tobin cites the track record of CWCapital, which reportedly has recovered 59% of par on average of the $1.4 billion of loans it has sold since the beginning of 2010. "When special servicers have access to investment sales platforms and in-house brokers they tend to be more successful in terms of par in loan sales," he says.

Tobin also points to recent data from Fitch Ratings showing that, between 2005 and 2010, the aggregate amount of resolutions increased by 500% while losses went down. "In 2009, loss severity was 57% on about $1.64 billion of resolutions," he says. "That compares with 53.4% in 2010 on $5.25 billion in resolutions."

Special servicers started their push to verticalization in earnest around 2009, and Tobin thinks Fitch's numbers are at least in part a reflection of that trend. "Historically, special servicers did not have a lot of tools available to do workouts," he says. Their options were either to foreclose on the asset or sell the loan.

After the servicer foreclosed, "it would retain an external appraisal, a broker and so on—but none of those parties had a vested interest in the deal," says Tobin. "They were just parties doing work for a fee."

Of course, not all special servicers are moving in this direction, Tobin says. "Different servicers have different approaches to resolutions and, frankly, all have their good points."

In general, servicers that are strictly fee-for-service are less likely to verticalize. Those companies that own the B piece, by contrast, are more likely to have a complementary platform. Some focus on just one client. Then there are those special servicers who don't have an exclusive relationship with one firm but are pure third-party plays.

Berkadia falls into this camp, and it has a solid record to support this particular model. Earlier this year, the Horsham, PA-based company was cited by Trepp as the special servicer with the lowest loss-severity level for the previous 14 months. Its average loss severity on special servicing loans was 32%, or nearly 10 percentage points better than the second-ranking special servicer in the report.

"One hundred percent of our business is third-party transactions," says Michael Carp, an executive vice president with Berkadia's servicing division. It is a distinction from the top special servicers, which tend to have single customers, such as LNR's relationship with Cerberus Cos., he says: "If you look at the top six special servicers, they generally have single customers. We have a multitude of customers for which we are responsible and we treat it as a business."

For that reason, Carp says, the company has elected not to buy any of these assets. "Our theory is if it is a great opportunity, we should notify our customers." There is also the perception of conflict of interest, he adds.

Whatever the approach a special servicer opts to take, however, clearly the industry is changing, Carp says. "For many years, special servicing was a loss mitigation department based on the premise that if you buy below investment grade, you should have the ability to control the workout."

The last recession turned that premise upside down, and servicing morphed into a cash cow. "Fees were negotiated long before the problems began to occur and these fees, especially when they came in the volumes that they did, were similar to other transactions," Carp says. Enter the private equity players.

In mid-November, CityBizList, citing Trepp, reported on the transfer of a $219-million loan on 315 Park Ave. South in Manhattan to special servicing. An all-cash buyer then emerged for the 334,000-square-foot Midtown South office building, with the borrower requesting a discounted payoff to sell the building.

It's the ideal transaction for a distressed-real estate investor, the sort of deal that has been more urban legend than fact. That appears to be changing, and this trend will be further facilitated by a private equity-fueled special servicing sector.

There is a theory that pricing for distressed assets will not be as frothy or overpriced as is has been. There is also plenty of evidence to suggest that banks and lenders no longer have the patience or reason—or perhaps most important, the regulatory cover—to continue their extend-and-pretend policies.

"There has been much talk about excess capital on the sidelines waiting to invest and the lack of product in this space," Monaghan says. "With this mix of events, though, that will change. Pricing in core markets for stable assets has gotten too high, though, so capital is moving into secondary markets seeking better yields."

In these markets, however, investors are not willing to pay premium prices, especially with distressed assets. At the beginning of this year, projections for economic growth were far rosier than the cautious view that many now hold. Jobs have not recovered and fundamentals in terms of rent and opportunity growth haven't improved materially that much, either.

"Investors are having trouble projecting future growth in their investments and that has impacted how much they're willing to pay, especially for assets that are troubled," Monaghan says. In turn, "the servicers are becoming more conservative because they're not sure about the pricing they'll achieve."

If everything falls into place, special servicers are going to bring more product to market in an orchestrated fashion along with a more regimented approach to pricing. Which, after all, has been what investors have been waiting for since the beginning of the crisis. It just took a nudge from private equity to deliver. ■

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