Silk Purse or Sow’s Ear: Navigating the Busted Deal Landscape

by Patricia Kirk
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The real estate bust left the nation’s urban landscape littered with a plethora of deteriorating, unfinished projects. After sitting untouched for a couple years, some failed projects are finally getting a second chance as banks begin offering them to investors at steep discounts to clear their books and replenish capital reserves.

Often priced at 40 or 50 percent or less of the original note, broken projects may offer tremendous upside potential for investors willing to finish and hold them until the market turns. Upside can be particularly compelling in hard hit regions with high barriers to entry, such as California and South Florida.

City Walk, a seven-story, 252-unit condominium project in the heart of Oakland’s downtown redevelopment district, is a prime example. Wood Partners, a national apartment developer, purchased the project for $5 million two years after the previous developer, the Olson Co., abandoned the site, says Wood Partners attorney Stephen Ryan, a partner at the San Francisco law firm of Cox, Castle and Nicholson. About $70 million had already been invested in City Walk when Wood Partners acquired it, and the company is investing another $50 million to

finish it as apartments.

Similarly, Cleveland-based Legacy Capital Partners acquired a 200-unit condominium-conversion project on the waterfront in St. Petersburg, Fla., for $9 million and invested $6 million, or $32,000 per unit, to finish renovating it to apartment standards. The project, which is now 90 percent leased, is generating income and conservatively valued at $21 million, according to Legacy Capital President David St. Pierre.

While both projects have high-yield profit potential, they were very risky at the time of acquisition, with all the problems inherent to busted deals.

When Wood Partners purchased City Walk, the project had literally sat covered with bubble-wrap for about two years. “They [Wood Partners] had to be willing to take a risk on something with no certainty all,” says Ryan, explaining there was no financing at that time, and there were liens and other issues. Additionally, construction had been exposed to the elements, so there was potential for environmental issues and deterioration in structural quality.

The project acquired by Legacy Capital was 100 percent vacant and looked like a war zone, says St. Pierre. He notes that the best use was to renovate it as apartments, but at the time the area’s apartment vacancy was at an all-time high.

These projects were successful because the new investors cleaned up legal issues in advance, developed a strategy that took advantage of everything going before, and changed the end use to reflect current market conditions.

Most failed projects require a new vision or new business plan to make them

work. In converting City Walk as rentals, Wood Partners, for instance, was careful to work the redesign to stay within entitlements already approved. Similarly, when Resmark Equity Partners LLC, acquired The Madrone, a 180-unit condominium project in Hollywood formerly owned by John Laing Homes, the company rebranded the project The Avenue and repositioned it as luxury apartments. Architect Jonathan Watts, a principal at the Los Angeles design firm, the Cunningham Group, notes, however, that Resmark completed the project to condominium standards and may convert units back to for-sale product when the market turns.

But opportunities like these are scarce, according to Stephen Smith, ULI Commercial & Retail Council Silver Chair and principal and chief operations officer at Chicago-based Bryanston Realty Partners. “Even with the large supply of distressed properties you have to really work to find opportunities in this market,” he says, contending that financial institutions aren’t under pressure from regulators to take write downs to get properties off their books like in past down cycles.

“It’s a frustrating time for anyone anticipating taking advantage of market dynamics,” concurs St. Pierre. “This [current market] should be a perfect storm for bargains, but they [projects] aren’t coming to market or when they do there’s lots of problems and the bank only wants to sell the note, not foreclose and sell the asset.”

“We are seeing some [broken projects] go,” says Ryan Iwasaka, partner in the Los Angeles law firm, Greenberg Glusker. He notes that any movement in distressed assets is driven by a bank’s need for a cash infusion or to clean up the books due to pressure by bank regulators. “But banks are sitting on the projects that will command better prices when the market turns, and are unloading properties that won’t see those [high] values again.

“The problem in California is projects were so over valued, no one knows what the actual price should be,” Iwasaka explains “They [lenders] aren’t willing to discount [well-located properties] to the level buyers are willing to pay, so it’s a stalemate. At the end of the day, buyers will win the argument,” he believes, “but we just don’t know when it will happen.”

“Banks have a backlog of properties, and they’re not sure what to do with which,” notes Barry Saywitz, president of the Newport Beach, Ca., brokerage the Saywitz Company. “They’re cautious about write-down amounts and tend to deal with the biggest fire in front of their face, so it’s frustrating for investors trying to make a deal,” he adds. “Time is killing deals because banks can’t decide what to do and wait too long to get back to prospective buyers."

“What we’re seeing now is banks dealing with large projects like shopping centers in one-off situations, but pooling good projects with bad ones, making buyers take them as a package deal,” Saywitz adds. In the end he agrees, “If the project is under water or there’s no income, the lender will have to take a haircut.”

Meanwhile, banks are deferring property maintenance or allowing new structures to deteriorate in the elements, then offering them for sale in “as is” condition, Smith points out. He advises caution in underwriting deals, with consideration of whether the project is viable or ill conceived from the start, and what it would take in upfront capital to make the project work.

The biggest challenge for investors is getting control of the property. However, control of the asset is essential to securing private equity partners, emphasizes financial consultant Steve Duffy, managing director of Moss Adams Capital LLC, and underwriting, therefore, should include everything that needs to be done to gain control.

While pricing of broken projects may be enticing, broker Brian Janak, senior associate in the Houston office of Marcus & Millichap, emphasizes the importance of thorough due diligence. “Some of these deals have a lot of hair growing on them,” he warns, noting potential for unpaid taxes, liens or other issues that affect the title or the project’s viability.

Foreclosure may clean up the title, but is expensive and takes time. Duffy advises a “friendly foreclosure,” where investors work simultaneously with the original borrower and bank to avoid the high cost of a forced takeover in which the borrower is “fighting investors every step of the way.”

In considering what to pay, Mark Weinstein, a Los Angeles developer who serves as court appointed receiver in foreclosure cases, emphasizes that pricing should reflect the cost of foreclosing and number of issues encumbering the property. He also stresses the need to be selective in choosing a receiver experienced at solving problems upfront and negotiating title policies that protect investors from surprises when the project is completed.

While conditions may vary by market, Janak points out that the basic real estate mantra of location, location, location still applies regardless of geography. He advises investors to avoid projects on the fringes unless they are income producing and/or priced at the value of the dirt. He says the opportunity in Houston is to buy location and manufacture yield by taking advantage of discounted construction pricing and temporary low interest rates to add value. Weinstein notes that the “sweet spot” for condominiums in Southern California is a price point that qualifies for a FHA mortgage, with a $417,000 ceiling.

No matter how bad the market, there are always good opportunities for someone. Saywitz notes that in this market, investors who can pay cash have the advantage. “But if you need to get a loan, that’s going to be difficult.”