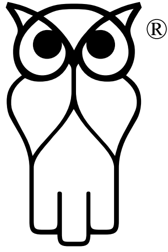

CONSTRUCTION
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MANAGING "DISTRESSED PROJECT" RISKS (PART 1)

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MANAGING "DISTRESSED PROJECT" RISKS (PART 1)

For several years, the real estate development and construction industries have been reeling from an economic slowdown with reductions in property demand, significant standing inventory levels, and bank-initiated project foreclosures. As a result, both the residential and commercial real estate "roller coasters" are racing toward the bottom of this economic cycle in declining property values and sales/leasing activity. Lenders' balance sheets have ballooned with distressed and nonperforming assets.

Contractors and developers with patient capital and a long-term investment mindset have an opportunity to take over some assets at bargain prices, but these transactions present some unique risks that must be addressed. The following article will explore these risks, and solutions for evaluating these opportunities.

The Problem

During the extended construction boom that spanned 1997–2007, homebuilders, commercial property developers, and large public builders all relied on debt instruments (land secured, development and construction loans) to finance their operations. The easy access to project financing was, in fact, the life-blood of the construction industry and the driver of its enormous growth. For large public builders, project financing is arranged at the enterprise level through large, money center banks and facilitated by corporate lines of credit. For smaller builders, regional community banks have provided the primary source of debt capital through specific project loans (assets on the banks' balance sheets). In both arenas, lender balance sheets have swollen with these assets, many of which are now distressed and nonperforming.

As property values plummeted and credit markets dried up, many residential development projects were abandoned due to lack of funds. Project sponsors without access to equity injections from outsiders (e.g., friends, family, institutional investors and off-shore sovereign capital) were often unable to keep the project afloat. The typical path of such ill-fated projects usually involves the bankruptcy of the project sponsor, lender foreclosure, and transfer of the property into the bank's "real estate owned" (REO) portfolio.

Lenders' Perspective

Lenders seek to maintain balanced loan portfolios as a function of good underwriting management practices. This means maintaining sufficient equity to debt ratios with their borrowers on specific loans. When recessions cause property values to decline, rebalancing requires repricing their assets to some semblance of market value ("mark to market") rather than the value when the project was underwritten ("mark to model"). Given their precarious capital

structures in the current economy, this is easier said than done. Marking REO portfolios to market, for example, could result in a 10–15 percent drop in value, which for some banks could mean a technical insolvency in the current economic environment.[1] (Real estate owned properties are foreclosed properties that the lender is unable to sell at a price that covers the outstanding debt.)

Lender Strategies

Lenders have essentially three options for managing REO properties, as summarized in Figure 1. In reality, some combination of these three strategies is usually employed based on the size, complexity, and stage of development of a given asset.

Figure 1
Lender Options for REO Properties

1. Hold the assets and try to preserve their value.
2. Sell off the assets in bulk at market value (likely at a significant discount).
3. Complete the build-out and sell the properties at retail.

When a lender forecloses on a project, it unwittingly enters the property development business, with all the associated tasks and risks of engineering, design, construction, marketing, sales, property management, and warranty/customer service obligations for the project. Banks are in business to lend, not to build out projects, and as such are typically unfamiliar with these responsibilities. This strategy also exposes the lender to the prospect of ensuing construction defect litigation risks, which is inversely related to the quality of execution in the homebuilding process. That is, if the bank's lack of experience in construction results in a lower quality of construction, the probability of construction defect ligation rises.

In a depressed economy, lenders may pursue "participation" (seller financing with a "kicker") for REO assets in hopes of catching the "rate of return" ride back up over the next cycle. Participation comes in three forms—participating loan structures, equity participations, and deed restriction participations.

Participating loan structures are very similar to a second loan much like those used in the property acquisition and development environment, wherein the lender may sell the property in bulk to a buyer, however the lender maintains an interest in future revenues through a loan

[1]In April, 2009, the Financial Accounting Standards Board (FASB) loosened mark-to-market requirements, thus easing the valuation rules for inactive markets and illiquid assets. This is a move which, when coupled with actions of the Federal Reserve Board (FEB) and the Federal Deposit Insurance Corporation (FDIC), is intended to create more flexibility in the financial markets for lenders and thus borrowers.

instrument that may call for future payments that are due if the buyer subsequently resells the property at prices above what current market conditions allow. In effect, this lets the lender "participate" in increasing values.

In equity participation, the property would be sold in fee, but the lender would maintain an equity position in the asset. That is, the lender would remain on the title in some manner as a co-owner, such as by maintaining an interest in a limited liability company (LLC). A provision for return of the equity upon further bulk sale, or in a predetermined per lot or unit release price upon subsequent sale, may also be included. (This strategy requires the use of a nonregulated bank affiliate.)

Deed restriction participation calls for a specific amount of revenue to be returned to the seller upon subsequent sale of the individual interests, often expressed as a percentage of revenue over a predetermined value. This strategy allows a lender to participate in any "upside" should market conditions improve.

Participating loan structures have the potential to create some future value for the lender through an increase in revenue on the sale of distressed assets in an environment of improving economic conditions when the buyer of the REO assets eventually sells the properties at a higher-than-currently-valued price. (The higher price could be the result of simply holding the assets until the market rebounds or developing the assets.) Lenders would need to address any potential regulatory restrictions in the bank's operating environment and seek qualified legal counsel before undertaking this type of approach.

Builders Perspective

Builders have a different problem: they need to rebuild their project pipeline and strengthen their balance sheets. The current market offers new opportunities for achieving those goals, as banks are seeking to unload properties obtained from struggling or bankrupt builders through foreclosures. Some of these properties are land only, others are partially completed, and some may even be fully developed and ready for sale as residential units. These foreclosed properties represent an opportunity for builders with some financial resources and a bit of patience to turn these properties into profitable investments.

Builders with a long history of brand recognition, temporarily compromised by the economic situation, can build a bifurcated portfolio using an "old company—new company" capital structure. In this strategy, the old entity keeps the nonperforming projects with all their unresolved issues. The new entity is a holding company that takes in new projects, compartmentalized by separate project ownerships. This mechanism has helped some builders shore up their balance sheets and even pursue growth in previous down cycles.

Creative builders have a couple of options for obtaining control of distressed or foreclosed projects. One option is to take control of the property indirectly by acquiring the bank's debt (at a discount). Another option is to take direct control by acquiring the REO at a significantly discounted price. (The amount of the discount will be determined by supply and demand conditions within specific markets in the United States.)

Evaluating the Risks of Foreclosed Properties

The balance of this article explores the types of property opportunities, risk management issues, and toolbox solutions for a builder and lender to pursue in evaluating REO assets. This discussion focuses on residential properties, but there will almost certainly be a subsequent wave of similar activity and opportunity in the commercial and retail property sectors.

For simplicity purposes, we will break the process of evaluating the risks of taking over distressed projects into four steps.

1. Determine the asset category.
2. Perform critical due diligence.
3. Determine customer service and warranty obligations.
4. Utilize appropriate tools.

Determine the Asset Category

REO assets are categorized based on their stage of development. There are five physical types of residential REO asset classes, as outlined in Figure 2. Most banks have a combination of these assets in their REO portfolios. Each asset type requires a different set of evaluation tools.

Figure 2
REO Asset Classes

Asset Type	Description
Paper Lots*	Tentative maps or preliminary plats approved by the appropriate planning commission, city council, or board of supervisors.
Blue-Topped Lots	Lots are rough graded to a stage of completion which is ready for installation of the infrastructure.
Finished Lots	Water, sewer, storm drain, and other street improvements are completed.
Partially Complete Homes	Partially complete homes, in various stages of construction.
Standing Inventory of Completed Homes	Complete except for finish flooring and utility meters. Sufficient for notices of completion and certificates of occupancy to be issued.

*A subsequent stage of paper lot development is the final recorded map or final plat, in which all improvement engineering plans have been completed, approved, and signed with the bond and fee letter issued by the government agency and bonds posted by the builder (for proposed public improvements). Final maps are a saleable commodity.

With the exception of partially completed homes, all of these assets are saleable commodities, which means there is a ready market of buyers at the right price. Partially completed homes, however, require a buyer with adequate development and construction expertise to assess their condition and complete the project in a manner that minimizes the probability of litigation down the road. Usually only another builder or developer will have these skills.

Examples of broad risk categories are summarized in Figure 3, but there are many nuances to each category, and risks vary based on asset type. For example, Paper Lots have none of the construction assembly risks, since no construction work has been performed. They do, however, carry a number of preconstruction risks, including entitlement issues, fees, environmental constraints, and unforeseen geo-technical issues which affect the project designs. Partially completed homes and standing inventory present the most risk for everyone—builders, lenders, insurers, and prospective purchasers—due to their unprotected conditions (e.g., exposed framing, lack of full enclosure, etc.) and attractive nuisance characteristics (squatters, vandals, etc.).

A risk matrix that shows how each of these risks varies based on asset type is a useful tool. Additional technical detail on this subject is available should the readers like to learn more.

The risk of future construction defect litigation must also be considered in the risk analysis, acquisition strategy, development program, and construction processes. Builders cannot fully escape this risk, but lenders can take steps to minimize their risk. Analyzing the definitions of “developer” and “lender” (embodied in caselaw and state civil codes) and comparing them to the activities in which the lender engages is a first step in determining the lender’s exposure to construction defect litigation. Highly specialized legal advisors should be consulted in this task.

Figure 3
Broad Risk Categories

Preconstruction Risks	Construction Risks	Other Project-Specific Risks
Entitlement issues City/county fees Environmental constraints Unforeseen geo-technical issues	Soils Concrete foundations Structural framing Weather barriers Mechanical, electrical, and plumbing (MEP) issues Acoustical assemblies (attached housing)	Homeowner associations (HOAs) Regional infrastructure improvements (large master-planned communities)

Depending on the type of asset, Receivers can be helpful in limiting the risk of downstream construction defect litigation to the lenders. (Receivers are officers of the court, charged with various responsibilities outlined in the court order issued by the presiding judge.) Receivers can work between the bank, foreclosed builder, and the prospective property purchaser, so that the lender is not on the chain of title and therefore less likely to become entangled in construction defect litigation. Where an exposure exists, builders and lenders face a 10–15 year period of exposure for construction defects, depending on the statute of repose in the state.

Perform Critical Due Diligence

The type of due diligence required varies based on the asset type. The more documentation available from the original builder, the better. Lenders may be able to provide some of the original builder's documentation, but that ability may be compromised by other banks that participated in the original loan and are now engaged in the work-out and disposition process. If the original builder is still financially viable and pro-actively cooperating with their lenders, project management documents are a vital source of information. Local city or county planning and building departments may have architectural and engineering plans of record, if not available from the original builder or lender. The architectural plans will typically name the entire consulting team on the cover sheet.

Unfortunately, obtaining the needed information can be difficult. Banks may not be properly staffed to keep organized records, especially in light of the currently high foreclosure rates. Files and documents are sometimes lost in the process of bankruptcy and foreclosure. In fact, as a builder downsizes, much of their institutional knowledge is lost through staff downsizing.

REO assets also carry marketing and sales risks. Expertise in marketing and selling a defined product to the retail consumer is a critical component of the process. This is more akin to a homebuilder's challenge than a general realtor's challenge, and is accomplished thorough disclosures, properly drafted sales contracts, and limited warranty language. Professional legal advice is necessary to assure consistent use of legal protections in contracts, from trade contracts to home warranties and customer service procedures.

Determine Customer Service and Warranty Obligations

The customer service and warranty obligations associated with a project do not go away with a builder's bankruptcy or a lender's foreclosure. For example, on a partially built subdivision or condominium project, lender representatives should participate in the HOA meetings to manage the information flow and protect their interests as they pursue alternative disposition strategies. Relative to customer service obligations, builders often walk away, leaving the bank without the knowledge or resources to tend routine minor or major service requests. Homeowners with unmet expectations and lingering service requests are another road to litigation. By proactively managing homeowner and HOA expectations, these risks can be minimized.

Utilize Appropriate Tools for Evaluating Properties

Property Condition Assessment Reports (PCARs) are an evaluation of a property at a specific point in time, at a specific site, with a variable level of due diligence for different asset types. PCARs should provide increasingly cumulative project detail to correspond to the higher standards of care required on certain asset classes (discussed above). The American Society of Testing and Materials publishes a Standard Guide for Property Condition Assessment Reports on commercial properties (ASTM 2018–08). Some proprietary versions, including those produced by La Jolla Pacific, incorporate parts of ASTM 2018–08, as well as other relevant data such as discount cash flow models. The strength of these tools is the ability to tie together pertinent asset management costs, allowing an "apples-to-apples" comparison across various REO assets in the portfolio.

Conclusion

By gathering, sifting, and analyzing critical information, developers and builders can develop an estimate of the asset's discounted future cash flows. Used wisely, these tools can form the basis for an acquisition program to refill their project pipeline. Lenders also benefit from these tools, regardless of their disposition philosophy and strategy. PCARs provide lenders with comprehensive insights about the subject properties and become a critical component of a lender's business plan for work outs and dispositions. They assist in the project evaluation process for these lenders to achieve successful dispositions at maximum values. Proper use of these evaluation and risk management tools will benefit both lenders and builders in this challenging market.

Insurance company perspectives on foreclosed or abandoned properties will be examined in a future article.