The Loan Sale Advisor

Winter 2010

Best Practices in Active Portfolio Management

Demand Grows
For Real Estate Loan Valuations

DebtX valued a record number of real estate loan portfolios in 2009 and expects to surpass this record activity in 2010 due to an accelerating need for pricing transparency.

"After the recent real estate market crash, investors and regulators are demanding third-party valuations for loan portfolios," said Managing Director Karen Diane Johnson, who runs DebtX's loan valuation service. "As the nation's largest loan sale advisor, DebtX is in a unique position to provide valuations based on data from transactions executed at DebtX's loan marketplace as well as other relevant observable market inputs."

> In the wake of more than 140 bank failures in 2009, regulators are particuarly concerned about the CRE exposure of small and mid-tier banks.

Need for Pricing Transparency

Reduced demand for MBS and CMBS has resulted in lenders retaining greater percentages of commercial and residential real estate loans originated. As a result, portfolio transparency has emerged as a top priority for these institutions as they seek to manage risk and maintain balance sheet health.

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2010 Outlook
More Income-Producing CRE Will Come to Market

In 2010, financial institutions in the U.S. are likely to sell significantly more Commercial Real Estate (CRE) loans collateralized by income-producing property than they have over the past few years.

The increase in this category of CRE product began in the second half of 2009 and is expected to increase substantially as institutions work through their portfolios of distressed CRE in 2010.

> DebtX's marketplace is currently offering a wide range of CRE loans supported by income-producing property.

"In the near term, the availability of CRE loans backed by income-producing property is likely to be much stronger than resident-ial and commercial Acquisition Development & Construction loans," said DebtX CEO Kingsley Greenland.

Investors are interested in CRE loans secured by income-producing properties for a number of reasons.

First, these loans are less speculative than ADC loans because the cash flows on the properties securing the loans are still intact. Distressed CRE loans on income-producing property typically are discounted from par 20-30 cents on the dollar in the secondary market. Values are often discounted as much as 70-80 cents on the dollar for ADC loans.

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TheDebtExchange

The Deal Book

Highlighted transactions recently completed by DebtX

Seller: Financial Services Company

Assets: $60 million performing and non-performing CRE loans. The offering consisted of non-performing office, retail, multifamily, industrial, hotel and some residential loans. All assets were located in the southeastern United States.

Marketing: DebtX executed an extensive marketing campaign consisting of 5,000 emails and more than 1,500 phone calls to potential buyers.

Results: The auction generated an outstanding level of interest. A total of 428 investor groups performed due diligence and 233 bids were received across the portfolio.

Seller: Multi-Region Bank

Assets: $13.8 million from two non-performing CRE notes. The notes originated as acquisition and renovation financing for a 201-unit condominium project. The notes were secured by a first lien mortgage on 52 condominium units and related parking areas adjacent to a multi-billion dollar casino development in Atlantic City, New Jersey. The project's approximate monthly cash flow was $24 million, composed of lease income from the condominium units and parking spaces.

Marketing: DebtX's marketing campaign consisted of more than 1,000 emails and more than 160 phone calls.

Results: The auction generated exceptional interest with more than 300 individual investors conducting summary due diligence, and 40 conducting full due diligence. The offering ultimately received bids from seven separate investors.

Seller: Regional Bank

Assets: $52 million in non-performing CRE loans, residential development loans, C&I loans and commercial leases. The portfolio was composed of 11 pool offerings and six single relationship offerings. Collateral was concentrated in Ohio and Michigan, with others located in Pennsylvania, South Carolina, Arizona and Colorado.

Marketing: DebtX's marketing campaign consisted of more than 4,000 emails and 1,500 phone calls to potential buyers.

Results: The auction had excellent interest with a total of 678 separate investors conducting high-level review of one or more offerings. A total of 84 investors engaged in full due diligence, with an average of 18 investors underwriting each of the pools. Twenty-six investors submitted a total of 138 individual and combination bids.

Seller: Commercial Bank

Assets: $16.6 million in non-performing CRE loans. The sale consisted of six offerings secured by first-liens on multifamily, condominiums, land and industrial properties. The collateral was located in Southern California.

Marketing: DebtX's marketing campaign consisted of more than 3,000 emails and 1,000 phone calls to potential investors.

Results: The auction had exceptional interest with 814 investors conducting high-level due diligence and between 19 and 60 investors conducting full due diligence. Forty-two investors submitted a total of 58 bids.

Demand Grows

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"In the wake of more than 140 bank failures in 2009, regulators are particularly concerned about the CRE exposure of small and mid-tier banks," Johnson said. "By working with DebtX to obtain independent loan valuations, these institutions are able to identify and address potential vulnerabilities by managing CRE loan loss reserves to appropriate levels."

DebtX's CRE loan pricing service is one of the most widely followed in the industry.

DebtX currently prices more than 60,000 CRE loans with an aggregate principal balance in excess of $700 billion. Each of these loans, which collateralize more than 600 US CMBS trusts, receives a DXMark®. Data about the individual loans in the CMBS trusts is available through the BLOOMBERG PROFESSIONAL® Service.

Mounting losses in residential loan portfolios have compelled institutions to isolate the portfolio segments that represent present and future risks. By valuing and stress testing residential portfolios, DebtX helps clients surface existing portfolio weaknesses and predict future ones, enabling institutions to better focus on risk mitigation.

Pre-acquisition Loan Valuations

Opportunity funds and other investors routinely engage DebtX to provide portfolio valuations as part of their portfolio acquisition due diligence. Pre-acquisition portfolio valuations enable buyers to better allocate resources at the individual loan level, resulting in a more effective bidding strategy.

"DebtX's loan valuations have wide applicability to risk managers, those involved with the acquisition and disposition of real estate loan portfolios, and institutions involved in whole bank transactions," Johnson said. "In today's turbulent market, transparency is more important than ever."

For more information about DebtX's loan pricing service, contact Karen Diane Johnson, Managing Director, kjohnson@debtx.com, or 617.531.3432.

2010 Outlook

More Income-Producing CRE Will Come to Market

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Additionally, investors typically have an easier task valuing CRE loans because the income stream reduces variances in modeling outcomes. Because the loans can be priced within a relatively tight range, the bid-ask spread on CRE loans supported by income-producing property is relatively small, which increases the likelihood of execution. When the bid-ask price is wider, there is greater risk that a seller won't achieve the reserve price and the transaction won't be completed.

A Range of Choices

DebtX consistently offers a range of CRE loans, including loans secured by income-producing property. The diversity of product enables investors to purchase loans that best match their acquisition criteria.

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This year, a large source of product will come from community and regional banks. These institutions have among the largest exposures to CRE and are under pressure to reduce their volume of distressed loans. Loans from these banks tend to be under $5 million on average.

"In 2010, investors who have been seeking CRE loans of all types will have an opportunity to build portfolios from this highly desirable asset class," Greenland said.

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DebtX In Brief

2010 Is A Key Year For European Banks

European banks will be under increasing pressure in 2010 to address their expanding volume of distressed loans on their balance sheets.

"European banks have a similar amount of problem loans as U.S. institutions, but they have not moved as quickly to manage down those troubled credits," said Managing Director Gifford West, head of DebtX's European operations. "That may change in 2010 because of heightened regulatory concerns and the realization that the effective disposition of problem loans is one of the fastest ways back to profitability."

European banks are facing a host of loan portfolio issues. Reserve levels are insufficient for the volume of distressed loans and the underlying collateral. At the same time, many banks are seeing loans entering workouts more rapidly than they are being resolved. Moreover, those resolutions are taking consistently longer and yielding lower recoveries than expected. Finally, under-performing loans will likely increase in 2010 as real estate markets remain flat or weaken further.

Compounding the current loan management problem is that European institutions have inadequate capabilities to service distressed loans. Large, multifunctional workout groups have not been required in most G7 countries for the last decade. Many banks have moved staff from origination into workout groups with only modest results.

The Way Out

Some European banks have begun addressing the problem. They are making progress by executing the following strategies:

- Focusing the workout function only where it can be most effective – and not across all loan types, situations, and geographies.
- Identifying those categories of loans that are no longer core to the business (either by geography or by type) and selling them.
- Applying reserves against those loans that are non-strategic or offer the greatest risk and then removing them from the balance sheet.
- Demonstrating effective portfolio management to regulators by independently confirming loan valuations through market transactions and ensuring that reserves are headed in the right direction.

"Once the non-strategic assets in workout have been identified, they should be considered for sale," West said. "While this step may consume a disproportionate amount of reserves short-term, it's important to realize that non-strategic loans within workouts typically lead to bigger problems longer term. Historically, the combination of non-core assets and newly expanded workout functions has almost always delivered unpleasant surprises."

West said that institutions that proactively tackle the problem are likely to realize both short-term and long-term benefits.

"Regulators, investors and rating agencies are responding positively to banks that can demonstrate a portfolio management plan other than building larger workout departments with ever increasing inventories of non-strategic portfolios, troubled loans and REO," West said.

Upcoming Events

DebtX will attend the following conferences:

CMSA's 20th Annual Conference
June 8-11, 2010 — Lake Buena Vista, FL

2010 ERES Annual Meeting
June 23-26, 2010 — Milan, Italy

EXPO REAL
October 4-6, 2010 — Munich, Germany