



Required Content for Real Estate Finance Professionals

## PERSON OF THE WEEK: BARRY GROSS PINPOINTS COMMERCIAL REAL ESTATE RISK

IN FROM THE ORB

BY JESSICA LILLIAN ON TUESDAY 11 NOVEMBER 2008



**This week, MortgageOrb spoke with Barry Gross, president of Developers Research, a national real estate consulting firm** based in Irvine, Calif. The company uses proprietary analytical models and methods of evaluating risk associated with real estate acquisition, development and disposition. These days, Gross reports a pause in distressed asset activity while the market awaits final instructions on the federal government's Troubled Asset Relief Program (TARP).

**Q:** Are nonrecourse construction loans still available under any circumstances? When might they make a comeback (if ever)?

**Barry Gross:** Yes, but those loans are only available under special circumstances - for instance, in the case of large and stable companies that are looking for accommodating loans or secure credit tenants. The lender needs to feel confident that a company/tenant will have the financial ability - especially in this challenging economy - to repay the loan.

Nonrecourse loans - in most situations - will return, but we won't see a comeback for two to three years. Remember, banks have short-term memories, and in the future, they will begin to compete for business again.

Once this competition picks up, banks will loosen their underwriting standards, though they will never be as forgiving as before the crisis hit. In the meantime, developers that seek government-subsidized loans often can find debt, because lenders are confident that government-subsidized loans will be repaid.

**Q:** What do you see for the future of brownfield lending? Might the green movement increase the popularity of reusing contaminated land, or will developers and finance participants likely consider the risk too great?

**Gross:** There is a future for brownfield lending, especially in redevelopment. The cleanup effort is difficult due to the challenges in obtaining clearance from an environmental protection agency. However, developers can save money in brownfield redevelopment because often, features such as roads and parks already exist.

The green movement actually makes reusing contaminated land more difficult. In the short term, some developers might accept the risk, depending on the situation and the cost of environmental risk insurance, which is extremely difficult (and costly) to obtain in this economy.

But once the economy turns around, this market will become more active.

**Q:** One executive from an investment banking firm recently stated that banks will not currently consider any land financing right now. Are you seeing any exceptions? What, specifically, is inhibiting land finance for commercial development?

**Gross:** Yes, there are land loans out there. It depends on the collateral or guarantees the investor offers, and it also depends on loan-to-value ratios. Sometimes, sellers will finance the land purchase price (a form of land loan).

But in many cases, investors are concerned that former credit tenants - such as Mervyns and Linens-n-Things, for example - are defaulting on their rent agreements. All their space will soon be available for rent, and currently, it is difficult to find quality tenants that will take up such large blocks of space.

**Q:** In your project cost analysis, what variables have changed most dramatically in the past few months, given all the national economic turmoil? Can developers do anything to mitigate these financial stresses?

**Gross:** Impact fees have increased. Cities, in particular, are being affected by economic conditions because their revenues are decreasing, but they still may be required to pay to develop roads or complete other off-site improvements.

To help mitigate the financial stresses, developers need to be more careful and should thoroughly analyze design plans, thus creating cost-effective changes and new standards in order to save money in the long run.

**Q:** How much activity is there right now in acquiring/disposing of distressed commercial real estate assets? What are the most common causes of distress right now?

**Gross:** Activity has slowed down dramatically because sellers, investors and lenders are waiting for regulations for the recently created Treasury fund - TARP - to be issued. The banks are waiting to determine if the new government agency will advance funds to them at higher than current market values to jump-start the economy.

Basically, the main cause of distress is that tenants are not paying their rents, and thus, the buildings' property values are decreasing. Also, there was a plethora of overbuilding, especially in the retail market, where developers built too many regional malls. This oversupply is going to cause a lot of problems in the future.

Condos are still the most problematic due to the difficulty of getting insurance. Most

developers/owners of condos are now renting the condos out as apartments in order to create cashflow and to mitigate losses.

I do expect overall commercial real estate distress to increase significantly due to several factors - overbuilding, rents' dropping, the down economy, etc.