

# Identifying opportunities in a changing market

Investors in distressed debt survey results and analysis

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# About the distressed debt survey

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Ernst & Young recently surveyed various types of investors in distressed debt to get their perspectives on the market. The types of investors we polled include:

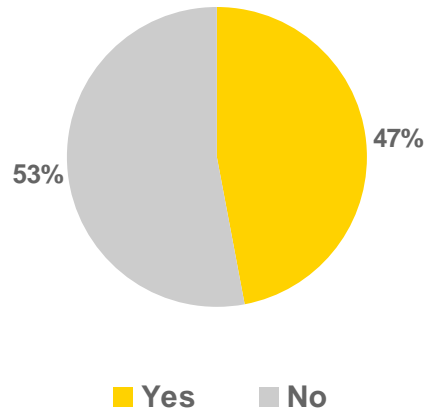
- ▶ Real estate investment/opportunity funds
- ▶ Private equity funds
- ▶ Institutional investors
- ▶ Real estate developers and investors

In the following summary, we share the responses of the survey participants and give our perspective based on the survey responses, client discussions and our industry knowledge as it pertains to the current state of the distressed debt market.

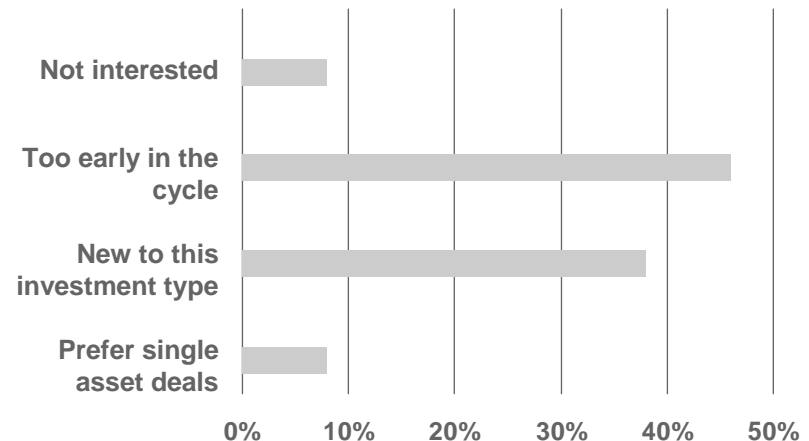
Overall, respondents felt that the remainder of 2009 would see loans of all types being brought to market, which includes whole residential mortgage loans, whole commercial mortgage loans, Commercial Mortgage-Backed Securities (CMBS)/Residential Mortgage-Backed Securities (RMBS), and unsecured/charge-offs. Not surprisingly, respondents also felt that of all distressed debt types, whole commercial mortgage loans would be the most prevalent, and that the commercial mortgage loan default rate would continue to rise over the coming 24 months. In addition, all respondents felt that the gap in the bid/ask spread was the primary, although certainly not the only, hindrance to a more active market to date.

# Distressed debt survey

Have you purchased or attempted to purchase NonPerforming Loan portfolios in the past 18 months?



If not, why not?

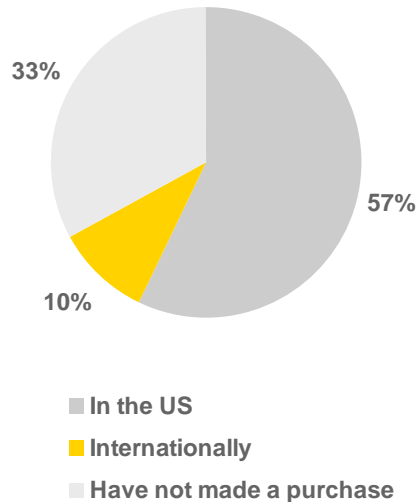


## Ernst & Young insights

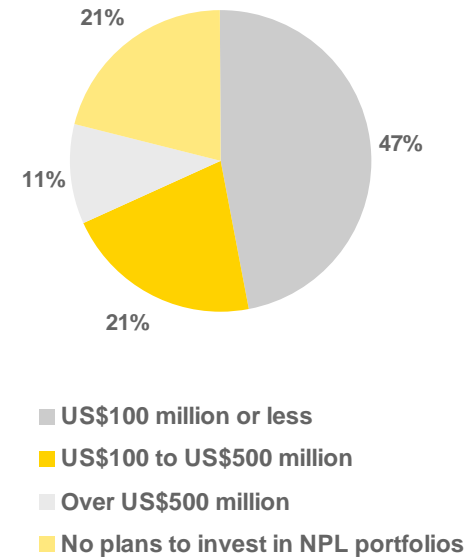
We are still in the early stages of the US market for buying and selling distressed debt, particularly for commercial real estate loans. Significant hurdles remain before the market can gain momentum, not the least of which are the resolution of the much maligned Public-Private Investment Program (PPIP) legacy loan initiative and the bid/ask disconnect. Nevertheless, about 45% of the respondents still believe we are too early in the cycle, perhaps influenced by what investors believe are overly high pricing expectations by the sellers.

# Distressed debt survey (cont.)

Where have you purchased or attempted to purchase NPL portfolios in the past 18 months?



How much capital has your company allocated for the purchase of NPL portfolios for the coming year?

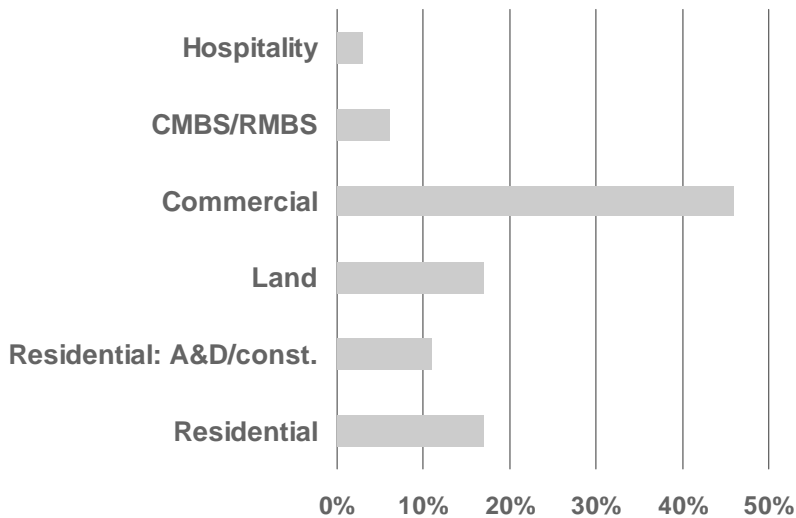


## Ernst & Young insights

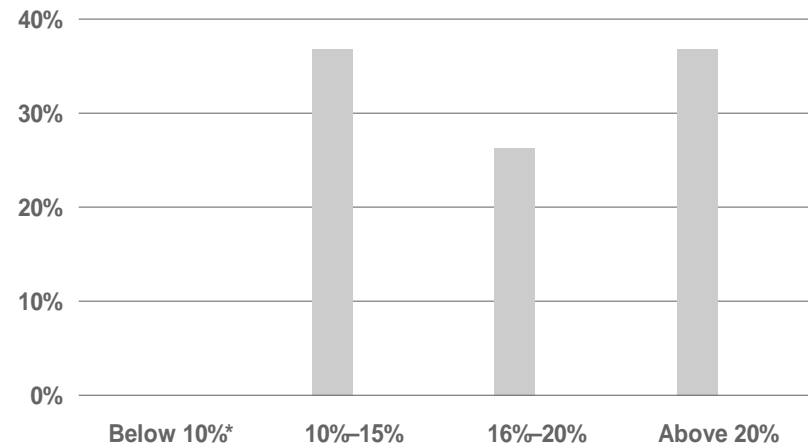
The current real estate downturn has motivated opportunistic investors to raise capital in order to play in the distressed arena. Larger, and in many cases, experienced distressed debt investors have allocated significant amounts of capital to invest, yet close to 50% of the respondents are allocating \$100 million or less. This suggests that the distressed debt market will be very competitive during this cycle due to the large number of smaller players.

# Distressed debt survey (cont.)

What NPL whole loan type best meets your investment criteria?



What are your investment return requirements?



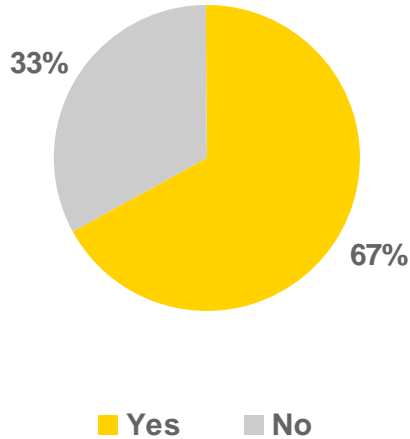
\*No respondents selected this choice.

## Ernst & Young insights

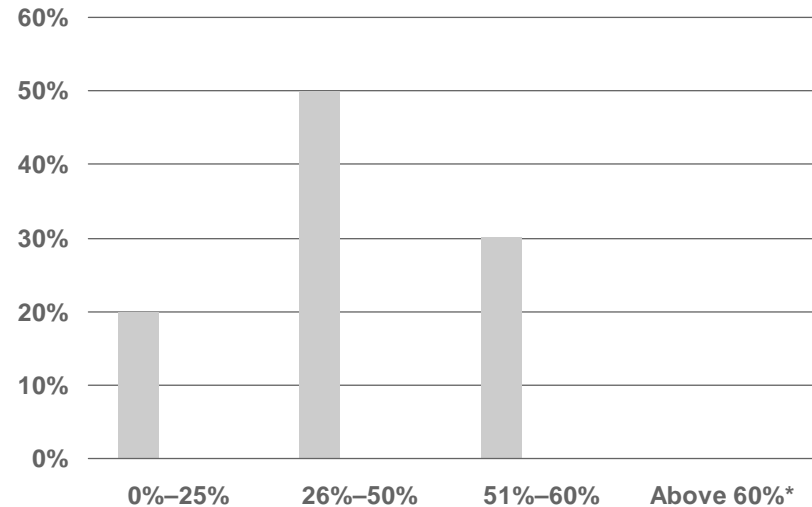
Overwhelmingly, respondents are looking at the commercial whole loan market as their primary investment type in the current downturn. Interestingly, only 35% are looking for returns above 20%, suggesting that investors are not as “unreasonable” as some sellers might think.

# Distressed debt survey (cont.)

Do you expect to use leverage in your acquisitions?



If yes, what are your leverage expectations/requirements?



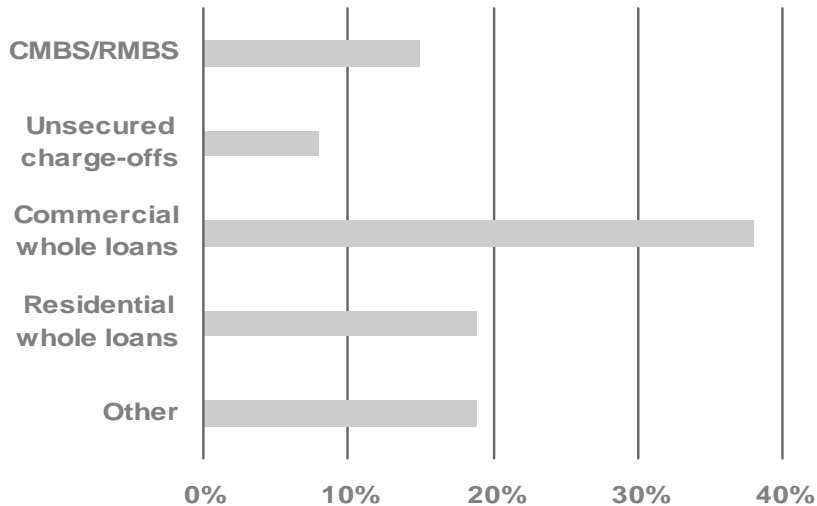
\*No respondents selected this choice.

## Ernst & Young insights

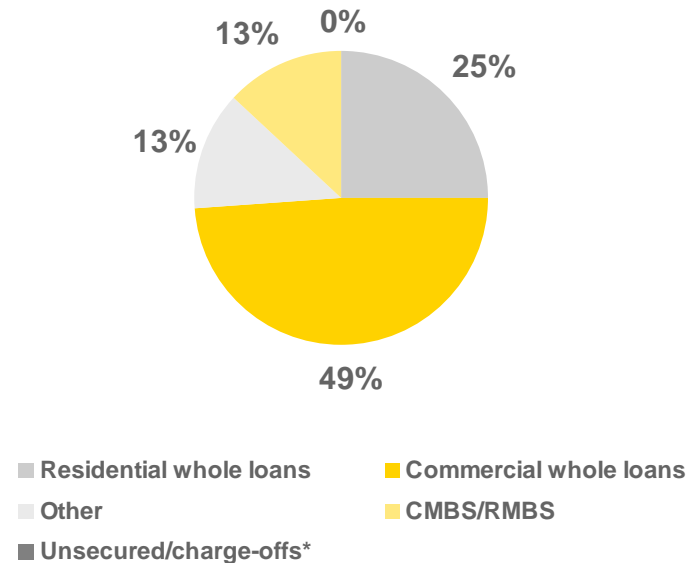
Respondents indicated that they expect to leverage their distressed debt purchases with only conservative levels of debt, at least in comparison to days of old, where leverage could be and was utilized at up to 80% or more of purchase price. However, even at conservative levels, leverage for distressed debt acquisitions is unlikely in today's market, unless the PPIP initiative gets off the ground or sellers fill the gap with seller financing.

# Distressed debt survey (cont.)

What types of portfolios have you performed due diligence on in the US during the prior 18 months?



What types of portfolios have you purchased in the US during the prior 18 months?



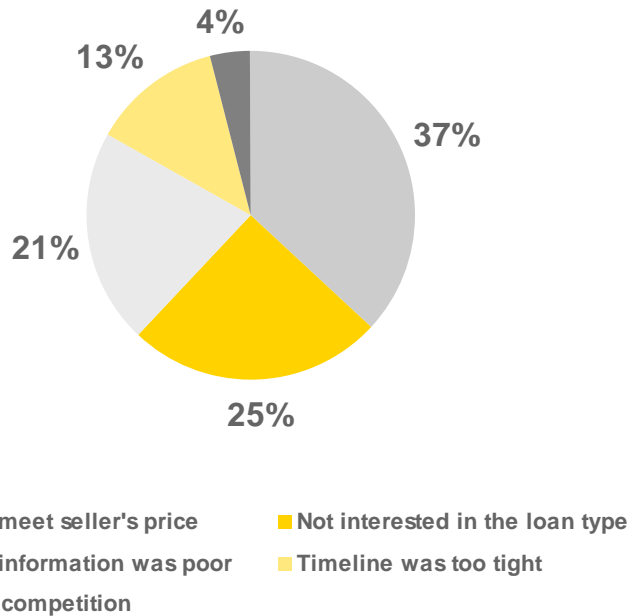
\*No respondents selected this choice.

## Ernst & Young insights

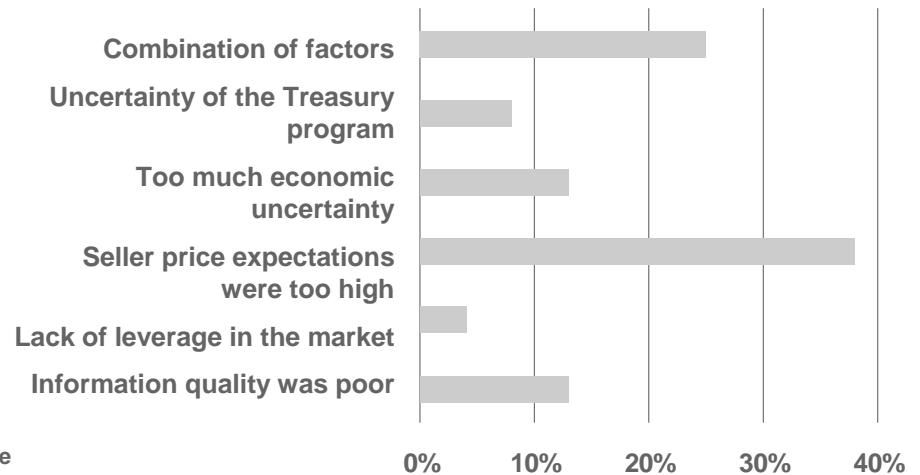
While much has been discussed regarding the distressed CMBS and RMBS sector and the distress in the residential whole loan market, the area of most interest to investors is the commercial whole loan market. The majority of respondents are looking at commercial whole loan portfolios in today's market, and we expect investor interest to remain heavily weighted toward this distressed debt class.

# Distressed debt survey (cont.)

What was the primary reason for not bidding, if you performed due diligence services?



What was the primary reason for not meeting the seller's price expectation?

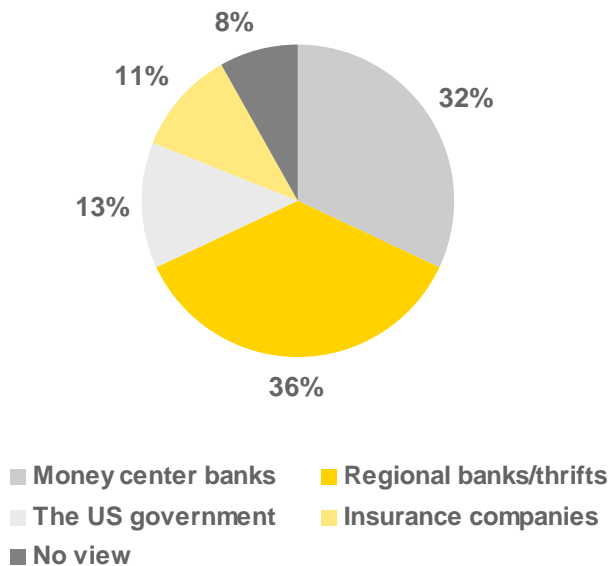


## Ernst & Young insights

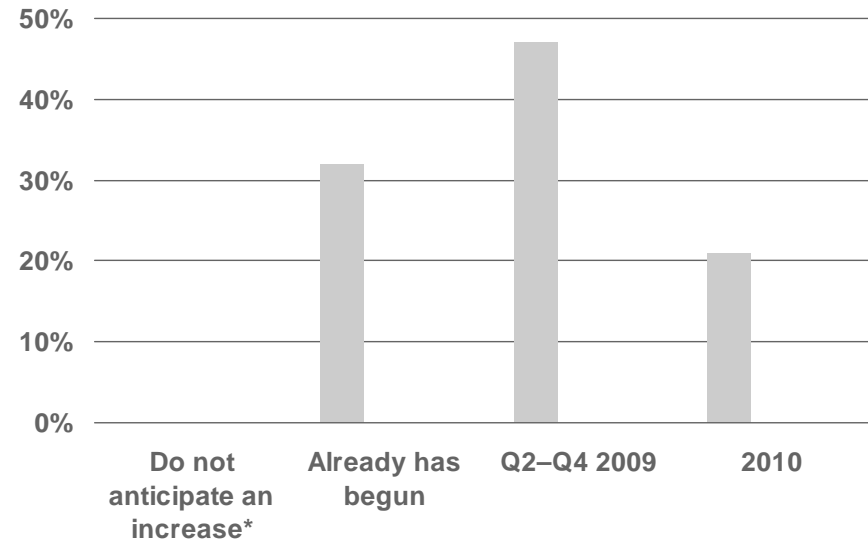
Not surprisingly in today's market, the primary reason for busted transactions is pricing. Buyers are not able to meet the price expectations of the seller. One in five respondents did not like the quality of information, which suggests that by providing quality and pricing-relevant information to buyers, sellers could increase interest and likely come closer to their price expectations by reducing buyer uncertainty.

# Distressed debt survey (cont.)

In 2009, who will be the most active direct sellers of NPL portfolios?



When do you anticipate a significant increase in commercial mortgage defaults will begin?



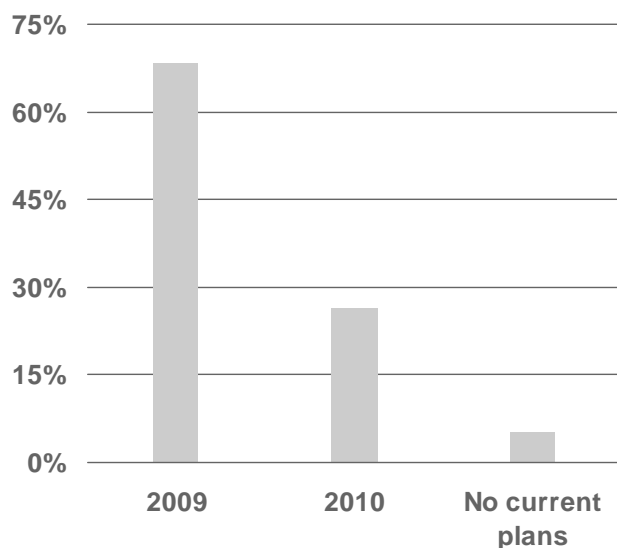
\*No respondents selected this choice.

## Ernst & Young insights

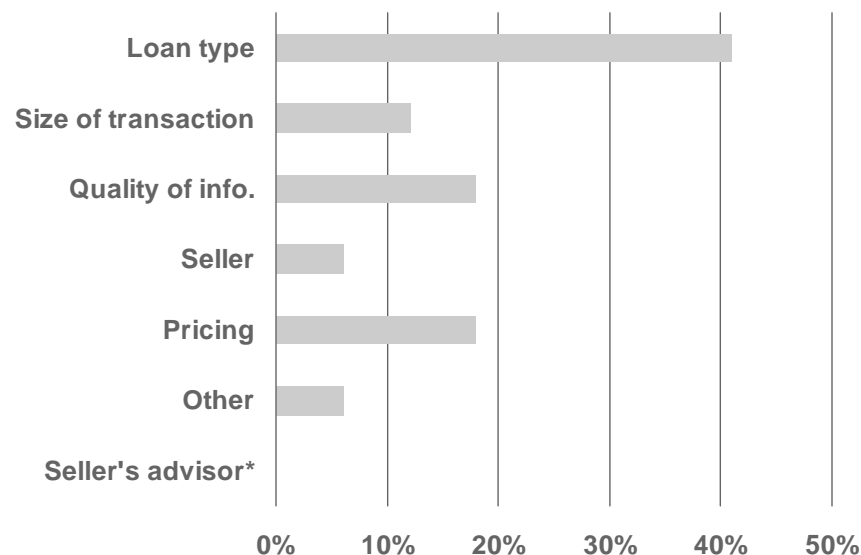
The distressed debt market will continue to develop as money center banks and regional banks begin to deal with their troubled assets in earnest. The largest number of respondents believe the activity level will be greatest with the regional financial institutions. Additionally, a majority of the respondents believe commercial defaults will significantly increase over the coming months.

# Distressed debt survey (cont.)

If you are not currently evaluating NPL portfolios, when do you anticipate market conditions will be favorable for you to enter the market?



What is the single most important factor in deciding to pursue the acquisition of an NPL portfolio?



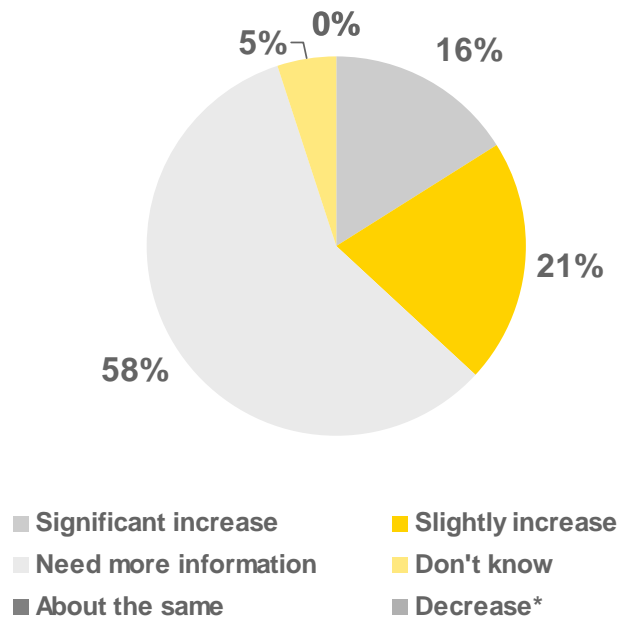
\*No respondents selected this choice.

## Ernst & Young insights

The market for distressed debt has not materialized as swiftly as many anticipated it would; however, 70% of the respondents still believe 2009 will be the year the market takes hold. If banks do not start cleaning up their balance sheets and begin to lend again, Japan may not be the only country to experience a "lost decade."

# Distressed debt survey (cont.)

How will the Treasury's recently announced public/private investment fund affect bank's decisions to sell NPL portfolios?



\*No respondents selected this choice.

## Ernst & Young insights

The PPIP Legacy Loan program has been much maligned. At best, the program will likely be modified to deal with investor and seller concerns; at worst, based on recent press reports, the program might be scuttled. Respondents have underscored one of the keys issues: the need for more information and details on how the program would work.

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# Conclusion

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The market for distressed debt in the US is still developing. The US government and analysts alike believe that banks must dispose of their toxic assets and generate cash flow before they can resume lending activities. The US economy will be impacted for better or for worse, depending on the course the banks pursue, whether to aggressively dispose of these toxic assets or to deal with the assets over time by managing the exposure internally.

Investors, for their part appear to be ready, willing and able to buy distressed assets. Significant amounts of capital have been committed to purchasing these assets, yet deals to date are limited.

While the government's PPIP initiative was expected to help motivate the market, the program has yet to interest buyers or sellers. So in the meantime, little is happening for seemingly rational reasons: sellers don't want to sell into this distressed market, yet investors don't want to overpay for assets they believe have further to fall. Only time will tell what happens next.

# Distressed real estate contacts

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