

## **Guide to Underwriting a Distressed Deal**

### ***Minimize Risk – Maximize Profit!***

**by Patrick S. Simons**

Remember the good ol' days of the RTC? It seemed that back in the early '90's, when they were unloading assets at literally pennies on the dollar, every deal penciled if you could come up with the cash to buy it. In fact, the vast majority of those deals turned huge profits for the buyers.

So, here we are almost twenty years later, and, unfortunately, it looks like a lot of other folks do remember those good ol' RTC days. So much so that billions of dollars have been raised by countless opportunity funds, institutional investors, REITs, developers, and private individuals to pursue distressed assets.

What all this capital on the sidelines means for you is that your margin for error is much smaller than would have been needed during the last major down cycle. As an example, I was recently involved in the bidding on a large lender-owned offering that ended up receiving a few dozen bids. The cutoff for the best-and-final round was set at around a 5% cap on current income, and there were about a dozen bidders in that range. I don't know how it will work out for the "winner," but I do know that he will have his hands full chasing his investor's return expectations during the coming recovery with its questionable strength and duration.

The key to your future success will be how well you underwrite distressed deals before making an offer and, if you win the bidding war, how well you reassess the deal during due diligence. So, here are some tips for how to do that.

1. **Be Realistic with Your Schedule and Pad Your Contingency** – Yeah, I know it's pretty basic, but it's also all too easy to forget. Remember, you're looking at a *distressed* property. The first cardinal rule of distressed asset management is that everything takes longer and costs more than it ordinarily should. Many of the other tips here address anticipating extra costs, but a realistic schedule is just as important. Of course, if you're either fortunate enough or good enough to beat expectations, then any excess contingency goes right back to your bottom line.
2. **Review Maintenance** – It's no big revelation that most distressed deals have suffered through at least one extended period of debilitating cash flow constraint. Oftentimes, this results in deferred maintenance problems that may be cosmetically masked for a sale but pose the potential for large capital requirements shortly after closing. In addition to a detailed third-party property inspection, thoroughly review the work order files and past capital expenditures for any red flags or discrepancies. And, if you're lucky enough that the current maintenance staff has been at the property for a while, spend some time eager to share their knowledge and professional expertise thereby providing you valuable insights.
3. **Understand the Vacancy** – An unfortunately all too common mistake many buyers make is to overestimate their operational abilities while underestimating the real market vacancy.

Understanding the real vacancy of the relevant competitive properties will ensure that you keep your pro-forma projections realistic and achievable. So, don't just rely on the offering memorandum or a generic market-wide report; make sure you survey the relevant comps in a competitive market area with correctly defined geographic boundaries.

4. **Inspect All Resident Files** – The rent roll is a great start, but it doesn't always tell the whole story. Someone needs to go through each and every resident file to confirm lease terms and other paperwork for each resident. Not only will this help you accurately assess how many expirations to anticipate each month during your first year of ownership, it will also help you identify potentially expensive problems such as missing leases, missing deposits, or additional “mystery” occupants not on a lease.
  
5. **Be Realistic with Your Value-add Plans** – It's only too natural to look at a distressed deal as a lucrative diamond-in-the-rough that just needs the right (aggressive) business plan in order to reap huge returns. While this can sometimes be the case, it is not always a safe assumption. Even the best conceived business plan executed by the most experienced professionals will ultimately be limited by the performance of the immediate market. So, if you're buying a distressed Class-B asset, and you're budgeting a simple cosmetic renovation plan, don't underwrite your stabilized rents at the same level as the rents for new Class-A properties.
  
6. **Know the Market** – The market is more than just vacancy and rents. No understanding of the market is complete without knowing how competitive properties are structuring concessions (all up front or pro-rated?), what premiums are supportable (views, floor-by-floor, short-term leases, etc.), and what opportunities there are for other income (parking, storage, and pet rent to name a few). Some of your findings will boost income while others will reduce it. Either way, it's better to go in pricing a deal knowing whether or not you're actually going to get parking income, view premiums, etc.
  
7. **Review the Delinquency History** – You may have great experience in getting residents to pay, but oftentimes the previous owner of the distressed asset may have tried to keep the occupancy up by looking the other way when residents failed to pay timely. Go through the delinquency report for each month, and note whether several units are “repeat offenders.” Also, note how much delinquent rent is written off each month. You'll need to budget accordingly since it takes at least a year, sometimes two, to significantly change the resident profile of a property.
  
8. **Don't Base Rent Growth Assumptions on the Past** – This tip has never been more pertinent than today. The economic conditions that created seven and eight percent annual rent growth in some markets don't exist anymore, and may not again in the foreseeable future. So, it's very dangerous, especially if your business plan is dependent on growing income over a defined period prior to a targeted disposition date, to plug in future rent growth based on past market performance. Ultimately, rent growth depends on tightening of the supply-demand ratio, and that depends on future job growth and construction among other factors.

9. **Review Historical Expenses** – With apologies to Sinatra and Elvis, don't fall into the trap of thinking "I'll run it my way." Combing through the monthly expenses for the past two years will help you identify any unusual expenditures that could reveal operational areas you need to address in your budget going forward. Some examples are atypical utility fees you may not ordinarily budget, seasonal expense shifts (especially in markets with potentially severe weather seasons), and unit turn costs that might be indicative of problems with the resident profile.
10. **Research All Code Violations** – Oftentimes, the bankruptcy and foreclosure process is messy and lengthy. During that chaotic period, it's not unusual for a property to be cited for code violations. Paying a call to the local building or housing department can help you find out two important things: first, whether there are any outstanding capital improvements you will need to address right away; and second, any recurring physical issues for which you should budget.
11. **Assuming Any Liabilities?** – Make sure your transactional documents estop potential obligations from any outstanding litigation or existing contracts. Also make sure that the current owner's insurance carrier is not disputing any current insurance claims. Of course, if there is any possibility that you will have exposure on either of these fronts, budget time and money accordingly.
12. **Review Existing Concessions** – Just because concessions are not being offered currently doesn't mean that they weren't offered in the past (sometimes, very recent past). A review of both the rent roll and the lease files will show how many leases received free rent or other freebies. It's especially important to understand how the concessions were granted such as one month free up front or a pro-rated rent discount for example. Some concessions are easier to "burn off" than others.
13. **Examine the Existing Lease Form** – This is one of the areas of highest financial impact. Think about it; if you're buying a 100-unit property, you're inheriting 100 separate financial contracts both obligating you and restricting your actions. If the standard lease terms are too loose, it could take a couple years and a lot of money to work through some bad residents or less than favorable economics. Not impossible, but you just need to budget adequately for it.
14. **Run Sensitivity Scenarios** – Last, but definitely not least. Not only does each distressed deal have several moving parts (many discussed here), but so do the national and local economies. So, what's the outcome if the 10-year Treasury hits 7% and occupancy dips to 90%? Or what if expense inflation jumps to a 6% annual rate but rents only rise 1%? Does the property stay afloat? It's prudent to analyze several combinations of positive and negative assumptions.

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