San Francisco
Business Times
SAN FRANCISCO • EAST BAY • PENINSULA • NORTH BAY

September13–19.2002

UNPLEASANT VIEW: Trouble ahead unless market improves, say bankruptcy attorneys Bayer, Shier.

Foreclosures foreshadowed

Lenders fire warning shot

BY STEVE GINSBERG
sginsberg@bizjournals.com

The foreclosures are coming.

Lenders may be another three to six months away from snatching up distressed commercial real estate, but an early warning sign suggests they will if the Bay Area slump continues.

The evidence: So-called "deed in lieu of foreclosures" have begun cropping up. In down real estate cycles, they

See FORECLOSURES, 37

CONTINUED FROM PAGE 1

are seen as precursors to foreclosures.

Some second-tier and hybrid lenders are losing patience and taking deeds from their borrowers to gain title to property, according to developers and bankruptcy attorneys. The lenders then try to perform their own non-judicial trustee sales of the property or sit on them awaiting a real estate recovery.

These deals are hush-hush to protect lender and developer from the public embarrassment of bad loans stemming from bad real estate transactions. Such below-the-radar foreclosures avoid high legal costs, but are often seen as a precursor to more formalized court foreclosures by bankruptcy attorneys and some developers.

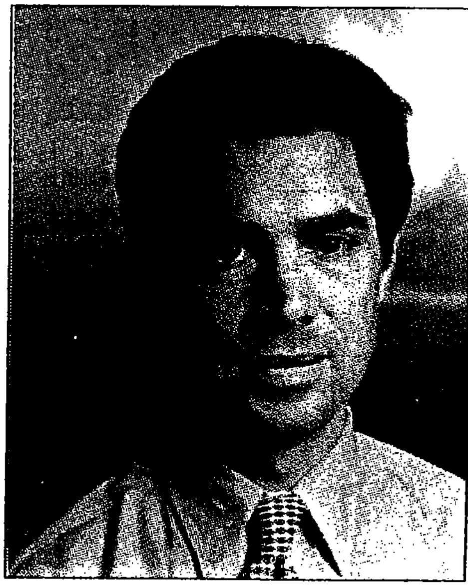
Last week, developers in San Francisco and on the Peninsula were quietly presented two properties that a lender had taken back in a deed-in-lieu-of-foreclosure agreement. The lender's properties:

■ A $38 million, partially entitled piece of land in San Francisco that is for an office/retail building.

■ A $22 million Silicon Valley research and development project that is 50 percent vacant.

Bids were due last week, but sources would not reveal the lender or specific properties because of confidentiality clauses.

"The R&D building is worth about $4 million, but the lender wants to walk away with between $10 million and $12 million," said the president of a major development company. "These deed in lieu of foreclosures signal the start of the foreclosure wave. I saw it in the last downturn. It usually means the flat-out foreclosures are a year out."



JOE HAKIM

GRASSI: Developers seeking capital.

The executive said deed in lieu transactions are being done now to qualify for 2002 tax-year benefits.

No high-profile Class A office properties have been foreclosed on in 2002, although residential developer Kent Swig lost his Natoma Street highrise condominium project in San Francisco last year when Prudential formally foreclosed.

Low interest rates have kept developers in their projects, but as the months grind on with high vacancies and low rents, the pressure is mounting especially on those who bought their properties at the height of the market in 1998 and 1999.

'Dance of death'

Bankruptcy attorneys and vulture investors report they are getting increased work because of distressed real estate.

Pinnacle Law Group's Matt Shier is working seven real estate-related bankruptcy cases from both the debtor and lender sides compared with just one case a year ago.

Despite the activity, most lenders are not eager to take back properties because the market is so poor, Shier said. Once they take possession, it is difficult to get their investments back through resale. He said appraisals on capitalization rates and building values are in flux, and debtors and lenders are not often in agreement.

Noted his partner Ted Bayer: "Unless there is an improvement in the next six months, we will see foreclosures. Today's developers are not as highly leveraged as they were in the late 1980s, but there is only so much that they can sustain. If you had a single tenant who goes bankrupt, you have a problem."

Bayer and Shier are recommending their clients don't do deed in lieu of foreclosures because they don't have the protections of a court action.

John Grassi, founder and president of Spear Street Capital, started his San Francisco investment firm to provide capital to distressed landlords seeking to save their properties.

"I get calls weekly from developers looking for capital to make their lenders happy," he said. "Lenders don't like foreclosures. They are messy, scorched-earth situations. What we have now is the dance of death, prior to actual mortality. There will be some outright foreclosures."

Not this time

Some developers are confident that the foreclosure wave of the early 1990s downturn will not occur this time.

Jack Myers, who developed two buildings in San Francisco in the last three years, argues that times have changed.

"Most players who are part of this market are able to weather the storm. And besides, the worst of this downturn is over. The impact of the dot-com impact has been digested," Myers said. "There has been restructuring and dealing with reality. Foreclosures will be the rare exception."

Steve Ginsberg covers retail and real estate for the San Francisco Business Times. ■

'If you had a single tenant who goes bankrupt, you have a problem'
Ted Bayer
Partner, Pinnacle Law Group

FORECLOSURES:

Lenders quietly put pressure on developers, a sign of possible foreclosures to come