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INVESTMENT STRATEGIES > **DISTRESSED**

Investors Bide Their Time Waiting for Distressed Apartment Deals

Some highly-leveraged investors who bought at the market peak are running out of time and may be forced to sell.

Bendix Anderson | Mar 13, 2023

Before the Fed began its regime to rase interest rates, many apartment investors took advantage of floating-rate loans offered by many private equity debt funds to snatch up assets, often at very aggressive loan-to-value ratios. However, with rates rising and with interest rate caps—contracts in which investors receive a payment when an interest-rate benchmark exceeds certain thresholds—becoming more expensive , many borrowers are facing turbulence as the cost of servicing their large loans has gotten much higher. Worse still, some investors have not hedged their debt costs at all.

"When these deals start having cash calls, refinance needs and anything that requires deeper pockets, we see this being where a lot of forced sellers coming from," says Brennen Degner, co-founder, CEO, and managing partner of DB Capital Management, a private equity group based in Playa Vista, Calif.

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This is why DB and other private equity fund managers are lining up funds positioned to invest in distressed assets that they anticipate will come to the market. Other investors may opt to become limited partners in deals to buy these properties. While others could opt for private equity debt funds being raised that provide "rescue capital" in the form or preferred equity to owners of distressed properties who are still trying to keep them.

Distressed properties already offered for sale

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Sellers are already offering the first apartment properties distressed by rising rates to potential buyers.

"We have seen one large package coming to the market which we looked at last week—almost 1,000 units in Los Angeles," says Henry Manoucheri, CEO of Universe Holdings, based in Los Angeles.

Manoucheri could not share the name of the property being offered confidentially. The prior owners had bought the property a year ago for roughly $400 million. "They put $306 million of debt fund money on the deal. The variable interest rate of 3.5% just went to 7.5%." Universe is likely to pass on the opportunity to buy this distressed property because it falls in a submarket they find less attractive. However, the firm is expecting more opportunities as the year progresses.

“There are many, many, many borrowers who since 2020 got intoxicated on low interest rates—they borrowed up to 80% or 85% of cost,” says Manoucheri. “They didn't really buy any rate caps. Now these deals are completely upside down.”

Universe is considering raising a fund of as much as $100 million for investments in distressed apartments. Universal’s last closed-end fund of $27 million is now invested in five properties. “We're shooting for an overall internal rate of return of 18% for that fund.” The firm will also offer the investors it works with the opportunity to invest as limited partners in the distressed properties it buys.

Investors in distress look forward to the summer

So far, relatively few distressed apartment properties have become available for sale. Sellers took in just $1.0 billion from sales of distressed apartment properties in 2022, according to MSCI Real Assets. That’s down from $2.1 billion in sales of distressed properties in 2021, which included sales of some properties hurt by the coronavirus pandemic.

Buyers with capital ready to spend expect more opportunities as 2023 progresses.

“What we're hoping to see is motivated sellers—distress where sellers are forced to sell in some capacity,” says Yisroel Berg, chief investment officer for multifamily for Harbor Group International (HGI), headquartered in Norfolk, Va.

It’s not yet clear how much of a discount investors are likely to receive. These properties will also have an opportunity to improve the income from these properties. Many owners now struggling to pay the debt service on properties may be forced to deferred maintenance or delay planned renovations.

“If the interest rate had doubled, let's say, you know you don't have money for capital expenditures,” says Manoucheri. “You’re going to use all that money to survive.”

Some of the partnership forced to sell or give up these distressed properties may also be wealth managers who participated in private syndications.

“Some of the largest amount of pain in the multifamily space will come from undercapitalized operators who raised money through smaller private syndications,” says Degner. “These deals were typically higher leverage and often with higher-octane debt given the potentially weaker balance sheet of the operator.”

Some of owners of distressed properties may look for rescue capital from other private equity debt funds that now offer “rescue capital.” These private equity debt funds can also offer other wealth managers who have capital on hand an opportunity to invest in these distressed apartment properties.

“You can go to Walker Dunlop or Pacific Urban Investors or Blackstone,” say Manoucheri. “There are many, many shops that offer preferred equity today.”

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