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What Happens When the Money Well Dries Up

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IRVINE, CA—An apartment investment company that built up a considerable portfolio during the halcyon days of the capital markets is now seeing its fortunes crumble as the financial industry tanks. Bethany Holdings Group, a locally based umbrella firm that specialized primarily in value-add multifamily plays, is now seeing the bulk of its residential property portfolio dispersed to a handful of distressed receiverships.

Bethany invested in its first property in 2004. Over the next several years, the hyper-liquid financing environment allowed the firm to snap up some rather large portfolios. In 2006, the company got a \$159-million loan from GE Real Estate to buy and renovate a 2,873-unit portfolio of properties in Florida, Texas and South Carolina it acquired from Aimco, an apartment REIT. The following year, Bethany was able to reduce its capital costs and replace that floating-rate debt with another GE Real Estate loan—this time for \$156.5 million. That five-year, fixed-rate, interest-only debt included a \$130.5-million CMBS A-note and a \$26-million mezzanine note that GE held on its own books.

Also in 2007, Bethany set records in Arizona when it shelled out \$427.5 million to Greater Phoenix Bascom Arizona Ventures LLC for a 12-property, 5,178-unit portfolio. The firm planned to spend another \$50 million in upgrades to the communities over the next couple of years. At the time, the package was about 91% occupied. Bethany funded that purchase with a kick-in from a private equity investor, as well as 90% financing from Lehman Brothers and a 20% mezzanine piece.

Within five years of its initial purchase, Bethany had grown its holdings to more than 15,000 residential units in some 60 communities across the US that it held through several subsidiaries and affiliates.

A look at the firm today tells an entirely different story. Having filed for Chapter 11 bankruptcy protection, the company revealed that it had to walk away from most of its properties, many of which have since been deemed abandoned by the court system and handed over to a collection of receivers that will manage the communities until the lender officially forecloses on them. The Bethany Group website has been taken down and calls to its headquarters, local offices and even property managers go unanswered or straight to a full voice mailbox.

After several attempts, GlobeSt.com was able to make contact with Bethany Group CEO Gregory P. Garmon. The executive maintains that while there's no denying there were problems, "abandoned" is not the appropriate way to characterize the situation. He relates that the company's management was "working diligently behind the scenes with the lenders, bankruptcy attorneys and local Bethany vice presidents to solidify a smooth transition of our apartments. Unfortunately, we were unable to control the delays from partners' decisions, lender follow-through and legal receivership stipulations in order to spring open the lender bank account lock boxes, where millions of dollars were being held."

Garmon explains that the firm had no access to the funds collected in rents, or capital reserves which would have gone toward payroll and utilities. In fact, the lenders continued to “underfund” operating expenses for months, he says, which led to their deteriorated condition and the company’s inability to pay some of its workers. Referring to its institutional partner, Garmon tells GlobeSt, “Our failure was waiting too long and trusting the outside investor’s promises to recapitalize our company.” The majority ownership buyout stalled, and the firm was left with too little time to put together a “decisive” exit strategy.

Ultimately, the team’s hand was forced, says Garmon. “We ended up with no choice but to wait for lenders to show up and take over,” despite having invested millions of dollars to cover payroll, utility shutoffs, liens and levies, he states. “Unfortunately this went from days to several weeks on several portfolios. When the recap stalled, we had only two viable options: reorganizing under Chapter 11 bankruptcy protection or turning the properties back to the lenders under a receivership.” The firm chose both options; it initiated the receivership process and let go of most of its holdings, while including the rest in its bankruptcy filing.

Receivers are neutral third parties that are appointed by a state or federal court to take legal possession of the property. These groups are never the owners of the assets, but rather, earn fees for their work—protecting the value of the asset that serves as collateral for the defaulted paper. Meanwhile, the lender is shielded from liability because the receiver takes possession of and operates the business, but the lender does have to be prepared to fund losses of the business in order to meet operating costs. All the income generated by the property goes into a receivership estate that the borrower cannot access. Trigild Inc. of San Diego is one of the firms appointed to oversee the Bethany portfolio. Court-appointed receivers typically have to work quickly; assignments can come within as little as 24 hours. And although they act as independent third parties, it’s usually a receiver’s duty to preserve any value remaining in the properties they take possession of, and if possible, enhance the value so the lender—the eventual owner after the foreclosure—can recover as much as possible.

In most cases, the receiver also handles the disposition of the asset. “These are all solid properties with positive cash flow, which represent the very foundation of the lenders’ security for their loans,” says Bill Hoffman, president and founder of Trigild. And in today’s market, he points out, receivers are increasingly able to sell off the properties before they are foreclosed upon. “That’s a strange development in recent years that we haven’t seen before,” he says, adding that’s the case with at least 80% to 90% of the assets. “It makes sense to have the receiver sell the property, especially in downturns, because the sooner you get a property on the market and sell it, the more you’re probably going to get right now. I don’t have any lender client who would say the price would be better if you wait six months.”

Though he admits it’s only a guess, Hoffman believes the former Bethany properties will likely take that route. The receiver can get them on the market within weeks, rather than months, as is the case with the foreclosure and REO process.

Before that happens, however, the firm has some immediate issues to tackle. After having received no maintenance or care for weeks, many of the Bethany Group properties were in dire condition by the time Trigild came into the picture. Local newspapers told stories of trash bins piling up and overflowing at the complexes; the water in some swimming pools turning

thick and green with lack of cleaning; insect infestations; and notices to tenants that the buildings' electricity, water or gas was to be shut off. Further, many employees at the sites, as well as contractors and vendors, had gone weeks without receiving paychecks.

The Trigild team was on site within hours of the court order and within a week or two, there reportedly was some semblance of normalcy for the tenants at the properties. It was also able to get approval to pay former Bethany employees, many of which Trigild retained and brought onto its payroll.

"Legally, I'm not supposed to take what is now the bank's money and pay the borrower's debts, so it's not appropriate for the receiver to pay the borrower's unpaid payroll," says Hoffman. "Nonetheless, most lenders and servicers understand it's for the benefit of the property to be sure we pay and retain these people."

In fact, Trigild immediately gave each worker \$500 to get by with until the payroll issues were sorted out; Hoffman says actual paychecks started going out last week.

As Garmon tells it, the issue here wasn't poor management but rather, the lenders' unwillingness to provide Bethany with the funds it needed to operate the property portfolios—not to mention the fact that most of the capital sources it did business with went through their own collapse. For the majority of the assets, the firm's business plan was to invest \$8,000 to \$12,000 a door in renovations and upgrades. "The real precursor to our demise was due to the amount of high leverage we borrowed with Lehman Brothers," he explains. "Some of these portfolios were 93% to 95% leveraged." The high mortgage levels made the debt service coverage tests onerous, says Garmon. One group of properties, for instance, had to maintain at least a 98% economic occupancy in order to receive the remaining 50% of the capital being held by the lender in order to finish the renovation.

"Our failure was recognizing how the lenders would calculate this funding test prior to signing the loan documents, or before the DSCR Test was given. There was clearly ambiguity in favor of the lenders on whether they funded," he explains. "With more than \$40 million in untapped capital funds that we were paying interest on and no access to the capital reserves, the accounts payables began to rise and the assets became extremely challenged to find vendors and buy supplies to maintain the properties to an appropriate standard."

Further, the lender interest reserves on the property were being wiped out as the lender/servicer tried to cover B- and C-note holders and rent collections in lender-sweep bank accounts totally controlled by the lender/servicer. Those rents were being collected for debt coverage at higher amounts resulting, which cause shortfalls in monthly lender expense reimbursements. "In some cases, toward the end of 2008, the lender wasn't even funding enough to cover the monthly payroll or utilities, let alone to pay any vendor payments," Garmon adds.

In addition to the 13 assets it just took control of, Hoffman says Trigild expects to see more Bethany properties in Texas coming its way in the near future. "Law firms and lenders tell us they have properties they'll need our help on," he says.

Yet those Texas assets—12 in all—along with four properties in Maryland, are part of Bethany's bankruptcy protection filing. The firm hopes to reorganize about 5,000 units, although Garmon notes, "I anticipate that these portfolios will end up in a much different structure than they reside today. We will ultimately be a facilitator and not a successor in this process."

The process of restoring those apartments and paying the employees at those complexes is slow and painstaking. The firm did receive interim approval from US Bankruptcy Court to use cash collateral to pay their expenses on the three Maryland portfolios, including debt payments, utilities, maintenance and payroll—approximately \$350,000 in unpaid wages dating back from Feb. 1. The court handed over property management of the 16 properties to Investor Property Services, which has hired most of the workers that were at the communities.

As Bethany tries to salvage whatever it can from its operations, Trigild's Hoffman is gearing up for an increase in new receivership business. All the highly leveraged financing deals done in the past few years are set to mature over the next couple of years, and lenders aren't willing to refinance many of them. At the same time, owners are dealing with performance metrics that are falling short of their pro formas. The receivership arena started to pick up gradually toward the end of 2007, but Hoffman notes that observers in the banking industry saw the fallout coming prior to that. "The common conversation in mid-2007 was that this bubble will eventually burst, but we don't know when," he says. "The subprime bubble hit first, and then it hit commercial lenders, many of which held bonds in those pools. All the senior people in banking, at least the ones I know, saw it coming, and they told me we'd better gear up" for more business.

The initial pick-up in receiverships was first seen in condo projects because owners are more likely to walk away from their debt obligations since many of them bought the units as investments, according to Hoffman. "On the individual units, a lot of the loans are non-recourse so the borrowers can just walk away," he relates. "In the larger developments, even if the debt is full recourse and guaranteed, the borrower may not have anything left to get at anyway, so the value of the property is really all that's left for the lender."

It then trickled down to the single-family sector, as homebuilders with unfinished or unsold developments fail to meet their debt obligations.

Further, the full impact of creative financing structures and the increased use of securitization in mortgages is yet to be felt in the industry, contends Hoffman. If what he's hearing from lenders is any indication, there will be a massive wave of commercial properties entering the receivership arena due to loan defaults. "From a real estate basis, I don't think we're even near the bottom yet," he says. "If I look at our pipeline—and by that I mean all the projects we've been told to get ready for—we still have a long way to go in terms of getting into that inventory. And it's not going to be easy to dispose of, at least without some very serious discounts."

Once that happens, it will have a snowball effect on the industry, bringing values down across the board, Hoffman notes—but that's not necessarily a bad thing since it will help bring values

down to more reasonable levels and help get the liquidity flowing again. "Say you're a borrower and your loan-to-value when you closed the deal was 80%, but now it's really 120%. It's going to cause a massive shakeout," he says. "But like every other down cycle, there are tremendous opportunities. I have no doubt that five years from now, maybe a little longer than that, we'll all be reading stories about real estate geniuses that amassed great fortunes around the country."