Distressed Assets Market: North by Northwest

It's being said that turbulent times are good for investment deals. It's being said that turbulent times are murky waters, and it's better to avoid going there. What is a real opportunity between these two ideas, the most promising areas in the NPL market for a qualified investor, and what tips this investor should consider? To be elaborated by Louis Amaya, CEO and founder of PEMCO Capital Management.

The NPL market: 2020 outlook

The cracks in the U.S. economy started to appear before COVID-19 in March, laying a foundation for some increase in NPL. However, COVID-19 onset has changed the landscape quite dramatically. The Housing and Urban Development (HUD) HECM auction, initially scheduled for mid-March, was postponed due to a lot of participants' financing issues. From mid-March till June, non-QM mortgage loans and their investors vanished from the marketplace. In the end of June, an increased flow in modified non-performing loans appeared in the market. The reason for re-defaulted loans and REO flow was apparent: some of the larger players started to look at their portfolios and manage risk, liquidating the parts of their portfolios. This ended up in the HECM auction went off on June 24.

The biggest question that industry professionals ask themselves is how the market will look further in the year. The first point to that discussion is that COVID & its consequences will stay for at least 12 months. The latest long-term mortgage default projections from many analysts, is now hovering around the 7% range. A loan product will bifurcate this number with FHA expected to see the bulk of the defaults. However, the long-term number, not a pure projection, will depend on the expiration of the supplemental unemployment benefits that occur at the end of July, a further increase in the unemployment rates, continuing jobless claims, and potential decline in home values. Luckily for the economy, the unemployment rate estimations of 14% in April and 20% in May never came true. In June, US employers added 4.8m new jobs, and the unemployment rate dropped to 11.1%. Still, the Federal Reserve experts expect the unemployment rate to stay in the 9 to 10% range for at least 12 to 18 months. The second straight monthly increase in retail sales reported by the Commerce Department on July 16 is mostly attributed to the government's additional weekly $600 checks for the unemployed, a benefit that is set to end on July 31. The program expiration will leave millions of gig workers and the self-employed, who do not qualify for regular state unemployment insurance, without an income.

"The growing amount of NPL and REO trend will be developing towards the third and fourth quarters. Investors will have more clarity on how the economy is going to pan out after the COVID-19. The HECM auctions will continue. I think that's going to be unimpacted by the COVID issue, as we move forward," says Louis Amaya. He also anticipates increased delinquency on FHA portfolios, based on the FHA lower underwriting criteria, low FICO, high LTD, and a lot of low-income origination, designed to promote homeownership. Those types of loans are more susceptible to the job losses during the COVID crisis. Moreover, the FHA loans are now about 20% of the origination space, compared to about 2% of origination in pre-2008 time.

After the big crash: NPL market healthcheck

The distressed assets environment in 2020 looks stronger compared to 2008. "We'll see a consistent flow of NPL and distressed debt over the next 18 to 24 months. That means a steady flow and lots of opportunities to deploy capital," says Louis Amaya.

2008 distressed market slowdown was caused by the financial crisis, poorly underwritten loans, and slow government reaction. It resulted in a big and fast crash with very steep value declines. In 2020, although the market is going to see an increase in distressed assets, the financial markets are pretty strong. The stock market continues to do well, bouncing back after COVID: the sharp rebound in June was followed by new records in July, with the S&P 500 coming back to the pre-pandemic levels, and the Nasdaq 100 jumping to the most since April.

The reliable health indicator of the property market in 2020 is the home values. It remains steady, there are no indicators of home values crash in the year, with some areas (i.e., California) moving up. Some bubbles may appear in service-related regions such as Las Vegas, since the COVID crisis impacts that.

The second market health checkpoint is the low interest rates. "We're not catching a falling knife, as we used to say when we bought NPL back in those times. These times we had value declines, and we were racing to liquidate or get assets reperforming, because of the drop in the home values," recalls Louis Amaya. These days, distressed assets are coming primarily due to unemployment.

It creates a very stable environment to invest in NPL without some of the swings the market saw in 2008. "It's a great time to be in distressed asset space. There's going to be plenty of opportunities, we have got a stable financial market, and the key is picking the right operating partner that has the experience and track record to manage assets in this type of environment," sums up Louis Amaya.

Where did the opportunities go?

The real hard opportunity that distressed markets give to the investor is to deploy the right amount of capital at strong returns, but not big trade at outsized return. To think of 300-million-dollar trade with 50% IRR means missing the boat, points out Mr. Amaya. It's more about the opportunity to deploy capital at a high mid-teen unlevered return. Still, it's a lot more capital, then the market did pre-crisis.

Another promising segment is the commercial property. In a few March nights, the way corporate America works changed utterly. People started working remotely, and a lot of the big tech firms have just already announced that they're going to keep working remotely indefinitely. Many of the firms start to see the huge savings in real estate costs by not having leases in class A buildings in the most expensive parts of town. Which means there would be a lot of movement, a lot of unknowns, and a lot of opportunities.

Looking for an ultrasonic spaceship, or Accredited investors are welcome

During the last 2 or 3 years, some funds were opening up to the general public. Mostly, it was done through a Reg A offering for the not accredited investors. Anyone can invest $500 or $1,000 into the fund, deploying capital through the operating partner managing the fund. This innovative way to raise capital and get retail investors involved has its downturns. For the accredited investor, the problem is the upside of the transaction, that the Reg A funds generally keep. With a fund offering a preferred of 8%, they're going to keep everything over and above 8% for themselves. These funds are not necessarily scaled to acquire large portfolios. They don't have the infrastructure and the track record of attracting accredited investors.

PEMCO Capital decided to change that, providing an accredited investor with opportunities initially designed and available only for institutional investors. It will be shaped as a Reg D fund, as the distressed asset space is a sophisticated investment, which requires solid qualifications on the investors' side.

The Reg D accreditation pre-requisite is to have an income of at least $200 000 to $300 000 for the last two years or have a net worth of at least a million dollars. The program is designed for the investors who are sophisticated and understand the business aspects. "The reason you want to look for these platforms, because there are a few of them out there, is these platforms built for institutional investors," points out Louis Amaya. "We give the same type of terms to our retail investors as to our institutional investors. One of the reasons people create Reg A funds to deal with unsophisticated investors is to get better terms. And the unsophisticated investor doesn't realize what terms are normally negotiated with an operating partner at the institutional level."

The terms for Reg D accredited investor partners at PEMCO Capital will be 13% preferred, and 80/20 split above the 12% preferred. Compared to giving the investor the first 8% and keeping everything over and above that, that is quite a difference. Reg D also implies smaller fees, the same as for institutional investors.

Mr. Amaya thinks of it as the best opportunity to participate in this market. "We've had a lot of requests over the last several years to open up our platform to the retail accredited investors, and we haven't done that. There's going to be a lot of opportunity over the next 24 to 36 months. That we are launching the Reg D fund, to reach out and partner with some accredited retail investors."

Bonus track: checklist for your operating partner

Fresh-faced and eager "distressed asset managers," thinking of the distressed space and the opportunities when jumping from one industry to another, sometimes decide that this is a great time to deploy capital and get just outsized returns. Those investors generally miss the opportunities that are out there, with many of them not surviving the next cycle. The distressed market is a very sophisticated marketplace.

To pick the right operating partner, you want to look at his track record and history. "You don't want to partner with someone who's just building a platform for this particular environment. You want to look for a partner that is in this space indefinitely," points out Mr. Amaya. PEMCO Capital, to this regard, has never left the distressed asset space for the last 25 years.

A checklist for the operating partner in the non-QM market should include the following points:

- **Track record.** The company is better to be in the market for a few cycles.

- **Infrastructure**. Nationwide broker networks, selling a lot of real estate, nationwide contractor network, different servicers, and the technology to bring that all together.
- **Strong balance sheet.** There should be a decent amount of assets under management or on the balance sheet.
- **It has experience in structuring different types of deals**, either joint ventures, LLCs, trust, and Reg B formats, depending on what the investor is interested in.

Dealing with sophisticated investments to the distressed markets, you better not pick a company that is just jumping into the space because of the current environment. It probably doesn't possess an experience needed.