

# 12 STEPS FOR Evaluating Non-Performing Commercial Real Estate Loans

An NPL portfolio can offer significant opportunities for value creation, but also comes with heightened risks. Here's a systematic approach for evaluating NPLs and NPL portfolios.



## STEP 1

### Understand the Loan Portfolio Composition

#### Type of Assets

Different types of real estate have different risk-return profiles and market dynamics.

#### Geographic Distribution

Location can greatly influence the property's value and ease of disposition.

#### Loan Sizes and Maturities

Larger loans might mean more concentrated risks, while varied maturities can impact resolution and cash flow.



## STEP 2

### Evaluate the Underlying Collateral

#### Property Appraisals

Engage an independent appraiser or get a broker opinion of value (BOV) from a CRE broker.

#### Property Details

Understand the type, location, size and other pertinent details of the property.

#### Physical Condition

Physical inspections can provide insights into the property's condition and potential capital expenditures.

#### Environmental Review

An environmental consultant can determine if the collateral has any exposure to current or past environmental risks.

#### Occupancy Levels

Level of occupancy can significantly impact a property's value and cash flow potential. Review the rent roll, lease terms, and tenant quality.



## STEP 3

### Legal and Documentation Review

#### Loan Documentation

Ensure all loan documents, including promissory notes, mortgages, guarantees, and any modifications or extensions, are in order and enforceable. Obtain a complete set of all loan documents.

#### Title Review

Confirm the property titles are clear of any liens or encumbrances that might affect value or the ability to sell the asset.

#### Legal Jurisdiction

The laws in the jurisdiction where the property is located may help or hinder enforcement of the loan terms.

#### Enforceability

Review the documentation to ensure the loan terms are legally enforceable.



## STEP 4

### Understand the Loan Details

#### Loan Terms

Review the interest rate, original loan amount, maturity date, payment frequency, etc.

#### Payment History

Examine the borrower's payment behavior, duration of default and any previous instances of default.

#### Reason for Default

Understand why the loan became non-performing. Was it borrower-specific issues, property-specific problems or broader economic factors?



## STEP 5

### Analyze Borrower Solvency, Willingness to Cooperate

- Understanding the borrower's financial condition can provide insights into the likelihood of the loan's recovery or restructuring.
- Examine the borrower's financial statements and credit history.
- Gauge the buyer's willingness to find a resolution. Sometimes a cooperative borrower can smooth the restructuring process.



## STEP 6

### Determine Recovery Scenarios, Strategies

#### Restructuring

Consider modifying the loan terms to make it feasible for the borrower to repay.

#### Foreclosure

Understand the legal process, costs, and timeframes to foreclose on the property.

#### Sale or Disposition

Explore the possibility of selling the property or the loan itself to recover the funds.



## STEP 7

### Understand Market Conditions

Analyze local real estate market trends and any upcoming macroeconomic factors that might influence the real estate market.



## STEP 8

### Operational Capabilities

If considering purchasing an NPL portfolio, evaluate your or your team's ability to manage, restructure or work out the loans.



## STEP 9

### Financial and Sensitivity Analysis

#### Discounted Cash Flow

Estimate potential recovery amounts based on expected cash flows. Consider your required return and the time value of money.

#### Scenarios

Run different scenarios (best case, base case, worst case) to understand potential outcomes and risks.

#### Discount Rate

Understand the required return for your risk profile and use it to discount future cash flows.



## STEP 10

### Exit Strategy

- Determine upfront how you intend to exit from the investment— through restructuring, foreclosure, property sales or securitization.
- Determine the costs associated with holding, managing, or disposing of the asset, including legal and property management fees.



## STEP 11

### Engage Experts

If you are new to NPLs or unfamiliar with the local market, consider engaging real estate experts, legal counsel and financial analysts to assist.



## STEP 12

### Due Diligence

Ensure every aspect, from legal to financial to property-specific details, is thoroughly scrutinized to help avoid overvaluation and potential losses.

#### Need help evaluating an NPL or NPL portfolio?

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