

# ColonyCapital, LLC

Recently, **Ryan Mattox**, managing director—North America at Institutional Real Estate, Inc., spoke with **Kevin Traenkle** of Colony Capital LLC. The following is an excerpt of that conversation.

*As we begin coming out of recession, where is Colony seeing the best opportunities?*

There are a lot of interesting possibilities out there, but one of the areas we are particularly focused on is FDIC non-performing loan (NPL) portfolios, a subset of the distressed debt market. These types of portfolios are a unique animal in terms of how you underwrite, value, resolve and monetize them.

*Why do you like this section of the investment world?*

We like FDIC loan portfolios for a number of reasons, all of which tie in nicely to Colony's primary competitive advantages. First of all, these portfolios are large. The sizes of the two most recent portfolios that we acquired were each more than \$1 billion, with more than 1,000 loans per portfolio. Therefore, you need a deep team with the infrastructure to underwrite that many loans, and we do. Secondly, if you don't have the time-tested processes and procedures in place, these portfolios can be relatively costly to underwrite as one-off investments. In addition to the institutional knowledge that we have acquired over the years, our team has the benefit of multiple recent underwritings and current portfolios under management to inform that process and make it as efficient as possible — economies of scale really come into play here. Thirdly, you have a guaranteed seller in the FDIC, who will clear the assets at the prevailing market price. You will never end up in an expensive and time-consuming price discovery exercise without a trade at the end of the process. The list goes on, but ultimately, it is an attractive market opportunity that is here now, and we are making money by executing it. Given the amount of assets that the FDIC currently has on its books and the number of banks that are in danger of failing, we believe that this is an opportunity that will be with us for awhile.

*How long has Colony been involved in FDIC-type loan portfolios?*

Since the beginning. When Tom Barrack founded Colony back in 1991, the first dozen deals that we did were buying portfolios from the RTC, so we have been in the space for nearly 20 years. After our last RTC deal in 1994, we started buying distressed loans and portfolios from some of the European banks. Then in 1997, we established a presence in Asia in a big way to execute the same strategy and ended up buying large amounts of loans in Japan, Korea and Taiwan, where we still have a big presence. I think the last NPL deal that we did, prior to the recent crisis, was in 2005 in Taiwan. So from 1991, consistently through 2005, Colony has been doing some kind of distressed debt deal in the global marketplace.

*How do you add value in the underwriting of those transactions?*

Our value add is the detailed underwriting analysis that we perform; it provides us with a comfort level that is very important when ascribing a value to these portfolios. Through that process, we uncover thousands of indi-



**Kevin Traenkle**, principal of Colony Capital, LLC, is responsible for many facets of the firm's activities including distressed debt initiatives, investment and divestment decisions, business development and global client relations. Kevin also serves as the CIO of Colony Financial (NYSE: CLNY), Colony Capital's publicly traded mortgage REIT.

## CORPORATE OVERVIEW

Colony Capital is a private, international investment firm based in Los Angeles. Founded in 1991 by Tom Barrack, the company focuses on real estate opportunities around the world either on its own, through funds run by the company, or in joint ventures.

## CORPORATE CONTACT

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vidual nuggets of information, which collectively, start to tell a story. After re-underwriting a couple hundred loans that were originated by a particular bank in a particular region and then even by a particular loan officer, you start to get a feel for that bank's or person's underwriting strengths and weaknesses. We see it all the time. Underwriting and valuation have a very important subjective component, and it is hard to obtain that "feel" by simply underwriting a few loans over a brief period of time.

We also add value to the underwriting process through our experience and efficiency. We've been doing this for nearly 20 years, and we pretty much have the process down to a science. Our in-house team is made up of veteran real estate investors with deep knowledge of fundamentals and ground-up analysis gained from decades of real estate investing. The team knows the key issues to look for and focuses on the due diligence items that really make a difference, the ones that can hurt you if you don't get them right. Of the 15 FDIC portfolios we have bid on, we have won four, which is where we want to be. If you win more than that, you may be paying more than you need to be. And for those that we did lose, which is the majority, we weren't out a lot of spec money.

*Is the quality of the assets this time around any different than the quality of assets offered during the RTC days?*

Out of the 4,000 or so loans we have purchased in the last 18–24 months we have not experienced any surprises regarding type or quality of collateral. Since inception, we have owned more than 12,000 loans in different geographic regions collateralized by many different asset types, so we have seen it all. The majority of the banks that are failing today are regional and community banks that lend to local businesses, which is very similar to the S&Ls that failed in the early '90s. The quality of assets can vary greatly, but so does the pricing. One thing that we like about these government-auctioned portfolios, is that they typically cannot be cherry-picked. You must take the good with the bad — you just need to make sure you

price each accordingly. To that point, the prices for the four portfolios that we have purchased so far range from 44 cents to 68 cents, a clear reflection of the quality of the loans in each of them. Operationally these assets are not facing as cataclysmic a supply-demand imbalance as we saw in the 1990s, so the path to performance is clearer.

*It seems everyone is talking about getting into the debt business and bidding on NPL portfolios. Does the competition worry you?*

I've heard of lots of groups that are saying they are focused on this area, but I'm skeptical. There are only a handful of firms that have the in-place infrastructure and experience to execute this strategy effectively. Many people underestimate the commitment required to run a small-balance loan operation. For instance, when the FDIC first started selling these loan portfolios, there were 30 bidders showing up at those first auctions. We'd often look at many of the other bidders and wonder. "How in the world is that group underwriting this portfolio? They know nothing about real estate; they know nothing about the NPL business; they know nothing about the resolution process for these small, commercial real estate assets. How are they doing it?" People might think it is easy, but I would save that judgment until after you have done it. Although a healthy pool of qualified investors remains, and the FDIC has done a great job structuring these transactions in a way that makes them affordable to a wide number of players, the costs associated with the proper underwriting of these portfolios can clearly take a toll on firms that do not have an established infrastructure.

*How exactly do you make money on these portfolios?*

There are many ways to make money in this business. For sure, pricing the portfolio right and making money on the buy is a big component of the profitability. But more importantly, it's how you constantly de-risk and actively manage the overall portfolio that matters most. I cannot emphasize enough how critical the "day two" asset management is for profitable execution of this business plan. In-house asset management is absolutely key. It is a very demanding job to manage huge portfolios of performing, subperforming and nonperforming loans. After acquiring a portfolio, we perform triage to identify the low hanging fruit that can be easily monetized. Then, we move to the truly performing loans on decent collateral with low LTVs and good DSCRs and put them in a drawer, collect an attractive coupon or sell them for a premium in the secondary market. Lastly, we get to the sub and nonperforming loans, our high-touch situations. Our real value-add comes from this last category of loans. We've found that there is a lot of liquidity even in some of the hardest-hit markets for these small-balance loans and assets. Many times we are dealing directly with our borrowers to reach mutually agreeable resolutions. We have a dedicated asset management team that handles just the FDIC portfolios. It's a big team today and, as we continue to ramp up our acquisitions, we will likely be adding around 25 more people to the platform over the next 12–24 months.

*How do you protect the downside?*

These portfolios are huge and usually diversified by borrower, product type, market exposure and tenant mix. Seldom does a single loan make up more than 1 percent of the portfolio, so it is very difficult to be hurt by any individual failure within the portfolio. In addition, when you are buying a first mortgage interest, it's an extremely safe position within the capital stack. The

1st mortgage lien holder is usually the first in line, after taxes of course, to collect from even the most painful of fire-sales after a foreclosure. We also find these relatively modest loans attractive because there is a high proportion of borrower credit enhancement through recourse and guarantees and the relatively small loan balances provide higher likelihood for borrowers to obtain liquidity to help us generate profitable solutions. Historically these portfolios have generated some of the highest risk-adjusted returns we've ever made.

*What has your performance been to date?*

We bought two portfolios in the spring and summer of 2009, and we've already resolved around 40 percent of those loans at prices that, in the aggregate, were much higher than we had initially underwritten. Since then, the FDIC instituted a different format for divesting itself of the loans it is taking in through receivership. The first portfolio that we bought under this new structure was in January 2010, and we have been very pleased with our experience in negotiating favorable workouts, well ahead of our expectations. The last portfolio that we won was just two months ago and was comprised of better quality assets than the first structured portfolio. Although still early, by all indications this should be a very profitable acquisition as well.

*Why are you doing this at this time, when the loans are relatively small and there are larger, better-quality assets coming in the future? Why not wait for those to come?*

Attractive buying opportunities for these smaller balance loans are here right now, and you can pick them up at very attractive pricing. On the other hand, we are also actively pursuing the larger single loans that are collateralized by the more institutional core assets. However, unless the seller is unwilling or unable to widely market that position, which does happen, these processes tend to be competitive with no one participant having a competitive advantage other than a cheaper cost of capital or a clearer crystal ball.

With respect to the FDIC opportunity in particular, we believe the time to act is upon us because the government is a very real and sizeable seller. We have a considerable advantage through our long history in transacting with government agencies, and we have been one of the first investors to learn how to work with the FDIC as a seller and partner, which is a different proposition from most conventional private transactions.

Another reason we are in the market now is because we believe that the opportunity that most people are waiting for is already here — they just don't know it yet. The proverbial tsunami of maturing debt that will overwhelm the system within the next three years just isn't going to happen that way. The governments, banks and the special servicers are orchestrating an orderly deleveraging scenario that will take place over a longer period of time. With interest rates near zero, they should be able to achieve that goal. We believe we are already knee deep in opportunities, and there is plenty to do right now at attractive prices. The Federal Government, including corporations within it such as the FDIC, has the tools to control the flow of distressed product hitting the market, including accounting, regulatory, monetary and fiscal policies. Therefore, we don't believe these assets will get any cheaper in the future or that we have entered the market too early. We believe the most profitable stage of the cycle is right now and, if you wait until it becomes clear to all, then the opportunity will surely have already vanished. ♦