Understanding REO Risk Management Strategies

By Don Neff, President/CEO, La Jolla Pacific
April 2009

Upon first glance, a distressed real estate asset can be overwhelming. What did I just acquire? What do I have and what is the current value? What do I do with this, hold, sell, or improve the property? There are different levels of risk associated with each of these options. In order to make the process more palatable, let's break this down into smaller bites.

First, let's assemble all the critical risk elements and physical attributes associated with a property. Now we are going to reduce that tangled pile of legal, technical, engineering, financial, construction, sales/marketing, and warranty information down to the essential bullet points of cost and contingent liability. Finally, let's organize it into the development timeline of pre-construction, during construction and post-construction project needs.

Phase two of this exercise includes a review of legal and contractual liabilities, analysis of inconsistent or overlapping project insurance coverages, assessment of SB800 litigation risks, proactive entitlement due diligence, and estimated costs to build out the project across all five potential asset categories. Those categories include: 1) approved paper lots; 2) blue-topped rough graded lots; 3) partially finished lots; 4) partially finished houses; and 5) completed houses. Distressed or foreclosed assets falling within the first two categories are easily disposed of through bulk sales, given a willing buyer and seller for mutually agreed upon terms. The last three categories of these assets pose a more challenging dilemma for the REO asset manager, as discussed below.

Partially finished lots may have little value depending upon the condition or completeness of their improvement. Improvements not well constructed or now deteriorating from natural or man-made causes will need to be removed and replaced at a (potentially) significant greater cost than if completed with the original construction phasing. For example, we have seen street sections required to be fully reconstructed due to a missing final lift of asphalt; the lack of which prevented rain water and run-off from entering the flow line in the gutter. These drainage flows traveled onto and deteriorated the base course of asphalt adjacent to the edge of the gutter.

The problem becomes more acute with the fourth asset class - partially completed houses. In a state of incompleteness, these vacant houses are an attractive nuisance and become magnets for theft, all of which can further deteriorate a neighborhood. One needs to assess and quantify the different stages of construction and recognize what is salvageable and what must be torn down. For example, is that house partially or fully dried-in, or is it exposed to the weather on one or more sides? What is the condition of the building paper? Is the house dry-walled and stucco-ed? Estimated costs to complete will vary with each of these conditions.

The fifth asset class consists of completed inventory homes waiting to be sold. Their situation is unique. While constructed per approved plans, permits and industry standards of care, these homes may remain unoccupied for 1-2-3 or more years and buyers of these homes may be first timers stretching financially to achieve homeownership. Warranty service becomes a critical concern when, for example, AC compressors are sold in a "new home" which is actually already three years old. Rubber seals in the plumbing systems may malfunction. Homes sitting idle may have developed mold and fungus problems where slow leaks from nails penetrating copper or PEX-type water supply lines silently grow without notice, since no one is around.

A swat team of experienced, litigation risk-oriented construction personnel is one good solution to these problems. A comprehensive property condition assessment report followed by a comprehensive pre, during, and post-construction risk mitigation strategy will go far in reducing risk exposure and also serve to stabilize and maintain the value of these real estate assets.