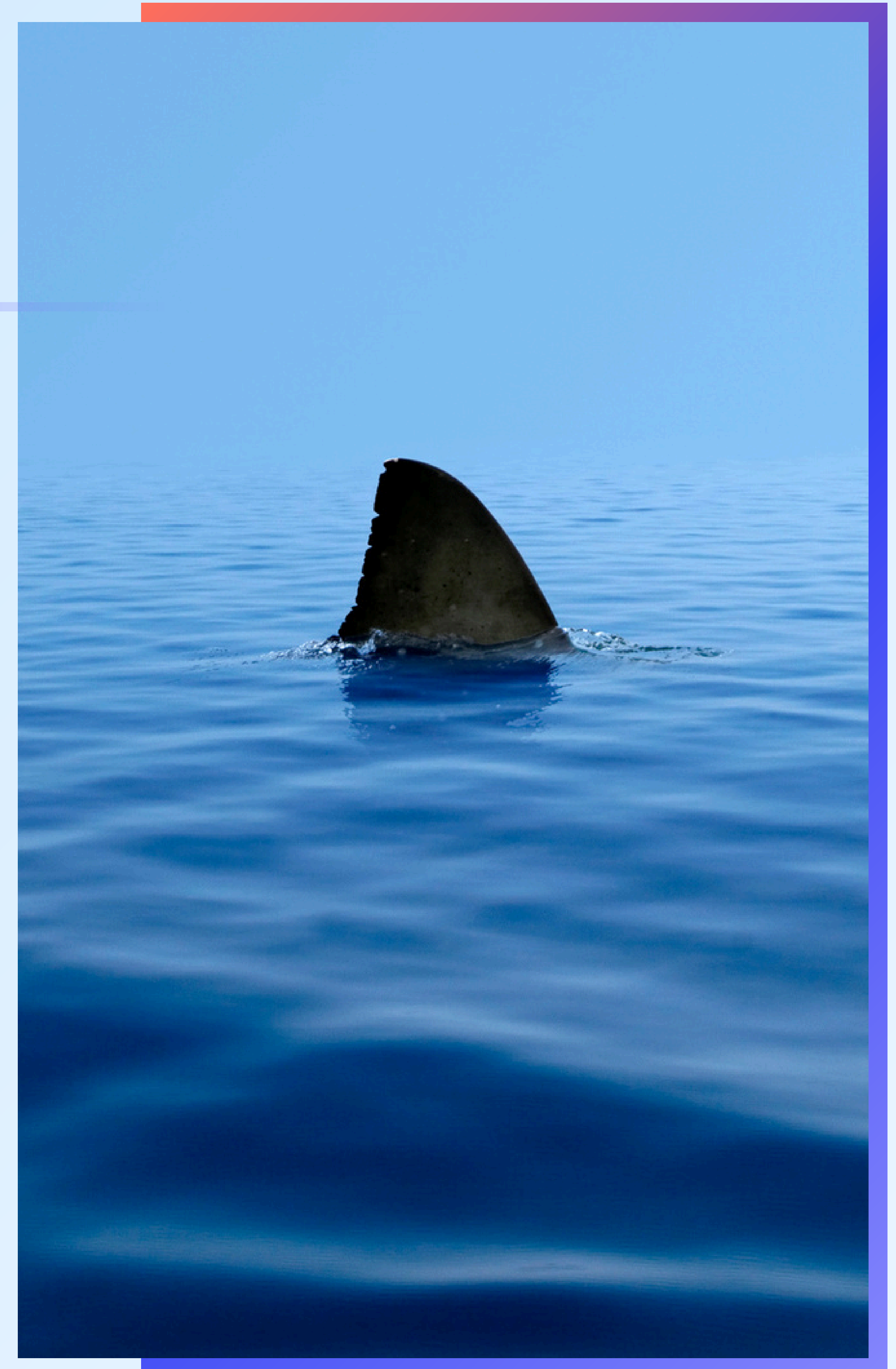
SitusAMC

# What Looms Beneath the Surface

## How Forensic Diligence Builds on CRE Asset Management to Uncover & Mitigate Deeply Hidden Risk



# Introduction

With commercial real estate (CRE) distress on the rise and a wall of maturities looming, lenders and asset managers need to be on guard against rising risk in their portfolios. Between the timely mortgage payment and default, a range of issues can occur, which may be outside asset managers' typical scope of work. Unless asset managers have experience in forensic accounting and specialization in distressed CRE assets, risk can often go unseen, especially deeply hidden risk factors.

To guard against risk, lenders and asset managers must understand what can go wrong and when to take a deeper dive into a loan or portfolio. In this white paper, we explore deeply hidden risk factors and the best way to approach identifying and managing these risks in your portfolio.

# Risk Areas In CRE Loans & Portfolios That Often Go Overlooked

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## Financial Inconsistencies In The Balance Sheet: Look Beyond NOI

The first common area of risk is Net Operating Income (NOI). NOI is the gold standard to determine the profitability of an income-generating property, providing a high-level perspective on the health of an asset. But relying solely on NOI does not provide a complete picture of an asset's financial health. Seasoned forensic accountants will look beyond NOI to uncover potential financial anomalies. This requires a dive deep into monthly balance sheets, income statements, bank statements, general ledgers, rent rolls, accounts receivable and accounts payable to uncover inconsistencies.

Forensic accountants are trained to follow the money trail on an ongoing basis through bank reconciliation, looking at deposits and withdrawals. They identify unexplained changes in assets and liabilities.

This analysis positions the lender to hone in on discrepancies that can be resolved through deeper exploration of financial reports.

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## Misappropriation of Cash

A second common area of financial risk is the misappropriation of cash. When distress occurs, and loan covenants are not met, it typically triggers cash management. All revenue, including tenant rents, are swept into a lender-controlled lockbox. Funds are disbursed to the borrower to pay monthly operating expenses, typically based on an approved budget. Lenders often feel confident they have trapped the cash and trust that it will be spent on property operations. But sometimes that doesn't happen.

Borrowers may fail to pay vendors, a red flag that can be evidenced by an increase or plateauing of accounts payable, despite cash injections. There have been instances in which borrowers have misdirected funds to pay for unapproved travel and entertainment, legal fees, vehicles – even medical expenses and children's college tuitions. In addition, borrowers may spend the funds to pay expenses of other properties they own to avoid additional distress in their portfolios. Depending on the size of the property and how long the problem endures, financial leaks caused by misappropriation can snowball into hundreds of thousands of dollars.

Misappropriation can also occur in the other direction, when income is introduced that is not tied to the asset in question.

For example, in one instance, SitusAMC discovered a $150,000 deposit that came from the settlement of a legal suit filed years before the default. The borrower had the settlement wired to the property's operating account instead of the lockbox. The lender was unaware of the lawsuit, and only caught the issue because forensic accountants were combing through bank statements. Finding that anomaly allowed the client to reduce the next month's cash release by $150,000. In other cases, there may be a real estate tax appeal in process that yields a refund. Because of the Covid-19 disruption to county government offices, some appeals have taken years to resolve. Those kinds of situations won't be discovered without reviewing the property's bank statements.

To prevent these losses, forensic accountants do a deep dive into the books and records that support the monthly financial statements to track what's being paid from operating cash. If misappropriation of cash is uncovered, the lender can either recoup the funds -- in the case of a recourse loan -- or take back the property through foreclosure.

CASE STUDY

## We Helped an Asset Manager of a Hotel Identify Misallocated Funds Through Deep Financial Analysis

### The Opportunity

An asset manager responsible for monitoring the cash flow of a hotel asset had concerns that property management was misallocating corporate overhead costs.

### Our Approach

The loan agreement gave the lender had a right to inspect the property's financial records. Armed with those records, SitusAMC interviewed the property manager and accounting personnel to understand the nature of the corporate costs as well as the methodology for allocating those costs. We developed a document request list that included financial reports such as balance sheets, income statements, detailed general ledger, vendor invoices and contracts and a schedule of allocated costs for the last 12 months.

### Client Outcome

Through our forensic analysis, we found that the property manager used inconsistent percentages to allocate corporate costs with no backup to support the inconsistencies. We concluded that approximately $250K was overallocated to the property over the last 12 months. The lender used the analysis as support for requiring the borrower to replace the existing property manager and to negotiate additional language in the loan agreement that required the borrower to have oversight of property management and accounting.

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## Guarantor Financial Instability

A third area of hidden risk lies in the guarantors of the loan. At the inception of a loan, lenders will typically validate guarantors' net worth and liquidity, to be sure they can support the loan, if needed. Once a loan is closed, a lender will typically seek certification on a quarterly basis. But this does not involve a comprehensive look at financial statements. In fact, most certifications simply ask the guarantor to state if they are still able to support the loan and do not require any proof.

In the current climate, it's prudent to validate the guarantors' current liquidity and net worth by scrutinizing bank and investment statements, cash positions, partnership interests, mortgage statements, property appraisals, tax returns, etc. If the guarantor is not positioned to support the loan, this can trigger a covenant which positions the lender to request additional financial backing from the guarantor.

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## NOI Inflation

A fourth area of risk, NOI inflation, occurs when the borrower either hides or shifts expenses below the NOI line. Expense items that were moved below NOI at time of the origination can come back to bite the lender as they obscure the true picture of the asset, and can negatively impact ongoing asset management.

One example is reflected unit turnover costs in multifamily properties. These costs involve routine repairs, such as carpet cleaning and painting, performed when the apartment is prepared for a new tenant. Borrowers will often reflect these costs below NOI, which inflates it. Unit turnover costs should be included in NOI and consistently reflected as operating expenses in financial reports.

# What To Do If You Feel Your Portfolio Is At Risk

## Start Early

The journey to uncovering financial risks often begins when asset managers feel something is awry. Conversations with the borrower have been different lately; they're avoiding emails or evading questions about financial reports, occupancy or other issues. The asset manager senses something could be wrong. That's the moment to engage a forensic expert to begin scanning monthly bank statements and reconciling them to financial reporting -- to help confirm or refute the asset manager's hunch.

If lenders are concerned about risk in their portfolios, it's critically important to dive in right away. Dig into financials when loan covenants aren't consistently being met and continue to monitor through foreclosure. Timing may vary, but best practice is to begin the in-depth review at least six to 12 months prior to foreclosure.

At SitusAMC, our engagements typically kickoff with a phased approach and scope to determine what level of forensic diligence is required.

## Bring in the Experts

Financial institutions are not in the business of owning properties.

That's why experts with an accounting and investigative mindset are particularly valuable in distressed situations.

Forensic diligence helps everyone understand hidden threats. With better clarity, lenders can minimize exposure to the risks of distressed assets; set the table for a potential workout conversation; and mitigate financial risk when they decide that taking back the property is the only option. In-depth forensic diligence can assist in determining reserves or estimating loan losses. Overall, forensic expertise is crucial to help identify deeply buried risk factors that could negatively impact loan value and business profitability.

# Risk Is Everywhere.
# We Help You Spot It.

As distress in commercial real estate rises and maturities loom, lenders and asset managers need to be vigilant against the rising risk in their portfolios. Forensic diligence is essential to uncover deeply hidden risk factors that may go unnoticed by asset managers. Financial inconsistencies, misappropriation of cash, guarantor financial instability, and NOI inflation are some of the risk areas that often go overlooked. Starting early and bringing in experts with an accounting and investigative mindset can help lenders and asset managers understand hidden threats, minimize exposure, and mitigate financial risk when they decide to take back the property.

## About SitusAMC's Financial Diligence & Forensic Analysis

SitusAMC's Financial Diligence & Forensics Analysis Solutions provides CPA-led forensic diligence to proactively identify and mitigate risk in large, complex loans and portfolios. Our team works hand-in-hand with participants across the debt and equity spectrum, including CRE operators, banks, management companies, special servicers and law firms, to conduct comprehensive analysis. We scrutinize financials and identify deeply buried risk factors that could negatively impact loan value and business profitability.

### To learn more, contact:

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