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Loan Workouts
Part 4 – Sage Advice

You have to love Warren Buffett. If nothing else, he produces some of the best one-line words of wisdom ever spoken – at least in the realm of investment. His business advice is unmatched in its simplicity and unsurpassed in its value. Though he typically gives advice on investing in business equities, much of what he says easily translates to commercial real estate. That makes sense. While commercial real estate investment is certainly about real estate, it is equally about business. Big business. And the problems facing commercial real estate investors, developers and lenders today are not actually *real estate* problems so much as they are *business* problems. As business problems they require business solutions. Real estate has not changed. The business of real estate has changed.

Three of my favorite Warren Buffett quotes (and there are many) are found in *The Tao of Warren Buffett*, by Mary Buffett and David Clark (Scribner, NY 2006). It's a great read. Buy it.

> *"A pin lies in wait for every bubble, and when the two eventually meet, a new wave of investors learn some very old lessons".*
>
> *"You want to learn from experience, but you want to learn from other people's experience when you can."*
>
> *"You don't have to make money back the same way you lost it."*

My commercial real estate practice is dominated at the moment with clients and projects in financial distress. Fortunately – or unfortunately, depending on your point of view – because I have been in practice over thirty years, this is not the first time I have represented a wide range of commercial real estate investors, developers and lenders work their way through a serious real estate recession.

Here's a basic truth: What worked two, three or four years ago probably doesn't work now – especially if you were momentum investing based on rising property values instead of value investing based on discounted cash flows. For momentum investors, the current momentum for commercial real estate is headed down and is not expected to hit bottom for another two to three years. If you are relying on rising commercial real estate values, the momentum is against you. Pretty much like trying to swim against a rip current. Try not to panic, but if you don't swim quickly to the side, it could kill you.

Even value investors should stop and think. Can the revenue stream you are relying on to establish value be sustained? Most indications are that while we may be near the bottom of the residential housing bust, challenges in the commercial real estate sector have only just begun.

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Until unemployment stabilizes and starts to decline, and housing prices stabilize so consumers stop feeling poor, consumers are not likely to increase spending in any significant way. Until consumers increase spending, retailers and service providers (think office workers) will continue to suffer, and in some cases will fail. If they don't fail, many will continue to downsize which, of course, adds more fuel to the unemployment fire.

As retailers and service providers fail or downsize, commercial space will become vacant or, at least, underutilized. They won't be acquiring new space or expanding until they are again fully utilizing the space they have. That's not likely to occur until consumers have begun to feel confident and start spending – and do so for a long enough period, and in big enough amounts, that the retailers and service providers regain their financial footing and feel confident that the consumer part of this recession is over and a consumer lead recovery is in full swing. At that point, we will be at only the beginning of the commercial real estate recovery.

For commercial real estate developers, investors and lenders to recover, not only do retailers and service providers need to expand, they need to expand enough to re-fill the huge number of retail and office vacancies that exist today, and which are likely to become more prevalent until the commercial real estate downturn hits bottom. With so much vacant space available, the bargaining advantage will be with the new or expanding tenants. This means rents are likely to be lower and, in turn, that net operating income is likely to be lower. Applying the often used cap rate method of valuation – even if we apply the historic low cap rates of the past few years – this will result in property values being lower. To compound the problem, capitalization rates are rising as investors seek a higher yield to cover what they perceive to be higher economic risk. Real estate values move inversely to cap rates. With cap rates up and net operating income down, commercial real estate values will continue to suffer a double whammy.

It is going to take a long, long time to get back to where we were. Consequently, commercial real estate loans are going to continue to be upside down, leaving borrowers and lenders in trouble unless they find a way to work together to right the ship.

As lenders and borrowers see the light and conclude it is in their mutual best interests to work together to get through this mess, I want to caution borrowers once again to be mindful of the dangers discussed in my prior article, *Loan Workouts, Part 3 – Call to Action*. It is not that lenders cannot be trusted. In fact, they can be trusted. But what they can be trusted to do is to act in a manner that is consistent with their own best interest. If you keep that in mind, always, you can workout a solution that protects your interests as well. If you are lulled along until your lender doesn't need you to get out of its loan without a loss, you are virtually certain to sustain a loss. The time to make your deal is now – while you both need each other.

It has been observed that in the current economic climate, commercial real estate lenders have three basic choices when it comes to dealing with distressed commercial real estate loans. Simply stated, they can extend; amend; or pretend.

Some will say they have a fourth choice, which is to sell their distressed loans. I discuss that option in greater detail in my next article, *Distressed Note Transactions – Panacea or Poison* which will follow shortly. Until then, let me just say that it is the "pretend" choice that creates to greatest obstacle to successfully buying or selling distressed loans.

So that we are on the same page, let's review the three basic choices in the order stated: EXTEND; AMEND; or PRETEND.

<u>Extend</u>: If a loan is essentially performing (that is, if at least payments are being made on time), the lender and the borrower can buy time by extending the loan term and hope the loan can continue to perform until the economic climate improves to the point where the lender can get paid off through a sale or a refinance of the property. If the loan is not in default, and the only problem is that it is maturing, this may be the best solution. Tip to Borrowers: Right now, lenders really don't want any more defaulted loans. You have some leverage. Fight to get yourself a long enough extension to have a fighting chance to come out of this alive.

<u>Amend</u>: If the loan is in default, or about to go into default, merely extending the loan may not be an adequate solution. You may also need to amend the loan terms. It is in the interest of both the borrower and the lender that commercial real estate loans not be in default – especially not as to payment. Especially now.

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Some lenders will focus on all events of default – even *technical defaults* such as failure to comply with loan covenants like debt coverage ratio, or loan to value ratio. *Question*: Today, at this point in this real estate recession, does it make sense to declare a technical default when the loan is already fully funded?

You may not agree, but it seems to me that a lender calling a loan in these challenging economic times by declaring a technical default because of a blown debt coverage ratio (DCR) or a non-compliant loan to value ratio (LTV) stands, in virtually every case, at the height of blind stupidity. How is this an exercise of sound and safe banking practices?

Let's be real. If you are a commercial real estate lender and have a required loan to value ratio on a fully funded loan of .75 to 1.00 (75% LTV), but because of market conditions the collateral value has declined, resulting in the loan equating to 90% of value – or worse yet, 120% of value (your loan is "upside down") – do you, the lender, really want to call the loan if your borrower is nonetheless making all payments on a timely basis? What is the upside for you if you do? What are you going to do with the property if you foreclose on it? Do you think your borrower can refinance the project? Do you think it will be easy to sell? Do you really want to own it and be responsible for managing it and maintaining it? Alternatively, do you think you will collect on the guaranty? Forget the financial statement you received when you made the loan; have you considered the current financial condition of your guarantor?

Similarly, if a loan covenant requires a DCR of 1.20 (i.e. net operating income equal to 120% of required debt coverage payments), but the borrower has vacancies or delinquent tenants resulting in net operating income being 1.00 to 1.00 (i.e. net operating income equal to required debt coverage payments), - do you really want to call the loan if your borrower is current on all required payments? How are you going to be any better off?

Worse yet, what if the existing debt coverage ratio is less than one, but somehow the borrower is still finding a way to subsidize the project and make its payment? Are you sure you want to declare a default?

What if, even worse, the borrower cannot quite make the full payment but is willing to essentially work for free by continuing to manage the project? The borrower may be willing to do this to protect itself from liability on a guaranty, or perhaps even in the hope it can hold on until the economy recovers sufficiently to enable the investor/ borrower to sell the project for an amount sufficient to recover part or all of its equity investment. Are you going to maximize your recovery by declaring a default?

You may suffer from lender fatigue with this borrower, but do you *really* believe the loan is in default because the borrower is a poor manager? Are you sure? Have you heard about the recession we're in? How does adding another layer of expense by hiring an independent property manager or having a receiver appointed help you maximize your recovery? If the borrower simply walks away, then, of course, you must. But if the borrower is serious about continuing to work with you and manage the property, does it make sense to say "no", or to make it so difficult or painful that the borrower is forced to give up?

Think about this: Until this economy recovers, your chance of selling the project for enough to pay off your mortgage is probably not very good. Remember, you just concluded the project cannot support your mortgage. Do you think some other investor is going to pay you more for the project than you have already concluded its worth? Probably not. Even if you believe the project is worth substantially more than your loan, have you considered the risk and consequences of the borrower filing a Chapter 11 bankruptcy to protect its equity?

The more sensible and cost effective solution may be to amend the loan documents to reflect loan terms that actually work in today's market. [See: *Loan Workouts, Part 1 – Note to Lenders*]. Ask yourself: Is it better to *accrue* interest at 8%, or to *actually receive* interest payments at 3%? What is your current cost of funds? What if the loan is a non-recourse loan, or has effectively become a non-recourse loan because the borrower and its guarantors are financially compromised [read that as *effectively broke*] and the collateral is worth less than the loan?

Depending upon the answer to these questions, the lender and borrower may have something to talk about. Perhaps enough common ground can be found to satisfy both the legitimate needs of the lender and the legitimate needs of the borrower. If so, the workout solution is to amend the loan documents to reflect those terms.

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Pretend: This is the tough one. It's tough because it's what a lender does when it is either unable or unwilling to face reality. Don't get me wrong. Borrower's are just as susceptible to pretending as are lenders. In either case, it is a prescription for disaster.

If you won't face reality, you won't find a real solution to real problems. It's as simple as that. Loan workouts are based on finding real solutions. A real solution is one that actually works and is achievable under circumstances as exist today. Not conditions the lender and borrower wish existed; conditions that actually exist. You may not like the solution, and it may not make you entirely whole, but if you are not willing to connect with reality and be honest with yourself about what can actually work under circumstances as exist today, you are engaged in a real world game of pretend and will suffer the consequences.

Recommendation: If you have not read the book *SWAY – The Irresistible Pull of Irrational Behavior*, by Ori Brafman and Rom Brafman, Doubleday, ©2008, I highly recommend it. I found it so useful for placing loan workout negotiations in context that I read it twice. [. . . and, no, I don't get a commission.]

Successful loan workouts must be built on reality. There is virtually no case in which pretending you don't have a problem, or pretending that the problem will go away on its own, will work for very long.

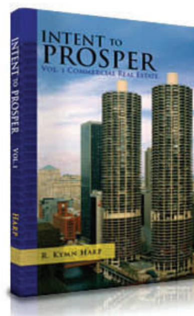
Since pretending seldom works, extending or amending likely represent the best solution in today's market.

These are tough times. We understand that you have been successful in real estate by following your instincts in the past. But understand this: The bubble has burst and the economy wide rules of the real estate game have changed. How else can you explain the unfamiliar financial obstacles you currently face? It may not be your fault that you got caught in this rip current of financial havoc. The choices you made and the deals you got into may have been sound and reasonable based upon conditions as existed at the time you made them. But make no mistake: it will be your fault if you fail to act rationally to do what is necessary to extricate yourself from this quagmire. *Don't pretend. Get help if you need it*.

Thanks for listening,

R. Kymn Harp

P.S. While I'm recommending books: Please allow me the liberty of recommending my own book: *Intent to Prosper, Vol. 1 – Commercial Real Estate* available at www.IntentToProsper.com or through your favorite online bookstore. Enjoy!



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