

Facing the storm: How commercial developers can survive

by Meagan Hardcastle

With the next real estate typhoon looming on the horizon, shrewd commercial developers are urgently preparing their 2010 disaster readiness plans.

Their residential counterparts have been fighting for survival since the housing market imploded in 2006. Sales of developed residential



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lots have nearly ground to a halt, with new home sales not faring much better. A severe, widespread liquidity crisis among these developers, coupled with plummeting property values and defaulted or maturing loans, have decimated the businesses and accumulated wealth of many competent, experienced and successful residential developers. Now, commercial developers face a similar “perfect storm.” As we head into a tumultuous 2010, plotting a course through that storm should be top of mind for everyone in the industry.

Record high commercial property values drove a massive wave of real estate financing transactions during 2006 and 2007. The landscape has changed dramatically since then.

First, the economic recession is wreaking havoc on most businesses, which in turn impacts the commercial property market. As companies scale back or go out of business, demand for all types of commercial space declines.

This translates into increasing vacancy, decreasing rental rates and cash flow, and depressed property values. The Moody's/REAL Commercial Property Price Index has slipped 39 percent from its peak in October 2007, while the average price of a development site as reported by Real Capital Analytics has plunged nearly 60 percent since December 2007.

Second, the credit crisis has had a catastrophic impact on banks, severely impeding their willingness and ability to hold loans against real estate. Lenders scrambling to manage the flood of nonperforming residential development loans can't handle an additional wave of troubled commercial loans. That's very bad news for developers.

As commercial real estate loans initiated at the peak of the market begin maturing in 2010, many borrowers will find themselves in the center of the storm. Here's the gloomy forecast:

- Dwindling NOI (net operating income) that no longer supports debt service.
- Severely depressed property values that no longer support acceptable loan-to-value ratios.
- An illiquid personal wealth position that precludes “right-sizing” deals.
- Lenders desperate to reduce their real estate exposure.

Commercial developers are facing a painful restructuring period over the next few years. Some will survive, but many won't. Even owners of properties with stable cash flow and no impending loan maturities will be hurt as foreclosed commercial properties flood the market, driving values down even further.

Consider Tom, a successful commercial property developer with a diversified portfolio that includes office, industrial and retail holdings, a few projects under construction and a few parcels to be developed. Tom has \$150 million in secured loans across half a dozen lenders and a handful of insurance companies.

While Tom is still able to service all of the debt, cash flow from the income producing properties has declined and he can't withstand much more deterioration. Two major tenants threatened to move if Tom didn't significantly reduce rental rates. Others walked away from lease obligations. Leasing prospects for projects under construction don't look as rosy today as when he broke ground. And land holdings that

held promise just a couple of years ago won't be viable for development any time soon. It's clear that Tom needs to think strategically about protecting himself.

Commercial developers like Tom can learn much about what to expect and how to survive by reflecting on how their residential counterparts fared over the past three years. Take Bob, for example. Bob is a second-generation residential developer who has amassed substantial personal wealth during his 30-year career. In 2005, Bob had several hundred developed lots sold under contract to national homebuilders like Pulte and Centex, had several hundred other lots being actively developed, and had confidently purchased several prime tracts for future development. Lot sales had been brisk over the prior five years and projected demand appeared strong.

Suddenly, the market changed. Lot sales slowed and then stopped. The national builders walked away from purchase agreements, leaving Bob with a glut of inventory and a multi-million dollar income shortfall. Cash flow slowed to a trickle, and soon Bob was making loan payments and funding payroll out of retirement savings.

Bob had more than \$100 million in land acquisition and development loans spread across 10 banks, collateralized by properties with a market value in excess of \$350 million in early 2005. By 2006, nearly all his properties were worth less than the respective loan balances. Bob quickly realized his personal wealth would only last for so long. He couldn't continue funding loan payments and cash shortfalls indefinitely, and was speeding toward a cliff.

When several loans matured, Bob's bankers saw the severity of his problem. Calls from workout loan officers and their attorneys brought payment demands and threats of lawsuits.

At the advice of a long-time friend and banker, Bob hired a financial restructuring firm to help develop a strategy to manage the crisis. Advisors began with a detailed, global analysis of Bob's situation, including quantifying the economics of each property:

- What was the collateral value and expected cash flow?
- What disposition options were available?
- What liabilities were associated with the property besides the secured debt? How could the property value be maximized under existing and forecasted circumstances?
- What were the implications of the options available to lenders?

The advisors accurately quantified the secured lenders' collateral positions, identifying shortfalls and potential solutions that would result in fair treatment to all creditors. They also determined Bob's personal guarantee exposure under varied scenarios.

Another key analysis Bob's advisors produced was a detailed monthly cash flow projection. Bob was able to see exactly where he stood, where he was headed, what options were available and exactly what the financial impact would be for each. The underlying financial model provided a critical tool to assess and revise strategy based on changing circumstances, and to aggressively manage cash flow.

While developing the global cash flow projection, Bob's advisors carefully scrutinized all business operations – including overhead structure and operating costs – and persuaded him to make immediate, drastic cuts. They also advised against cutting certain things that would assist him strategically in the long run, but that Bob had initially planned to cut as a knee-jerk reaction to immediate cash shortfalls.

The advisors' analysis provided the hard evidence Bob needed to act. Rather than letting delay deplete cash reserves, he moved quickly and confidently to preserve critical resources.

Having assessed the economics of each property and Bob's cash flow, advisors worked with Bob to determine how personal resources could

be most efficiently allocated to help Bob survive the downturn. This process generated a viable workout strategy, addressed collateral shortfalls and ensured fair treatment for secured lenders and other stakeholders.

Bob and his advisors approached each lender with a workout proposal requesting accommodations including extensions and dramatically reduced payments. Each

bank's proposal varied according to the amount of credit exposure and collateral shortfall, and was tailored to appeal to each lender's internal credit parameters and workout philosophy. An information package provided a detailed roadmap lenders could use internally to support credit decisions, and analysis that clearly demonstrated the logic and economic merits of requested accommodations. A similar negotiating process was undertaken with trade creditors and lien holders.

Lenders appreciated Bob's full disclosure and concise, actionable financial analysis supporting his requests, as well as his proactive and realistic approach. Each lender ultimately decided to cooperate with his proposal. Within three months, monthly debt service dropped from more than \$1.1 million to less than \$200,000. In the three years since engaging his advisors, Bob has worked hard to optimize his lenders' collateral value and create liquidity events to make loan paydowns.

He also has gone back to the lenders with numerous additional requests, including temporary new funding to support operating overhead, each with a valid economic basis demonstrated by credible analysis. The lenders have continued to extend loans, make payment accommodations and waive Bob's personal guarantee exposure for shortfalls on property sales. This level of cooperation, enjoyed by very few borrowers and lenders, is the direct result of Bob's proactive use of professional experts to restructure his business.

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The long journey hasn't been easy and isn't over yet. Several times, Bob's attorneys urged him to file bankruptcy. But each time, his financial advisors were able to reinvigorate his sense of determination, reminding him that bankruptcy represents a failed negotiation and would only ensure a loss. Bob has to stay in the game for anything good to happen, so his optimal goal is always to survive to fight another day. Bob is hanging on, riding out the downturn, working with his lenders. When the economic "green shoots" eventually sprout and the market begins to rebound, he will be in the best possible position to take advantage of opportunities.

The key to survival is preparation.

Step one is engaging a credentialed financial restructuring professional with real estate experience—the earlier the better.

Step two is developing a strategy for negotiating the rough road ahead. That strategy will be driven by detailed financial analysis. It will likely change as conditions and circumstances change, so the analysis will be an ongoing, dynamic process. In addition to driving sound strategic decisions, some of the financial analysis will be presented to lenders and other stakeholders.

Step three is actively managing lender and stakeholder relationships. Professionals who have repeatedly handled this task for other clients will be most adept at working through the process. Experience and real-time market intelligence are keys to success. Some of the critical insights acquired along the restructuring learning curve include:

- What workout philosophies and incentives apply for different parties.
- What market events might impact the process.
- What optimal deal structures look like under varied circumstances.
- What constitutes reasonable expectations on both sides of the table.

While many developers are financially sophisticated, having secured loans for projects and maintained lending relationships as part of their core business, the dynamics and skills needed during a workout situation are vastly different. Developers can learn expensive lessons trying to navigate an unfamiliar restructuring landscape alone.

Advisors' roles are wide-ranging, and include:

- Applying hands-on restructuring experience, creativity, and on-the-ground market intelligence to negotiate the best path for a client to survive the downturn.
- Developing a fact-based workout strategy that protects client interests and is acceptable to lenders and stakeholders.
- Effectively demonstrating to lenders and stakeholders why a developer's proposals make economic sense for all.
- Maintaining productive communication with adverse parties.

Bridging the gap between capabilities and expectations of the borrower, and those of the lenders and stakeholders, to find reasonable common ground.

The restructuring process for commercial developers over the next few years is likely to be very similar to what we've seen with residential developers, with one major exception: a radically different banking environment.

When the residential downturn started in 2006, banks were generally in business as usual mode. Not any more. Today the entire financial system is in crisis. During the first half of 2009, 45 banking institutions failed, compared to only 25 during all of 2008 and three in 2007. There were no bank failures in 2006 and 2005. The FDIC's list of "problem" institutions — those at high risk of insolvency— included a staggering 416 banks at the end of June 2009. That's up from 252 at 2008 year end, 76 at 2007 year end, and roughly 50 at the 2006 and 2005 year ends. Banks are under tremendous pressure and regulatory scrutiny as they struggle with financial losses, rapidly deteriorating collateral quality and rising loan defaults. Workout departments are already overwhelmed—the upcoming commercial loan wave will hit them hard.

How bad will the situation get? Stay tuned — we'll find out as the commercial real estate loan wave hits in 2010 and the industry spends the next few years grinding through the aftermath. One prediction seems obvious — however difficult it already is for developers with distressed loans to work with their lenders, it's about to get a whole lot tougher.

An effective restructuring process is necessary for survival in this environment, but it's only one piece of the picture for commercial developers. Someone still needs to be focused fulltime on managing the core business and working the deals to maximize property value. The developer is in the best position to do that.

Surviving the downturn will be an endurance event — not a sprint. And there may be points along the way where all will seem lost. Stress levels can be overwhelming and must be endured over long periods. Resilience and mental toughness are absolutely necessary. Developers need to focus on what's truly important and expend their efforts where they can have the biggest impact, while outsourcing activities that require external expertise.

With no market recovery in sight yet, this liquidity crisis is likely to get much worse for real estate developers and their lenders. It's time to get busy battening down the hatches.

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