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The Art of Loan Restructuring

By Pat O'Keefe

As if the economy and the tight credit markets were not enough, real estate developers are faced with a new challenge. Banks are informing developers at loan maturity that their cash-flowing, debt-servicing properties are now substandard based on current appraisals.



Waiting for the Ship
to Reverse Course

By Pat O'Keefe

Last Word

As a result, there has been a surge in the number of loans being restructured through a process that is more art than science. Loan restructuring requires a detailed analysis of all possible solutions and a clear understanding of the motivations of each party.

Litigation and bankruptcies are evidence of failed negotiations. This article addresses some of the prevalent issues involved in a successful negotiation.

Clearly the highest cost of capital is not having it. Securing new debt carries a high price because it is so scarce. Midwest regional banks, for example, have cut their loan portfolios by 5% to 15% over the last year, according to a recent study.

While cash flow is dwindling, banks want more of the developer's limited cash for principal paydowns and increased pricing. The key to more reasonable pricing involves a series of metrics such as limited paydowns, shorter maturities or credit enhancements such as more collateral or guarantees.

If the maturity is shorter and the property can be positioned for a liquidity event - sale or refinancing - then optimal pricing may be achieved. In the final analysis, the bank either wants a liquidity event or a performing loan.

Falling valuations

Most development loans were underwritten at loan-to-value (LTV) ratios ranging from 70% to 80%. If the loans were more aggressively underwritten, they often included curtailment payments, which required principal paydowns regardless of sales. Occupancy levels and minimum rent thresholds were also monitored.

Today, appraisers are taking ultra-conservative positions to the detriment of both the bank and developer in the loan restructure process. We have seen significantly higher capitalization rates used from the initial underwriting for the construction loan to the permanent mortgage. Appraisers are not using existing rent rolls to assess income potential and are depressing future rent rolls.

As a developer, you can fight about valuation, but it is hard to argue that value hasn't dropped at some level. Unlike securitized lending, bank financing is typically recourse and has its consequences. And I have yet to see a developer litigate over value with a bank as a defense to a lawsuit over a borrower loan guarantee.

Many banks are now more reasonable if they can at least get a loan to meet an acceptable debt structure - as high as 95% LTV - in the current regulatory environment.

If a developer has a property that is underwater, I find splitting loans into good-bad loan portions, often referred to as an A/B structure, helps restructuring. The A piece is conforming in terms of LTV and pricing and looks like a standard performing loan that requires no loan loss reserves by the bank.

The B piece is the "air ball," or exposed piece, representing the potential loss. It is often reserved based on the strength of the guarantor and other credit enhancements. This structure works best when the B piece gets a new borrower that may be affiliated or related in some way to the A-piece borrower.

The strategy for the bank is to not have the full value of the original loan reserved for potential loss after it is restructured. By breaking the loan into two pieces and having a new borrower for the B piece, the bank can have at least one good loan and possibly a lower reserve on the B piece.

Dealing with a submerged loan

No developer wants to resolve a maturing loan by paying the spread between the outstanding loan balance and the current value of the property, or taking on a deficiency note. The developer only agrees to this structure if there is a likelihood of value recovery in the foreseeable future.

The deficiency note settlement often involves a distressed sale or a deed in lieu of foreclosure. With a deed in lieu and settlement with the bank, the stigma of bankruptcy or judgments can be averted. The developer can live to fight another day rather than engage in a protracted and costly fight where the only conceivable outcome is eventual loss.

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