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TRENDS, OFFICE LEASING/BUYING, RETAIL & RESTAURANT, BUYING FOR INVESTMENT, TAXES, FINANCES & LEGAL, INDUSTRIAL & WAREHOUSE, MULTIFAMILY INVESTING, HOSPITALITY

How to Break Up with Your Lender, Gracefully

Discuss a Workout Even if You Know You Will Lose the Property

At 6.3% San Francisco tops the U.S. with the most office sublease space as a percent of total inventory.

Many commercial real estate assets — especially office — are feeling the weight of three shocks that hit the commercial real estate industry in succession, mostly triggered by the pandemic in 2020: decreased demand and declining revenue; rising inflation and higher operating expenses; and increased capital costs and lower valuations.

These bleak conditions are pushing balance sheets into the red with expenses exceeding revenue. Even in cases where high-quality assets are revenue positive, lenders are reluctant to make loans, keeping cash-strapped owners from offering tenant improvement allowances or paying commissions. So, even owners intent on leasing space to keep their buildings financially whole — and meet their debt and equity obligations — are severely hampered or completely stuck.

Meanwhile, lenders (banks and their regulators as well as non-bank lenders like insurance companies, mortgage REITs and others) are watching to see if borrowers violate loan terms or miss a payment — actions that could trigger a
foreclosure
. Adding insult to injury, some borrowers are turning assets over to lenders (deeds in lieu of foreclosure), typically for their worst performing properties, leaving lenders with troubled real estate to manage, sell and, most likely, write off at a loss.

The notion of this scenario repeating thousands of times across thousands of markets — in the U.S. and across the globe — is disturbingly reminiscent of the Great Recession when the financial system was destabilized by hundreds of millions of nonperforming and underperforming residential mortgages.

However, it is important to note that the scale of this scenario in the coming months is unclear and that private rescue capital could play a role in softening the blow. What is known today is that a growing number of property owners are
defaulting
or turning assets over to
lenders
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Additionally, according to the
Mortgage Bankers Association
, of the $4.4 trillion of outstanding commercial/multifamily mortgages, $728 billion (16%) mature in 2023 and $659 billion (15%) mature in 2024 and face interest rates hikes of 250 to 400 basis points. These figures set the stage for more distress among property owners and lenders, as owners find that the new cost of capital on some of their assets is too high to maintain profitability.

Workouts With Your Lender

For some perspective on what property owners facing these conditions can do, LoopNet spoke to Matt Mueller, a director at Tauro Capital Advisors based in Plano, Texas, about workouts or loan modifications made between lenders and borrowers to avoid foreclosure.

For nearly 10 years, during and after the Great Recession, Mueller focused on creating workout solutions and restructuring projects in default. "We had six attorneys on staff; I ran our capital markets group, and we did billions of dollars' worth of consulting on busted or defaulted projects for workout and restructuring," Mueller said.

He spoke about steps owners can take now to help them hold on to some assets, protect their reputations, avoid bankruptcy and keep assets from clogging the banking system. One theme that persistently resonated was that owners should develop a plan and talk to their lender, in that order.

The Benefits of Talking With Your Lender

"It's best to be responsible with your lender, have the conversation, and figure out what the right way out is," Mueller said. "If you say, 'you guys figure it out,' they're probably not going to be all that reasonable and willing to work with you."

But, he added, if you come to them with a package that breaks down the pros and cons of the property and includes a business plan showing how they can recoup as much of their debt as possible, they might be willing to work with you. "That may be a way for you as a borrower to maintain your asset management fees or to get a hope note so you can potentially return a small portion of your investment to your investors or to your firm," Mueller said.

"You want to have early conversations even if you think you're going to give a property back to a bank," or if it's in or approaching foreclosure, Mueller added. Early conversations, "limit reputational dings because at some point you're going to be back in this business."

And when you apply for your next loan, Mueller said, it goes a long way to be able to put together a letter to your next lender explaining what happened and acknowledging that there are blemishes on your credit and track record. It's important in that scenario to be able to convey that issues were resolved honestly and ethically. "They should know you didn't tear out all the toilets or steal all the brass knobs or leave the lender with an empty shell of a building."

Your current lender may loan to you again if you have a long-term relationship, Mueller said, but if an investor needs to seek out new lenders, illustrating that the breakup was amicable may help secure a future loan. He added that when any kind of lender does a background check, a foreclosure will show up; and, if you go into bankruptcy in the real estate business, the chances of getting a loan in the future are difficult. "If you can avoid bankruptcy because you are able to negotiate with your lender, that keeps your business as an investor as solidified as possible," Mueller said.

This is a time for tremendous humility, transparency and proactivity, Mueller said, adding that there needs to be "acceptance of what is occurring and trying to get in front of it as best you can."

Basic and Tailored Workouts

The beauty of a workout is that it can be tailored around the circumstances of an asset, a lender and a borrower. In the current market, the overarching goal for a borrower is to reduce current capital costs to free up cash and the objective for the lender is to keep the loan performing.

Three typical workout approaches include: modifying the loan structure by changing the terms of the original loan, such as the interest rate, repayment schedule or loan maturity date; a forbearance that allows a borrower to temporarily pay a lower mortgage amount or pause payments on a mortgage; and a refinancing that involves replacing the original loan with a new one that has different terms, such as a lower interest rate, longer repayment schedule or different collateral.

Other restructuring plans are more complex. One is aptly named a "hope note," and involves sharing some portion of the potential future upside with the lender and enables the borrower to obtain some amount of equity when the asset is sold in the future.

During the global financial crisis of 2008, Mueller was involved in generating a number of hope notes for distressed projects. With a hope note, an owner can maintain ownership of a property, renegotiate or restructure a loan with the lender. In the future, if a property's value increases, they "maintain a certain level of the profits over what the project value is today or in the future," Mueller said.

This gives the owner a little bit of incentive or "hope in the future to maintain some semblance of equity; return of equity, not return on equity," he said.

Mueller explained that a hope note lays out a plan that establishes where the market is now and what the challenges are for the lender if they take the project back. It identifies potential liabilities as well as what is working with the project. Shortfalls — whether they are building, management or market related — are clearly identified. Previous and current valuations are included, along with projected amounts a lender will recoup on the loan. He added that during the financial crisis, terms on hope notes ranged from two to five years.

Workout negotiations with a lender can take anywhere from three to 12 months, "depending on how receptive that lender is and what they have going on," Mueller said. Sometimes they'll simply give the borrower an extension as they work through it, because they don't have the necessity or capacity to engage in a more complex workout conversation.

Counsel for an Office Building Owner

Asked how he might counsel an owner with one or more distressed properties, Mueller suggested the following:

Understand your liabilities. Owners need to think about their potential liabilities relating to personal guarantees on assets, he said. "That's always going to be number one." Next, determine your tax liabilities, especially with 1031 exchanges, because you could have hundreds of thousands of dollars of deferred taxes that you need to pay if that property goes into foreclosure.

Inventory what you have and calculate exposure. Making a "keep" list and an "I don't know what to do with it" list is important. Inventory what you have, then be proactive in addressing the best ways to stabilize each property. Mueller added that calculating exposure on each property is critical. "With interest rates as volatile as they are, property owners should be calculating — on a weekly or monthly basis — what their exposure is, and how far in the red or how little in the black they are in a market such as this."

Surround yourself with a great team. Owners should build a solid team around them with professionals such as attorneys, accountants, brokers and others that are relevant to their assets and situations. Mueller suggested that options be vetted "from a place of humility." From there, work through each project based on what the vacancy is, what your loan covenants are, etc.

Financial and Market Conditions Can Exacerbate Problems for Owners

Mueller noted that the workout process involves conducting assessments across three general areas relating to market and economic indicators, financing and banking and legal execution, with his

expertise centering on the first two components. These finance and market conditions can deteriorate quickly, forcing owners to the workout table.

Some of the financial factors to be considered relate to loan covenants, like occupancy covenants for office buildings, or the debt service coverage ratio (DSCR), which is probably the most relevant for all asset types, Mueller said. The debt service coverage ratio (net operating income/debt service) measures a property's available cash flow to pay current debt obligations.

Mueller said that in times of economic uncertainty, lenders will adjust their DSCR criteria in an effort to manage risk. Under normal conditions, lenders may underwrite commercial properties between 1.25 and 1.50 DSCR and multifamily projects can range between 1.18 and 1.25.

Considering a hypothetical office building that is classified as A-minus, is 50% leased with a loan maturing late this year and located in a submarket where rents have been falling, Mueller said that the building owner is probably not meeting their DSCR covenants. So, "they're probably already in default, even if the lender hasn't come to knock on their door."

Typically, the next step in this scenario, Mueller said, is that a springing lockbox arrangement is triggered, in which incoming "rents get trapped and the lender will end up holding them." Unfortunately, this action produces a snowball effect for the property owner, because now they don't have access to rent payments, so they are cash constrained. This makes it harder to pay for tenant improvements and leasing commissions that are needed to market and lease the building, regardless of what the market is doing.

Deteriorating market factors can compound the problem. Mueller said that if an owner has a macro market problem, such as businesses leaving a downtown area, they need cash to market and position their buildings to capture new or remaining tenants.

But, if an owner is competing with office buildings that are 80% full, a 50% occupied building will feel like a ghost town in comparison. Also, at 50% occupancy, paying tenant improvements and commissions can be hard. "The moment you delay or don't pay a leasing commission, the rumor mill gets going," among the brokerage community and suddenly there are fewer tours of your property, exacerbating the problem, Mueller added.

Engaging an Advisor

Many debt and equity intermediaries offer advisory services helping property owners identify the best strategies for their assets and their companies. "We help them work through steps, whether it's presenting the package to the lenders to negotiate a deed in lieu [of foreclosure], a hope note or a restructuring program, or identifying, if it's so lost, that they need to speak with an attorney," Mueller said.

"We can package a project, help negotiate with the lender, and then we can also source funds for recapitalization or restructuring," whether it's a refinance, white knight capital to save a firm or rescue capital to save an asset.

Typically, firms charge hourly fees for advisory services, but when sourcing debt or equity, they charge a success fee if they can refinance the project. In terms of commissions, the industry standard for debt is about 1% and for equity the range is 2% to 3%, depending on the size of the deal.

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