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"Hanging on to Your Building (or Otherwise Working Out in the Post-Bailout Era)"

Even the most conservative real estate owner-operator is faced with the realities posed by the current credit markets, which may impact her business plan and value of assets in several ways. Properties purchased during recent years of plentiful credit and subject to high debt (e.g., in excess of 80% of market value), place the owner in a difficult bind when dealing with tenants facing downturns in business activity. Because the owner is faced with meeting its own substantial debt-service payments (in addition to other expenses which have inched upwards, such as fuel, payroll, insurance and the like), they may find their options severely limited. Owners may expect to receive, at least over the near term, a steady parade of tenants seeking concessions not only due to a slowdown in consumer spending but due to neighboring vacancies in the case of mall locations or ruinous competition from nearby big-box operators or "power centers". And while there is some humor in the old story about the tenant who never asks permission to pay more rent when times are good, the reality is that you want to be in a position to accommodate a long-time reliable tenant, for doing so not only creates obvious good will, but cuts down on re-leasing costs such as upgrades, leasing commissions, "dark" time and so on. Where there is that equity in the property accompanied by a low mortgage, the owner simply has that invaluable "slack", if you will, to take a hit on the rent in order to keep the tenant.

But what if that luxury is not there? Or what if your mortgage is low but, alas, your topline watermark has deteriorated in the current market and you are facing a short maturity? It pays to examine the causes of an evaporation of value, for a combination of subtle factors affecting even the finest buildings is currently at work: clearly, a declining rent roll resulting from vacancies or tenant concessions as described above will eat away at market value through simple arithmetic. But additionally, even where the building fundamentals are totally healthy, you may face the reality that a refinance upon maturity of your existing debt might not be in the cards due to the scarcity of credit. Take this example: a need for working capital arises by reason of tenant concessions; you assume there to be no problem since there is substantial built-up equity in the building which will allow you to raise capital through an investor group without approaching the lender. But when you come to market with your offering, your investors hold back because the perception is that there will be no credit available to refinance the mortgage, even though the amount is conservative, thus attributing a diminished value to the building.

What to do? There are avenues on which to approach your lender, each of which hold out advantages for you, but potential disadvantages to the lender. It is essential to have a concrete proposal in mind and be sensitive to the lender's needs because, unlike in the case of residential loans, institutions will not have a set policy but

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will craft a workout separately for each loan. (Residential owners are welcome to contact us for suggestions in this area.)

Possible proposals may be inspired by the following templates:

- reduce the interest rate – this will lower your total as well as monthly costs; disadvantage to lender: reduces return on investment and perhaps impedes ability to market loan to investors or participants

- reduce monthly debt service payment by accruing interest to maturity or extended date, or re-scheduling the payback (i.e., amortization) table – while reducing monthly costs, it poses the threat of a high payoff at maturity, when credit may be even tighter; also, unless the loan carries a prepayment feature, you are possibly increasing your overall costs by having the loan out longer, as well as being subject to compounding. Disadvantage to lender: it will wait longer to recover its investment, compromising credit quality and possibly diluting opportunities to take on participants in the loan

- taking advantage of so-called conversion features – these are frequently used in corporate finance as a means of reducing debt or obtaining better loan terms. In this example, the outstanding loan amount is materially reduced in exchange for a participation in the equity or "upside" of the property. Depending upon tax considerations affecting the parties, the participation may take the form of the issuance of equity securities in the entity owning the asset, or a direct profits participation in the property through a joint venture, carried interest or similar arrangement. The advantages of lowering indebtedness to the borrower are obvious, but the giving away of potentially valuable equity is not. The short-term amelioration delivered from loosening the credit noose may be costly later. From the lender's point of view, it makes much more speculative the landscape from which investment recovery may be viewed.

- "buying down" the loan with additional collateral—here, no deferred cash requirements will be out there to place a drag on future returns and the reduction in the debt obligation provides needed relief. The price involves the tying up of other assets and limiting future financing availabilities. From the lender's point of view, it receives a lower return as well as the underwriting (i.e., valuation) obligations involving the additional collateral.

Weighing the pros and cons of the various approaches is the most difficult part of the exercise, which should be performed in conjunction with accounting and legal advisors, bearing in mind first and foremost obtaining the greatest advantage to your business plan with the least cost. We have found the current market to be conducive to open and frank discussions on both sides, which is the one possible improvement in market conditions over those we enjoyed in the boom times of the early decade.

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