

Approaches to Maturing Commercial Real Estate Mortgages

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As events unfold in the current environment of insolvencies and frozen credit markets, the issue of maturing commercial real estate (CRE) mortgages has finally surfaced as a recognized and escalating problem in the financial sector. By and large, the realization of this epidemic should not come as a surprise to anyone. For more than a year and a half, we, along with financial theorists and industry experts, have voiced deep concerns over the looming tsunami of mortgages set to expire between 2009 and 2013. As more and more lenders struggle with tight (or non-existent) credit, falling property prices, rising cap rates, increasing tenant vacancies and a return to more traditional underwriting standards, the seminal question becomes: what solutions and strategies should mortgagees and mortgagors employ to remain solvent when dealing with these assets?

To best combat the threat that these maturing CRE mortgages pose, it is important to recall and commit to memory the lessons that were learned in the fallout of the halcyon lending period of 2004-2007.

- The money supply is not infinite nor is the money free.
- Fixed-asset risks cannot be systematically eliminated using esoteric financial instruments.
- The CRE business is cyclical and is usually a lagging economic indicator.
- The Federal government will use RICO laws to prosecute and punish those guilty of manipulating the system for their own advantage.
- We need to put aside the rhetoric about finding “who is responsible for creating this mess.” There is more important work to be done.

Foreclosure proceedings are not the ideal solution to properties in distress. The real professionals have learned from experience that prolonged legal proceedings run counterproductive to the overall goal of improving the value of a property. No banker would prefer to instruct a loan committee to expend legal fees to secure title, or to expend institutional operating cash flow to carry REO assets. No broker would prefer to take a tenant to a foreclosed property (or a property in the process of foreclosure) as there is little to no guarantee that the broker will be paid an earned commission. Similarly, prospective tenants will not seek out foreclosed properties as there is an uncertainty over who will assume landlord duties.

One solution to the problem is to de-leverage, recapitalize and extend. Any professional who deals in bank credits, REO, tier one capital allocations, loan loss reserves, and write-offs will not welcome borrowers who force additions to the loan loss reserves accounts or write-offs of an institution's equity capital. When talking with a lender, it is imperative to have a prudent business plan for CRE assets that recognizes, and attempts to address, issues pertaining to both the lenders and the borrowers. Proceeding in a responsible manner will lead to a more constructive and fruitful dialogue. Furthermore, if the parties

remain focused on asset preservation or value reclamation, both parties will find mutually beneficial goals and common interests from which to proceed.

At the onset of any discussions, there is a need for honest and realistic projections, with respect to operating plans. Reality is often a “cold shower,” but when the parties are able to make decisions based on facts rather than fiction, they are better positioned to craft a workable solution. In addition to bringing a working knowledge of the REO rules and bank auditing procedures to the discussion, any plans and projections should be established to account for one-year, three-year, and five-year periods. It is important to look beyond the end of a quarter (or even the end of next year) for the answers.

Additionally, lenders need to determine how an effective de-leveraging of assets will fit in their economic profiles and whether such an action would help maintain or undermine their competitiveness in the marketplace. The answers may be found in the historical record. Many of the loans issued between 1995 and 2001 were written when treasuries and LIBOR were at significantly higher levels than they are today. An in-depth analysis of existing in-place cash flows may reveal a hidden equity reserve, when calculated based on artificially-low rates, as is a function of today’s unprecedented governmental intervention. There is nothing wrong with trying to take advantage of subsidized low rates. However, the key concern is to address refinancing problems now and not later, as experts foresee an increase in rates on the horizon.

There is a need to find or develop the creative solutions for today’s and tomorrow’s financial challenges. The concept that a borrower’s position is secure if the property’s mortgage comes due next year or later may be a false premise. The lender’s problem of today may well be the borrower’s problem of tomorrow. Therein may lie the solutions.