

Watching, Waiting, and Working It Out

In the real estate freeze, banks sit on the sidelines, buyers look for really good deals, and tenants decide to stay put.

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“**T**here ain’t no credit here, either,” said one 30-year veteran of the European property markets when asked if the real estate situation was any different in Europe than in the United States.

The fact is, “there ain’t no credit” anywhere, and that has put a considerable chill on the market. This chill turned into a freeze with the passage of the Emergency Economic Stabilization Act of 2008, while the market awaits the implementation of the act’s Troubled Asset Relief Program.

The result is that once again, cash is king, and lenders, real estate developers, investors, and tenants are developing short-term strategies to hold their positions by preserving

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cash and by working out loans and leases to minimize credit and lease defaults. Where that is not possible, lenders and landlords are not hesitating to foreclose on properties or to seize collateral through every available legal process.

Here’s a closer look at where the real estate world is now for these participants.

A snapshot of the market presents a number of trends and anomalies. Banks and other lenders are trying to work with their “good” borrowers, those who are honest and cooperative with them, by providing extensions, modifying loans, and doing what they can to avoid credit defaults. But at the same time, existing lines of credit are being reduced or eliminated.

In very distressed situations, lenders are attempting to work out so-called “friendly foreclosures,” so that borrowers do not rush into court seeking an injunction or filing for Chapter 11 bankruptcy protection. (That’s even though a Chapter 11 proceeding would be of limited use because the borrower would still have to pay interest on its loan or risk losing its property.)

Recently, for example, a bank postponed a foreclosure on

a Virginia shopping center three times to give a mezzanine lender more time to work out a strategy to keep the property from going into default. In the end, the mezzanine lender did not proceed, so the bank did foreclose.

Although there have been a number of defaults and foreclosures, there have been very few real estate bankruptcies. This is not only because a Chapter 11 bankruptcy is disadvantageous to a property owner, but also because the credit freeze means there is a lack of “dip” (debtor in possession) financing. New money in the form of “dip” financing is often critical to companies seeking to reorganize under Chapter 11, and without it, distressed companies may be unable to reorganize and see no benefit in filing for bankruptcy protection.

PRICING RISK

Given the current credit freeze, real estate owners have either put projects on hold or have gone overseas, mostly to the Middle East, to look for money.

Most domestic banks have adopted a “W” approach (no, not that “W”); watch, wait, and workout.

They remain on the sidelines watching the events that change lending opportunities. As the market changes day by day, even by hour, it is very difficult for banks both to price new transactions and to price risk generally. The appropriate risk/return balance is not easy to determine when it is impossible to predict when the economy will change for the better, so bankers continue watching until the crystal ball becomes less hazy and they can “see” things starting to turn around.

As banks watch, they also wait. They are waiting for the credit markets to thaw, and they are waiting to see what market develops or re-emerges to buy their loans. They are also waiting for prices to correct and for the sense that the bottom of the cycle has actually occurred, so that their collateral will not be at risk. In addition, they are waiting for repayment on existing loans, so that they have cash to invest in new transactions.

WORKING IT OUT

The maturity of existing loans in this current market, with no sources available for refinance and few, if any, oppor-

tunities for a borrower to sell, are the cause of the third “W”—workouts.

For loans that matured in the spring or summer of this year, or are about to mature, there are no sources for borrowers to obtain money to pay off their existing loans, even if tenants are in place and paying rent. With no opportunity to refinance existing loans, borrowers would be forced to sell their properties to generate cash to pay back their loans at maturity.

With limited exceptions, selling the project is not an option because the spread between bid and ask prices is too great. Unless the property is attractive to an all-cash buyer, there really is no market.

Cash buyers are an anomaly in the overall market, though the Washington, D.C., area has more than many areas, perhaps because it is a government town less susceptible to what is taking place in the rest of the country. Here, an active market still exists, and pension funds, foreign buyers, and others that benefit from favorable interest rates are still seeking investment-grade properties at attractive prices.

Of course, the buyers who are out there are looking for real deals because they believe that any real estate currently for sale is distressed, which leads to a lowering of the perceived value. Even if a property is distressed, its seller may be in denial, continuing the spread between the bid and ask prices. Finally, unless buyers have cash backing, the buyers themselves are having great difficulty finding sources of money to purchase real estate.

So, even if deals are struck, the period for performance may be extended or the contract may be terminated because of the inability of the buyer to perform.

This inability to refinance and sell means that the lenders are not being repaid timely. For property owners, those with loans coming due should be keeping in close contact with their lenders and taking advantage of any workouts designed to maximize use of available cash and minimize the possibility of a default.

As for lenders, they have a variety of options. Banks typically don't like to have defaulted loans on their books, so many of them are modifying existing loan terms to extend the maturity dates. This can be a short-term extension on the maturity date, typically periods of two to six months, to provide additional time for the borrower to come up with a strategy to repay the loan. As consideration, the lender typically requests an extension fee or an increased interest rate (though generally not to the default rate) for the extension period.

For those projects that are not fully performing but have a “good” borrower, mezzanine lenders also can be willing to work out loans rather than seek to foreclose. They can agree to extensions of the maturity date on the senior loans and to extensions on their own outstanding loans, again, typically in exchange for an extension fee or an increase to the yield.

DRAMATIC CHANGES

Performing projects, even those without loan issues, are also being affected by the economic changes, as evidenced

by the dramatic changes in the leasing market. Traditionally at lease expiration, approximately 30 percent to 35 percent of tenants elect to renew. Very recently, that percentage has jumped to well over 50 percent, and the leasing market is slowing down.

For tenants in distress or near distress, we are seeing an increase in litigation and “near litigation” (meaning that the negotiation process gets far closer to the courthouse than previously). Retail and commercial tenants are especially hard-hit. Tenants in luxury or discretionary-buy businesses, such as high-end retailers and restaurants, are particularly vulnerable as consumers pull back on spending.

As a result, we see two different groups: marginally viable tenants who chronically fail to meet their lease obligations but who expect to continue operations, and tenants whose businesses are failing and whose leases inevitably will be terminated.

For the tenants with barely sustainable businesses, landlords are generally willing to work with them to accommodate the circumstances. Leases are being modified either permanently or temporarily (with provisions to revert back to the original lease provisions after a certain time period or if circumstances change). Or, if a lease contains a clear non-waiver provision, as most do, the tenant is de facto allowed to underperform without amending the lease.

Landlords may reasonably choose these options where the tenant's performance is deemed “good enough” considering the alternative of the cost of replacement and having empty space in a weak market, or where the landlord believes the tenant's circumstance is temporary.

For tenants whose problems are too profound to accommodate—or for landlords who, even in this market, have better opportunities and who wish to terminate the present tenant—litigation to gain possession is an increasing result.

A note of caution, though: Some property owners may have an impulse to rush to court, but remember that some tenants are realistic and may voluntarily relinquish possession without litigation. Remember, too, that even if the landlord wins in court, there often will be competing demands on the tenant's collateral that could satisfy any judgment. Not only do landlords want the value of a tenant's property, but so does the tenant's lender, and in large leases, the landlord's lender. Suddenly, the tenant's property, which previously may have been viewed as salvage material, can seem more desirable as a multitude of parties scramble to cut their losses.

This credit freeze has put us all in uncharted territory. Until the freeze thaws, the entire real estate industry will be watching, waiting, and working things out.

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