WEATHERING THE PERFECT REAL ESTATE STORM

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A perfect storm has hit the real estate markets in the United States and many other parts of the globe as well. Financial institutions, the lifeblood of the real estate industry, have been hit hard and many have been propped up with government assistance, more as a way to shore up their capital base rather than injecting liquidity into the system. The secondary market based on the acquisition of complex mortgage backed securities has virtually disappeared, as there are no buyers willing to take the risk of default in the underlying mortgage assets. What started out several years ago as the collapse of the residential real estate bubble fuelled by exotic and risky home loans pooled and sold to investors has infected the commercial real estate markets. As the debt markets for commercial real estate have all but disappeared and capitalisation rates have dramatically increased resulting in a reduction in property value, real estate transactions have been brought to a crawl, as whatever debt may be available comes on onerous terms at a high cost.

If a commercial real estate developer or investor bought at the top of the market, which was not so long ago, with the most aggressive financing available, not only is the developer or investor in trouble, but so is the lender. Add falling occupancy rates and rents in both commercial and multi-family properties to the lack of liquidity (and lower loan to value requirements for any debt that is available) and lower property values, and this coalescence of negative events creates a vicious circle dramatically changing the dynamic of the commercial real estate markets. Prospective sellers and buyers have vastly different perceptions of value which is influenced significantly by the existing financing that must be repaid by the seller and the financing (or lack thereof) available to the buyer to fund a significant portion of the purchase price. These perceptions lead to the reality of frozen real estate markets and owners with maturing loans and little hope of timely securing a refinancing loan.

We have a pretty good idea of what went wrong and what caused the problems; we have much less of an idea of what it will take to fix them. The United States government has been putting its fingers in all of the many holes in the dike known as the financial markets and is trying to create a base from which it is hoped that market forces will lead to a recovery. At present no one knows what actions will work and what will ultimately happen. It is more likely that we will not know until we arrive there and look back. Commercial real estate developers have suffered through, and survived, recessions before. While the current recession may be worse than many, the fact is that the commercial real estate market is not going to disappear – it never has. Thus, the task of developers, lenders, investors, government and certainly lawyers is to understand where we are, how we got here and help craft solutions for both the owners and lenders to enable them to survive until the market stabilises and begins on an upward trend.

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WHAT WENT WRONG

In a few words, it was a combination of investor demand for mortgaged backed securities, originators of mortgaged backed securities who packaged the loans and sold them without any stake in the loans' success, and property owners, buyers and developers with access to the relatively cheap and easy money in the debt markets who, understandably, could not resist. Add into this mix the exotic debt instruments created to increase single family residential (detached and condominium) ownership with loose standards for qualification, inadequate regulation of financial market activity (including the betting being made through the sale of credit default swaps), fraudulent activity in connection with the loan application process and the payment structure for rating secondary market securities that impinged upon the independence of the rating agencies. The result was an unsustainable run up in property values and easy and cheap debt to finance acquisition and development.

THE IMPACT OF THE COLLAPSE OF COMMERCIAL MORTGAGE BACKED SECURITIES (CMBS)

To understand the challenges facing the commercial real estate markets, one need only start with reviewing the activity of the CMBS markets prior to and after their collapse. Consider that in 2006 the CMBS markets exceeded US$200 billion. In 2007, the number was even higher, in excess of US$225 billion. Yet, in 2008, securitisations accounted for approximately US$10 billion and have been virtually non existent since the second quarter of 2008. That is a lot of available credit that is no longer available. More problematically, as reported in the 1 February 2009 online edition of the *The National Real Estate Investor* in its article entitled "Reviving the CMBS Market", 2009 CMBS and portfolio maturities could approach US$400 billion. For better or worse, the CMBS markets have become a vital component to a rationally functioning debt system and a strong commercial real estate market and cannot simply be replaced by the more traditional portfolio lenders, who themselves are reducing their current commitment to commercial real

estate lending. Clearly, in the absence of access to CMBS loans, the commercial real estate markets will struggle.

THE UNITED STATES GOVERNMENT STEPS IN

The United States government is not unmindful of the importance of capital to the stabilisation of the commercial real estate markets. Despite the commercial malaise, Fannie Mae, Freddie Mac and HUD continue to be somewhat active in the market place, providing an element of relief for owners of existing multi-family properties. The Federal Reserve and Treasury Department are each acting to deal with the crisis in ways that may or may not work, with programmes that may require adjustment from time to time. While banks and other financial institutions have received government funds that are theoretically available for lending, the funds have more generally been used to shore up capital positions as required by the federal banking regulators. However both the governmental investment in financial institutions to keep them afloat and the lack of actual lending by financial institutions brings the public into the conversation about how financial institutions are to be run.

One goal is to leverage government funding and guarantees to bring private investment funds to the financing platform. For example, in May 2009, the Federal Reserve brought some limited relief into the commercial lending markets by expanding its Term Asset-Backed Securities Loan Facility (TALF), which provides non-recourse government loans from the Federal Reserve Bank of New York to investment funds acquiring asset backed securities. It added new CMBS to the list of eligible securities that may be purchased by the investment funds and securing the loans and, additionally, it extended the maturity of the loans to five years, which brings the programme more in line with conventional real estate secured loans.

The Treasury Department also established the Legacy Loan Program as part of the Public-Private Investment Program (PPIP). With this programme, the Treasury will use funds from the Troubled Asset Relief Program (TARP) to try spur banks to sell some of their troubled loans to new entities formed for this purpose. The FDIC oversees the formation, funding and operation of the investment funds. The Federal Deposit Insurance Corporation (FDIC) provides a loan guaranty of up to US$6 for every dollar invested by the Treasury and the private investor. The Treasury contributes up to 50 per cent of the equity. Private investors bid on the assets through an auction process assuming the public participation as described.

There are also some conversations in Washington, DC about creating direct governmental involvement in the form of yet a new agency similar to Fannie Mae that would back commercial loans secured by non-residential property types, which may become a reality in some form in the not too distant future.

The programmes described above may have succeeded, failed or been revised. The jury is still out and may be for some time as the real estate lending world transforms itself. But what is clear is that the rules for financial institutions and real estate owners have changed and will continue to change. The result will be new rules going forward for how the financial institutions will be run and regulated and how real estate owners will operate.

COMMERCIAL REAL ESTATE (CRE) OWNER OPTIONS

New financing

In the absence of working securitised loan markets as well as limited funding availability from traditional lending sources, CRE owners are left with two options. First, several newer lenders are coming to the market, but demanding higher than conventional pricing. While not necessarily "hard money" lenders, these lenders are demanding a yield in the low teens. For a cash flowing project that is facing maturity, this type of financing might be a (hopefully) short term option. Unfortunately, CRE owners will also need to grapple with the fact that there has been an overall economic downturn resulting in lower renewal rents along with rent concession requests from existing tenants, eroding the value of the underlying real estate. In a rationally functioning lending environment, this is likely to lead to a need for "new equity" to meet the new conservative loan to value ratio requirements. That 75 per cent loan to value first mortgage loan with 15 per cent mezzanine debt no longer exists and simply cannot be refinanced without a significant equity infusion.

Even for a conservative loan, the situation is troubling. Assume that a loan with an original loan to value of 65 per cent originated in 2003 is coming due in 2010. Taking into account any amortisation, but also factoring in devaluation of the property, not only is a 65 per cent loan to value ratio loan unlikely to be available in the current environment, but even if it were, there might be insufficient loan proceeds to refinance the entire remaining principal of the loan due to the reduced valuation. In addition, any loan that might be available would come with more aggressive pricing, origination fees, amortisation and, perhaps, personal recourse than before. Adding to the problem is the limited availability of mezzanine debt that was formerly utilised to span the equity or first mortgage loan gap.

Extensions and restructures

For those CRE owners where financing is unavailable due to either pricing or loan to value requirements, the CRE owners' second choice (and, perhaps, last resort) will be to try to negotiate an extension or other restructuring of the loan. Certainly, in the context of CMBS loans, this is not easily done. Many factors influence what can and cannot be done by the servicer (either master servicer before default or special servicer after default), including the terms of the pooling and servicing agreement to which the servicers are bound, the "servicing standard" required by the pooling and servicing agreement, the views of the investors in the CMBS loan pool, the loan documents, the Real Estate Mortgage Investment Conduit (REMIC) rules of the Internal Revenue Service and the FASB accounting rules. Whether an extension or restructure makes economic sense, which, given the lack of liquidity in the market would generally be the case, is beside the point. Certainly an extension or restructure is "easier" to negotiate with a portfolio lender where there are only two masters – borrower and lender – and each can negotiate based on their economic considerations. But that is not the situation in the CMBS world.

Special servicers are increasingly more willing to discuss extensions (which are typically permitted under the relevant pooling and servicing agreements), but only

where the equity, cash flow and business plan warrant it. Critical to a special servicer's analysis will be whether more capital is required to stabilise (or even re-tenant) a project and, if so, whether the CRE owner will provide the equity. In light of the CMBS constraints on the servicers, interest accruals, discounts and other vehicles commonly employed by portfolio lenders are simply not generally available to special servicers. With the reduction in real estate values, even the portfolio lenders, who have been willing to employ more creative restructuring techniques during recessionary periods, have been less willing or able to make concessions to restructure any given loan. Ironically, the PPIP programme, combined with the new FASB guidelines providing more flexibility in the valuation of loans and mark to market requirements, seems to have worked at softening the stance of many portfolio lenders. As the regulatory market becomes less punitive to financial institutions, more lenders appear to be willing to consider restructures.

COMMERCIAL REAL ESTATE OPERATIONS – WHAT THE FUTURE HOLDS

With or without loan extensions or restructures, stabilisation of commercial real estate properties is becoming more difficult. Making this task much more difficult is the fact that rents are down and vacancies up. Many multi-family property owners, including larger ones such as Equity Residential and AvalonBay, have reported the softening of the rental markets (see, for example, *Thompson Reuters*, 29 April 2009 Online Edition, *Equity Residential, AvalonBay See Soft Rents*). Similar issues face office complex owners who are compelled to compete with tenants who are attempting to contract and sublease space. In the retail sector, not a week goes by without a report of some major tenant considering bankruptcy, following in the steps of Mervyns, Linens 'n Things and Circuit City. Retail centre owners are coming under constant pressure to lower rents for existing and rolling over tenants, especially as stores go dark. Indeed, based on recent statistics from such sources as the International Council of Shopping Centers and articles available on various industry websites, it is estimated that there will be 73,000 store closures in 2009, as compared to only 2,000 new stores opening during the same period. Such statistics, if accurate, will widen the abundance of dark stores in the nation's regional malls and neighbourhood shopping centres, and are indicative of a continuing decline in the retail sector in the near term. Hotel owners and resort operators are not only suffering from a general malaise of tourism caused by the global economic recession, but are also susceptible to extraordinary events, such as the panic caused by Swine Flu.

Apartment owners have a somewhat straightforward methodology for dealing with the current crisis – maintain rents and occupancy, and cut costs. Ironically, hoteliers have a similar methodology. In particular for the latter, there is an increasing focus on the efficiency of management companies and reservation systems. Reassessments to reduce property taxes in line with reductions in property value are also becoming more common, as CRE owners look for any way to reduce expenses and be able to show an increase in the bottom line on which potential new financing will be based.

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For retail and office tenants, a paradigm for dealing with lease modifications is developing. For a tenant requesting concessions, the threshold step is for the landlord to request and review evidence of the tenant's economic distress. Many retail leases require reports of gross sales figures even if the tenant is not obligated to pay percentage rent for just this purpose. After analysing a tenant's gross sales reports or financial statements, or both, the CRE owner can better determine if tenant is in as dire financial straits as it may claim, as well as the amount and nature of rent relief that is most appropriate under the given circumstances.

To the extent that a CRE owner elects to grant some relief, rent reductions may generally result in a temporary concession to the tenant. By having a relatively short-term horizon for the relief (for example 24 months), the CRE owner can keep occupancy high and also plan on some rent "escalation" as the global market slowly emerges from the current recession. Indeed, in some instances, CRE owners are only offering rent "deferral" rather than rent "abatement", so as to attempt to recapture what would have been forgiven rent in the future. Finally, CRE owners seem to be renegotiating concessions otherwise afforded to tenants (such as exclusive use and prohibited use provisions), under the theory that there should be some consideration to the CRE owner for the rent forgiveness.

Beyond the economic terms, CRE owners appear to be utilising the lease restructure process to buttress the lease documentation. For example, many CRE owners may have had other financings delayed by a non responsive tenant; utilising the lease restructure process to get current estoppels as well as revising the time frame for delivery of further estoppels may prove helpful when the capital markets emerge from the current crisis and the CRE owner is looking to refinance its existing loan. Releases are now also finding their way into lease modification documentation, to "settle" existing lease disputes. Finally, CRE owners are bargaining for the right to show tenant space while the existing tenant is in occupancy, so as to expedite a roll over if the tenant ultimately fails.

Unlike the situation with CMBS loans, there is room for creativity that can be implemented relatively quickly, unless, of course, the CRE owner is obligated by its CMBS loan documents to secure the approval for any lease modification from the servicer, which would slow down the process.

Obviously, CRE owners face an almost Herculean task. However, it is at times when things appear to be the most grim that creative structuring and lawyering can be the decisive factor that determines success or failure.