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Real Estate Finance

C O N F E R E N C E

Strategies for the 1980s

PHARAOH AND THE REAL ESTATE MARKET

By Daniel Rose

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Pharaoh and the Real Estate Market
or
"What to do when your loans hit the Fan"

By Daniel Rose
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Ever since the Biblical Joseph warned Pharaoh that the seven fat years could be followed by seven lean ones, thoughtful observers have worried over problems connected with economic cycles; and in no field have the worries been more justified than in real estate.

The reasons for the feast-and-famine nature of real estate markets are another discussion for another day; but no mortgagee active today needs to be reminded that once again, in a variety of markets, previously "firm" demand for the end product can become a faded memory; final capital costs can bear no relation to preliminary budgets; "bottom lines" can evaporate and "take-out" lenders can walk away. To complicate matters further, yesterday's "rules of thumb" today often have a nostalgic ring, to the confusion of bank officials trained to deal with an existing or prospective "bottom line", not to help create one.

In times like these it is prudent to remember the painful lessons of past market turns and to profit from the experience gained from past debacles: the lender's over-riding goal is to protect his loan investment and his accrued interest.

His goal is not to awe his colleagues with entrepreneurial razzle-dazzle; it is not to have the chance he always secretly wanted to "play builder" and to Trump Helmsley's ace, or to show Gerald Hines or Trammell Crow that he can do it better; it is not even to "cook the books", trying to hide indefinitely the reality of sick jobs which must eventually come to light.

All those actions are tempting possibilities for lenders today, and they bring to mind the wry comment of General Bosquet, the French officer who, watching the real-life massacre of the "Charge of the Light Brigade" commented, "It's beautiful, but it's not war!"

Well, for the prudent mortgagee, "war" means protecting asset value.

When major loans go bad, lending officers often at first go through the reactions that psychologists associate with many traumas – denial, anger, blaming others, and so forth; but when the dust settles and reality reappears, certain fundamental truths are seen as self-evident.

First, lenders are trained to lend and to supervise loans, rather than to operate real estate or to make operational decisions;

Second, such operational problems should be handled by those

equipped by training and experience to deal with them;
Third, there are particular skills involved in being a good owner, and they constitute a specialty in themselves.

Knowing what questions to ask, knowing when and how to ask them, and knowing what to do with the answers are all part of a clearly defined game with its own set of strategies.

Some institutions use in-house personnel; others turn to outside talent; and most use a combination of the two. But the smart ones all use specialists for what is, indeed, a specialty, or even a group of specialties.

The first steps these specialists take with a problem property are a thorough and objective analysis of the job and a review of all feasible alternatives. Often, an outsider can see (or admit to himself) things someone closely connected with the problem cannot.

Once he has a clear, accurate and up-dated picture of the property and its curent market prospects,the lender has several options available when faced with a defaulted loan.

He can:

1. Re-negotiate the debt agreement with the existing developer;

2. Start foreclosure proceedings;
3. Attempt to acquire the deed in lieu of foreclosure.

If the property is acquired, the lender can:

1. Attempt to dispose of it "as is";
2. Provide necessary fresh financing to permit a new developer to acquire and complete; or
3. Have the institution undertake completion of the project for its own account.

Each of these alternatives has pros and cons which must be considered in light of the particular circumstances.

Just as it has been observed that happy families resemble one another but unhappy ones are unhappy in individual ways, so each halted job (or one whose net cash flow doesn't justify its capital costs) is an individual case; and it is difficult to generalize.

Some major points, however, should be kept in mind by everyone concerned with troubled real estate loans. They almost constitute a modern decalogue for the work-out field.

1. Appraisal Problems Concerning Distressed Projects:

It is formidably difficult to come up with meaningful appraisals of problem properties; one must guard against approaches that seem plausible but do not reflect actual market value. Historic costs, for example, can be totally irrelevant, and efforts to work backward from discounted future values can be misleading. A "residual approach" is probably the soundest, if it involves a realistic projection of a future net cash flow and capitalization rate, and a reasonably accurate estimate of the true fresh capital costs and accumulated deficits involved.

2. Hidden Start-Up Costs

Vandalism, pilferage and the destructive effects of weather, as well as the substantial labor and material costs sub-contractors meet in winding down a stalled job and in reviving it, are facts of life that must be faced. Experience has shown that in desperate efforts to forestall foreclosure, developers often take short-cuts, omit crucial equipment, substitute materials of lower quality than specified, and otherwise hurt the job.

The professional competence and the integrity of the building team resuming construction are therefore of even greater importance than on a new project.

3. High Marketing Costs For Problem Jobs

The time, talent and effort required to "turn around" a sick job are out of all proportion to what might ordinarily be required on a successful project, and they must be budgeted accordingly. For the long range health of the project, it is important to avoid an image of failure, shoddiness and decay.

4. Realistic Budgeting Of Deficits Of Distressed Property

The operating costs of a partially occupied building are not much less than for a full one. The two corollaries are:

- A) The difference to the "bottom line" of successful merchandising is crucially important; and
- B) Interim operating deficits should be faced squarely and funded appropriately.

5. The New Financial Plan

The key to successful handling of a troubled property lies in proper tailoring of the new financial package to a realistically projected income stream and to all capital costs.

In cases where construction has stalled and additional sums are required, fresh monies to complete must be viewed (and rewarded) differently from previous "sunk costs". In instances where several institutions may have participated in the original loan, but not all are equally prepared to advance fresh funds, it may be wise to treat the "new" money as a first mortgage and the "old" money as a subordinated second mortgage.

If the total value on completion is less than the fresh money required, the project may have to be abandoned.

If completed value is greater than the new money needed but less than the total capital expended, a realistic discount should be placed on the "sunk cost".

In stalled projects with several participating lenders the lead lender often finds it desirable to "buy out" the others at an appropriate discount.

6. "Who?" Rather Than "How Much"?

In view of the many "unknowns" and "unknowables" involved in reactivating or turning around a problem job, the importance of the competence and integrity of the take-over team is crucial.

Institutions which focus on the amount of up-front money, guarantees, etc. rather than on the ability to perform, commit a classic error.

7. Realistic Repayment Schedules

One sometimes hears of workout deals being made with lenient terms "up front" but with future conditions and repayment schedules so severe that they have little chance of being met. This means that the stage is being set for a new round of repossessions and foreclosures a few years later.

Ostensibly shrewd in the short run, this practice will, in the long run, hurt not only the over-optimistic take-over agent, but the greedy lender as well, for the job that will one day face repossession will most likely have been bled in the interim.

8. Long Term Financing

Workout loans should have terms long enough so that the "balloons" have a realistic possibility of being re-financed. It should not be automatically assumed that in the future fresh long term financing will be available in the amount and rate the job can stand.

9. Sale of Tax Losses

The dollar value of excess depreciation and tax losses generated during construction can be sold for the benefit of the job, and in the past these values were often substantial. Although it is likely that proposed changes in the tax laws will reduce them significantly, it is all the more important that whatever benefits remain be handled imaginatively. (In several cases, Rose Associates has recommended that these proceeds be applied to a reserve for working capital and payment of mortgage interest shortfall.)

10. Short Term vs. Long Term Goals

The immediate problems of a troubled project put strong pressure upon a lender to take direct action in his immediate short term interest at the expense of his long term position. But basically

sound real estate has historically shown a strong recuperative power. Many of the bad loans of the 1970's, when handled wisely and competently, actually worked out well for the lenders.

The traditional benefits of the equity owner – capital appreciation, the value of tax shelter, increasing cash flow, and proceeds of sale – have become matters of importance to the lender as well.

Although the lender's goal is the protection of loan principal and interest, he may find that in the long run he will get back even more dollars than anticipated but in somewhat different form. That, perhaps, is the most thought-provoking note on which to end.

It is true that, almost by definition, a distressed job will tend to be in a distressed market.

It is also true that appropriate changes in strategy or in approach, or the introduction of more skilled players in the game, can substantially change the odds for success.

It is true, too, that in time soft markets do firm up, and if the interim period has been used wisely, surprisingly good results can flow.

At Rose Associates, we normally do not talk publicly about specific projects we have been called in to turn around, but in order to end an otherwise sobering discussion on an up-beat note it may be

worthwhile to note two happy thoughts. The first is of a small work-out we did in 1928 for the Metropolitan Life Insurance Company, which began a half century's happy relationship with that institution. The second, is that when we were asked years ago to become involved in Manhattan Plaza, the 1700 unit residential development on 42nd Street and Ninth Avenue here in Manhattan, it was standing uncomplete, with construction halted and serious people suggesting that to keep from further deteriorating an already decaying neighborhood, the partially completed buildings be torn down.

The introduction of the concept of housing designated specifically for individuals connected with the performing arts set in motion a chain of events that has not only made the project itself a roaring success but that triggered a remarkable up-grading of the entire neighborhood.

Pharaoh and Joseph were right; lean years do come from time to time, but they were also right in showing us that energy and imagination can pull us through.

Thank You.