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Borrower, Have You Started Preparing for Your Meeting With Your Lender to Discuss a Loan Extension or Restructuring?

PART III - WHAT THE BORROWER NEEDS TO INCLUDE IN ITS PRESENTATION AND PLAN

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In Part I of this three-part blog on meeting with your lender, I discussed the new June 2023 Policy Statement (the "2023 Fed Policy Statement") issued by the Federal Banking Authorities (the “Feds”), the upcoming real estate crises due to $4-5 Trillion of office mortgage loans maturing in 2024 and 2025, and how the Feds foresee and want to modify current banking guidelines to assist both banks and borrowers in extending and restructuring their troubled commercial real estate (“CRE”) loans to get past the next few years.

In Part II, I discussed how the borrower needs to approach the initial meetings with the lender when its CRE loan is in the near future maturing and the borrower needs a loan extension or restructuring. The borrower needs to understand the lender's regulatory restraints so that the borrower's plan is not dead on arrival. Further, with its loan near maturity, the lender has the winning legal hand as there is no harder default for a borrower to overcome than a maturity default. However, the borrower also knows the Feds and lender want to work with borrowers, if possible under the 2023 Fed Policy Statement guidelines, to avoid foreclosures with possible immediate and future losses suffered by the bank. The borrower needs to reach an agreement with the lender for a repayment of the loan on reasonable terms that provides the lender with a reasonable probability of being repaid in full.

What Elements Should be in Your Presentation and Plan:

Initially, the borrower has to take an honest look at its property and the properties it competes against. Are the problems facing the borrower caused primarily because of the hangover from the 2020 pandemic and worker reluctance to return to the office or are there problems with the property itself, the borrower's or manager's operations of the property or its surrounding market? The borrower must have answers for specific market issues and cannot walk into the lender meeting, throw up its hands and say it has no idea how to make the situation better.

Hangover from the 2020 Pandemic, Worker Reluctance to Return to the Office and the Amount of Time to Request for the Extension:

For many office properties, the primary reason the property is in trouble is the hangover from the 2020 pandemic and worker reluctance to return to the office. One example is a Class A office building that is currently 75% leased, however, only 50% actually is occupied with active tenants. In this case, a quarter of the building's rental space is empty of the tenants who now allow a predominant part of their employees to work from home. With their employees no longer coming to the office, the tenant is paying rent on unused space waiting for the lease to expire by its own terms. Once these leases terminate, this Class A office building will be down to 50% leased, occupancy and rents. Not a good position.

In this case, the borrower was caught by surprise by the pandemic, the quick ability of employees to work from home and their desire to stay working from home.

So, what is the fix for employees returning to offices? Unfortunately, other than time and hoping that corporate America forces its employees back to offices, there is no silver bullet. Because this is an entire market problem and not focused on individual properties with unique problems, a market-wide solution has yet to arise. At present, office owners are hoping that time will see a return of employees to the office or new companies take over the empty space. While the lack of a clear answer is obviously a problem for owners, at least it also causes banks to hesitate foreclosing because they do not have a better solution and don’t want to foreclose on and own money-losing properties. Similarly, the 2023 Fed Policy Statement evidences that the Feds don’t have a better answer. Otherwise, they would not have published a policy that favors granting property owners more time to figure this out. So if the problem with the property is primarily a result of the 2020 pandemic and worker reluctance to return to the office, the borrower should receive a hopeful, if not receptive, ear from the bank because the bank has nothing better to suggest.

One popular answer currently being discussed is to convert uneconomic office buildings to residential towers thereby killing two birds with one stone, getting rid of excess office space, and increasing needed urban residences. However, the costs and engineering of such conversions do not work with every building. In fact, due to the last half century's fixation on large cube office buildings (which are the most efficient for office use), a huge percentage of such buildings are not profitable or practical to convert to residences.

For two very informative presentations on the advantages and difficulties of office-to-residential conversions, click on the links below to see video presentations by The Wall Street Journal and CNBC:

- **WSJ** -- How to Convert Empty Offices Into Luxury Apartments
- **CNBC** -- How Empty Offices Become Apartments in the U.S.

Therefore, regarding the 2020 pandemic and worker reluctance to return to the office, a request for a year or two extension to get past this period is expected by lenders. However, it still must be backed with other elements that the lender will believe will result in the extended loan having a reasonable likelihood of being repaid in full at reasonable interest rates.

The Extended Loan Interest Rate:

Property owners have been hit with the recent double whammy of lower occupancy rates plus higher interest rates. Higher interest rates when balanced against stable or even decreasing rental rates do not provide a winning combination for the borrower. In such cases, the borrower's first thought is to ask for a decrease in the loan's interest rate for the extended term to assist in the borrower's survival. However, in that case, the borrower is asking the lender to decrease the lender's income and profit. Such a request needs to be backed up with a detailed analysis and projections to convince the lender to incur such a cut. But the lender will also want to know why it should take an income hit just so the borrower can suffer fewer losses. Obviously, the lender will ask, what is in it for the bank? What concession to the lender or benefit to the property will the borrower make or contribute so that the lender does not feel that the proposal is one-sided, i.e., the lender makes all of the sacrifices? Additionally, there are, of course, many properties where the property's income will cover a current market interest rate, and, in such cases, it will be nearly impossible to convince the lender to grant a lower interest rate during the extension period.

Throughout the 2023 Fed Policy Statement, the Feds, time after time, speak to borrowers obtaining an extension at current market rates *"that provides for the incremental risk."* (The immediately preceding quoted language and all quoted language in italics below are quoted from the 2023 Fed Policy Statement.) "Incremental risk means the default risk and credit migration risk of a position. Default risk means the risk of loss on a position that could result from the failure of an obligor to make timely payments of principal or interest on its debt obligation, and the risk of loss that could result from bankruptcy, insolvency, or similar proceeding. Credit migration risk means the price risk that arises from significant changes in the underlying credit quality of the position." (12 CFR § 324.202). In other words, the Feds, if at all possible or with some reasonable amount of pain suffered by the borrower, want the extended or restructured loan to be at current market rates.

However, this is a negotiation, and if the property can only support the loan at the existing interest rate or even lower, but not the higher current market interest rate, the bank, not wanting to foreclose if not necessary, should be receptive to keeping the existing rate if the path to full repayment is reasonable. It might, if the Borrower's future lease-up or rent projections warrant it, even permit a below-the-existing interest rate change for a temporary short defined period. In such cases, the borrower needs to come with projections ready to show how the property just squeaks by at the requested interest rate and that full loan repayment should be achieved. But it is also possible that the lender will require the higher market rate and insist the borrower or guarantor come out of pocket for the difference. Again, the bank will ask, if one of us has to take a loss of some type, why should it be the bank and not the borrower or guarantor/sponsor who stand to profit from the deal if the extension or restructuring is successful and the borrower can later sell the property at a profit? If that question is asked, it is usually the borrower who will have to reach into its pocket, unless the borrower's reply is there are no additional sources of funds and the bank will have no choice but to foreclose unless it agrees. Then the bank will have to make a tough decision.

Principal Pay Down:

In many of the recent extensions or restructurings I have been involved with, whether on the borrower or lender side, it is not uncommon for the lender to require a principal pay down of some type. Usually, the pay down is an amount to allow the loan, at the new interest rate, to fit within a debt service coverage ratio ("DSCR") test that provides the lender some level of comfort. Since the context of the meeting is a troubled loan, the new DSCR will most likely not be the normal 1.25 to 1.00, but some easier/tighter ratio if a DSCR makes sense to use at all. Assume the lender has/will carefully review the borrower, guarantor and sponsor's financial statements. If any of them possess liquid funds to contribute to the deal, the lender, to prove to that the borrower really believes in its own presentation and plan, will justifiably want to see the borrower reach into its own pocket and contribute more equity to the deal.

Additional Collateral or Guaranties:

Similar to a principal pay down request, the lender may ask for the borrower, guarantor or sponsor to provide additional collateral or an additional guaranty or expansion of an existing guaranty. This may be more palatable to the borrower side at the time of extension because there is no cash out of the borrower's or guarantor's pocket, but, if the borrower's plan or projections fall apart, the borrower could lose a valuable piece of additional collateral to foreclosure or the guarantor may expose itself to a large deficiency liability.

Borrowers should note that the 2023 Fed Policy Statement, in numerous places, discusses how the bank should look to the borrower side's financial statements for additional support. Whether it is a general guaranty of the entire loan, a bad boy guaranty of non-recourse carve-outs to cover specific concerns like the payment of taxes, or a guaranty specifically focused on specific risks in the loan such as construction cost overruns, deferred interest or other third party costs, such as ground rents or franchise fees, having an additional source of payment is a definite plus in the bank's and examiner's analysis.

Loss of Major Tenants and/or Leases Expiring in thee Near Future:

The current national office market finds itself caught in a predicament of overall higher national vacancy rates and competition amongst building owners for future tenants. In its presentation, the borrower must address this problem and present a plan that shows how the borrower plans to replace tenants and keep the property's occupancy at acceptable levels and rates. The plan can address property renovation and updating, introducing more or new technology to the property, changing the mix of tenants, roof leases for telecommunication towers, re-designing floor plates for different type of tenant operations, and switching portions of the property from strictly commercial tenants to a mix of hotel on some floors, residences on others, retail on others, etc.

Of all of the elements of the borrower's presentation, solving the problem of terminating leases with fewer future tenants may be the truest test of a borrower's skills as an office owner.

Significant Decrease in Fair Market Value:

As noted earlier, fair market values of office buildings are down approximately 30% nationwide primarily due to the 2020 pandemic and worker reluctance to return to the office. The borrower in its presentation needs to deal with this declining value as the lender is obviously aware of the issue and waiting to see how its borrower will address it. Also, since many fair market values are now determined by using cap rates of income based on existing leases, this issue is related to and similarly solved when the borrower addresses a loss of tenants and future rent rolls.

The truly good news is that the 2023 Fee Policy Statement clearly, and in more than one place, states that the fact that the current fair market value of the property is below the outstanding balance of the loan is not fatal to an extension or restructuring, *"...modified loans to borrowers who have the ability to repay their debts according to reasonable terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the outstanding loan balance."* The key, as stated many times herein, is for the borrower to show in its presentation that its plan will, in fact, offer: *"...the ability to repay their debts according to reasonable terms...."*

Updating or Renovating the Property:

A few times in the scenarios provided in the 2023 Fed Policy Statement, the Feds discuss properties that have become old or non-competitive due to outdated technology or other reasons. While putting such renovations and updating plans in the presentation are important for the lender to see, the real question will be who pays for the renovation or updating? If the borrower parties' funds are truly exhausted through covering earlier losses or setting aside funds to cover the projected debt service if the extension or restructuring is approved, it is not unusual for the borrower to request a mini-renovation loan to be added to the primary loan.

However, if any of the borrower parties have liquidity to cover such renovation cost, the lender will insist that the borrower side pay for the renovation. Accordingly, the borrower needs, as part of its plan, to show what renovations need to be conducted, the timeline for completion, the projected increase in occupancy and income, and how the borrower side will pay for as much of it as it can.

Change of Managers and General Contractors:

While lenders do not want to see their borrowers hopping from management company to management company, they do want their borrowers paying close attention to the manager and not being an absent owner. If the existing manager is not taking all appropriate steps to maximize income and decrease costs, then replacing the manager should, if possible, be an important element of the borrower's plan. If such a change of management is part of its plan, then the borrower should include in its presentation why the manager is being changed, how the borrower sees the change improving revenues, and who the new manager will be so the lender can confirm it approves the new management company, the difference in management fees, if any, when the changeover is to occur and the time to complete the changeover.

Similarly, if the loan is a construction or renovation loan and the general contractor is behind schedule and/or above costs, a change of the general contractor may be one of the important elements the lender is looking for in the borrower's corrective actions.

KRCL's attorneys have sat with numerous borrower clients assisting them devise their plans, as well as with many of our bank clients reviewing, analyzing and sometimes making sense of borrower-submitted plans. We will play “Devil’s Advocate” and be brutally honest in analyzing the pros and cons of our borrower clients' plans before submission to lenders so that they can be revised or tinkered with to achieve the maximum possible positive reception. This process is not KRCL's first rodeo to negotiate and close. We know how to help our borrower clients get this done.

About the Author

Charles Aster has a diverse real estate practice which includes not only working closely on the development and financing of a number of premier stadiums and arenas across America, but also over 40 years' experience in the financing (both lending and borrowing), acquisition, ground leasing, construction, leasing and sales of major office buildings, hotel groups and hotel projects, apartment complexes and shopping centers throughout the United States.

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