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Reach Out with Recapitalization

Options still exist for distressed borrowers with little refi potential

COLLECTIVELY, COMMERCIAL REAL ESTATE owners across the country need to refinance more than \$1 trillion in commercial debt in the next few years. And there isn't enough liquidity in the U.S. capital markets to refinance even half of that.

With the outlook as bleak as it is, what options do distressed owners have?

They have a few, albeit none that many owners are likely to describe as attractive. Even so, mortgage brokers can play a positive role in helping their clients through this difficult time. Brokers may help distressed owners and developers seek refinancing for their loans. When refis are unavailable, brokers can point clients to other options, such as recapitalizing their loans.

Before suggesting specific assistance options, brokers must first understand the market reality confronting troubled property-owners. There are a few primary distress factors that are adversely affecting some owners' ability to refinance maturing debt.

From 2005 to 2007, many commercial real estate owners leveraged projects heavily, often attracting debt financing with loan-to-value ratios (LTVs) of 90 percent or greater. By and large, owners were financing their projects with as little of their own money as possible and as much of someone else's as they could get. This often was an important component in property-owners' investment strategies because of its influence on profitability and equity risk. Highly leveraged owners historically use leverage to stay as liquid as possible and to maximize profit potential, consistent with their needs.

The key to meeting these needs is dealing with the project's capital structure, or capital stack. The capital stack includes the

various components of capital invested in a property. A highly leveraged capital stack typically includes about 10-percent owner equity, 20-percent junior debt and 70-percent senior debt. The higher the position in the stack, the greater the potential return on investment and the greater degree of risk involved.

Another key factor is that real estate property values are down dramatically. Leverage, however, can be a double-edged sword. Just a few years ago, many property-owners used it to secure five- and 10-year mortgages — many that will come due in the next few years. Since their peak in October 2007, property values have plunged more than 40 percent, according to Moody's/REAL Commercial Property Price Index this past October. The decline in property values, in effect, wiped out the upper levels of the typically highly leveraged capital stack. It erased all of the owner's equity, along with all of the junior debt and 10 percent of senior debt, resulting in a property worth less than the original senior debt.

Worse, commercial real estate values may tumble another 17 percent by the end of this year, according to Goldman Sachs Group Inc. Many of these property-owners will find it difficult, if not impossible, to refinance when their mortgage matures and their property's value is less than the amount needed to pay off the loan.

Also, the buildup in demand for commercial debt has created a historic imbalance in the U.S. capital markets. Today, most commercial banks, which account for 50 percent of all new commercial loans, are not in a position to extend credit to new borrowers because of the banks' deteriorating commercial loan portfolios. On top of that, the commercial mortgage-backed

securities market, which represents about 20 percent of commercial loans, has virtually dried up, according to the Mortgage Bankers Association.

In addition, the bad economy has accelerated cash-flow contractions, which has caused late payments on commercial loans to jump sevenfold in this past September from September 2008, according to Credit Suisse Group AG.

The combination of these distress factors means many property-owners and developers will find it nearly impossible to refinance. As such, many will have to sell their properties — if they can find a buyer. Many more will be forced into bankruptcy. Some may just decide to give the keys to the lender and walk away.

When refinancing is unlikely, another option for distressed owners is to recapitalize their property with a new equity partner and new debt. Those owners who accept recapitalization as a solution likely will see that it gives them a chance to stay in the game, to buy time and to ride out the market until it turns around.

There are billions of dollars of alternative real estate capital available on the sidelines ready to step in to recapitalize distressed properties that have intrinsic commercial real estate value. Included are private-

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equity funds, institutional and individual investors, certain corporations, and others.

This available pool of alternative capital represents an opportunity for savvy brokers and property-owners to step outside their normal comfort zone and explore new opportunities.

The first step for brokers is to identify distressed owners. This category essentially includes any commercial real estate owner who is highly leveraged, who has experienced a significant decline in property value or both. They are in every community. Once they find these owners, brokers can proceed with business as usual in helping their clients but with other options in mind to match distressed owners with well-funded investors.

Recapitalization works similarly for distressed owners of existing properties and

for distressed developers of partially completed projects. For both types of clients, when they wish to refinance, the key is to identify and to cultivate investors willing to purchase the note from the bank at a discount. The owner or developer will continue to make original payments to the new investor and will subsequently participate in the upside when property values increase.

If the bank won't discount the note for a reason such as not wanting to write off the loss, the new investors may instead opt to recapitalize the property. Doing so, they will provide the equity or mezzanine financing required to secure new senior debt of 50-percent to 65-percent LTV. Owners of existing properties could continue to operate their buildings, and developers can complete their projects in this scenario.

To restructure the capital stack effectively, distressed owners and developers will require someone with extensive market-focused expertise along with rigorous, highly disciplined due-diligence skills. Equally important is having access to a wide-reaching network of active, well-funded private investors who are willing to recapitalize those properties that need refinancing. ●