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Critical Steps in Developing an Action Plan for Non-Performing Real Estate Investments

There is a seismic shift of control - if not full ownership - of real estate assets taking place today. The shift from the "owners and/or borrowers" to the "lenders and/or investors" is more profound than at any time in our modern history. The primary function of real estate lenders is to lend money, and then collect payments, on loans secured by real estate assets. With the dramatic collapse in asset values, many lenders now find themselves in the position where they are taking back the loan collateral as commercial real estate loan defaults spike to the highest level in 20 years.

Almost everyone that was an active lender or provider of capital to the real estate investment and development community over the last several years is struggling to evaluate their positions to determine the appropriate management and exit strategy for these positions. Below are some of the steps necessary for lenders and capital providers to develop and implement a strategic plan to resolve their troubled real estate assets.

Perform detailed legal review.

In order to develop the appropriate strategy the lender needs to perform a detailed review of all legal documentation. The review should be comprehensive and should include supplementary documents including guarantees and intercreditor agreements. Many best-in-class workout groups are separate and distinct from the group that originated the investment. This action item may also include engaging different legal counsel to review the documents in order to get a fresh perspective on the transaction and an unbiased review of the documents.

The primary goal of the document review is to make sure that there are no deficiencies in the documents and to gain a thorough understanding of the lender's rights and remedies so that the correct strategic plan can be designed and implemented. Common issues to address include: What is the full collateral pledged to the debt? Are the building and improvement plans, architectural drawings, trade names, license agreements, and engineering reports all assigned to the lender? Are there partnership or LLC interests that are assigned to the lender? Are there any rights to repurchase the asset from the original seller recorded against the property and senior to the loan? If loan modifications were made, were they agreed to in writing by the guarantor? What are the benefits of other agreements affecting the property that the lender might want to assume (for example, a development agreement with the city) and, conversely, what potential liabilities are there that the lender may not want to assume.

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Gain detailed knowledge of the asset.

The lender should take all steps necessary to completely understand the underlying collateral. This will provide the lender with information about the collateral and in addition will be invaluable in assessing the borrower's (or developer's) management practices. Time, and often money, needs to be invested in order to understand all of the issues related to the underlying real estate. A current site visit must be made to ascertain the current status of the project, as well as the status of competing projects. It may be necessary to employ third party consultants to conduct an overall project review or a specialized component analysis, such as an independent cost to complete analysis. If the loan is secured by a development or construction project several key questions must be answered: What is the current status of the on-site and off-site construction? What development agreements exist? What are the ramifications if construction at the project is shut down? Is there a stage of construction where the costs of a shut down are minimized? Are entitlements fully secured and, if not, what entitlement issues exist? Are there outstanding mechanics liens? What is today's cost to complete? What needs to be done to protect the site from waste? What are the carrying costs under a mothball scenario?

At this stage, documents should be requested from the borrower and, ideally, obtained prior to foreclosure or even in advance of beginning the foreclosure process. Typically borrowers are most motivated to assist the lender at the beginning of the deterioration of the loan's condition. As soon as the first real signs of distress arise, the lender must be proactive in requesting necessary project documents and establishing a complete project file to assure that they, or the potential buyers of their loan or REO, have the necessary information to value and manage the project in case of foreclosure.

Evaluate the borrower/partner relative to the events affecting them today.

A borrower whose projects are in distress may well have "given up" before the lender is aware of the extent of the borrower's problems. The lender needs to critically determine the quality and focus of the borrower. How are they managing the project in a distressed situation? Are they truthful and communicative? Do they have other liabilities that have caused them to lose focus? Do they have adequate cash flow in order to maintain their management infrastructure?

The lender must quickly determine the borrower's ability, wherewithal, and desire to continue managing the project. As part of this evaluation, the lender must consider not only the financial strength of the borrower but also the condition of the existing organization. Are the people with the right expertise in place? Do

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they have the capacity to devote the appropriate effort to the project? Have they suffered a loss of key individuals within their organization?

In addition, the lender should ensure that there is a structure in place that aligns the interests of the lender and the borrower. Is there a reason for the borrower to ensure that the property or development is being managed to maximize value? Personal recourse can sometimes accomplish this alignment; however, lenders should not always assume that personal guarantees will result in management strategies and effort that are completely aligned with the lender. Often, the borrower will recommend a strategy that involves substantial risk that may result in a lower deficiency judgment or, at a minimum, postpone the lender's inevitable loss; however, there may be strategies that are much more appropriate for the lender on a risk adjusted basis.

Another important consideration is whether the borrower adds value to the project. Is there something unique or hard to replace about the borrower that would warrant special consideration in deciding whether to foreclose? Some lenders rush down the road to foreclosure with no plan or ability to replace the unique management organization that they are in the process of removing. Equally important, and sometimes overlooked, is the analysis of what cooperation is needed from the borrower in order to maximize value. Even if the borrower's qualifications are easily replaced, there may be significant cooperation that is needed. Does the borrower own or control other assets (that are not collateral for the loan) that are imperative for the operations or development of the collateral? These determinations need to be made early in the process and thoughtfully considered when developing the management strategy.

Develop an alternative plan in the event that the borrower needs to be replaced.

Even if the lender determines that the best course of action is to work with the existing borrower, an alternative plan should be established in the event that a deal can not be worked out, the borrower becomes insolvent, abandons the project or for some other reason becomes unable, unwilling or incapable of managing the project. This alternative plan should consist of both a pre-foreclosure and post-foreclosure strategy.

The pre-foreclosure plan should include the evaluation of whether a receiver should be utilized. Receivers are appointed by a state superior court and are charged with preserving the property and performing the same general responsibilities as the owner of the property. A receiver can be absolutely critical in the event that the underlying asset can deteriorate in value or if substantial liability can be incurred if the asset is not managed appropriately. Is there rent and other cash that can be used for the benefit of the property or to satisfy the debt? Is there construction underway that needs to be continued? Is proper

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insurance coverage in effect? Are there dangerous conditions that need to be corrected? One material benefit of a lender utilizing a receiver is the potential avoidance of construction defect liability, environmental liability and lender liability. For example, for a residential housing project in California, use of a receiver to complete and sell individual units can significantly reduce the lender's exposure to construction defect liability as the seller.

The post-foreclosure plan should include an analysis of what expertise is needed to manage and maximize recovery from the foreclosed loan and a realistic analysis of whether that expertise exists in-house or needs to be obtained from a third party. The analysis should consider whether specific market or property-type experience is needed and who the likely candidates are to execute the property level business plan. Lenders must make sure that as much thought goes into selecting a receiver and REO team as went into evaluating the experience and expertise of their borrowers in approving the original loan. Lenders need to carefully assess the asset management, development and operating skills of any internal group or third party that is selected to handle troubled assets.

Currently, there is an abundance of individuals and groups with no operating history who are selling asset management and receivership services to lenders. In making the correct hiring decision for a receiver or asset manager, lenders should not only evaluate the individual backgrounds of key employees but also should assess the stability of the company's platform. Has the group been together for an extended period of time? Do they have experience operating as a fiduciary? Do they have current risk management and institutional quality reporting systems in place? Are there contingent liabilities associated with the principals of the group that may cause them to prioritize their issues ahead of their clients? Are they well connected in the specific sector of real estate, and is their reputation intact with the other companies that they will need to work with to resolve asset issues?

Perform market due diligence to gain an understanding of what an asset is worth today - including the value as a Loan or as an REO asset.

This evaluation should consider the value of the loan prior to foreclosure as well as the value of the collateral as REO after completing the foreclosure process. It should also consider what short and long term strategies could be employed to add value or what circumstances could lead to a decrease in value. For example, some loans may be perceived as having a significant amount of bankruptcy risk and, therefore, will be discounted considerably by buyers under a loan sale strategy. In this event, it may be beneficial for the lender to complete the foreclosure process and then sell the collateral as REO with a higher realization (of course the lender bears the bankruptcy risk in this scenario). In addition, this same lender may determine that they can hold the same asset for

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six months, spend a modest amount of money to complete the entitlements and sell the asset for significantly more then it would be worth without the entitlements completed. Alternatively, the lender may determine that a project's entitlements will expire within the lender's expected hold period and may decide to sell the property prior to entitlement expiration.

In developing and implementing any successful strategy, the lender must realistically evaluate all the steps that must be undertaken to maximize value. The lender must also use realistic assumptions for potential improvements in value as the economic cycle improves

In conducting the necessary valuation due diligence, the lender should limit its reliance on appraisals. Appraisals in today's environment can vary significantly from current market values. By nature, appraisals are backward looking and rely heavily on actual closed transactions. In many markets, sales volumes have slowed so dramatically that there have been very few closed transactions that are based on current market realities. Today's buyers are setting values on a forward looking basis that differs dramatically from the value used in the recent past. Consequently, lenders should get multiple valuation data points from other sources such as loan sale advisors, property brokers and distressed asset buyers.

Develop a loan and asset strategy and implement a resolution program quickly.

Depending on what the lender discovers from the analysis above, a loan strategy and asset strategy must be developed. The loan strategy (how to handle the defaulted loan) will generally consist of the following four options:

i. Forbearance
ii. Work-out
iii. Deed in lieu
iv. Foreclose

A forbearance or workout will be employed to the extent that the lender determines that the borrower provides the greatest opportunity to preserve and add value while a deed in lieu or foreclosure will result in the necessity for the lender to develop an alternative plan for managing the asset.

The asset strategy (what to do with the loan/underlying collateral) will have a number of different options and the lender's chosen strategy may change over time as the real estate environment evolves. Generally, the options can be lumped into several major categories.

- Sell the loan (immediately or after forbearance/work-out)

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- Use a receiver to complete and then sell the project or note (faster asset control and sheltered liability)
- Foreclose the note and sell the asset as REO immediately
- Foreclose the note, manage the REO to add value for near term sale
- Foreclose the note, manage the REO to add value and hold for long term sale

Because most lenders are not long term real estate investors, the chosen asset strategy will usually include a near or mid-term sale of the asset as either a loan or REO. Lenders must carefully evaluate ways to add value or minimize uncertainty with the asset in order to improve the asset's marketability. With numerous distressed opportunities in the market, buyers will focus on the assets that they can quickly understand and evaluate. Providing a complete asset file and a business plan or "road map" for maximizing value of the asset being sold will enhance marketability significantly.

And the most important point of all: act quickly. The above steps and strategic plan should be developed and implemented as soon as possible. Value is preserved and potentially enhanced by immediate action. Time is truly of the essence given the uncertainties in the current economic environment and the expected future wave of new distressed sellers that will add a tremendous amount of product to the market.

About Capstone Advisors

Capstone Advisors is a real estate asset management and investment company located in California. Over its 13 year history, Capstone has asset managed nearly $5 billion of real estate assets including office, retail, industrial and all types of land development and for-sale home construction. Capstone's clients include some of the world's largest regulated financial institutions, real estate opportunity funds and a variety of private investors.