

# **GILMORE, REES & CARLSON, P.C.**

## **CLIENT ADVISORY**

### Tips for Commercial Real Estate Borrowers in this Turbulent Economy

Commercial real estate borrowers may face a harsh reality when their commercial real estate mortgages mature this year or next. While many commercial real estate loans are amortized over a period of fifteen or twenty years, they often reach what is termed a "hard maturity" in five or ten years.

We are all aware of the rapid decline in value in residential real estate, but alas, this phenomenon is not unique to that particular sector. Commercial real estate values too have clearly declined in most areas and have actually plummeted in some. Just look at the Hancock Tower in Boston. That particular asset was valued at over 1.3 billion dollars in 2006 and it just recently sold at auction for \$660 million. There are other cases where commercial real estate values are at or substantially below their values of the last four or five years.

What does this mean to you as the borrower? If your loan is about to mature in the next year or so, be proactive. If you purchased your property within the last ten years, it is likely that the value of your commercial asset is below that which most lenders find comfort in. Perhaps your loan covenants require that you maintain a loan-to-value ratio (LTV) of 75% and based on recent property devaluation, you cannot meet this. Perhaps declining rents and vacancies have jeopardized your cash flow and as a result, the cash flow requirements are not meeting the loan covenant either.

What options are available to commercial real estate borrowers who may be facing a default in their loan covenants?

First, if you are a good customer of the bank and your loan is fully performing, ask your banker for a one to two year extension on the hard maturity date. This will clearly give you some breathing room and the ability to right those violated covenants.

Second, if you do not necessarily have a good working relationship with your banker and/or you sense that the bank would rather be out of this loan than extend the maturity, then consider the following options:

- Make some prepayments of principal now (but be careful to stay within the dictates of your loan prepay restrictions). This may enable you to bring that loan-to-value covenant in line for a refinancing at another lender. Remember, that while your LTV ratio covenant may be 75%, another lender may offer 80%.
- Shop for another lender early. Do not wait until there are only two or three months left until maturity. This will provide you with ample

opportunity to explore options and also take steps to improve the collateral value or cash flow at the property. Certainly, a short term lease for less base rent in an otherwise vacant space will improve your cash flow and might make sense in this economy.

- Be open with your banker. He will likely give you an honest answer as to whether or not he sees an extension or renewal in your future. Be open to increasing your rate to a new five year fixed rate. With recent historical lows in the indexes (Fed funds, FHLMC, and the libor rate), it's likely that your last reset resulted in your note yielding only a 4-5% interest rate. Both parties may benefit to a reset at a fixed rate of 6%.
- Enter into a like-kind exchange. If your heart is no longer in this property and you can find an alternative investment that satisfies your cash flow requirement and promises greater chance for appreciation, you can pull this off and pay no capital gains taxes in doing so.
- Explore SBA 504 refinancing with a qualified, designated SBA lender. SBA has just made this program available for refinancing (where, historically, it was available only in purchase money transactions) and it could provide the perfect resolution to your situation.

These are not the only options for borrowers, but, in all cases, do not procrastinate. It takes significantly more time and effort in this depressed market to get anything accomplished and this is especially true with commercial real estate financing.