



Real Estate

MONITOR

Refinancing: Properties Under Pressure

Real estate markets continue to struggle in the current recession, with weakness primarily due to lower demand rather than large new supply coming to market. As a result, many owners income properties may be experiencing significantly lower operating income and be close to the point of distress, where current rental income is insufficient to pay operating expenses and debt service. A property owner in this position should consider whether to seek a restructuring of existing mortgage loans that carry interest rates significantly higher than current levels. How should an owner proceed in this situation? The first point to remember is that a lender will agree to restructure a loan only if convinced this is the best (or least distasteful) alternative in dealing with a loan under pressure. The lender must also have confidence in the borrower's ability to manage the property in harmony with the lender.

Restructuring the Debt

The borrower wants the lender to restructure the debt in one form or another. Possible formats include:

- reducing the debt service constant
- accruing interest
- using a cash flow mortgage
- providing additional financing
- creating good/bad loans
- creating a third-party agreement

Reducing Debt Service Constant

If the property is now in a negative cash flow position, one approach is to cut the monthly constant by one or two percentage points. For example, a loan of \$750,000 might have been secured by property worth \$1 million that was generating net operating income (NOI) of \$100,000 annually. If the loan carried a 9% interest rate and a 10% constant, debt service would be \$75,000, leaving a \$25,000 cushion. If high vacancies and increased operating expenses cut NOI to \$60,000, the property would have a negative cash flow of \$15,000. Reducing the constant to 8% would put

the property at a break-even point. A lender might agree to this for a specified time, after which the constant would return to its former (or higher) rate.

Accruing Interest

Another approach to the same end is to reduce the payment rate of interest while accruing the difference between it and the contract rate. For example, the rate could continue at 10% but only 8% might be payable currently, with the remaining 2% accrued for a period of years or until loan maturity. (One issue is whether the accrued interest will itself accrue interest.) A possible advantage of using this approach over a straight interest reduction is that it is more likely to be deemed a modification of the existing debt rather than an exchange of old debt for a new debt. The latter can have tax disadvantages for the borrower.

Cash Flow Mortgage

In a cash flow mortgage, the lender receives all cash generated by the property except that required to meet operating expenses. The lender may require that its consent be a condition to any capital improvements or cash distributions to owners. This type of mortgage, in effect, makes the lender and the borrower partners in the property and so the lender will want to closely monitor its management. One risk with the cash flow mortgage is that if the property is subject to other loans, the cash flow lender risks being held liable to them or becoming subordinate to their liens if the lender's actions are deemed prejudicial to them.

Additional Financing

If the lender is optimistic about the recovery possibilities, it may agree to advance additional money to finance current operating expenses and to make capital improvements. The new money can be secured by a junior mortgage on the property or by other collateral, such as personal assets of the borrower. If the property already is subject to junior financing, the junior mortgagee may be

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willing to subordinate his loan to the new loan, since it is in his interest to avoid a foreclosure.

Good/Bad Loans

If the current value of the property is substantially below its book value, the existing loan may be separated into a good loan and a bad loan. The good loan, calculated as a percentage of current market value, might carry a market interest rate. The bad loan, calculated as a percentage of the difference between market value and book value, might pay a reduced or deferred rate, or it might be structured as a cash flow mortgage.

Participation by Lender

In return for any of the relief measures described above, the lender may ask for some form of participation in future cash flow or refinancing/sale proceeds. Alternatively, the original loan may be divided into a conventional mortgage and a participating mortgage. Initially, no return may be received by the lender on the participation loan since all cash flow available for debt service will go to the conventional first mortgage. However, if and when the property turns around and cash flow increases, the lender can anticipate receiving a participating share.

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Investments: Timberland

Timberland is defined as a forested area capable of growing 20 cubic feet of timber of merchantable quality per year and where timber production is not barred by legal or regulatory rules. Approximately 504 million acres, about two-thirds of the total forest lands in the United States, is considered timberland. Relative proximity to timber consumers - most often pulp and lumber mills - is a key consideration affecting the value of timberland due to the reduced transportation costs of the cut timber. Another factor affecting value is the location of the timberland; areas with more rain will experience faster growth.

Federal, state and local governments own approximately 40 percent of U.S. timberland, or about 200 million acres. The remaining 60 percent, owned by private entities and individuals, include timber REITs as well as timber investment management organizations (TIMOs). However, the large owners still represent less than 10 percent of privately held timberland. (Plum Creek, which owns approximately 6.8 million acres of timberland, is the largest private landowner in the United States.)

Returns and Risks

Timberland is an attractive investment for long-term holders such as pension funds because the "timber crop" is renewable, as cut trees are replaced by new growth. So-called "biological growth" is fairly predictable, although it varies by species and region. For example, timber in the western United States grows an average of 2.4 percent a year, while northern timber grows at 3.4 percent and southern timber at 6 percent. By one estimate, biological growth is the most important factor in generating returns on investment, accounting for between 50 and 70 percent of total return.

The major physical risk to timberland is destruction from fire, pests and disease. Overall, the risk is minimal, accounting by one estimate for losses of less than one-half percent per year. The primary

economic risk in timberland investment is that prices are highly volatile. If prices are at a low point when timber is harvested, anticipated profits may not be realized. Offsetting this is the option to hold off timber harvesting and sale until prices improve. In effect, timber can be "stored on the stump."

There is also a risk due to new environmental restrictions or regulations imposed by federal, state, or local governments. Tighter regulations or restrictions could impact a company's ability to harvest timber in a cost-efficient manner and may put it at a competitive disadvantage.

Timber Real Estate Investment Trusts (REITs)

In recent years, timber REITs have been significantly affected by the downturn in the housing market and have shifted from saw-timber (raw material for manufacturing lumber and building houses) towards pulpwood (raw material for paper and paperboard) in an attempt to mitigate the impact on earnings. In addition, some timber REITs are looking to overseas markets, especially Asia, to increase revenues.

According to information published by the National Association of Real Estate Investment Trust, through August 31, 2011 the timber REIT sector had a year-to-date return of 4.64% and offered an attractive dividend yield of 3.82%. It should be noted that there is a lack of diversification within the timber REIT sector, as it currently consists of only four REITs.

Tax Benefits

As with traditional real estate, standing timber and timberland is a capital asset. Thus the usual rules relating to capital gain and loss apply to sales and exchange of timber. In addition, a timber owner's opportunity for capital gain treatment is significantly expanded by Code Section 631 to include the sale or exchange of cut timber. Thus the owner of timber or the holder of a contract to cut timber can elect to treat the cutting of the timber as



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a sale or exchange, whether the timber is held for sale or use in a trade or business, provided the timber or the contract has been owned for more than one year.

Furthermore, the disposition of timber pursuant to a contract under which the taxpayer retains an economic interest in the timber is treated as a sale or exchange if the timber was held for more than one year. In effect, Code Section 631 permits the portion of a taxpayer's gain attributable to the natural growth of the timber to qualify for capital gain treatment even if the taxpayer cuts the timber and holds it for sale in the ordinary course of business.

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Investments: Net-Lease Partnerships

Net-lease deals always generate much interest when there is concern about the economy, because net leases combine an assurance of a safe return with the prospect of some growth if conditions are favorable. Now is such a time and investors have a choice among a number of public net-lease real estate programs. A net lease partnership is one in which the lessee pays all operating expenses so that the rent received by the lessor is entirely net.

What should an investor look for in choosing one program over another? Professionals who perform due diligence work for real estate firms say there are six matters to consider before putting a client into a net-lease partnership.

Right Strategy

The first point to consider is the strategy of the sponsor, in terms of the type of property and the degree of financial leverage. Since the main goal of a net-lease program is safety, the property should be of high quality and capable of being converted to other uses in the event of a default. Therefore, office buildings might be a better choice than such single-purpose facilities as child-care centers or automotive centers. Similarly, use of financial leverage can increase the overall return (particularly if zero coupon financing is used) but at the cost of additional risk, since if a default occurs and rent is not paid, debt service on the financing is still due or interest continues to accrue.

The Sponsor

As in virtually all other real estate partnerships, sponsor strength is critical. A major concern of the investor is that the sponsoring organization has enough assets under management so that it can keep operating even if it were unable to promote any new syndicates. If the sponsor's operation depends on a continued string of successful syndications, it may not be the right sponsor to deal with. Another important feature of a sponsor organization is its ability to fill space vacancies, which inevitably will occur over the course of a

partnership's term. Investors should seek out sponsors who have been able to find tenants in the past or who have particular expertise in the type of property being net-leased.

The Acquisition

The safety in a net-lease partnership arises from the strength of the net-lease tenant or from the high quality of the real estate (which assures that vacancies can be filled easily). If the particular deal is offering high-quality real estate, the investor wants to be assured that the acquisition team is professional and experienced, since the risk of vacancy then is reduced.

The Tenants

The best assurance of safety in a net-lease deal is the quality of the tenant. A triple-A credit who signs as tenant either will pay the rent every month or will buy out the lease. The investor, in exchange, usually must accept a somewhat lower rental. In this case, the net lease thus becomes a "bond-type" lease similar to a corporate bond.

Deal Structure

Many public net-lease programs project a first-year distribution of between 9% and 10%. The sponsor normally must write leases at two points above the yield in order to cover upfront fees and costs. If a program offers a higher return, the investor should find the reason. One reason may be that the sponsor is reducing upfront fees in order to make the offering successful. Another might be that the sponsor is providing working capital or equipment to the tenant. This is not necessarily bad but may increase the risk somewhat. Overall, the net-lease market is competitive and sophisticated so that a sponsor is not likely to be able to obtain above-market rents unless a special inducement is given to the tenant.



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Lease Insurance

Commercial lease insurance is not generally available but even when it is, many professionals consider it as nothing more than a marketing gimmick. Lease insurance probably does not increase the safety of a diversified portfolio and simply is an added expense.

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Leases: Negotiating Subordination Provisions

Commercial lease agreements are often long and complex, containing numerous clauses that neither party expects will ever be triggered by events. But sometimes they are triggered. One such agreement is the lease subordination clause, by which the tenant agrees the lease will be subordinate to any present or future mortgage the landlord may put on the property. Accordingly, foreclosure of the mortgage loan (depending on the law of the state involved) either automatically terminates the lease or entitles the lender, at its option, to terminate the lease. (If the building has been constructed on leased land, the subordination clause normally makes the lease subject to present or future ground leases as well.)

Tenant Acceptance

Tenants who enter into leases at market rentals often assume (if they think about the problem at all) that foreclosing lenders or repossessing landowners will be happy to keep them as tenants. This may or not be the case, however, particularly where a tenant has received extensive concessions in the form of free rent periods or desirable renewal options – a common situation in today's oversupplied marketplace. As a result, a tenant who may have spent several hundred-thousand dollars in fixing commercial space could conceivably be put out of business simply because his landlord failed to pay the mortgage or the ground rent. The lender or ground lessor who takes over the mortgage can then force a re-negotiation of the lease. The absence of a subordination clause prevents the lease from becoming subordinate to any future mortgages or ground leases. However, the lease remains subordinate to prior mortgages and ground leases because the general rule in law is "first in time, first in right." Consequently, the tenant must still act to be protected.

Landlord's Position

The landlord wants a subordination because this eliminates one potential problem in refinancing the property. Consequently, a tenant leasing only a

small amount of space in a large building and who spends little money on leasehold costs will not get very far in seeking to eliminate the subordination provision. However, a major tenant prepared to invest a substantial amount is in a much stronger bargaining position. That tenant should seek protection with a non-disturbance agreement (sometimes called a recognition agreement). Such an agreement provides that as long as the tenant is not in default under the lease, a foreclosing lender or re-possessing ground lessor will recognize the lease and permit the tenant to remain in possession of the space. If at the time the lease is entered into there already is a mortgage or ground lease, the non-disturbance agreement should be signed by the lender or ground lessor. With respect to future mortgages or ground leases, the lease should either contain no subordination provision (so that the tenant maintains his priority position) or should specifically provide that a non-disturbance agreement will be offered to the tenant by a future lender or ground lessor.

Non-Disturbance Clause

A lender or ground lessor may be willing to give the tenant a non-disturbance clause but only if certain conditions are met at the time the tenant takes possession of the property. Typically, these include the following: (1) the lease has not been modified by the original landlord without the approval of the lender or ground lessor; (2) the lender or ground lessor is not liable for any obligations not performed by the original landlord; and (3) the lender or ground lessor shall not be obligated to make any payments promised by the landlord or be obligated to recognize any rent prepayments by the tenant. In addition, the lender or ground lessor may insist that, at the time of taking over the space, the tenant must provide an appraisal by an independent appraiser certifying that the rent then paid represents a fair rental value of the property. This condition is intended to meet the main objection to a non-disturbance agreement by the lender or ground lessor – that the agreement may prevent



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space in the building leased at below-market rentals to be re-leased at market rates.

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RESPA: Supreme Court to Review Act

The Real Estate Settlement Procedures Act (RESPA) will be debated before the Supreme Court in a case that could shield banks and other lenders from extensive litigation under a variety of state and federal statutes. (*First American Financial Corp. v. Edwards*), 131 S. Ct. 1592, 179 L. Ed. 2d 472 (2011)). The court will decide this fall whether a consumer who purchased title insurance through a referral arrangement that allegedly violated the anti-kickback provisions of RESPA can bring a suit in federal court even if no monetary loss resulted. If the high court rules against the consumer, banks and companies charged with violations of RESPA may begin challenging the constitutionality of awarding damages in cases where the plaintiff cannot prove actual harm. RESPA prohibits payment of any "fee, kickback or thing of value" in exchange for a business referral. The act also prohibits "a portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service" for services not actually rendered to the customer. Anyone in the real estate industry who provides settlement services under RESPA is potentially affected by the case.

In the Edwards case, the plaintiff bought a home in Cleveland in 2006 and paid \$455.43 for title insurance. A year later she began a lawsuit in federal court claiming her insurer, Tower City Title Agency, entered into a captive insurance agreement with First American that was a violation of RESPA. The lawsuit alleged that because First American paid \$2 million for a 17% minority interest in Tower City in 1998, it received most of the local agent's referral business. The suit sought class action status on behalf of all consumers who purchased insurance through a title agency subject to an exclusive referral agreement with First American. The suit alleged damages of up to \$150 million. After the District Court refused to grant class-action status, Edwards appealed to the Ninth Circuit Court of Appeals, which rejected First American's motion to dismiss on the grounds that Edwards lacked standing under RESPA. The court ruled in favor of

Edwards, saying "the damages provision in RESPA gives rise to a statutory cause of action whether or not an overcharge occurred."

First American, in its appeal to the high court, is asking the court to review two issues: (1) whether a consumer can recover treble damages measured by the charge paid even though no injury was suffered; and (2) whether such damages are a violation of the U.S. Constitution, which requires an injury to bring a claim. The high court has limited its review to the constitutionality issue. If the Supreme Court reverses the Ninth Circuit's decision, it will be a very rare case where the consumer will be able to prove actual injury under RESPA and TILA, which could be a very positive event for the banking industry.

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