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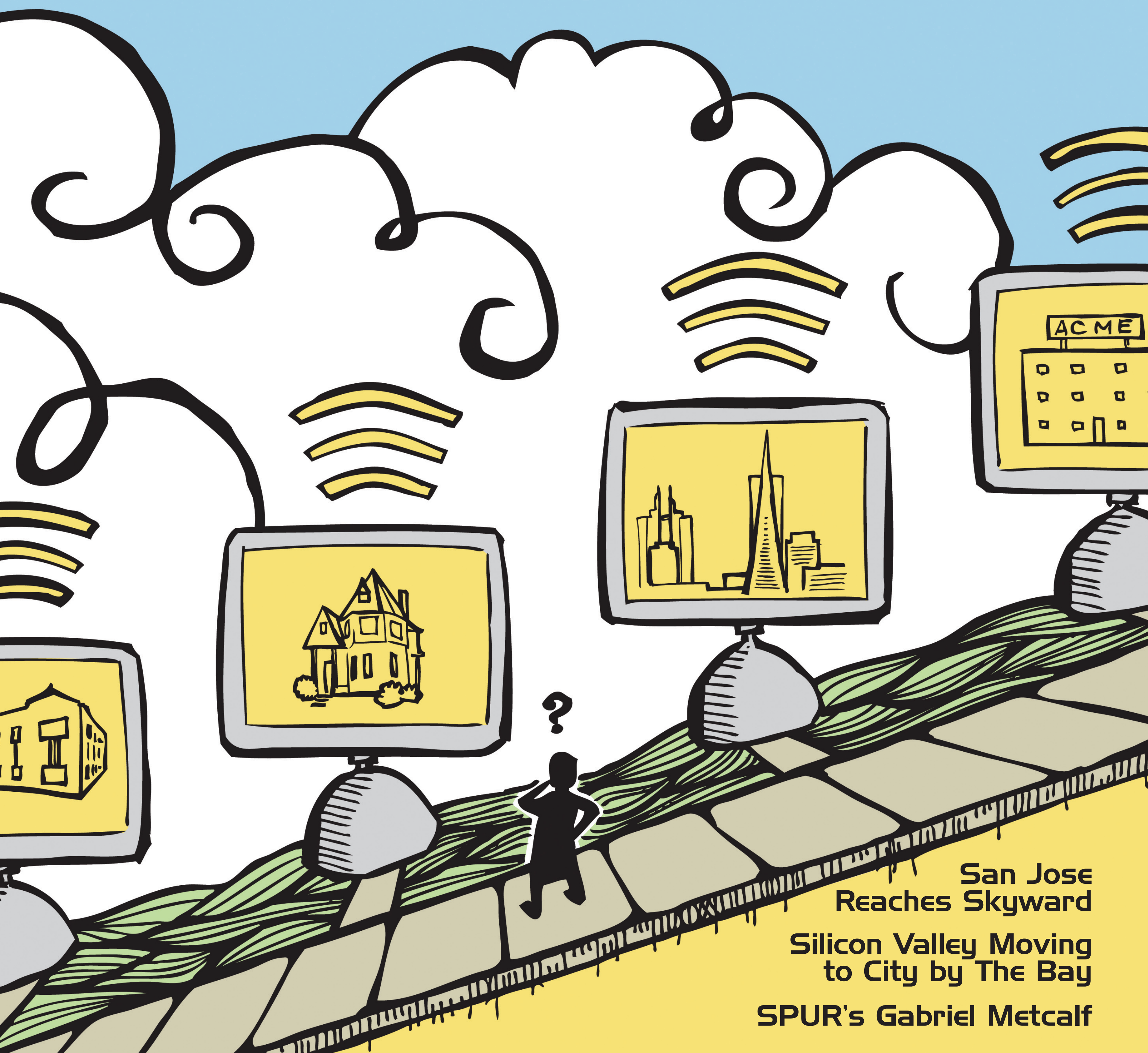
The World Will Never Be The Same p.18



San Jose Reaches Skyward

Silicon Valley Moving to City by The Bay

SPUR's Gabriel Metcalf

The Art of Credit Crunch Negotiations

Practical advice for borrowers at both ends of the spectrum

By Jennifer R. Berland

The historic flood of liquidity that created one of the best borrower markets ever in commercial real estate has ebbed. The credit crunch that followed in its wake created a short-term situation that remains to be resolved. Lenders are holding loans in their portfolios that they counted on syndicating for lucrative profits months ago. In response to this problem, lenders are adopting negotiating strategies to gain concessions from existing borrowers to allow for syndication. They are also adopting new underwriting criteria to apply to the new financing environment. If you are an existing or prospective borrower, your ability to navigate these new lender strategies and criteria may mean the difference between success or failure to your venture.

If you are a borrower who closed a transaction several months ago, especially one that involved mezzanine financing with any quirks whatsoever, do not be surprised if you get a call from your lender. During this call, your lender may seek concessions from you of one sort or another to facilitate the loan's syndication. Hopefully (a) you are performing on this loan, and (b) your loan documents require only non-substantive cooperation with the lender's syndication process. If this is the case, you will have the leverage you need to listen as a good partner and to help (or not) as you choose. In these discussions, do not be afraid to remind the lender that the risk of syndication is the lender's, not yours. Remember too in these discussions that you have a fiduciary duty to your own investors and will have some explaining to do if you agree to substantive changes without good cause.

If you are not meeting your debt service on this loan, or more likely, if you are covering debt service but are in technical default of a performance or other loan covenant, you can expect an entirely different conversation. In this conversation, the technical default may be used as leverage against you to obtain substantive amendments to your loan that will allow for its syndication. The hard-nosed lender may go so far as to impose provisional remedies, such as requiring a lockbox or withholding distribution of excess cash flow — all as a means to syndicate your loan. This can be an effective lever against you, especially if your investors are expecting monthly distributions.

If you have received a draft forbearance agreement in this situation, do not despair. Your predicament may not be as bad as it appears. A lender will think long and hard before declaring your loan in technical default. An event of default will trigger disclosure requirements for the lender and impair (if not destroy) the lender's ability to syndicate the loan. Understanding objectively the relative strength of your performance under the loan will be an important key to success in these negotiations. If you are only in technical default, having a frank discussion with the lender and holding your ground may be your best negotiating strategy.

Today's prospective borrowers face an entirely different set of challenges, namely, fitting their transactions into new underwriting criteria. The following observations and strategies should help assist you:

- At least in the short term, look to strike a deal with a portfolio lender who has not adopted syndication as its primary revenue model. These portfolio lenders tend to be mid-market or regional private banks with whom a borrower has a pre-existing banking relationship.
- Stick to negotiating a detailed commitment letter. The commitment letter is still the best place for the borrower to exert whatever leverage it has in today's market. By detailing key terms (performance covenants, recourse exposure, syndication assistance, etc.) in a commitment, the prospective borrower can avoid surprises later in the loan documentation process. With the market fluctuating as it is, seek a right to extend the commitment (or to rate lock) in case your closing is delayed, or risk a re-trade later on.
- Avoid agreeing to unrealistic performance covenants that could place you in technical default at some point in the future.
- Pay close attention to provisions that allow the lender to change the economic terms of a deal for any reason (we recently saw a provision that allowed the lender the right to increase its rate if its return was not high enough). Understand your obligations to the lender in its effort to syndicate. Be sure your interest rate is not subject to increase if the loan is not syndicated within a certain period of time. Remember, syndication is fundamentally the lender's risk.
- Negotiate for an interest rate swap. The financial markets remain unstable. Although the Federal Reserve appears determined to keep interest rates low in the immediate future, the prudent borrower will protect himself with a swap. A swap enables the borrower, for a fee, to limit risk by exchanging interest rate payments but not loan principal. In a swap, the borrower trades its duty to pay a variable rate with a creditworthy third party, perhaps the lender, and assumes that party's obligation to pay a fixed rate for the same principal amount. Thus, the borrower's interest rate risk is significantly less: if rates rise, the third party pays the borrower the rate differential; if rates fall, the borrower pays the third party the difference between the fixed and lower rates. In any event, many lenders still require interest rate swap arrangements. ■

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