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A relevant guide book to recession strategies!

The Developer Holdout

by Jeffrey Palmer

Serious problems surfaced in the real estate market during 1982: Housing starts were below 1974 recession levels, housing sales were depressed, and office vacancy rates were rising. The general disarray was blamed on interest rates.

It's uncertain now whether or not this period represents a new era in which real estate in general—and housing in particular—will take a back seat to other forms of investment. Recently the *Los Angeles Times* quoted Anthony Frank of First Nationwide Savings: "A start-up of 1.5 million new homes annually will never be achieved again." In the same article, Leonard Shane, chairman of Mercury Savings and Loan, explained, "Housing simply will not get its accustomed share of capital and will be hard put to compete for it in the coming years as the entire structure of financing undergoes unprecedented changes."

Others feel, however, that 1982 represented a cyclical trend varying only in amplification and intensity. In 1972, Lyle E. Granley, a Federal Reserve economist, wrote: "Housing starts in the United States since World War II have gone through six short-term cycles. At this writing the seventh upswing is in process. Though the timing of short-term variations in housing and general business activity is variable, the correlation has been generally negative . . . The short-term cycle in housing product reflects the choices we as a nation have made, deliberately or inadvertently, as to the types of stabilization policies we have employed to impose restraint on real resource use during periods of excess demand. . . The results have been the same: credit demands have risen above available supplies at existing rates, interest rates have been driven up, credit availability curtailed, and housing production has declined."

The cycle theory suggests that real estate developers should be prepared to manage effectively in both boom and bust conditions. Gluts arise not only because of rising supply but also because of deteriorating demand. Consequently, the worst conditions appear: financing dries up, project reimbursements do not materialize, real estate property assets become illiquid, sales slow or become nonexistent, and leverage begins to cut the other way.

A real property developer facing a difficult climate does not need to turn around management; rather, the developer needs to implement "holdout" techniques and adapt to an ever-changing environment. The primary goal is to maintain as much financial and business potential as possible until more favorable economic conditions develop. This article will present ideas, adapted from corporate turnaround management theories, that enable developers to survive a poor economy until the economy improves.

A shift in management focus

A developer can prepare for a serious downturn by taking less risk, at the expense of a lower return on investment. The sooner the developer recognizes a changing market and anticipates rather than reacts to problems, the more likely is survival.

To identify the problems, the developer must change from an optimist depending on fortuitous events to a conservative relying on adjustment of policies for survival. Instead of concentrating on individual properties, the developer must be concerned with the allocation of money, time, and manpower towards preservation of the entity. The developer must shift focus from "paper profit and loss" to the realization that "cash is king." Decisions must not be based on the recovery of sunk costs but rather on minimizing present losses and maximizing future profits.

Evaluation and information collection

The developer must make a rapid assessment of the major problems that could jeopardize the entity and then evaluate the critical assumptions he or she is depending on for solutions. This assessment will include a review of the firm's financial position, major notes and trade payables, and the status of all projects.

The developer should establish ongoing reporting systems. Each organization is different; the most useful reports and frequency of those reports will depend on the needs of each organization. Reports including monthly cash flow, major payables, and project cost control, however, are critical for any organization.

The developer may be so involved in daily problems that he or she is unable to see the forest for the trees. Therefore, the developer should assemble an advisory panel consisting of consultants, attorneys, accountants, and other business people.

Cash flow and financial information reports

The cash flow report, combined with other summary financial information, identifies critical problems and assumptions. Financial reporting and projections must be management-oriented, rather than accounting-oriented, to be valuable as decision-making tools. One decision-oriented cash flow report divides receipts and disbursements as follows:

Cash Receipt Schedule

1. Reimbursement by projects by source.
   A. Construction loan proceeds.
   B. Partnership or joint venture capital contributions.
   C. Sales proceeds.
   D. Other.
2. Cash profit distributions by project by source.
3. Development fees.
4. Net rental income.
5. Other direct cash receipts.
6. Loans and advances.

Disbursements are subtracted from total receipts to arrive at net cash flow. Net cash flow is subtracted from beginning cash balances to arrive at ending cash balances.

Disbursement Schedule

1. Overhead disbursements by category such as salary, rent, office supplies, etc.
2. Advances to each project by use: cost overruns, interest, taxes, predevelopment costs, land principal paydown, etc.
3. Contingency.
4. Repayment of loans.

The report should show at least one prior quarter of actual monthly cash flow results as well as a projection of cash flow results for the following 24 months. The end columns summarize the actual receipts and disbursements to date, and the total projected receipts and disbursements remaining for the balance of the year as well as for the projected holdout period. The last column reports the total receivables, payables and outstanding commercial loans in order to assess current obligations which may distort the projections. Certain disbursements, such as nonrecourse land loans (which, pragmatically, might never be paid), should be bracketed and not included in the summation. Furthermore, the projections should reflect trade payment practice rather than trade payment due dates. The report should be tailored to the needs of the organization to represent accurately where money comes from and how it is spent.

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The report will become more accurate as it is used. The tediousness of the preparations can be reduced by programming the report using simple software programs such as Visicalc or Supercomp.

The projections should start conservatively; only receipts evidenced by commitments or with a high degree of certainty or past reliability should be included. During a downturn, land sales are slower, escrows are longer, and loan closings are stretched out. The projections should reflect these considerations.

The end result should be a conservative projection of cash requirements over different periods of time from which one can estimate how long the entity can survive with present liquid assets or lines of credit. The developer should experiment to see how the holdout time is affected by cutting overhead, eliminating a project, delaying payables, and so forth. These projections will help the developer weigh the loss in profits from eliminating a project against its impact on the developer's survival, thus greatly aiding the preparation and execution of the action plan.

The action plan

The developer is now in a position to create a game plan based on cash flow projections. In a severe real estate downturn, a game plan is a cash flow plan, because real estate recessions produce negative cash flow situations. During a downturn, problems mushroom and project consummations backlog so that time and manpower become scarce. In order of priority, the developer should begin to formulate plans of action to solve major problems, provide for alternatives, reduce disbursements, and increase collections. The developer should deploy resources of manpower, time, and money so as to maximize holdout possibilities. This allocation could involve, among other things, jettisoning properties, shelving projects, and repositioning. One project may have a smaller profit potential than another but also less impact on the entity's survival.

The result is an action plan showing what is to be done, who is to do it, how it is to be accomplished, and when it is supposed to be done. The action plan should correspond to a cash flow projection that balances the developer's cash sources and uses over the desired holdout period. Progress must constantly be evaluated, plans revised, and cash flow projections updated as experience provides more information and circumstances change.

One must take control of both ends of the cash pipeline by controlling purchase orders, payables, and everything else that could affect cash flow, acting as the referee who makes commitments and disbursements according to the game plan. For example, the decision might be to defer an overdue bill or property tax payment in order to pay C.O.D. items.

Establishing new marketing programs

At some point, the developer should re-examine each project freshly. This examination will include market-absorption study, cash flow forecast, and project cost analysis. If the developer cannot do this objectively, it must be done by someone without prior ties to the project, examining the market in general and the project's relative performance in the market. Price, product, merchandising, and promotion should be examined independently. The developer must have confidence in the price, product, and merchandising evaluation before spending money to create traffic. On the other hand, prices cannot be dropped or merchandising changed solely on the basis of inadequate traffic. Marketing team members (sales staff, public relations experts, etc.) should be replaced if their performance—not just the market's performance—is poor. A management agent or market researcher might be added to the team for new input.

Based on the evaluation, the team should formulate new market options. In some cases, radical alternatives will be proposed, such as converting condominiums to rentals or leasing full floor single-user office space as built-out multitenant space. Other cases may call for less drastic changes, such as upgrading landscaping, creating a new finance program, or changing promotion tactics. In other cases, solutions may be approached from an entirely different perspective, e.g. dividing the remaining condominiums among the existing limited partners or syndicating units to new limited partners for tax shelter. The key is to anticipate, not merely react to, the market. An office building might be filled by offering leasing concessions before concessions become widely offered. Undeveloped land should also be examined for its highest and best use under present conditions and plans revised accordingly.

At this point cash flow and profit projections will help determine the best strategy. The best strategy may be to abandon the project altogether. Absorption and traffic standards should be selected to evaluate results. Based on these results, strategies must be revised and new programs relentlessly implemented as old ones fail or slow. In no-response cases, controlled but frequent experimentation should be used. In all cases, momentum must be perpetuated.

Renegotiating purchase money debt

It is often critical for the developer to get relief from unbearable debt, gain needed concessions, and find new sources of bridge financing. Three sources of developer financing are purchase money deeds of trust; construction loans; and commercial, unsecured credit.

The developer may have purchased land at the height of economic prosperity with financing on terms and rates no longer consistent with or feasible under current economic conditions. If the developer has made the decision to make sacrifices to retain the land, he or she must be prepared to approach the holder of the note for concessions. Such concessions may include:

1. Deferring the due date of a principal payment.
2. Accruing all or part of the interest.
3. Converting to a joint venture or allowing some other participation.
4. Reducing the amount of a principal payment or the purchase price.

The developer should evaluate the equity position and the saleability of the property in relation to the remaining amount of the debt to judge whether or not the noteholder would want the property back. If necessary, the developer should review with an attorney some foreclosure-delaying tactics, such as injunctions or bankruptcy, which stay the default proceedings. For example, the developer can put a development entity—whether a joint venture, corporation or limited partnership—into a Chapter 11 bankruptcy without affecting his own solvency or credit.

Before meeting with the noteholder, the developer should conduct a study that illustrates the deteriorated state of the market, the slowdown in land sales and, if possible, the decline in land values—factors making the present note untenable. The developer should present a plan showing how the balance of the debt will be paid off and why this proposal is the noteholder's best alternative. In negotiating, the developer should avoid taking on personal debt or waiving valuable protections.

Restructuring the construction loan

Similarly, the construction loan interest reserve may be depleted due to slow sales, slow leasing, or an unrealistically low initial interest reserve. Very few developers can afford to pay the monthly interest costs out of pocket. Each construction lender has a different policy with regard to underwriting and lending and, likewise, will have a different policy with regard to the workout. Lenders don't want to take property back; some wouldn't even take it as a gift—they want their money back. Most lenders remember their experiences in the 1974 recession and are willing to participate in the upside. Construction lenders have taken

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the following approaches:

1. Agreeing to accrue interest and giving financing concessions in return for receiving all net proceeds from sales.
2. Giving a short-term loan at a favorable rate so that the developer can rent a condominium property.
3. Using sales proceeds to pay interest even if net after-interest proceeds are lower than release prices.
4. Deed in lieu of foreclosure.
5. Power of sale or judicial foreclosure.

Before negotiating, the developer should be armed with as much knowledge as possible: his or her own equity position, the lender's equity position, and the lender's approach with other developers in similar situations.

The developer must make a management presentation showing a continuing ability to perform under extremely difficult circumstances. The lender should be presented with a management plan, cash flow projections, and marketing strategies that convince the lender the plan is best for the bank and the workout will actually work. Due to the lender's fear of the repercussions following approval of a bad loan, a lender may demand payment and foreclosure. Even so, keep a positive attitude: show statistics demonstrating unforeseen and uncontrollable events as the sources of difficulties and remain firm in the wisdom of the plan. During implementation of the workout, keep the lender constantly informed and reinforce confidence in your plan by showing momentum and progress: if not in rapid absorption, then in slow but consistent sales; if not in sales, then in traffic; if not in traffic, in continued experimentation and program revision to find a solution. The lender must see momentum and progress in the developer's efforts to get out of the situation, not just accruing interest pointlessly or forestalling eventual foreclosure. In the workout, don't give away valuable protection, but enthusiastically volunteer the use of your valuable talent and management abilities.

Renegotiating lines of credit and obtaining new financing

The developer needs bridge financing to close cash-flow gaps between good times and bad times. The developer who has a commercial credit line or loan probably already has a good relationship with a commercial lender. The developer should attempt to clean credit lines, if only for 30 days. If the line has been outstanding for less than a year, the developer stands a good chance of winning an extension; if it has been outstanding for over two years, the chance is lessened, but the developer can suggest converting the outstanding line of credit to a new term secured loan. The developer should present a workout plan with strategy and cash flow showing how the lender, by forebearance, will be repaid and the relationship perpetuated in future business.

It will be very difficult to obtain unsecured credit during an economic downturn. The secured loan is a way to liquify personal property, real property, and partnership interests. The developer can present to a commercial bank or finance company a standard loan proposal showing the use of funds over the holdout period, a business plan to get through the holdout, a cash flow plan, the prospect of a long-term business relationship, the eventual source of repayment, management capabilities, and the security's value in excess of the loan amount. The stronger the prior relationship and the greater the value of the security, the greater are the developer's chances of receiving the loan.

Conclusion

Serious economic downturns call for a different management approach focusing on survival versus growth, cash flow versus paper profit or loss, and strategic allocation of resources versus rapid acquisitions. It requires an ability to creatively and relentlessly maintain marketing momentum, to negotiate restructuring of existing debt, and to find a needle of new financing in a haystack of lender pessimism. Most of all, an economic downturn requires the determination to hold on until the developer is out of danger and can focus efforts on adapting, changing, and profiting from the opportunities of the next upturn.

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