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Options for borrowers with maturing loans: Start the refinancing process earlier than usual

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The commercial real estate market continues to be mired in the liquidity crisis currently gripping the country. Any good news about the market's resilience has been overshadowed by bad news surrounding Fannie Mae and Freddie Mac and the struggling health of the nation's financial institutions. Not surprisingly, all of this news has managed to put a damper on the market. Buyers and property owners are waiting on the sidelines for current market conditions to improve, resulting in a dramatic decline in sale transactions.

However, property owners whose loans mature within the next six months do not have the luxury of waiting out this market. To get a sense of the magnitude of the dollar volume of loans coming to term, we can use information from the Commercial Mortgage Backed Securities (CMBS) market. According to Wachovia Capital Markets, $9.1 billion in fixed-rate loans will mature over the next six months. While this total does not include loans from commercial banks or insurance companies, it does give a sense of the need for refinancing in the near future. The overwhelming majority of these loans were originated prior to 2005, which indicates they were underwritten at values lower than we're experiencing today.

However, with current underwriting standards relatively tight, borrowers could run into situations where new loan proceeds may not be sufficient to pay off the existing debt. This will become more prevalent as current lenders continue to lower their preferred loan-to value range, which is currently 60% - 65%, down from a high of 75% - 80% at the market's peak. Lenders will also be very diligent in reviewing rent rolls and any near term lease expiration's will be looked at very closely.

As an example, if a borrower has an $8 million loan maturing and can only raise $7 million in refinancing proceeds due to current market conditions, there will be a gap of $1 million that still needs funding. Some of the options for these kinds of borrowers include:

* Extending the loan with the existing lender. This is not a viable option for borrowers with CMBS loans, as these lenders are usually prohibited from extending loans for more than a short time period (usually three months). However, this option makes sense if a loan is with a non-CMBS lender, the loan has a history of performing well and the property's cash flow can support debt service at current market rates. Most lenders would like to avoid this scenario, but if the loan is performing, buying six to 12 months of time to allow for re-leasing of vacant or expiring space or to just wait out the market may make the most sense for both parties.

* Injecting more equity into the deal. From the lender's point of view, this is the easiest and quickest method. However, most borrowers would consider this a last resort because it is often difficult to raise equity from existing entities in the deal or bring in money from new sources.

* Sell the property. While this would probably generate enough proceeds to pay off the debt, equity holders could lose money with this course of action. Most borrowers would like to avoid selling in

this market considering current conditions.

* Using mezzanine loans to bridge the gap. A borrower may be able to bridge the gap by securing a mezzanine loan, but the cost of mezzanine debt in today's market is in the 10%-12% range.

While this list represents only a few of the available options, borrowers must be prepared to tackle this issue in today's market. The borrower should start the refinancing process earlier than usual, because (1) there are fewer lenders funding commercial real estate deals, (2) underwriting criteria has gotten more stringent and (3) deals are taking longer to close because they are being scrutinized much more carefully. If a borrower realizes there may be an issue with refinancing their loan, he needs to approach the lender to discuss the problem. While the tendency is to avoid discussing the issue with the existing lender, it makes the most sense to be upfront and work through the problem. From a lender's point of view, it is much easier to work out problems on the front end than when cash flow has substantially deteriorated.

Johnson Capital has remained extremely active recently. By helping clients understand their various options in the current market, we ensure all of our clients' decisions are made with up-to-date information and current market conditions in mind.

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