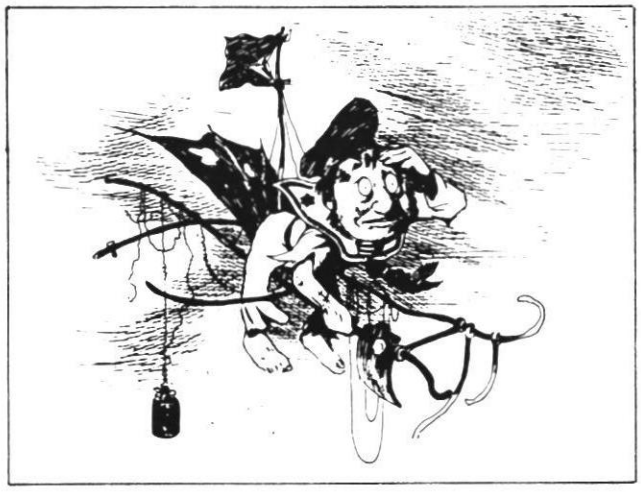
A LENDER'S VIEWPOINT: SIX WAYS TO SURVIVE TODAY'S REAL ESTATE DEPRESSION (AND OTHER OBSERVATIONS)

by Donald J. Stratton and Barrett R. Bates

Investors who bought real estate between 1976 and 1979 were prepared to accept negative or zero returns, counting on unprecedented appreciation rates and pent-up demand to make up the loss and provide a tidy profit upon sale or refinance. The pent-up demand is still very much present, but the appreciation is not. When interest rates hit record levels, building becomes unprofitable, existing property is almost impossible to buy and formerly cash-productive property is difficult to hold.



Because of the continuing demand for housing and some types of commercial property, the real estate market should rebound as general economic recovery begins and mortgage rates subside. Yet no one knows when, with what strength, or even whether the market will show improvement; consequently, few property owners know how to approach problems in the meantime. Magical incantations, wishful prayers or supplications to the IRS may not suffice to solve these problems. The following suggestions should help as practical, preventive medicine for the ailments of forward-looking investors.

Identify your rescuers. The Loan Arranger is still the hero of the day, but its disguise has changed somewhat. Specialty lenders have entered the market to fill the vacuum left by institutional lenders who have exhausted their lendable funds or even their net worth. Some specialty lenders have been around for awhile, but are just now diversifying or expanding their lending programs. A partial list of currently active lenders includes:

- REITs (Real Estate Investment Trusts)
- Pension/Retirement Funds
- Insurance Companies
- Industrial Revenue or Mortgage Bonds (local)
- Corporate Lenders, Private Investors, Mortgage Bankers, Finance Companies

The primary advantages of borrowing from REITs, such as those sponsored by Consolidated Capital companies and others, are quick decisions and fundings, nontraditional flexibility in tailoring a loan to meet the borrower's special needs, minimal participation in comparison to partnerships, and a variety of payment programs designed to improve cash flow and the borrower's ability to ride calmly through the current trough in the real estate cycle.

Each type of specialty lender tends to orient itself to specific property types. Pension funds seem to like residential and resort property, insurance outfits and corporate lenders prefer offices and retail, and REITs are generally interested in commercial property. Private lenders, finance companies and mortgage bankers are most frequently involved in home mortgages.

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These areas of interest are by no means fixed; there are wide variations between lenders with respect to property type, so the investor must do phone or legwork to find the lender best suited. It's helpful to know that real property is usually classified by lenders according to tenancy, purpose and whether or not income is produced.

Specialty lenders, because of their autonomy, are not usually subject to geographical limitations. With some, lending authority is in the "front lines," a circumstance that allows rapid processing. Others, notably insurance companies and pension funds, must often answer to many masters before a loan can be approved, and terms can change accordingly.

On the other hand, the slower lenders may offer longer-term financing, though equity participation and prepayment penalties may be substantial. Limitations on loan amounts vary according to the lender, each attempting to fit into an identified market sector. Each lender usually offers a specific structural advantage, with most involving some degree of negative amortization and/or the exploitation of older, lower-rate underlying loans.

Careful shopping will turn up some programs that have surprising and unique applications to real estate transactions. The fact that most creative financing takes advantage of older loans already in place leads to the next rule of survival.

Avoid 'wrap-o-phobia!' The hesitancy and even suspicion with which borrowers sometimes regard wraparound loans are mostly due to lack of information and myths arising from coffee-break scuttlebutt. Wraparound loans are certainly nothing new; multi-family building sellers have used them for years to offer buyers seller-carried financing while enjoying the interest rate spread between it and the underlying first mortgage. A wraparound is just a form of secondary financing in which the lender takes control of, and makes the payments on, the primary financing. Usually the borrower signs an all-inclusive trust deed (or mortgage) and note, pledging to make regular payments to the lender on the entire amount of the wrap. The lender takes the borrower's payment, deducts the amount of the first mortgage payment and pockets the rest. This way, the borrower has the convenience of making a single payment and receives a below-market interest rate; the lender can protect his or her secondary position by being sure the first is current.

The most prevalent misconceptions about wraps are that the lender always enjoys the underlying equity build, that the borrower remains responsible for payments on the wrapped loan and that wraparounds take precedence over the underlying financing.

In fact, an interest-only wrap will still give the borrower the equity build; the lender receives interest dollars on the total wrap amount, but must pay out principal dollars to amortize the underlying loan. As wrap equity is paid off, the borrower accrues the advantage because the underlying balance becomes lower than when the wrap was originally placed. Thus, the borrower takes advantage of equity build, not the lender. As to the last myth, wraparounds saddle the lender with full responsibility for making payments on underlying loans. The legal consensus is that wraps never take priority over earlier loans.

To stay afloat in a sea of ambiguity, you must first acknowledge the imminent possibility of drowning. A successful real estate investor must stay in touch with the property and financial markets, especially now when they're in almost daily flux. King Lear, the U.S. railroad industry, the brontosaurus and Detroit automakers have at various times shared one common, tragic flaw: an inability or resistance to change with the times. Even though inflation and short-term interest rates are presently easing, the income property investor looking for a 14 percent, 30-year mortgage with a 2-point fee is wasting time.

This is presently more true of income property than of the single-family residential market. But the low-rate, long-term financing advertised by residential developers for end loans is usually subsidized by a profit sacrifice, short term buy-downs or are provided by an institutional lender who mistakenly issued a long-range, fixed-rate forward commitment in 1978 to '79.

Real estate lenders learned one permanent and extremely painful lesson in the last round of 20 percent or more interest rate inflation, and they will likely never allow themselves to be burned again by making long-term, low-yield loans while their own cost of funds soars to record levels. For instance, witness the current shake-out in the thrift industry, another segment of the financial community which has been unable to react quickly enough to the radical market changes.

Long-term, low-interest rate mortgages are already being called "dinosaur loans" by financial *cognoscenti*; some playful wags contend that old loans are being replaced by "neutron mortgages" which destroy the borrower but leave the property intact. Not only are long-term loans becoming extinct, but real estate loans from traditional lenders are hard to come by in any form. Experience tells us that the availability of so-called offshore money is usually a mirage; in fact, the money that is supposed to appear at the U.S. bank often turns out to be a letter of credit from a small foreign bank which the U.S. bank cannot honor. Creative financing has provided some breathing space for property owners, but asphyxiation may occur when all those balloon payments come due. The astounding rise in foreclosure rates over the past several months represents the tip of an iceberg composed of purchase money second mortgage defaults.

Understand the depression. On the surface, the depression in the real estate market is a function of unbearably high interest rates. Why have rates remained so high with inflation now on the wane? No one knows for sure, but there are a variety of variables influencing the situation. Some may be political; low unemployment and interest rates benefit an administration most when re-election time

rolls around and may take a back seat to other economic priorities in nonelection years. Other reasons involve the dynamics of the economy: Federal Reserve System credit policy has been elusive and is still suffering somewhat from a credibility gap over erratic money supply growth.

Another factor helping to boost rates has been the myriad of inflationary expectations, a market state of mind created by past experience. Only very recently have such anticipations been turning deflationary as the steep recession which began last July approaches the bottom of its chasm. According to Jude Wanniski, a prominent economist, author of *How The World Works* and a frequent contributor to the *Wall Street Journal*, deflation may ironically keep interest rates high as lenders seek to protect themselves from future defaults. During times of inflation, borrowers benefit because they can pay back loans with cheaper dollars than were originally advanced; in deflation, the borrower must scramble for more expensive dollars (in relation to gold), and the lender thus benefits to the extent that the borrower can continue to make payments.

Opponents of this view, however, complain that fear of defaults can't be the underlying factor in persistently high short-term real rates. As an example, they point out that rates on T-Bills are equally high despite the essentially default-free nature of the instrument. Opponents say rates will come down when people begin to believe that inflation is in check and that extraordinarily high real rates reflect an unprecipitated decline in inflation.

As inflation cools, a definite relaxation in rates takes place. But rates are declining at a very slow pace in relation to the drop in the inflation rate. It may take a long time for investors to give up their inflationary expectations, and many dark clouds remain on the economic horizon.

Many analysts believe that inflation will resume with a vengeance as soon as the economy begins to recover, and that the size of the federal budget deficits will provide disruptive competition by the government for funds in the credit markets. Whatever happens, most real estate professionals agree that the market will not improve until mortgage rates decline to 14 percent or below, a distant event by most measures. Henry Kaufman, a widely quoted and influential economist, has been predicting another upsurge in long-term rates during the second half of 1982 that will reach levels as high as those in 1981.

As lenders on medium-to-large income properties, we meet potential borrowers who have a plethora of difficulties, some of which are reoccurring frequently in today's market: a balloon payment or principal reduction is coming due, the deadline for a sale or purchase is approaching, a decision must be made on a once-in-a-lifetime opportunity.

Problems with timing are joined by problems with cash flow. Owners are being squeezed by the floating rate on an existing loan, by increased operating costs and by record vacancy rates in some parts of the country, due mostly to migration and recessionary doubling up. Many borrowers simply need to cash out their holdings to obtain working capital.

Resign yourself to a cut along the bottom line. Loans from specialty lenders may cost more than conventional financing, but the latter is inflexible and scarce. Moreover, the temporal and structural flexibility available with specialty lenders frequently washes out any extra cost increment. If a proposed real estate transaction shows profitability at today's high rates, a premium rate or fee will not render the deal infeasible. Investors are realizing that lenders will no longer be content to watch borrowers reap all the profit.

Since lenders now require equity or income participation, why not just form a joint venture with a financial partner? The answer is that a loan is almost always cheaper. Even though lenders today insist upon and obtain a chunk of the profit, their bite is usually a lot less than the 50 to 75 percent share that a full financial partner will demand. Also there's less personal risk for both parties, greater recourse if something goes wrong and the latitude for the developer to run his or her own show.

There's a sad ring of truth to the definition of a joint venture presently making the rounds: a partnership between a person with money and a person with expertise wherein the two switch places after about a year.

Today's savvy investor lets the bottom line take second place to the quality and feasibility of the transaction. Time wasted shopping for dinosaur loans can be costly in lost opportunities. By the time a fundable loan is secured, the profit created by the lower-than-market financing may have already evaporated. The advent of short-term mortgage financing, albeit bemoaned by many, improves market liquidity and makes it easier to refinance when rates decline.

Look before you leap, but leap anyway. There's no question that real estate investment is a scary proposition these days, but that doesn't mean that good deals and profit are impossible dreams. There are plenty of opportunities for investors who are willing to look for them. Of course, it's in a realtor's and lender's best interests to dissuade investors from their wait-and-see attitudes, but their arguments are good ones: Long-term financing is past history; today's market favors the buyer and transactions that would have been difficult or impossible using traditional lending sources and techniques can succeed today.

Successful investors in the '80s will be those who concentrate on substance rather than form, who won't take "impossible" for an answer and who give up chasing the windmills of the rosy past for pursuit of a reasonable return. The investor who makes a profit will be the one who has earned it.