Doctoring Sick REITS

by Thurston H. Ross, C.R.E.

Most REITs which have gotten into trouble were primarily short-term lenders offering construction loans, wrap-arounds, land and land development loans, and land purchase leasebacks. Their profit was in leverage, the spread between the interest that banks charged the trust and what the borrower could be induced to pay. Many of these loans were based on an interest rate tied to prime for borrower and lender. When prime was at 6% or 7%, two or three percent over prime for short-term loans did not seem unreasonable. But when prime went up to 10% or 12%, the two or three percent over prime became disastrous. Many borrowers walked away from their properties and their loans; many took bankruptcy. REITs, after costly delays, became owners of properties which because of the virtual collapse of the real estate market were only partially developed or not completed; some completed buildings were standing vacant or at least not paying their keep. Condominiums remained partially or wholly vacant, and lands which carried great promise two or three years ago could not—for want of capital, because of environmental impact, inflationary costs for improvements, or overbuilding—have become tax and interest burdens, frequently without much hope of relief.

Further aggravation of the situation occurred when accounting procedures required reserves to be set up for carrying costs anticipated over a three or four-year period, these reserves being a direct charge against the capital of the trust. This reserve is calculated to cover all costs to carry the property until it is able to carry itself or is liquidated.

Inasmuch as many trusts by their organizational structures are required to pay out about 90% of their earnings to shareholders, it has not been possible to set up adequate reserves during periods of high yield. The dilemma is obvious.

The earning potential of many trusts has been frozen because of stoppage of available funds either to revitalize existing projects or to loan on new projects; its debt status is inflated because of speculative estimates of future interest and carrying costs on problem properties; its personnel is so absorbed in paperwork involving theoretical survival details that they have no time to search out and pursue constructive procedures for returning to profitable operation.

The calculation for reserves now required by a debtor trust calls for some of the most sophisticated forecasting as well as the most esoteric legerdemain ever

Thurston H. Ross, C.R.E., M.A.I., is in private practice as a real estate counselor in Los Angeles, California.

demanded of a business operation. Leaving out any mechanics of compounding, a loan of $1,000,000 on a piece of property which has no market today but requires 10% or $100,000 for annual servicing becomes a loan of $1,300,000 in three years or $1,500,000 in five years. If the property has been worth $1,175,000 when the loan was made, it is anticipated that in three years it will be worth $1,529,412 or in five years $1,764,706 to merit a new 85% loan. If there is any prospect of such an increase in value of real estate in the next three to five years, it is not apparent now.

MEANS OF SURVIVAL

In many trusts the question arises as to whether to liquidate now and save the cost of struggling with bad loans and maintaining reserves (which means further capital deterioration) or to seek other alternatives, possibly with further administrative overhead. In some cases liquidation or even bankruptcy may be the easy and, in fact, the most justifiable way out of the dilemma. However, it should be considered only as a last resort when all other remedies have proven futile. Survival should by all means be the objective of the trust administration. This may mean a change in the existing trust form; it may be advantageous to abandon the advisor and internalize the trust. Perhaps, the advisor has no longer a useful function other than that which can be carried on by the trust organization itself. The advisor in some trusts, while performing an essential service to the trust, may have been primarily a mechanism for participating in the profits of the trust before distribution to the shareholders. While many advisors performed good services during the period while the trust was in the lending pattern, they may have little to offer in the process of working out bad loans or operating foreclosed properties. The trust itself may secure better qualified personnel and be better equipped to economically carry on these functions than the advisor, in which case internalization is justified. Nevertheless, the trust's problems remain the same.

It is likely that some trusts will reorganize in corporate form; the idea of paying out practically all of the earnings without consideration of adequate reserves and the apparent advantage of tax savings has lost its luster. The real estate investment trust has generally gotten a bad name. The fact should not be overlooked, however, that corporations, syndicates, partnerships, and other types of business organizations dealing in real estate finance and development have suffered; a never-ending inflation, environmental impact, the energy crisis and a plethora of legal regulations and restrictions affecting real estate as well as dislocations in the financial market have made long-standing "normal" economic operations in real estate almost impossible.

Real estate investment trusts' problems may be described in two dimensions: one has to do with the lenders and the other with borrowers past or present. Banks are the principle trust lenders. These banks want their money back together with delinquent interest and although they have a profound knowledge of money, in most cases, they know very little about real estate. If they did they would not have made loans to the trusts in the first place. The trusts, on the other hand, generally lacked the profound knowledge of money and sometimes even of real estate or they would not have borrowed and reloaned the money. Now both sides are faced with a dilemma and in the attempt to find a solution are ordering audits, interminable projections, and surveys.

Quoting from the Chicago Mortgage Bankers Association Seminar, "now that trouble has struck, lenders have reacted by requiring additional layers of examination and approval before a decision can be reached, resulting in delays which compound cost escalation, construction completion, and marketing problems."

Unfortunately, most of the forecasting and surveying that anyone can do is a waste of computer time, clerical effort, xerox copies, and general paperwork unless it results in a clear and definitive operational effort to get the troubled trust with its real estate, and the bank with its delinquent loans, out of their difficulties. To provide such relief requires a direct practical approach to the real estate and its characteristics and attributes which make it attractive in the market today or in a reasonable future period of time. The core of this relief is operational planning and execution of formalized plans together with cooperation of all interests to provide money and qualified service to make the real estate security attractive in the market.

If lending banks are given a well-organized plan of action to examine, they should have reason to look more favorably on present relief for their customer and to cooperate in helping him initiate his plan. The trust, however, must have the plan as well as the right administration and people to put it into action.

PORTFOLIO REORGANIZATION

Some trusts are getting cooperation from their bankers and their public investors, the often forgotten component of the lending entity, and are not only approaching their problems of survival but getting back into business as qualified real estate operators as well as liquidators. This involves a reorganization of their portfolios as follows:

1) Loans on real estate supported by values which assure repayment of capital, interest, and other carrying costs; in other words, firm assets.
2) Loans on real estate which after thorough investigation are on properties temporarily in trouble and exploration of ways and means for their rehabilitation.
3) Loans on hopeless real estate not only in the current market but in view of future prospects.
4) Owned properties in the above classifications.

Great care must be exercised to distinguish between bad loans and bad real estate. Some trusts have become so obsessed in their money problems that they have lost the capacity to rationally evaluate their real estate security. While the loan securities in category 1) usually need only standby attention, the properties in 2) and 3), as well as owned real estate, demand most careful administrative attention and astute management. They also demand cooperation from banks and other lenders.

The loans in category 2) may be on raw land, developed land, unfinished construction, completed buildings (unfortunately many slow-moving condominiums), existing improved and occupied property, wrap-arounds, subordinated land loans, and standbys with problematical takeout prospects.

Unfortunately, raw land is the least marketable real estate to realize on today and is the most difficult to keep out of category 3). In most cases because of the static real estate market and in view of high development costs, environmental and other restrictive regulations, increasing taxes and other matters beyond a developer's control, most raw land can be disposed of only at a substantial loss or abandoned. The internal and external costs to carry raw land are enormous and the justification of incurring them is subject to serious consideration.

Should this land be liquidated now at a sacrifice price? Should it be abandoned for taxes and wait out the redemption period in anticipation of a rising market? Will it be worth its present liquidation price plus carrying costs for a reasonable period of time? Although the lender will hold the trust responsible for interest and principal for the full amount of its loan, it may be better to abandon the property to save taxes and possible assessments and give more attention to properties which show more promise of survival.

ALTERNATIVES FOR DEVELOPED LAND

Developed residential lands with utilities, favorably located in compatible surroundings, frequently offer good opportunities for realization. In some cases zoning may have to be changed or variances applied for, but tax-hungry cities are becoming less reluctant to make adjustments where opportunities to increase the tax rolls are in prospect. Few REITs have the expertise or personnel to undertake the improvement of such properties because they are organized as financial institutions and not as real estate operators. If they have not already done so they had better enlist the services of practical real estate professionals in the geographic areas of their troubled properties, to find ways and means to administer this real estate as intelligent owners and operators instead of absentee liquidators. To do this they must have personnel qualified by experience and training to advise and cooperate with their field operators.

These observations apply not only to developed lands but also to improved projects and involve all phases of brokerage, including local planning, financing, operation, and/or sales of real estate. If a trust formalizes definite plans for this type of operation on all the owned or troubled properties in its portfolio and seeks the cooperation of its own borrowers as well as banks, it is likely that the result will be more productive and less costly procedures than those produced by all of the statistical and accounting studies now in vogue in most of the troubled trusts in the country. The costs to trusts of such investigative exercises are enormous. The statistical gurus were not too effective in warning of impending disasters in the past and their recommendations for the future may also be of questionable value.

Examination of appraisals made under historical market conditions, bookkeeping reports and audits, forecasts on properties remaining in the same condition as put them on the delinquent list, and notices of creditors' insolvency become academic as contrasted with what is popularly known as "affirmative action."

The REIT is a useful component of the overall real estate market but its structure is faulty in at least two ways. Perhaps not more than 50% of its earnings should be paid out as dividends. This remainder should be equally divided between real estate equity investments and reserves to guard against losses in a highly cyclical real estate investment market. This reserve can be examined from time to time and, if desirable, reduced to pay an extra dividend or increased in prospects of an approaching storm.

Secondly, the trustees as well as the advisor should include real estate professionals (not only real estate lenders) knowledgeable in market conditions in the geographical areas of lending, in addition to people well qualified in the field of finance. The separate or internalized advisor should have the responsibility for proper accounting, adequate legal advice and other operational functions which will assure the beneficiaries of sound long-term results rather than the feast and famine of the last several years. Leveraging is out of date as it was used in the past although it cannot in principle be abandoned. Perhaps more types of securities not under such cyclical influence as short-term bank loans might be appropriate, but in any case the ratio of borrowed short-term capital to ownership and preferred types of capital should be reduced. This is an imperative requirement for the future viability of the real estate trust. Banks should not be forced into the position of long-term lenders by trusts who often serve, in fact, only as their real estate lending agents without a sufficient capital base to properly administer their own, that is, the trusts' financial responsibilities.

THE COUNSELOR'S ROLE

Real estate counselors have been quite effective in assisting trusts in working out their problems. Unfortunately, anyone who can read and write and has some such experience as a door-to-door book salesman can call himself a real estate counselor. Unless his professional qualifications include membership in a recognized counseling body or association, he may not be able to perform much useful service. On the other hand, if he is well qualified in the real estate business and can intelligently understand and use the services of the engineer, the attorney, the accountant, and other professionals who may be called upon, he may be considered a true real estate counselor. He should not only practice objectivity but be as qualified as the engineer, the attorney, or the accountant are in their respective fields.

Without depreciating the need for accounting records so essential in maintaining the statistical position of the trust, the "bottom line" does not provide all of the information essential to the intelligent administration and programming of the operation of a real estate parcel. It certainly does provide an excellent accounting display and may set a pattern for the establishment of trends, but often at best can be only one element in the formulation and testing of real estate operational policy. Trust managers have tended to view all of their owned property or property in prospect of ownership on the basis of historical data, which, in many cases, caused the trust to assume positions of unreasonable risk. Now management must take advantage of all of its facilities and provide new ones which pay less attention to historical trends and more attention to property potential under skilled operation and management. Often such action may be the first step toward the development of the equity trust posture, thus taking trusts out of the assumed lending agent patterns of the past. Some inventory lands may be broken up into attractive parcels for marketing; existing improved properties may be rehabilitated; and others may be given a new market identity by formulation of new plans and aggressive salesmanship. Usually this takes money which the trust itself would have great difficulty in raising without current lenders' continued cooperation.

Sound counseling may suggest that such properties be deeded to a new corporation or other entity which has borrowing power, thus enabling the real estate to be put into attractive marketable condition for disposal or retention as a profitable asset. Creativeness can bring new value to real estate, justifying a larger mortgage loan and providing equity return over a long period of time.

The trusts which have the expertise and qualified personnel to work out their present difficulties very probably will be attractive buys in the real estate market in the future, provided, however, that:

1) They are not strangled by interminable investigations of historical events and studies resulting only in enormous trust overhead.
2) They are treated as bank customers today and in the future rather than as economic disasters.
3) Long-time working capital is provided to give the trust a firm capital base.
4) Trust structure is reshaped to enable it to take long-term equity positions in real estate projects, both existing and proposed well-organized developments with carefully analyzed prospects.
5) Economically justified profit distribution procedures are formulated to offset overall cyclical market movements.
6) Their operation includes provisions for long-term as well as short-term or interim financing.
7) Their lending policies are on the security of the real estate itself and not on the sometimes ephemeral credit of the borrower.

These suggestions are starters for relief of present difficulties as well as for setting up revised trust structures. The beneficiaries then would be owners of shares in solid real estate operational entities with substance, rather than participants only in financial brokerage operations which have proven so disastrous.