

CRE WORKOUTS - A CASE STUDY

by [Steve Brown](#)

The facts are these - A bank holds a \$3.6mm loan against the first trust deed of a class A-, office building in FL. It has had steadily declining occupancy, lower rents and a borrower that has little left in terms of additional financial resources. A recent

appraisal from Jan. 2010 comes out at \$1.5mm. The Bank, moves to liquidate all reserves to reduce the balance to \$3.5mm. In addition, instead of liquidating the loan/property or "amending and extending" the loan, the Bank "dopes and hopes" by making the decision to split the loan into two parts. Part A will be \$1.4mm and carry a 5.4% fixed, interest-only rate which will have 1.3x coverage. Part B will be a \$2.1mm no interest loan that will be payable upon sale or refinancing. Maturity was extended for both notes from 5/12 to 5/16. Through this structure The "A" loan is "doped" so that it is now performing (but still substandard), while the "B" loan is written off, but kept current in order to capture some future upside should the property appreciate. The question arises - did the bank make the right choice?

We will assume that expenses and fees (including accrued legal) associated with liquidation are about 10% of the original loan amount and we will assume that we can liquidate at the appraised price. If the Bank liquidated right now, they would come out with a loss of \$2.36mm ($-\$3.5\text{mm} + \$1.5\text{mm} - \0.36mm), or a 67% loss severity. Note that this is the same economic value if the Bank would have written off part of the debt and restructured in an extension and reamortization scenario. Now, let's look at the projected recovery given the A/B loan structure.

After researching 2016 projected property prices from 3 independent brokers, we get a range of a per foot increase of 21% to 200% higher than today. This is plausible, given 3% average GDP growth and the fact that no further material supply is slated to hit this area over the next 3Ys. If you take the mean and work backwards, this comes out to a potential \$2.2mm of proceeds, or \$1.8mm net after all sales, loan costs and accrued fees (still assuming 10% liquidation costs). The loss would be \$1.7mm ($\$3.5\text{mm} - \1.8mm net proceeds) for a loss severity of 49%, or \$700k better than the immediate liquidation scenario.

Obviously, there are a host of variables that could result in a higher loss in the future. However, in a situation where capitalization rates are projected lower and interest rates higher, delaying liquidation will likely lead to additional recovery. One important aspect of this workout is the ability for the bank to lock in a fixed rate now. Because the probability of rates is higher in the future, locking in the fixed rate now allows additional value to accrue to the borrower and bank, providing greater coverage in the future. As a result of the tenor of leases and an expectation of rising rates in the future; structuring the loan as floating increases debt service (to the point of putting the loan below 1x cash flow by the middle of next year). This dramatically increases the probability of default. In a rising rate environment, the fixed rate loan provides further economic incentive for the borrower or future equity investors to maintain the note going forward.

The A/B note modification approach allows the borrower to survive the current market correction by immediately increasing debt service coverage on a portion of the debt. This makes the

weighted expected loss less than if the note was kept together and liquidated in today's market. Splitting the note into 2 portions, one which is performing and the other that receives back-end payments, permits the borrower to ultimately refinance in several years, remain in good standing and hope for future proceeds past the refinance date.

BANK NEWS

Closed CU (5 YTD)

The NCUA closed St. Paul Croatian Federal CU (\$250mm, OH).

Consequences

In a release rife with irony, Moody's said the financial regulatory reform legislation would likely result in 17 of 70 large financial firms it rates having their debt ratings cut because of the language around too big to fail. Moody's said the 17 institutions have higher ratings right now because they have implicit government support.

Student Loans

The percentage of private loans 90 days or more delinquent dropped to 6.34% in 4Q09 according to TransUnion. However, YoY has delinquencies rose from 5.4%.

Customer Losses

Only 33% of customers intend to stick with their primary bank in the next 12 months according to a new survey, down from nearly 50% in 2007. However, the difference between the big banks and community banks is substantial, with 41% of community bank customers saying they "definitely will not" move compared to 32% at bigger banks. The most widespread reason for leaving is poor customer service (37%).

Settlement

The OCC settled with T Bank (\$139mm, TX). T Bank will pay \$100k in fines and \$5.1mm to 60k customers affected by a 3rd party vendor that was allowed to process remotely created checks (that allegedly withdrew money from customers' accounts without their knowledge or promised them services they did not receive).

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