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WORKOUTS ARE BACK! - But what does it really mean?

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The terms "workouts" and "restructurings" are back in the real estate lexicon. They haven't been used for many years as all of us sailed through one of the greatest bull markets in the history of our industry. It was terrific while it lasted. Strong income streams, lower cap rates, rising values, cheap and aggressive debt all combined to cover up mistakes we might have made in our investments and developments. Well, those days are over as "The Perfect Storm" has hit our industry. We are being hammered by the unavailability of debt at a time when billions of dollars of short term debt needs to be refinanced, cap rates are rising, occupancy and income streams are plummeting and thus values are sinking fast. Now even the smallest mistake is magnified into a potential crisis. Investors and lenders, increasingly worried about their assets, are beginning - I repeat, beginning - to realize they may need "workout" help. But what precisely does that mean in this market?

As a veteran of serious real estate collapses in the 1970s and 1980s, I can say the workout challenges are going to be quite different this time around. Previously when the real estate markets deteriorated, borrowers were not able to make their loan payments and went into default. Their lender - <u>who typically owned the whole loan on the asset</u> - stepped in and foreclosed. It got title to the asset, gained control of its destiny and hired a specialist to protect and, hopefully, harvest some reasonable value. Today it is different. Loans have been pooled, "sliced and diced" and securitized which means that when one goes bad it can be a challenge - no, it can be a nightmare - to get control over the situation. Also over the last 10 years, especially in the last 5 years, many real estate assets have been purchased by commingled funds managed by some sort of investment advisor. If one of those assets gets into trouble an investor in the particular fund likely has only limited ability to protect its interests and gain control of its investment. This is particularly true of funds raised over the last 3-4-5 years where the managers were able to negotiate very strong manager's governance rights and protections for their authority and ability to deal with the assets. One friend calls it "the document bubble", wherein institutional investors, keen to get into "hot funds" simply surrendered governance rights to the fund's managers. Well, they are now finding out that bubble is also bursting. Its not only difficult to get control of a troubled asset, it is even more difficult to remove a manager.

While the term "workout" is once again buzzing around, whole "workout" conferences are being planned and advisory firms are setting up "workouts" groups, (one wag calls them "overhead coverage groups"). I am not sure whether people are yet asking the fundamental, but very important, question: **What precisely is a "workout" and when do you need one?**

Is it because an investment/loan is underperforming? I don't believe that is the key test. When markets collapse like our markets are doing almost all assets underperform original expectations. As they say, when the tide goes out it takes out the luxury yacht right along with the old, scruffy dinghy. It is virtually impossible to fight that strong tide. From having done scores of workouts and restructurings - from the quite simple to very complex - over my 30 + years in the real estate business, I think the test is: **when you lose confidence in your borrower or manager of your investment, you need to change things.** There are very fine borrowers and investment managers with assets in trouble right now, but they still may be the best group to mitigate the asset's problems. But that is not always going to be the case.

What might cause you to lose that crucial confidence?

The market is admittedly bad, but your asset is doing much worse than the market. I call it "underperformance squared".

You may have now discovered that their investment strategy is fundamentally flawed and the poor market has uncovered that fatal weakness.

Their organization may be in turmoil. Rapidly declining values are having a very damaging effect on a lot of real estate organizations. Fee income, often based on asset values, is plummeting along with those values. That usually means serious cutbacks on overhead, especially staff. But who are they cutting? Maybe it's the individual covering your asset? Maybe internal strife is distracting your managers/borrowers from focusing on <u>your</u> problems while they worry about <u>their</u> problems. I have seen this dynamic over and over again in my workout career.

If they discover that because of poor investment performance - which today is virtually a given - there will likely be no "pot of gold", there is a very high possibility they will seek other opportunities.

Most managers/borrowers have built up their teams with bright young men and women who believe they will participate in a "pot of gold at the end of a 5-7-year rainbow". Our poor market conditions means that "pot of gold" may never be realized. If that happens, the best (i.e., most readily employable) employees are the first to jump ship, so you can be stuck with the second stringers. This can seriously destabilize an organization and make resolving their and your investment difficulties even more troublesome.

Maybe their organization is in financial trouble and cannot meet their future required co-investment requirements? Maybe they are so focused on their problems that any semblance of the much vaunted "congruency of interests" has disappeared. This is hard to pin down, but I believe it is possibly the most crucial issue. Once you conclude that a borrower/manager is no longer putting your interests first, they need to be replaced.

More often than not, the problems you will uncover are a combination of some or all of the above.

There will be many instances where, while an asset is underperforming, "working" with the existing borrower/manager is the correct decision. To do that they should pass the tests outlined above. Otherwise you are just asking for more trouble.

Recently "The Economist" had an article about Greg Brenneman, a well-respected corporate tur-around specialist (Continental Airlines, Burger King, Quiznos). He had several basic rules for a successful workout - or as he called it "turnaround". First, "stop the bleeding": fix the immediate problems which are causing the losses. (As they say, "the first rule of holes is stop digging ".) Second, new managers are often absolutely essential. As Brenneman puts it: "It's hard for the same people who put you in the ditch to pull you out of it". He confesses he was sometimes slow to do just that to the detriment of his turnaround efforts. My personal experience in doing corporate and asset workouts in the 1970s and 80s is essentially the same. Sometimes an investor is unable to get what I call "un-varnished and un-conflicted advice" from the very people who created the problem. There are simply too many pressures on the existing managers to correctly and adequately confront and deal aggressively with the problem: overly rosy PPM projections, tattered client relations, dependence on fees, wavering staff, reputational risk, and raw human emotion. They are fundamentally "overly-invested" in their investment decisions (pun intended) to be coldly rational.

So if you decide you need "workout" help, where do you go to get it? It is something of a lost art or skill. Many of the most experienced veterans of the 1970s and 80s are retired or running their own investment firms - with possibly their own share of problems. As mentioned above some of the investment management firms are setting up "workout" groups, but there is a fair amount of skepticism about their skill sets. As one client of mine said to me: "The number of people coming in to pitch workout services to me based on their so-called wide experience from the RTC days, reminds me of the 8,000,000 people who claimed they were at Woodstock!"

I have found over the years that "workout" skills can indeed be different than investment, especially acquisition skills. It's partly based on personality. Good workout people tend to be somewhat more skeptical, partly because they have spent so much time resolving problems created by hyper-optimists. They are also good problem solvers, partly because they have spent a significant part of their careers solving them. Most of all they have done it before. Experience is crucial. They have seen similar problems and know what is important to focus on and what is less important. They know how to "run the drill" to determine when to push hard and when to back off. Most of all, they have learned how to judge people and firms to determine who is truly working in their client's best interests.

So if you decide you need help, look for a group with experience, with a problem solving history and which doesn't want to make a career out of managing your assets. Some people are viewing workouts as a way to build their AUM, but the best "workout" firms and "workout" executives are and should be incentivized to successfully work themselves out of a job.

One of the most interesting issues is how to compensate "workout" firms. It is always difficult when one has lost money to pay even more money to get the problem fixed. But whether you keep your existing manager or get a new one, you will have to pay appropriately to get the right talent and you will need to create some kind of incentive fee program to reward success in a very difficult market. People are about to find out that it is more difficult to solve existing, deeply embedded problems than to invest money in a healthy market.

Good luck. Its going to be an interesting couple of years, but those who survive will end up being much better investors, lenders and managers when the markets finally recover.