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A survival guide for commercial-property owners

GUEST COLUMN
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A perfect storm of adverse events is dramatically impacting the commercial real estate industry.

Commercial real estate owners face the prospect of loan maturities while credit markets are generally frozen and commercial tenants are either going out of business or facing their own financial difficulties. Stronger tenants view these difficult times as a window of opportunity to demand concessions.

There are measures, however, that a commercial-property owner can take in order to weather this economic storm.

■ **Analyze key financial covenants of existing loans.** In this climate, lenders often are willing to entertain loan modifications to address covenants that otherwise are in danger of violation by a commercial borrower. It is easier to attempt to address any issues with a lender before a default has taken place. In this type of "work-out light" process, a borrower advises the lender on which covenants are presenting difficulties.

■ **Seek remedies.** Given the decline in occupancy and values, a borrower may be faced with the prospect of violating key covenants related to debt service coverage and loan-to-value ratios. In a project under construction, the developer needs to review loan covenants related to timely completion and budget. Pending loan maturity dates must also be carefully scrutinized. Adjustments and extensions should be sought as soon as possible.

■ **Audit leases.** Review each lease underlying the loan to determine what impact a vacancy might have, not only with respect to financial loan covenants but also with respect to co-tenancy and other similar lease provisions. In a retail project, for example, space that becomes dark or vacant as a result of a lease termination can trigger a domino effect of adverse consequences. A retail lease might contain a provision that allows retail tenants to pay reduced rent (which might even be based upon a percentage of gross sales only, without any base rent component) or terminate the lease itself.

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■ **Check financial health of tenants.** A landlord in a retail lease may have recapture rights if a tenant goes dark. As a result, a landlord should become familiar with the financial health of all of its tenants. If the landlord suspects that a tenant may go dark, the landlord can focus on its prospects for releasing the applicable space. It is obviously important, in this regard, for a commercial lease to contain a covenant that obligates the tenant to provide financial information if the tenant is not a publicly traded company for which financial information is readily available.

■ **Prepare for tenant negotiations.** Lease analysis that is useful in loan workouts is also helpful for preparing a landlord for a rent-reduction request by a tenant. In increasing numbers, tenants experiencing financial distress are making such requests – often couched in terms of a plan that will allow the tenant to remain in business.

■ **Focus on restrictive-use clauses.** Landlords already experiencing an increase in vacancies and a reduction in lease income as a result of current market conditions are obviously troubled by the prospect of reducing rent for an existing tenant. However, there are steps a landlord can take to turn this adverse consequence into a more positive one.

Use restrictions in shopping center leases, for example, typically protect a tenant from a competitive use and also prohibit uses historically deemed unattractive to retail tenants. A landlord might be willing to grant a rent reduction in exchange for modifying or even terminating such use restrictions. Depending upon the amount of vacant space and its distance from the tenant involved in the proposed rent reduction, a landlord would be well-advised to try to position himself to be able to entertain creative uses previously not found in a typical shopping center.

■ **Reserve recapture/relocation rights.** A landlord who agrees to a rent reduction might want to reserve a recapture right or a right to relocate the tenant. This recapture right would enable the landlord to terminate the lease pursuant to a specified notice of, for example, 90 days.

Alternatively, the tenant might be allowed a rent reduction on a temporary basis and be required to go back to either paying full rent or giving the landlord the option to terminate the lease at any time thereafter, pursuant to written notice. A relocation right will offer the landlord flexibility to market the space in conjunction with adjacent space.

■ **Be diligent.** A diligent lease analysis will position the retail landlord to anticipate and resolve problems in connection with its loan terms. Other solutions should provide flexibility with respect to existing and future leasing as well as other development prospects for the shopping center. The same type of review applies to other types of commercial properties.

Together, a diligent loan analysis and lease evaluation will help the commercial real estate owner weather the current economic storm. ■

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