RHarper Consulting Update

New FDIC Policy "Pretend and Extend"

What it Means for Acquisition Opportunities

The Commercial Real Estate ("CRE") sector has been as adversely affected by the recession as any market segment and arguably has suffered a greater decline in value than any other. Further, it has been widely reported that anywhere from $700 billion to $1 trillion in CRE mortgages are coming due in 2010 and 2011 and will face a very challenging environment in which to refinance. Many believe this will begin a new wave of institutional failures and further credit challenges. Many have been anticipating this impending crisis as the second coming of the RTC with distressed assets trading at pennies on the dollar. However, a recent policy issued by the FDIC may mitigate some of the impact.

The policy recently issued by the FDIC provides banks and examiners with new directions on CRE loan workouts. The 33 page document outlines treatment of CRE loans and suggests acceptable workout guidelines. It also provides examples of various workout scenarios. In short, it allows the banks much greater latitude in modifying loan terms and evaluating the global credit picture of the borrower to assess the risk profile of the loan and its underlying collateral, and establishing credit monitoring to protect the loan. Some have cynically labeled this policy as "pretend and extend." If the bank and the borrower can establish a "plausible" workout plan then the bank will not suffer significant loan reclassifications and write-offs, thus preserving their capital positions and ultimately, their ability to provide credit to the market. Many believe this will allow the banks to "bury" their bad loans and postpone taking write-downs and foreclosing on the collateral.

While one can argue the pros and cons of this policy and how it may affect the long term capital positions of the banks, it is current policy and establishes the rules under which they will be operating. As a result, we believe the market will continue to see a relatively short supply of distressed assets, and that banks and borrowers may be willing to take a lesser discount. We may also find the application of "pretend and extend" will vary greatly depending upon individual interpretation of the policy by examiners in the field.

"Pretend and extend" is a new policy, and we will have to wait to see its impact before we can effectively evolve new strategies, but these suggestions are worth considering:

- *Realistic expectations* – Based upon the policy statement, we expect to see a relatively slow, but steady supply of distressed assets. Understanding there will be good values, but probably not "fire sales" is essential to formulating a successful acquisition strategy.
- *Continue developing information sources* – Stay in contact with your local banking community and let them know the types of assets your organization may be interested in, and make sure that local commercial real estate brokers know your strategic goals as well. Other great sources of information are appraisers, environmental engineers, and other professionals who banks might call upon to evaluate assets prior to going to market. The best opportunities are probably not going to hit the open market, but are going to be closed quickly and quietly by buyers with good information sources.
- *Due diligence team* – Have a group of professionals ready to react to the availability of an opportunity. Often, the bank will want to make a deal quickly and quietly. Being able to respond quickly with a well thought out offer that has identified the risks, has an operational plan, meets your internal financial hurdles, and integrates with your overall strategic plan is absolutely essential for success.
- *Financial strength* – The FDIC policy makes specific mention of replacement guarantees and many distressed assets deals can readily get done by being able to provide just such a replacement guarantee on the existing loan.

While we may not see great acquisitions available in every market, there will be opportunities for well prepared buyers that proactively pursue strategic acquisition strategies. If you have not yet clearly defined your strategic acquisition goals and assembled your team, start getting prepared today.

For more information please contact:
Roger Harper
615-218-4102
rharper@rharperconsulting.com
www.rharperconsulting.com

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For more information on RHarper Consulting Group please call 615-218-4102 Or rharper@rharperconsulting.com