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Restructuring New Apartment Construction Financing in Difficult Times

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DISCLAIMER:

I am the Advisor, you are the Decider

This paper includes a lot of prognostication. You, as an apartment owner, have the job of looking at the facts and deciding what is best for you. I, as an advisor to my clients, try to paint the most realistic picture of the market and surrounding political and societal structure in order to help you make the best decisions. I'm not looking to be a fearmonger (although some of the commentators I enjoy reading probably are), just a purveyor of information. Some of what I say in this paper may seem self-serving, but that doesn't change the fact that it may also be true and worth factoring into your decision making.

An important part of our focus is looking ahead to identify potential problems and opportunities for our clients. At this time, we believe there could be some uncertainty in the under-construction apartment marketplace. What does this pain look like, how bad will it get, and what are the solutions we can bring forward to avoid potential pitfalls and recognize opportunities?

State of the Industry

For apartments under construction, the financial realities now differ from those encountered early on in the process. Builders are seeing construction and borrowing costs continue to rise. In response, they must turn to their lenders to cover these costs. When they do, builders need to know what options are available to them, which lenders are receptive, and what solutions can be found that will work for all parties.

Our best guess is uncertainty affects approximately 500 new Canadian apartments of various sizes—those that have started construction or have spent too much money to stop and pause for them to be economically viable any longer. What happens if you're at the point where you can't stop?

Perhaps the market is beginning to turn a corner, bringing significant changes to the financial environment that everybody should be aware of. Lenders have been tightening their belts, looking hard at their portfolio risks, and deciding how to react to the changes. The availability and sources of capital will change, and the terms and covenant patterns will likely change as well. The increased requirements for equity may be a precursor to a deeper marketplace problem, but there is no crystal ball to foresee the future. Therefore, we must be prepared and not get caught off guard. Some think this trend mirrors the 1989 downturn, which carried on for quite some time before returning to the economic fundamentals that ran the economy.

It's our job to wrap our minds around how the world is changing. The world is changing rapidly, and restructuring from historical knowns to potential future unknowns. We must identify where we are in the cycle and what trends are emerging so we can be prepared to counsel developers moving into a difficult situation with viable solutions. We'll also cover some restructuring strategies and explain how to get through this uncertain time by providing concrete advice.

MARKET TRENDS

- **Expect less patient lenders**
- **Less "extend and pretend"**
- **More widespread insolvency**

For 2023, we expect lenders to be less patient, with less of an *extend and pretend* attitude than in previous years. Lenders may do things like forbearance, waivers of default, and out-of-court settlements. Canadian corporate and personal debt levels are high; therefore, we're likely going to see an increase in insolvency, though it may not be spread equally across the country.

Mismanagement can play a part in every industry. That's not what's happening here. Construction costs have passed their peak, rising interest rates are adding a new level of pressure, and the cost to complete construction is increasing to a point where it can trigger an event of default. The remedy is often more credit, but if you don't have more equity readily available, you must search for alternatives.

Apartment occupancy rates are still very high, so the long-term value of the asset remains, but builders do have a survivability issue obtaining the liquidity to get a project completed. Especially with lenders wanting to know up-front how a builder will be able to support the unavoidable increase in cost during construction.

WHO IS SAFE?

- **Apartments are stable and typically low-leveraged**
- **Transactions will be lower until new paradigm is accepted**

APARTMENT TRANSACTIONS – to April 2023

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Firstly, apartments are a stable asset class. Historically, apartment cash flows do not experience the peaks and valleys experienced in other asset classes—people must have a place to live, so it's smoother. Apartments are stabilized assets with low leverage, so they're not going to get into trouble typically, or en masse, because they're fully occupied and most have locked into longer-term, low-interest mortgages. Even if they're refinancing, their cash flow is certainly strong enough to survive. Apartment owners are telling us that they're taking short-term financing (two or three years) to get through this higher-interest rate period, and they expect interest rates to drop in the near term.

Secondly, something we're already seeing is that transaction volume is low and will remain low until a new paradigm is accepted. The nature of real estate brokerage may be changing.

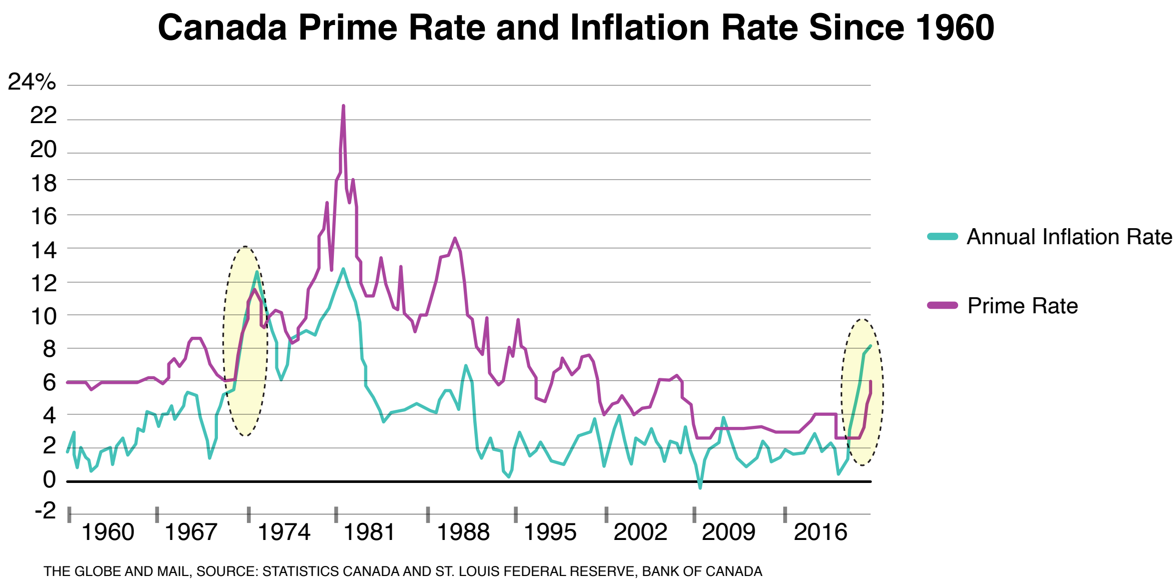
There is a spread between the bid and the ask. Buyers are saying that the cost of money has risen and that the cap rates should go up as well. Sellers are telling us they don't need to sell and want yesterday's prices. Buyers, of course, want today's price. Therefore, there's a gap between bid and ask. There's some uncertainty as to when that gap will close, or if it will close at all.

The number of apartment transactions between Q4 of 2021 and Q4 of 2022 was down 68% across Canada, supporting that uncertainty.

PRIME RATE AND INFLATION

When we asked financial professionals to comment on the chart shown at the top of the next page, they told us that prime was going to rise. The difference between the two lines (*teal*: annual inflation rate; *magenta*: prime rate) mostly tracks each other, but shows some interesting deviations in the two highlighted areas.

The patterns are quite typical, except in the 1970s, when the central bank fought inflation—interest rates kept tight with the inflation rate. In today's situation, the primary response, as everybody knows, was delayed, and you can see the delay on the chart—about eight months. As a consequence, the inflation rate has been allowed to shoot up a little further.



What we keep hearing from financial institutions and economists is that this interest rate is here through 2024, and it will ease off out of 2024, but it could go on longer—maybe a couple of years. Also, the new normal may not include the unprecedented rates that we've seen over the last decade, but rather rates that are a bit higher (there was nothing normal about the last 10 years of interest rates. The low rates were never sustainable).

Interest rates are almost always higher than inflation, except for now and during the '70s. This illustrates the point that we are at the start of something similar to the '70s and we must be ready, in a programmed way, for what may be coming. What we've been experiencing for the last 10 years is exceptional, and not reflective of the fundamentals that we're used to. We're not necessarily looking for a new paradigm as much as we're returning to the fundamentals that have carried the real estate market through its normal cycles.

We should also recognize that what we're going through is not new. We've made it through before, and understanding the reasons behind the current market volatility while not overreacting will get us through this short-term turbulence.

If we remove all emotion and bias and only consider the data—and this has been consistent for 60 years—the data shows prime going up, unless inflation goes down. If you believe inflation is going down, then interest rates are going down even if inflation is going to take a long time to tame. Be prepared for interest rates to remain high for a while.

RENT TRENDS

- **Rents are going down in the U.S.**
- **Rents are going up in Canada**
- **Recession impacts both rent rates and vacancies**

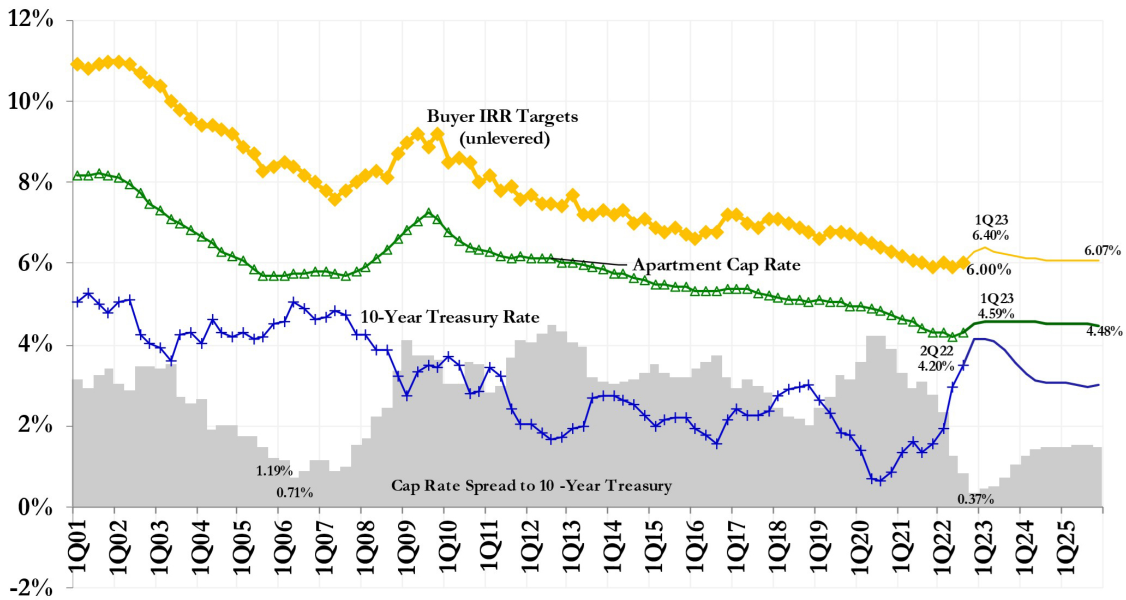
Rents, and interest rates, to a large extent, determine the success of an apartment building. Remember that this document is not concerned with apartments in general. We're focusing on new apartment construction—deals that have started and are underway. The pressures they face are higher interest rates, construction costs, and operating costs. I think it's fair to say that in the US, overall and average rents are going down, though they are going up in some markets, such as Florida and Texas. But here in Canada, the average rents are rising, and we expect this trend to continue.

If you ask 100 people in the industry where rents are going, the general message is that rents in Canada are rising. They're doing so because of the shortage of available rentals, the increasing population, and the current housing situation. For new construction, higher rents bring some relief to support rising costs and increasing interest rates for the foreseeable future.

The real danger in the apartment business is not a recession; it's overbuilding and having too many apartments for the population. Many US cities are in balance right now, so if there is a downturn in that economy and more apartments come onstream, they'll have some serious problems. But Canada is in a different situation. We believe that unless things get really bad, our occupancy rates and rents will continue to increase.

PREDICTIONS

Relationship of U.S. IRRs, Cap Rates, & Treasury Rates



Source: Witten Advisors

Ron Witten, from Witten Advisors in Dallas, provided us with this chart, which shows some important IRR and cap rate trends. This is US data since we have no Canadian data to analyse. In the US, the apartment business is ten times larger and more transparent than our own. However, as a proxy, we suspect trends are similar.

It's apparent that buyer IRR target rates (yellow line), are falling over time due to dropping interest rates. Institutions have realized that apartments are stable investments and have become more mainstream. To us, this reflects *more* institutional demand with *less* available product.

Cap rates (green line) are generally dropping as well, tracking with the IRR targets almost perfectly. This makes sense because they are two sides of the same coin—IRR targets and cap rates are highly correlated.

Where this gets interesting is how IRR targets and cap rates do not correlate well with the US Treasury rate (blue line). The spread between the two (gray bars) doesn't seem to follow any particular logic. Statistically, the correlation is 0.62, which translates into saying that 0.62 is the correlation of when interest rates turn up, cap rates turn up. However, there are many times when interest rates go up, but cap rates go down.

In the highlighted box at the far right, the chart suggests that IRR expectations are going to rise because interest rates are going up. If you can get 3% or 4% on a 10-year U.S. treasury, then you're going to expect a better return on your apartments for the risk and the work you have to do—but not significantly in the short term. They're probably going to climb from 6% to 6.4%, but that's only an educated guess. Nobody knows what that number will be. Later, the rates will flatten back down again as the mood settles and inflation gets under control. Remember, these are US cap rates. Canadian cap rates are lower.

In Canada, some say cap rates are up 25 to 50 basis points, maybe more. However, there's very little data currently available. We believe they're going to crest and then go down.

If the author of this chart is correct, the spread at the bottom is the narrowest it's ever been. If you think about that spread as being profit or profit potential, what it implies is that there's going to be more pain rather than less, but as time goes on, the spread returns and there will be a greater cushion.

We believe the expectation is that the tail end of the interest rate line (the proxy for it, the treasury rate) is going to be longer and push into 2024 at a higher level than in the US. The current expectation is that US interest rates may actually fall faster than Canadian rates. Canadian rates may peak sooner but hold longer. If that's the case, and if this is really a proxy for Canada, then the spread could be thinner for a longer period of time. That's bad news if you're an apartment developer building right now.

We caution that there's a tendency in our industry to overvalue the influence of cap rates. Cap rates are a snapshot in time. The true application should be to properly target IRR targets—what they incorporate is the cost of the development, the time you're holding it, the stabilization of the rents, and what yield you want leveraged and unleveraged. This is a better indication over the whole period, let's say 5 to 10 years. The cap rate can change overnight. IRR is more consistent. It brings in the three elements: *how many dollars in, when do we get them back,* and *how much do we get back.* It captures all of that information within a predetermined timeframe.

Think of a cap rate as a snapshot of the building today—and that's it. The IRR is a movie of the building over time, say for the next 5 or 10 years, and from there you calculate a return. It's the truest factor about your investment.

MOOD

The chart shown on page 7 is a measure of the temperature of how the financial markets feel and how comfortable they are. The markets were far less comfortable in 2007 and 2008. That market crashed, but it bounced back and stabilized for the following 10 to 12 years. Today, we see inflation becoming a problem. In Q1 2023 we see indications that the financial markets and the lenders are uncomfortable once again.

As developers approach the lenders, they must understand the lender's mood in order to address and solve the challenges brought to them. Now, that mood is similar to where it was in 1970.

How we feel, most of the time, is a good indication of the mood. The market moves in a reactionary pattern, lenders move in a psychological pattern, and for the most part, they move in packs. The mood test is, we think, probably one of the most succinct ways of describing the markets. The question now becomes *how quickly do you get out of this depressive mood?*

Developers wanting to preserve their projects are also looking for buying opportunities, but the gap between the bid and the ask is still large. If they have to sell, what happens? Well, prices go down, resulting in slightly more distressed sales. It then becomes a self-fulfilling prophecy: with distressed sales, lenders get a little more nervous, they see an erosion of value, and then they want to see more liquidity and even more equity. If they don't see this, then they reign in, tighten their facilities, and start to govern in that way.

This pushes projects that are on the margins over a tipping point. There must be analysis in order to know when this will occur, so preparations can be made before it reaches that point.

The markets have not reached a tipping point yet. The story so far is that costs have risen, rental rates have also risen, and we're not sure where the cap rate is. This is all due to a low number of transactions.

If you're searching for takeout financing, it's all about addressing what you see coming before it hits you. The train seems to be approaching, and we see its light in the distance, but what are we going to do? There seems to be a depressive mood in the capital markets right now. We need to find out what medicines are available to alleviate the lender's depressive mood so we can address the challenges that the builders are having right now.

We'll address solutions in the *Restructuring Solution*s portion.

INSTITUTIONAL MEMORY

Lenders come with varying amounts of experience and, what we call, *institutional memory.* Some have many years of experience, while others have less. We've seen two patterns emerge. One is from lenders who are less far along in the experience curve, and the other is from those who have seen it all before.

In the push to bring youth into institutions, a certain amount of institutional memory is lost. There's a generation of people inside the lending community that have no recollection of what a real estate downturn is like, and who believe in the infinite loftiness of the market. As a consequence, they can be caught off guard and have a knee-jerk negative reaction to current market volatility.

Those who have seen it before tend to be a little more circumspect, a little more cautious, and have a thorough understanding of the psychology of a downturn and the return to normal market conditions.

The developer industry also experiences similar institutional memory. Some forget or don't know what it looks like when things get really bad. Those who've experienced the downturns may be better prepared and not lulled into a sense of overconfidence.

We're not suggesting that developers batten down the hatches. We suggest that they proactively stress test their portfolio, their projects, decide whether they may have a problem in 2 to 5 months, and address any problems as early as possible.

CAP RATE

What's the cap rate? Our answer is that the market determines cap rate, not us. We supply a process but cannot determine the rate. In fact, there are many cap rates: *a buyer's cap rate, a seller's cap rate, a lender's cap rate,* and *an appraiser's cap rate.* It is important to note that different groups will have different concepts of cap rates to suit their own needs.

US data is showing that cap rates are up maybe 50 points, and could be on their way to 100 points or higher. But Canada is not the US. It may be more prudent to look at European cap rates, which are always lower than Canada's. Canada sits between US and European cap rates. If we're struggling to prognosticate, it's not because we don't know how to calculate the rates; it's that we don't have enough data to calculate them adequately in order to produce a reasonably representative measure.

As mentioned earlier, we believe the reality of cap rates invites caution. Markets are more about where the economy is, where the trends are heading, the cost of money, and what investors and/or developers are looking for as a return on their equity. It's more complicated than simply looking at where the market is at this moment. There are individual decisions to be made based on individual thought processes and where interest rates are at any given time.

The sophisticated investor is looking at IRR, not just cap rates. There may be some who don't even need a cap rate as long as they can get their loan, because their reasons for owning are long-term growth and intergenerational wealth. To them, cap rates mean very little.

We've found that when we sell a smaller asset, let's say a nice 50-unit apartment building, to the local investor and they're buying it for their kids, they're less cap rate sensitive. They're looking to invest in an asset for the long term—parking their money to pass on to their children as an income.

INTEREST RATE HEDGING

When a developer begins a project and the interest rate is a certain number, how do they avoid problems if rates rise by 200 basis points? How do they hedge against that?

What we've done, and have already seen implemented in some cases, is utilize a product where the loan is at a fixed rate when approved versus a rate that floats during construction. If there's concern that rates will rise too high, a rate can be locked in from the beginning—hedging against a potential rise. At that point, you know what your cost is going to be over a long period of time—up to 50 years, depending on the product.

For example, we locked in a rate on a build at 4.1% when the current long-term rate was around 3.8%. This rate will hold until the build is completed, thereby eliminating the risk of rising interest costs during construction.

Lenders are booking that rate long term, and they can disburse the loan in escrow during construction, and then progressively from the escrow account. With the whole amount disbursed, the lender and borrower eliminate the risk of increased interest costs during construction. The borrower can also generate interest on the unused portion to help offset interest costs during construction.

The lenders have come up with an innovative product because the market needed it. What we've done for the market is educate the many brilliant young minds that may lack long-term experience.

We're finding that lenders are receptive to these solutions. Some borrowers need more convincing. They say that they've done business a certain way for years, and it has worked. But the solution we've introduced works well and will also protect the borrower.

The challenge for builders is that they're accepting a slightly higher on-average rate. If the rate drops faster than they anticipate, they're locked in and have missed an opportunity—that's an opportunity cost to hedging. However, we feel it's an absolute opportunity cost that's weighed against the ability to sleep well at night.

How uncomfortable are you willing to be going forward? How important is it for you to say *I don't have to worry about this*? We detail how much it's going to cost the builders if it goes up by a quarter point, by 50 points, by 100 points, etc., and then let them make their decision. They're looking forward at their liquidity situation and deciding whether they have to lock-in in order to protect themselves from a potential interest rate increase versus exposure on cash flow.

There are two types of borrowers: the conservative ones who will always grab that hedge to make sure they sleep at night, and the others who'll say their liquidity and/or equity is sufficient to weather the storm. If they don't have a source of equity, or if the bank tightens up, they better lock in to protect themselves from a situation where they may not be able to support increased costs. The failure to adequately plan against eventual cost increases is almost an assured path to a foreclosure agreement and/or the foreclosing of the project.

It's important to understand that, since most borrowers are in the middle of their project, they're entirely focused on dealing with the sub-trades—not dealing with the interest rates. It's our job to provide support, identify the coming train, *and* plan for it.

ALL CASH DEALS

How do we advise the individual who's building for all cash and doesn't need to hedge?

The person with much leverage needs to hedge. Those who have the cash should look at protecting it and should use the bank's money instead. If the market turns, they're not going to get their money out from the bank—the bank's not going to lend, nor will they be able to pull out the equity they put in. It's best to protect that cash. In a volatile market, it is best to protect your cash by keeping it available. You can always inject it at the end of the construction program to reduce your loan if you wish.

IRRs

What is the development IRR target that a developer should expect on apartment construction, both historically and currently, if a deal goes ahead? There are a lot of questions you must ask before you target the IRR. Firstly, *who is asking the question?*

If you're asking us to set a target, I can tell you from the developments that we're looking at in a joint venture that they're offering safety-first positions to investors at 20% IRR over a five-year period. That's typical in both Canada and the United States. Lately, it seems harder to get; however, they're still aiming for that.

Stabilized, the annual return is looking at 5% to 7% annually. But then you have to ask the question: *if you're seeing IRRs or projected IRRs at 11%, why is it so much?* We're seeing between 5% and 7% stabilized.

For the development IRR I'm going to tack on between 50-300 BPS, so another three points to take the development risk into consideration. The riskiest part of any investment is the construction portion, so if you're putting in money and expecting a return, then during construction it should be more than the stabilized portion of it.

Most of our clients are private developers who punch above their weight class. They run it lean and are frugal and efficient. Their IRRs were in the 20s. They need to see that kind of development yield due to the risks involved. Now, running IRRs with new rents, new construction costs, and new interest rate costs—it has dropped to the mid-teens. Let's say it was 20-25% before, and it's 15% now.

The institutional builders are high-cost developers running bigger deals. Their spread is less, but the dollar amount is larger. Let's just say that their development IRRs have compressed as well.

The question the developers must ask themselves is *what's an acceptable IRR to me in these times?* The answer may be relative to what they can make somewhere else.

MACHINE MOMENTUM

One of the things we've noticed is that some developers have built machines. If they stop developing, the machine falls apart, so they're prepared to do smaller deals. We've seen apartment developers and private developers, who have machines to feed, take on an 80-unit building instead of a 250-unit one. Or they may even build smaller to ensure the machine keeps running. Alternatively, they'll build one tower and leave the second for later. Or they

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may pause the second tower so the first can be completed, and determine what to do with the second tower later. It may be safer to take a wait-and-see approach to better adjust for the increase in cost versus returns at that point in time.

How developers approach these decisions depends on the cost of capital and the leverage involved.

THE CAPITAL STACK

A surprising percentage of developers, 10% to 20%, build for all cash and do financing at the end. The others will look at structuring the capital stack to support construction.

For new apartment construction, the capital stack looks like the chart above. 75% is construction financing, 15% is mezzanine, and the remaining 10% is equity. Of the equity portion, 20% can be developer equity, with the remaining 80% coming from a joint venture partner or a private lender. This would be a deal that's considered highly leveraged.

This is the typical capital stack that most well-heeled developers are used to. This is what we'd expect to see financed for the last 10 years without batting an eye, and at the end of the project, we'd actually refinance—everybody got their money back and then some. Everyone was accustomed to this. This is the structure that has worked for the last decade, but now is extremely difficult, if not impossible, to achieve in today's market.

In the last year, there's been a dramatic turn. The capital stack has seen pressure applied to the conventional portion. Now, that conventional portion is coming down. Instead of 75% institutional, it's coming down to 70% or 65%, which is now putting pressure on the mezzanine and the equity portions.

If the cost to complete goes up during construction, the 75% lender is not going to add funds into the pot: this will need to come from mezzanine and equity, thus reducing the lender percentage. The lender *may* contribute, but only if you have an exceptionally good relationship with them. Most builders, in this case, will have to add the mezzanine and/or equity to support the increased cost of completion.

The Lender's Perspective

An asset manager once told us something very interesting. An office building had issues, and the building owner approached the lender and gave him the keys. The lender told the owner that they didn't want the building. Instead, they asked how much was needed to make the project work again.

The point here is that lenders *lend.* They don't *own, sell,* or *manage* an asset. They don't make money that way, and it's the last thing they want to do. They make money by lending money.

It's important to note that if you're having issues as things become more challenging, it's far better to inform the lender before it gets to the point where you cannot manage any longer. As long as lenders feel that the borrower is being collaborative to get through the challenge, you can expect a senior lender to support any reasonable request.

LENDER'S COMFORT

WE MAY BE TOO EARLY

- It may be too early for lenders to have issues on the books
- When things reverse, they sometimes reverse quickly

So far, we've been discussing numbers, facts, and experience.

How do people react when things go off the rails? We've shown that it may be too early to worry now, but some pain is on the horizon, and we have to prognosticate and look ahead at the gap in the marketplace.

However, though early, things can reverse quite quickly, and we must be prepared. Lenders may say that everything is fine, but we've seen that this is not the case. Lenders are now in the mood of attempting to figure out how to handle the coming headwinds. At this point, they may not have too many default situations, but they do have situations where they know their developer clients are struggling.

Lenders must manage their portfolios carefully. In order to keep a balanced portfolio risk, they're not going to be trigger-happy. Lenders are not only driven by *your situation, your loan,* and *your relationship with them*; they are driven by what's in their portfolio and how that's performing. If they have a good portfolio, they're going to be quite calm and comfortable. If they don't, they're going to be edgy and looking for excuses to call for more equity, or to stop funding construction.

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Although no lender wants to take over a project, sometimes they prefer to avoid increasing their position in a project that is stalling. And projects can be sold in a totally broken state to another developer at a discount.

LENDER'S MINDSET

What is the current lender mindset?

We believe that they're cautiously optimistic and hopeful that the interest rate peak won't go into 2025 in a material way. We think that they see a protracted increase as having a chilling effect, and they are still hoping for a mid-2024 interest rate drop in Canada.

However, mindset varies depending on the level of manager you're seeing.

- The account manager who is originating loans will have a positive attitude. His job is to bring new business to the bank, so he will do his best to accommodate the construction request.

- The VP will be a little more conservative as he has more contact with the credit committee and their current mood or mindset. They will usually recognize when the dynamics of a new construction request or an existing request that requires amendment, for example, to support overruns, will cause heartburn and try to address it right away.

- The illusive Credit committee is completely independent from the origination process. Credit, in times like we are living through, where the economy is on shaky ground and the rates have been on the rise, will turn up the conservatism and ensure that only the most worthy transactions get through by increasing the thresholds required to approve the transaction.

Being able to recognize the mindset or mood of Credit, instead of trying to push your own agenda (why your project is better than the next, or how you could not avoid the overruns) will help you address the points that will make Credit take a more interested look at your position. Credit hears all the excuses in times like these, they want to hear and see how solutions will be put in place. We need to ensure that Credit not only sees the solution but the exit strategy as well. It is seeing the clear path to being repaid that provides *them* comfort, otherwise they will simply decline and move on to the next file. Today, credit is overwhelmed with requests, and as such, if your request is not a clear and simple path to the successful completion of the project, they will not support the request. Make sure you are working with a broker that has a successful track record in submitting and approving construction transactions and is used to addressing the concerns the lenders and Credit have right now.

DEVELOPER'S TAKE

Usually, the developer in the capital stack—the two percent guy, is saying everything's good. Their land was appraised 18 months ago, and it's worth around $40 million.

The real story comes from the individual who has put up the money and is writing the check right now. Maybe they don't see the end of it as soon as they thought, and they're getting concerned.

What we're saying is that mindset depends on *where you are, who you are, how much money you have in the deal,* and *how close you are to the deal* as well as *how good the numbers look for the take out.*

THE OVERALL MOOD

We make a point of going out every month and measuring the credit mood of the different lenders. They see a little bit of manure hitting the ventilator. What's happening in their current asset portfolio for the renewals over the next 12 months is that about half of those renewals are going to be offside due to interest rate increases and debt service coverage requirements not being met. This will cause significant heartburn to both lenders and borrowers, leaving lenders with less appetite for new transactions.

Everything is slowing, including credit. In their portfolio, all new transactions and current transactions are more challenging to deal with. This is why it is important to ensure you have the right people on your team to recognize and address those challenges early, while educating those lenders who don't have years of experience to call upon.

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The mezzanine lender is in a potential quandary, knowing they'll often be a source of new liquidity requirements for construction. They may come in with some support for a time period (at a higher rate), but at some point, they're going to say *sorry the equity has to step up*, because the senior lender doesn't care where the equity comes from, as long as it doesn't come from themselves.

NO COMPLETE REVERSAL—YET

Sometimes things can reverse quickly, but that hasn't happened yet.

However, they have reversed in the sense that lenders are not lending new money. They're not transferring control of the borrower relationship to a special accounts unit, or having the special accounts unit shadow the files. They may also be adjusting the risk rating of the borrower, which will affect their ability to get new money.

With that said, it's not a call on the loan, and it's not a stop on construction advances. Projects that began with conventional financing need to consider rolling over into programs that provide higher leverage, longer amortizations, and better terms. We are seeing developers switch to CMHC programs to carry the increased costs.

Counselling Developers

ADVISORS' INITIAL COUNSELLING FOR THE DEVELOPER

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- **Read all mortgage documents carefully**
- **Enhanced discussion with trades**
- **More meetings, deeper conversations**

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We see ourselves as advisors and counsellors to our clients, as opposed to purely being brokers (because brokers just want to sell—no matter what).

SANITY CHECK

So far, we sense that developers are wearing rose-coloured glasses. They are not looking ahead in a practical manner, and they are not stress-testing to see the effect of cost increases. If there are JV partners on the equity, the developers must keep these partners fully abreast of the situation and provide contingency plans.

Frequently, when we're working through these difficult situations with a developer, they are not being fully candid—and we can't help them until they are transparent about their situation.

If they inform us that they only have enough budget support for two more months of construction draws, that's important for us to know as the advisor. We're the ones who are going to recapitalize the stack for them and bring them the money they need.

When a project starts to have challenges, you can't focus just on the numbers. Instead, our meeting begins with understanding the developer's story. Developers tend to jump right into a discussion about *numbers* and *the deal.* In our experience, these conversations are only useful after we understand the developer's story.

For example, a developer explained that they were a medical professional who had made some money by opening more locations, and then put that money into apartment development. Later, we discussed their personal situation: their hopes, dreams, desire for intergenerational income, and more. This gave us a true understanding of the bigger picture, which allowed us to proceed with implementing solutions that would meet their needs as well as the lenders' needs.

LENDER-DEVELOPER RELATIONSHIP

When we speak with a developer or borrower, it's important to get to know them and for them to open up—because we cannot help them otherwise. It is impossible to find the right solution when you only have half the relevant information.

When you take the time to understand the bigger picture and get all the relevant details, you build trust with both the borrowers and the lenders. When you map out the right solutions for the lender, they will feel comfort. It takes some time to build that trust. Over the years, we've established meaningful relationships with a deep base of lenders and developers rooted in getting to know them.

Having a clear picture of each individual situation allows us to provide the proper solutions—be it with joint ventures, bringing in more equity, or offering innovative financing solutions to counter the headwinds on the horizon. There are a multitude of possible ways to help those who are struggling. The first step is to allow them to talk about their situation with someone they can trust.

We're having these discussions with developers right now, but it's difficult to build relationships over Zoom calls. It's much more effective to have face-to-face discussions, often on the weekends, in order to understand their stories and get to the bottom of their financial predicaments. Practically speaking, three to five meetings will uncover the real scenario—where we can offer solutions that make sense and keep the developer's dreams intact while ensuring that the lenders continue their support of the project.

TRUST IS EARNED

A broker/counsellor who has built a relationship with a developer and truly understands them, becomes an advocate for their position and a strong ally. In this case, the broker has two things going for them that the developer may lack.

1. The number of deals negotiated / The number of deals exposed to, and
2. Knowing how to speak the language of both lender and developer.

As senior brokers, we know how to have these conversations, how to solve a problem, or how to get the borrower out of his predicament. This comes from experience, specializing in an asset class, truly understanding the market, having built relationships, and most importantly, having been part of many transactions. It is important to have conversations to seek creative solutions and explore opportunities to meet everyone's needs–this is part of the counselling process.

DISCUSSION WITH TRADES

If the developer needs to have an enhanced discussion with the trades, what does that mean?

As a developer, you need the support of the people around you, especially your trades. If you're experiencing a bit of a challenge, don't just hide it from the trades and say: *Oh, don't worry, your cheque is coming*, or *You'll get paid next week instead of this week*. They will become aggravated. If you see a challenge coming, be transparent about it.

Going back to the idea that trust is earned: from the very beginning, transparency with those you interact with will foster their trust and support in you. Simply making excuses gives no reason to expect trust or support.

Absolutely, a developer needs help and understanding from the sub-trades when putting forward a solution to the lenders. You can't fight a challenge in this market by just dealing with one intermediary—your lender. You're going to need the support of your suppliers and trades as well.

DISCUSSION WITH LENDERS

Many times, a builder will tell us that they've known a certain bank and have been well-supported for the last 10, or even 50, years. But they only see their lender once every 18 months. We see your lender every other week, and we do hundreds of projects with them. We know we can help you with your lender. We have the experience and exposure to transactions and solutions. Talking to the lender is the first thing that we'll do—that's going to be the path of least resistance, where there's the most trust.

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As advisors, when we call the lender, we get the developer's permission. The lender is relieved we're there because we're giving them an unvarnished view of the world.

That's why we refer to this as a *lender sanity check.* When we tell the lender we've had a developer hire us to review the situation, we both know we've completed a *feasibility study* a few years ago, and at that point, things looked fantastic. But now the project is 70% complete, and there are problems. In this situation, a third-party opinion may be more valuable to the lender than the developer's opinion because we *tell it like it is*, and lenders need that truth.

Come to us early! Quite frankly, in some cases, the developer should have approached the lender six months ago, but they waited and spent most of their money. With no cash left, there's nothing in the war chest to fight with, making the predicament far more precarious.

TIMING IS VITAL

- **Lenders are expecting a problem**
- **Bring a realistic solution**

Any hesitation in telling your lender you're experiencing some pain is a recipe for disaster. Before that pain becomes unmanageable, let the lender know you're recognizing the challenge, you're dealing with it, and you expect their support. In a couple of weeks, get back to them and say: *Here, I've talked to these experts, and here's what we're going to do to mitigate the support and get through this.*

The natural tendency is to convince ourselves that we don't have a problem—that's why we arrive late to a solution. Don't wait until the 11th hour, hoping that it's going to get better on its own— it's too late. You can't enact the solutions that you should have implemented weeks or months ago.

Don't be afraid to deal with it—the lenders know that there are challenges. They will be appreciative if you bring the challenges to their attention now. Lenders are far more likely to support you if they know that you're proactively working on it.

Don't necessarily ask the senior lender to support it—approach the mezzanine lender instead. In today's current market, senior lenders take a bit of a step back, but the mezzanine lenders are leaning in—they know that they can participate, they know that the pressure on rents is up, but they also know that the future revenues from that property are going to be better than what was projected 12 months ago. So, for the mezzanine lenders, it's their opportunity to come in and cover that position. When the senior lender knows that's what you're doing, they're going to say *great!*

TRUST AND TRANSPARENCY ARE VITAL

Trust and credibility are two sides of the same coin. Trust is something that you deposit, and credibility is something that you build and put in a bank. When you consistently bank trust with lenders and trades you build up a credibility account with them.

One lie, one concealed fact, and you've withdrawn all of the trust and credibility you've built over the years.

Developers must be transparent about their plans to solve the problem in a way that doesn't involve the senior lender giving them more money. To have this infallible sense that you've always done it right and then rush into negotiations is folly. You may not be speaking with the same individual—the one who treated you well. That person may be gone, and now you're talking to a new, younger individual with no institutional memory—and they may not be your best ally here. (Note: giving transparency to a disorganized mess is a recipe for disaster.)

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Lawyer's Restructuring Advice

- **"Crow is best served to oneself warm"**
- **Have a plan and a team (not someone else solving it)**
- **Build credibility with the lender**
- **Ask once!**

CROW IS BEST SERVED TO ONESELF WARM

You've likely heard the phrase *you have to eat crow.* If you make a mistake or you get into a troubled situation, you'll pay for it eventually. But those who survive the troubled situation are those who eat their crow warm. In plainer words, don't wait until the issue gets more complicated than it already is; own up to it right away.

HAVE A PLAN

When you have a conversation with the broker to understand the personality of your lender, the first step is to build a plan to bring forward to your mezzanine lender and your equity holders to arrive at a solution.

In meeting with a senior lender and saying: *We've got a problem and we need your help*, their response will be: *Help with what?* If your response is: *We have a liquidity crisis*, they'll want to know what you're going to do about it. You can't expect them to give you more money. They expect you to return to the drawing board, take out your pencil, find some equity, or get your mezzanine lender in on that conversation.

That first misstep, going in unprepared, takes away from your credibility account. Remember that trustworthiness and credibility are two sides of the same coin.

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BRING CREDIBILITY

Don't assume that, just because you've run a healthy business and you've never gone through a restructuring situation, just because you're a great operator and you know what you're doing, that you know how to speak the language of the people on the other side of the table. They're thinking with a different mindset than you are. Know your audience, and craft your message for them. Go in with a solid plan and ask only once.

As advisors, hopefully, we have reached the developer prior to things getting too bad. We've done some analysis and completed stress tests in the current pro forma with the new rents, the new construction costs, the new interest rates, and maybe a new cap rate—and we've supported it with data. From there, we can begin constructing a plan with the developer to approach the lender and inform them that things are tough, but there's still hope.

Research, collaboration with the developer client, and sharing available options with the developer client are all paramount when building a case to put to the lender. It's also important that the lender has a feeling of trustworthiness and credibility with you when you're going in on behalf of your developer client.

Often, a developer client will go in with guns blazing and say *they're almost there*. That is no way to approach a lender. In our experience, it's much more beneficial to approach with some humility.

Restructuring Solutions

RESTRUCTURING STRATEGIES

- **JV partner for equity – Safety-first position**
- **Subordinated debt**
- **Cross-collateralizing**
- **Exchange**

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Normally, during the course of apartment transactions, we complete a feasibility study for the developer. Over time, these have become much more detailed and complex. We've completed over 700 feasibility studies across Canada, with an increased number of those developments having been built or currently being built.

Example

Already Executing These Types of Deals...

1 CHALLENGE

- New apartment community, 90% complete, leasing started
- Financial partner triggered sale due to outside pressure

2 OPTIONS

- Marketing the sale
- Big players had their pens down
- Received few offers, but too far off developer's expectations

3 STRATEGY

- Developer purchased properties from partner
- Raised equity from private family to recapitalize the deal

Lately, due to the current market conditions, we've seen an increasing number of restructuring files cross our desks. This next example follows a deal we have already recapitalized and restructured. The project consisted of multiple buildings in an apartment community. It was 90% complete and leasing had just begun.

We had already listed the building, and had been actively working with the client for a few years. The merchant builder's financial partner wanted to trigger a sale earlier than anticipated. This is, oftentimes, what happens in these situations—the apartment may be the most liquid asset to raise money.

We took the building to the marketplace and found that the institutions had *put their pens down.* This means they might buy a strategic asset, but overall, they are not actively looking for new opportunities because they are currently handling difficult situations in their portfolios.

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We received very few offers relative to what we expected, and they were all far off from the developer's price. So, what was the developer to do here? The financial partner wanted his money back, and the developer knew he was selling too early.

The developer did the smart thing—they purchased the property from the partner. We were able to bring in a private family to recapitalize the deal, and that family wound up getting much better returns than they would have if they bought the stabilized asset—because they came in probably six months or a year early.

It was a great fit because the private developer wanted to get the active returns that a developer makes, but they wanted to be passive. They got what they wanted, and the timing was right.

PRIVATE CASH

The path of least resistance, for us, is with the private individuals who are cash-rich and understand the apartment business.

In one restructuring case, we had a client who had sold their apartment portfolio and understood the apartment business. Their goal was to earn developer returns, but they wanted to remain passive, not active.

When recapitalizing a deal, and you need to bring in more capital, there must be smart money coming in. For example, a wealthy individual who's accumulated their wealth in technology, and would like to invest in farmland, takes a good measure of skill. Bringing in money that already understands the fundamentals of the business is far easier and less problematic.

SAFETY FIRST CLAUSE

In a restructuring deal with joint partner equity, our clients need to know that there's a safety first clause. A safety first clause puts the client's position ahead of the developer partner.

This may take the form of a limited partnership or a debt instrument, and you get what we call a *coupon rate*: so much is either accrued depending on the situation, or is payable monthly or quarterly. Then you negotiate a piece of ownership in this project—your ownership could be anywhere from 40% to 60%. The benefit to the developer is that a knowledgeable partner is brought in, which is crucial because a partner must know the business.

We are connected to many knowledgeable individuals with extensive experience of sitting on large amounts of cash—yet they're remaining on the sidelines. We can approach them with an idea, or an opportunity, and they can see the benefits of activating that equity if the conditions and restructuring deal are right. The safety first clause plays a big part in this.

It becomes a win for the developer and a win for the equity partner. The key is that the equity partner knows the business, and they know not to take too much ownership so as not to squeeze the developer to the point where they have nothing left to fight for. Additionally, the developer could create a waterfall situation where they would earn some of the ownership back.

THE DEVELOPMENT FEE

How the development fee is handled can sometimes become an issue. Often, the developer receives a development fee *and* a construction fee out of the deal. The tendency is to squeeze that fee (3%, 4%) with the developer.

But this is what happens: Assume the developer is involved in four deals. In three of those deals they have a project in construction—and you have squeezed the developer down. The developer pays attention to your deal because they only have so many hours in the day. That 3%, 4%, could be keeping the office open and feeding their family.

Profits should be made on the development profit, not on fees going through. Developers deserve to make a living in order to feed their families and keep their offices open. Don't squeeze the developer too much!

EQUITIES BEYOND CASH

Cash is one equity, but there are many other forms. In many cases, there exists free-and-clear equity sitting around and not doing much. About 89% of net worth is on non-cash equities. About 11%, historically in both Canada and the US, is cash sitting in the bank.

There may be a piece of land that's free-and-clear that gets put into a deal to help a developer cross-collateralize and raise money. There are many creative ways that non-cash equities can be quite useful in building up a corporate balance sheet and strengthening it in times like this. There could even be equities that are borrowed and paid back when things straighten out again.

There are ample creative ways that non-cash equities can be brought in, particularly free-and-clear equities. Many qualified people are sitting on these equities, and many of these could be used to help a developer through.

Lenders are looking for security, and mostly they want cash because that's what they understand. But if you have a multi-million dollar free-and-clear piece of land to put in, you'll get the lender's attention because they're still in the lending business and they need to get money out.

EXCHANGE

Here is a simple exchange example. We have a developer who has an equity partner, and that equity partner wants out of the deal. However, they would like to receive something for their equity.

A second developer who would like to step in will do something in exchange for some of the equity partner's participation. They might give them 50 building lots that he currently owns. The equity partner could take those lots and trade them for something they want.

When there's lots of cash around, it's mostly all cash-to-mortgage or all-cash deals. As a broker, you're just an order taker, but the market has dramatically shifted toward creativity. If you talk to your grandfather who's a farmer, and is going to deal with someone, the first thing he wants to know is: *what can I trade, what can I barter?*

Think about the shares traded every day in corporate takeovers. There's no difference between real estate equities and how these corporate share deals are being done on a daily basis.

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The mindset of cash-only is slowing people down. Exchange is a reality. Non-cash equities have great value in helping transactions go through.

Conclusion

The market is turning. However, there are plenty of sources of capital and solutions to help support the challenges that you might be going through right now.

Active and experienced professionals will hold your hand and guide you through these challenges. They'll bring you to the capital sources, bring you to the solutions, and bring the lenders unvarnished truth while offering solutions that they may never have considered.

When you're operating within the zone of economic uncertainty, add a stress test to your model every quarter. The stress test is simple as long as you have a sophisticated financial model already built out for your construction project and your costing. Add in a line for a cost increase factor, an interest increase factor, and test it every quarter. Then decide whether you can shift here or there and have the ability to actually answer that question with your existing capital, your existing equity holders, your mezzanine, and keep on top of it. If you just ignore it, you're going to be caught off guard.

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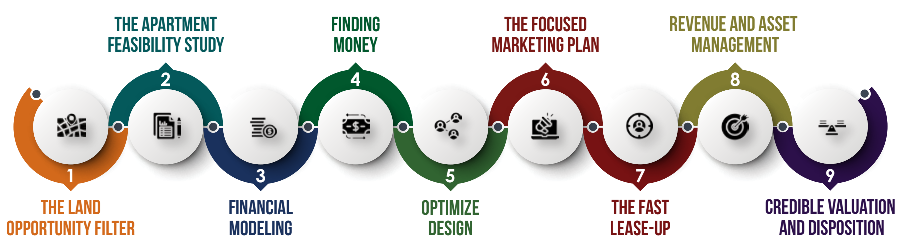

Our team serves clients through the entire project timeline:

- Land
- Feasibility
- Financial
- Finding $
- Design
- Marketing
- Lease-up
- Revenue + Asset Management
- Valuation + Disposition

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