THE Registry
SAN FRANCISCO

July 2008

Developers' Lessons Learned

How to survive, thrive and position for future success.

By **Dean Gloster and Greg Shean**

The end of cheap sub-prime money for home buyers in 2007 came after a long housing boom. The resulting weak demand has created the most difficult conditions for residential builders/developers in decades. In addition, the turmoil in the credit markets and tighter loan underwriting are impacting commercial developers and buyers, as well. Many will not survive the current downturn. There will also, however, be opportunities. Survivors of the current crisis may be able to build—and buy—at rock bottom prices to position themselves for decades of future profitability.

Unfortunately, most developers are already over-burdened by existing debts. Further compounding the problem is the fact that many of their lenders have cut back or entirely left the market of builder financing. Even lenders who stay in the business of lending to developers are likely to insist on changes to their financing models after a recent experience with uncollectible guaranties.

Lenders doing workout deals are increasingly insisting on cross-collateralizing their loans by real estate owned by affiliates—not just by guaranties of the parent company or pledges of membership interests in the other project entities. If that lending model persists and is also applied to new loans, it may force developers who want to maximize financing proceeds to use the same equity or money partner on all the sister projects. Otherwise, unrelated equity sources would be unwilling to permit their projects to be used to secure debts of unrelated ones.

The current crisis offers lessons for the future. And the overhang of contingent liabilities from the 2007-2008 slump also makes it more likely that developers will pursue new opportunities in new entities unburdened by those debts. So now is an especially good time for developers to adopt best practices to avoid future pitfalls and position for future success.

Use fewer lenders. If you use the same lender for multiple projects, your lender has a longer-term interest in your survival. If your loan portfolio is large enough, you can even gain some too-big-to-fail leverage with a lender: The lender has a greater economic interest in your survival than in maximizing collections on just one of several loans. If you have multiple loans with the same lender, however, be aware that cross-collateralizing those loans (each property provides security for payment of the other loans) is less dangerous than cross-defaulting the loans (a default on any loan means the lender can foreclose on all the loans.)

Insulate projects from liabilities. In the past, some builders owned multiple projects in the same business entity and even used that main company as the general contractor on every project, entering into agreements with all the subcontractors. As a result, problems on any project—including unpaid obligations to subcontractors on a job where a lender foreclosed—put all the other projects and assets at risk. A more prudent approach is to put different projects in different enti-

Now is an especially good time for developers to adopt best practices to avoid future pitfalls and position for future success.

ties, each of which hires its own contractors. Even if one company is managing all the construction for the multiple entities, it is less risky to act as the construction manager (supervising) rather than the general contractor (entering into agreements with each subcontractor and owing them under those agreements).

Getting beyond the personal guaranty. The business model of having the underlying owner personally guaranty the loans is a risky one: The owner can be successful for decades in a cyclical industry only to lose everything when lenders force a liquidation at the bottom of the market. The personal guaranty also doesn't work well for lenders, as they are discovering in 2008—the one time they need it, the guarantor doesn't have available assets because of the current economic situation that led to the call on the guaranty. It will be difficult to get beyond the unlimited guaranty, especially in a tight credit market, but some of the alternatives include: (1) A smaller guaranty of a specific amount, from a money partner, in lieu of more equity in the deal; (2) funding a guaranty entity (including by contribution of assets like apartment complexes) and giving of guaranties by that entity; (3) cross-collateralizing loans, so the assets of other projects provide security for repayment of the debt; and (4) providing a carve out in the guaranty that certain assets of the guarantor are not available for payment on the guaranty.

Conserve cash by reducing overhead. In 2008 and 2009, cash is critical. Land-rich but cash-poor developers with hundreds of millions of dollars in net assets can still be pushed into liquidation at fire sale prices if they don't have adequate liquidity. Even more cash is necessary in a tight credit market to take advantages of current opportunities to buy property at the bottom of the cycle. To preserve that cash, developers have to cut overhead to a bare minimum, which is difficult. Successful developers are optimists by nature and training, having surmounted obstacles for decades to build successful businesses and projects that others thought were politically or practically impossible. That optimism is a handicap, however, in the current market where cutting costs as quickly and deeply will serve better than an assumption that things will turn around soon. For an environment like today's, biology offers a model for survival: For survival in harsh environments, some microbes have evolved the ability to go into an almost dormant state, called a spore. Because they are doing almost nothing, they can survive in this reduced activity state for even decades or centuries until environmental conditions become more favorable, when they begin to expand and flourish again. Developers would do well to emulate this model, shrinking to the most minimal staff and overhead possible to survive the harsh current conditions, allowing them to survive to those more favorable times.

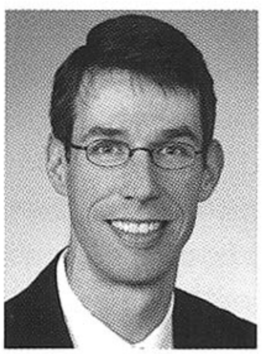
For developers who apply today's lessons to position for future success, those good times will come again. But it is important to take note of the lessons learned in this down cycle, so that the upswing is maximized when it returns. ■

Dean Gloster can be reached at 415.954.4472 or dgloster@fbm.com; Greg Shean can be reached at 415.954.4957 or gshean@fbm.com.

Dean Gloster

"Developers' Lessons Learned"

Dean Gloster is a partner in Farella Braun + Martel's San Francisco office and leads its Bankruptcy and Creditors' Rights practice. He represents real estate industry clients, including builders, developers and lenders in the restructure and workout of real estate and asset-backed loans. A frequent speaker on bankruptcy law, Dean is a former vice chair of the Commercial Law and Bankruptcy Section of the San Francisco Bar Association. He also advises a wide variety of intellectual property-driven companies in licensing, formation, funding, company acquisitions, asset acquisitions, licensing, strategic alliances, joint ventures and related contract issues.



Gregory Shean

"Developers' Lessons Learned"

Gregory Shean is a partner in Farella Braun + Martel's San Francisco office and leads its Real Estate Department and co-chairs its Hospitality Industry team. He maintains a diverse real estate practice, counseling a wide variety of clients in the areas of acquisitions and dispositions, leasing, entity formation and joint ventures, construction, financing and development. Gregory advises both hotel owners and managers regarding expansion and reduction of their property portfolios, management and technical assistance agreements and operational issues. In addition, he is a frequent speaker at industry events.