

# Taking A Contracyclical Step In A Down Market

The Editor interviews **Edward J. (Ted) Hunter**, Chair of Lowenstein Sandler's Real Estate practice group.

**Editor:** You have recently joined Lowenstein Sandler to chair its Real Estate practice group along with four other real estate attorneys. With the economic downturn hitting particularly hard in real estate and real estate finance, most firms are shedding real estate attorneys. Why is Lowenstein Sandler adding real estate lawyers in this environment?

**Hunter:** One of the things I learned about Lowenstein when I joined a few months ago is that the firm has an excellent history of making bold and strategic acquisitions. Awhile back the firm built up its bankruptcy department during an economic boom period, when no one was thinking about growing a bankruptcy practice group. That move has proved to be visionary as Lowenstein's bankruptcy group is now nationally ranked as one of the premiere practices in the country, especially in representing unsecured creditors. With real estate, as with some other transactional practices, business is always cyclical. When I began meeting with the leaders of the firm, including Gary Wingens, the managing director, it was made very clear to me that expanding the firm's real estate capabilities was one of Lowenstein's most important strategic objectives. The firm has made a long-term commitment to being a player in the real estate legal services marketplace.

Another reason to grow its real estate practice at this time is that the firm was able to attract some very talented people – a former general counsel of a major real estate investment firm, a former senior in-house attorney of one of Wall Street's most active commercial lending shops and two other attorneys from other well-respected law firms with significant leasing, acquisition and finance experience. These new attorneys are really the right complement to Lowenstein's existing stable of talented real estate professionals. Our overall team is well balanced, with expertise not only in the New York and New Jersey markets where the firm's two largest offices are, but also in transactions on a national scale. Lowenstein's clients include many significant private equity funds and national and international corporations and financial institutions, most of whom have survived the consolidations and tumult of the last few weeks. Our clients have an appetite for the sophisticated real estate services our expanded group can offer.

**Editor:** Are you seeing opportunities in the market?

**Hunter:** We are, however, the landscape is bleak in some sectors. Obviously the liquidity crunch and stock market crash have put a damper on many deals that would have otherwise been in the pipeline, but the investors in distressed properties are actively looking for opportunities. What we see a good deal of is investors waiting for the values to hit bottom. It seems that prices have not yet caught up to the depths that the market has reached. We get calls daily from investors who want to set up distressed real estate investment funds, who are out there in the marketplace looking at opportunities for buying both equity or distressed debt. There are also opportunities for us to counsel clients who are either involved in workouts of defaulted loans or in projects which are now under water. We created a task force with our bankruptcy group to advise our clients how to restructure their debt and joint ventures that are in or are headed for

trouble. One of the things we're seeing in the bankruptcy world as it's being impacted by the capital market crisis is there's no debtor-in-possession ("DIP") financing available once a debtor files for Chapter 11. The absence of DIP financing means that if an entity files for bankruptcy, unless there is a white knight at the ready to provide liquidity, you're not talking about a restructuring – you're headed for a liquidation and dissolution. That gives the debtor (or the soon-to-be debtor who hasn't yet filed) leverage in a negotiation during a workout that he wouldn't otherwise have if DIP financing were available. Because lenders may face so many distressed loans, rather than take the assets onto their own books, they seem more willing to work with borrowers to help them weather the storm.

**Editor:** Were you and the other attorneys who joined Lowenstein able to bring business with you?

**Hunter:** Yes. We've all been very busy despite the downturn. Lowenstein's existing real estate group was active when we joined, and we were able to add several new clients to the firm, including several developers, financial institutions and institutional investors. While we've seen many clients pulling back from some deals, waiting for the market to stabilize, we have been thankful to have hit the ground running and have integrated nicely into the firm's existing real estate practice.

**Editor:** I understand that you have been heavily involved in counseling clients who are involved in public-private partnerships, particularly with the military. What is a public-private partnership and what differentiates those transactions from other types of real estate transactions?

**Hunter:** They are very interesting and complicated transactions. I consider myself to be a generalist having represented developers and owners of real properties and financial institutions both on the mortgage lending side and equity investments in real property, but the one particular niche I've developed over the years is representing investors in public-private real estate partnerships, otherwise known as privatizations. At its core, a public-private partnership is a joint venture between a private entity, typically a developer or another institutional investor, and a governmental agency. In many privatizations, the government is seeking private sector investment and expertise to help refurbish and operate a governmental real property asset more efficiently. Examples of the kinds of assets that are being privatized these days are courthouses, prisons, hotels, toll roads and housing on military bases.

In particular, I have had a great deal of experience with military housing privatization. In military housing privatization transactions, the various branches of the military have sought private sector help to refurbish and operate the housing on military bases and arrange the necessary financing from the capital markets. The development budgets on these projects can range from \$250M to over \$1B for just the first five to seven years, depending on the number of homes and quality of the existing housing stock. Many in the private sector might not realize it, but on a given military base there could be over 5,000 homes, which house



**Edward J. Hunter**

15,000 to 20,000 residents, including the soldiers and their families. The government has realized that to attract and retain soldiers they need better housing. Before privatization, much of the family housing stock on our nation's bases was nearly uninhabitable. The homes my clients have been building on these bases are phenomenal. It's a tremendous opportunity not only for a developer from a business standpoint, but also for our military, which is in need of support for its mission to improve the quality of life for our military personnel. Housing privatization has really raised the quality of life for our military families and has helped the military attract and retain the soldiers who are protecting our country.

**Editor:** Who gets the return on investment in a military privatization deal? Does the government share with the developer in the NOI from the rental income?

**Hunter:** It is a true privatization in that a non-governmental entity, typically a joint-venture between the developer and the U.S. government, takes over ownership of the existing housing and gets a long-term ground lease for the underlying land. The developer is entitled to a very modest return on its investment but, aside from the developer's return (which is frequently capped at a very low rate of return when compared to a private-sector deal), the military requires that all of the remaining excess NOI is reinvested back into the project to sustain the development for the full term of the deal. These deals at a minimum are 50-year deals, and the housing stock is upgraded or redeveloped as needed over that time period.

**Editor:** What makes it attractive to private investors? Do they get a higher than usual ROI on the funds they put into the project?

**Hunter:** The return on investment is usually modest, much less than you would see in a private-sector deal. However, there are development fees to be earned on construction and asset management of the homes, and the rental stream is likely to be more stable than in the private sector since the homes are populated by soldiers who desire to live and work on the base itself near other military families rather than having to commute from a far distance. There is, however, a risk of base closure. If the base has a higher risk of closure, the developer might get a higher return on its investment.

**Editor:** I assume that many of your borrower clients were involved in the commercial mortgage-backed securities market. What are they doing for financing now that real estate securitizations have all but dried up?

**Hunter:** As you know, the U.S. commercial mortgage-backed securities market just finished its first quarter without an issuance since 1986. The only activity last quarter worldwide occurred in Europe, a single transaction with the European Central Bank to improve overall liquidity. To say that things have all but dried up in the CMBS market might be an understatement. There are only two transactions in the domestic CMBS pipeline scheduled for the fourth quarter, and based on what we're seeing in the market these days, who knows if there will be buyers for those securities. The problem is that we are not just experiencing a slowdown on the securitized side of real estate lending; portfolio lenders have also severely curtailed their deal flow. What we are seeing right now is a shut down in the

entire system. Lenders are not lending to each other, at least not on terms that anyone would consider favorable, and, consequently, are not lending to borrowers. In addition, as we have seen the underlying values of collateral drop, most lenders who funded portions of their issuances from the proceeds of repo lines or warehouse lines are getting pressure to repay those lines and need to liquidate assets in order to pay back their creditors, who are as thirsty for cash as everyone else right now. To answer your question, my clients are trying to ride this out and be patient.

**Editor:** What do you think would restore confidence in the CMBS market?

**Hunter:** The market needs time to recover before there's going to be a real appetite for securitization and mortgage-backed securities. When we look back to see how this all started with the onset of the sub-prime crisis, it is clear that the rating system must be revamped in a manner that instills confidence. The fundamental principal of securitization, namely the spreading of risk, is a sound principal, but as the structures that were being employed became more complex, there were obvious excesses and even abuses. In the sub-prime example, loans with fluctuating interest rates given to borrowers with poor or no credit history were able to garner the highest investment-grade ratings from the rating agencies – on a par with the debt issued by highly capitalized and credit-worthy multinational corporations. There's an inherent difference, though, between the debt of barely solvent and highly leveraged individuals and the debt of an appropriately leveraged blue-chip corporation; yet the difference wasn't being reflected in the ratings issued by the rating agencies.

The rating agencies have taken steps to self-correct and have significantly tightened their underwriting standards in response to the sub-prime crisis; however, in light of the magnitude of the upheaval, I am surprised the market has not demanded an entirely new and perhaps an independent way to evaluate the risk associated with an investment. The market could instill a lot of confidence by creating a truly independent rating structure that clearly differentiates risk and frees the rater from conflicts of interests with those whose debt is being rated. However, there has been so much panic caused by the recent economic crisis that confidence may be hard to come by for some time.

**Editor:** Do you think the collapse and consolidation of financial institutions in New York City will affect the real estate market in the City and surrounding markets?

**Hunter:** Yes, in both the commercial and residential sectors. The New York City residential market has been more resilient over the last year and a half while prices have been softening more rapidly in other parts of our suburban market. I suspect the loss of thousands of high-wage financial services jobs in Manhattan will bring down values more quickly than we've seen previously. As more and more companies are having difficulty making payroll and meeting other expenses, there are going to be difficulties in the commercial sector as well. Recently *Crain's* reported that the commercial vacancy rate in Manhattan is the highest it has been in quite some time. What people are surmising is that the New York City marketplace is likely to be more resilient than the suburban marketplace. The intrinsic value of Manhattan real estate is undeniable.

Please email the interviewee at [ehunter@lowenstein.com](mailto:ehunter@lowenstein.com) with questions about this interview.