

Reading the Tea Leaves on Forbearance

Here's the latest on forbearance strategies and a wager on what's next from Trimont Real Estate Advisors

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As business sectors and industries struggle to find their footing, lenders will have much to grapple with over the coming months.

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It is likely too early to tell how the recovery from the coronavirus crisis will play out and there is no single solution to the challenges borrowers and lenders are facing. Large tenant bankruptcies have begun and there is a growing chorus around the fact that certain shuttered businesses may never reopen. The speed of change is unlike anything we have seen and there are too many variables to make decisions in bulk.

To that end, here are some forbearance strategies most commonly being used in the market, as well as some thoughts on where current trends could lead us.

Current forbearance activity

From a structuring standpoint, short-term initial forbearances on hotel and retail products are common. Many of these are likely to become two-part resolutions: the initial short-term forbearance, followed by additional action (another forbearance, a modification, a default, or possible enforcement action). With limited re-openings starting to occur in several states, less than six months seems like a plausible amount of time to account for other factors to develop, such as consumer comfort around re-openings.

Deferment of payment continues to be the driving force behind the forbearance request. These accommodations range from a few months to a year or more, depending on the circumstances. However, lenders are less likely to go long in this environment. We are seeing a variety of payback structures that vary from: a) matching the forbearance period, b) spreading out repayment over twelve months, or c) adding it on to the end of the loan term (mostly on short term maturities).

Another concession to consider would be to allow the loan payment to float at actual LIBOR versus the documented floor in the loan agreement. The difference can be accrued as a receivable and repayment terms can be incorporated into the forbearance agreement. Another option is to allow for minimum interest payments. Similar to a pay rate and an accrual rate, you can document a minimum interest payment to be made monthly and defer the difference to be held as a receivable and repaid based on a defined schedule.

Additionally, noteholders are being very flexible with loan document language to allow reserve funds to be partially or wholly allocated to support operational or debt service shortfalls. Noteholders seem open to forbearing, waiving or deferring collection of specific reserve amounts (although not waiving requirements for tax and insurance escrows). For hotels specifically, it is necessary to confirm brand approval before documenting any flexibility on FF&E reserves.

Extending the loan maturity is another option. While we have seen some refinance activity occurring, things have slowed down. In some instances, flexibility is being offered around extension hurdles for short and full-term extension options, with lenders willing to (at least temporarily) waive loan-to-value and debt yield hurdles for extension requirements. That said, we've seen lenders hold firm on maturity dates for some loans. There is money out there for refinance, and deals are getting done.

It's also worth addressing alternative index language for LIBOR-based loan documents. The Alternative Reference Rate Committee has recommended fallback language that can be used as a starting point to make updates and provide options going into 2021. Adding this language helps to manage borrower expectations, giving them notice of what they will likely see moving forward.

Structure matters, and not all forbearance or relief options are available for each lender. Some may be limited by certain governing documents or other deal-specific limitations.

What's next?

Multifamily seems to be the next sector that's due for hardship. As work-from-home is extended and social activities are limited, the attraction of younger individuals to city centers is wavering. We are beginning to see a migration of young professionals back to their parents' homes and into the more spacious living arrangements that suburbs offer. This migration differs from market to market, with the transition focused more in large, dense cities. Specifically, markets that rely heavily on public transportation (New York, Boston, Philadelphia, etc.) will likely experience lingering effects, more so than regions that tend towards individual auto travel (Atlanta, Dallas, Seattle, etc.). There is also concern around the upcoming stoppage of government unemployment benefits in July and multifamily tenants' ability to pay rent (especially in expensive markets). This could compound the vacuum effect developing within metropolitan multifamily units.

Many of these same geographic trends are also affecting hotel and hospitality. While the travel industry shifts from globalized to localized (transition from planes and trains to cars and walking), the “drive-to” locations seem to be retaining occupancy better than “fly-to” locations. For example, hospitality products orbiting state/national parks, beaches, and other outdoor/vacation spots have more confidence in their occupancy outlook. It is foreseeable that hotels relying on group business (hotels with large conference centers in the city, etc.) will continue to struggle due to postponed corporate travel and business conferences. Our two-part resolution will likely depend on location and trend in major occupancy sources.

For retail, the writing was on the wall, and the pandemic is merely exacerbating the struggle of brick-and-mortar retail as we know it, in some cases, to its inevitable demise. It is probable that we will see a complete reconstruction of the retail landscape and the emergence of new and innovative players, as well as an overhaul in operations resulting from the full-tilt shift from physical to digital commerce. Restaurants are experiencing similar changes in operational processes with percentages in take-out jumping as much as 30 to 40 percent. Some states are taking innovative measures to keep businesses afloat. For example, parts of Texas are now allowing take-out for alcoholic beverages. Conversely, as government mandates and regulations relax, many restaurants are choosing to cut their losses and close down entirely rather than attempt to fight through the limitations of social distancing and potential future shutdowns. Less competition (even amid decreased overall supply) could bring higher levels of success to those restaurants that decide to remain operational.

Changes to the office sector are sure to come as well, a topic already highly publicized and debated. While we expect drastic changes in this sector due to new lifestyle norms, we expect them to emerge at a slower rate due to their dependence on factors such as a vaccine and tenant lease structures. Ultimately, there are plenty of individual and institutional owners that remain adamant that the natural human desire to congregate and socialize will curb this short-term spike in isolationist trends. Even so, it's becoming clearer by the day that these “short-term” trends will only intensify until we get a vaccine.

Re-openings have begun in several states, vehicle traffic is up, mobility data is pointing towards more interaction, and many seem to be itching at the possibility of resuming normal life. Granting short term forbearances with conditions that are favorable to both sides can be a sensible approach when the future is so uncertain. We may find that there will be enough activity to support projects until more substantial advances can be made by the medical and scientific community. Meanwhile, forbearance may help bridge that gap for some deals and buy time for consumer sentiment to begin to rebound and the broader market to start to recover. For other properties and locations, the unknown unknowns remain, and we continue to evaluate them with a perspective on our evolving reality.

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