
PRACTITIONER'S CORNER

Peppercorn Offers Advice on Expediting Mark-to-Market Restructuring Process

With HUD's new package of financial incentives sparking owners' interest in the Section 8 mark-to-market restructuring program, Office of Multifamily Housing Assistance Restructuring (OMHAR) Director Ira G. Peppercorn, in an interview with HDR, offered advice to owners that can help expedite the process.

The incentive package, announced on September 11, includes monthly capital recovery payments (CRPs) to provide a reasonable return on required rehabilitation expenditures and transaction costs. Also, owners can receive up to 3 percent of a project's effective gross income as a performance fee for sound management, and they can finance up to 100 percent of the initial deposit to the replacement reserve and 80 percent of restructuring costs.

The incentive package also provides for developer fees and financing of certain acquisition expenses, with reimbursement of other costs through CRPs. (*For background, see Current Developments, Vol. 28, p. 293*)

Restructuring Decision

HDR: What are the main factors that influence whether an owner should consider pursuing a full restructuring for their projects?

PEPPERCORN: The main factor really is a question of does the project work or not. The legislation originally intended that, in return for an owner being willing to reduce the rent on his property, we would convert a portion of his mortgage into a second mortgage. What we discovered was that many owners, because of the long-term use agreements specified in the legislation, preferred to take the rent reduction without a restructuring. What it comes down to is whether the project worked from a financial and physical condition perspective.

If in fact an owner can take a small rent reduction, the property is in good shape, the debt service coverage is strong, those are the conditions under which an owner can contemplate doing a transaction where only the rent is reduced and the debt is not restructured.

On the other hand, if the debt service coverage is the same, in general cases that will be below 1.1, although in some cases below 1.2, if there is a need for significant physical improvement and/or the rent reduction is significant, then those are the circumstances when an owner should contemplate a full debt restructuring. In the end, what really happens is that the analysis with input from owners and tenants speaks for itself.

Encouraging Participation

HDR: What is OMHAR doing besides offering incentives to get owners to participate?

PEPPERCORN: Let me take a step back if I may. The idea of the incentives is not only important from a financial

perspective. It is important from a perspective of communication. The package of financial incentives that was developed was developed in cooperation with both for-profit and not-for-profit owners and trade associations from around the country.

The reason I say that is because part of the issue here really is around communication. Easing fear of what this project means is making sure that people know that they'll be treated fairly and making sure that they know that they have options if they want to pursue additional communication. One of the issues that came up during that process was making sure that there are open channels for the appeal process. That was very important to the private sector. The not-for-profit sector thought that it was very important that we have a clearly articulated program for writing off a portion of the debt.

Communication with owners is important in encouraging participation in mark-to-market program.

So the point here is that the incentives are more than just about financial issues. It involves communication with some of the best groups, the most reputable groups across the country. They were all on board together with what the package meant. So, part of it is financial, part of it is communication.

In addition, we're reaching out to large owners. The legislation had it broken down state by state. What we saw was essential was being able to reach across to owners who had portfolios in many different states. It became far more efficient to handle transactions with them in a very consistent basis. So we did that. We also have a specific financial incentive for not-for-profits so that if a not-for-profit is buying property, we can write off a significant portion of the debt.

Also, we hired an expert, Peter Richardson, who is working with us on transferring physical assets because there are going to be times when owners might not want to stay in and new owners might want to come in, particularly if the new owners are not-for-profits. Then we have the ability to work with them.

We've also been very consistent about using the Internet and there is a new revised program guide that had input from all over the country. That's dramatically streamlined.... It's actually up on the Web. You can go right up on the Web and pull it down and print it out. You know exactly what's up there.

And we're doing training on what the guide means. The attempt was to make it much more streamlined. So part of our efforts is communication, part of it involves financial incentives. Part of it is reaching out to transfer physical assets, part of it is using the Web as a tool. So there is a whole series of things we've done and the feedback we've gotten from both the not-for-profit and private sectors has been excellent.

No Additional Incentives Planned

HDR: Are you planning any additional incentives? I assume that you're saying these incentives have worked?

PEPPERCORN: The answer is that what we told people is if we needed to put together a package, the package has to work and the package has to work now. We needed to be very clear that we'll do whatever we can, we'll push it as far as we can to make it work, but we have to send a message that says this is it. If we didn't do that, people would be waiting around for the next thing and the next thing.

So we had to be as fair as we could now and go as far as we could now and be as open as we could now in order to communicate that we were putting the best thing that we could on the table now. I think people felt it was both fair and we were both communicating with them directly and honestly...

HDR: So there will be no other incentives?

PEPPERCORN: I don't foresee any.

Discouraging Participation**HDR: Are there situations where you would discourage owners from participating in the mark-to-market program?**

PEPPERCORN: The legislation specifically contemplates that. There is an entire section that lays out who can and who can't participate. For instance, if an owner has been suspended or disbarred, those are circumstances where we would discourage an owner. However, I want to be very clear here. Just because we might discourage a particular owner does not mean we want to hurt the tenants. In those cases, what we would certainly do is be happy to work with a new owner coming in and help to facilitate the transfer of the property and do the restructuring in that case.

So in circumstances where we would say no thank you to an owner, we would also give the owner the option of transferring that property and provide financial incentives if a not-for-profit wants to buy it. Then we'll do the restructuring with a new owner.

HDR: Are there any guidelines you are using that aren't in the legislation to weed out owners that you don't want participating? I understand that there are some projects that qualify, but you have a problem with the owner.

PEPPERCORN: Suspension or debarment really the main ones.

Expediting Restructuring Process**HDR: If an owner decides to participate, how can an owner expedite the process of a full restructuring? What tips do you have to offer?**

PEPPERCORN: Both in terms of fulls and "lites" (restructurings), it's really a matter of good analytics, the property condition, good communication. The best thing to do on the front end when an owner is contemplating either a full or a lite is to make sure that he or she has done a (comparability) study that is fair and reasonable.

What will tie up the process is if a comp study comes through and people aren't impressed with what the market's saying. If the comp study is fair, then it will help the process significantly. Second, if certainly helps to make sure the property is in good physical condition. Actually, that can help more in the case of a lite than it will for a full. But it will help in both.

Owners can take steps in expedite restructuring process.

The owners should make sure that the property is well maintained and taken care of. We want people to live in good property and because when we do the analysis we are looking at the physical condition as well. We're not just looking at how the numbers work. We're looking to see the actual physical condition of the property. If the property is in good shape, only needs a small rent reduction, there is good communication with the tenants, and it can be handled financially, then the owner of course has the option of going to a lite.

Once you start into rehabilitation, when combined with a rent reduction, it becomes more and more difficult to do that in the context of a lite because you really start contemplating writing off the debt to pay for the rehab and because the owner has to come up with capital. If the property has already been taken care of, that's great. Again, it's the same with the issue on the communication with tenants.

A lot of what I have heard from the consultants in the industry is take care of this stuff before you walk in the door. Do your own analysis of how the property is positioned in the marketplace. Do your own analysis of what the rents should be from a reasonable and fair market perspective. Open a dialog with the tenants before we even come.

So considering the principles that guide what we're doing, owners don't have to wait for us to come in. In fact, it greatly facilitates the process if they already understand the property from the market perspective, already know what the rents should be, already have fixed it up, and have a good relationship with the tenants. Our job is absolutely simple when those principles are followed.

HDR: What steps can owners take to expedite a lite restructuring?

PEPPERCORN: The tips are essentially the same. Know your market, do a good comp study, make sure the property is in good physical condition and have an open dialog with the tenants.

Dialog with Tenants**HDR: Of the restructurings that have been done so far, are you finding that the dialog with the tenants has been lacking?**

PEPPERCORN: I think it varies. In some places, communication is excellent, in some place it's not. Part of what we're trying to do is facilitate and encourage a dialog to not only get through the OMHAR process, but a long-term dialog. Sometimes, tenants have been scared of owners and owners are scared of tenants and they don't talk to each other. In other cases, the communication is great. You find in the better run properties you have better communication.

HDR: What helps to make a successful dialog?

PEPPERCORN: Hold meetings that tenants can go to and are easy to get to and are at a time that is convenient for them. That might sound simple, but it's incredibly important. If you schedule a meeting at 3 o'clock in the afternoon and it's a family project, that's not going to build good faith. If you have at 8 p.m. and you have it on the property, that builds good faith.

If an owner is willing to come and listen, or a managing agent is willing to come and listen, not defensively and not

with any sense of retribution, but with a sense of openness that the tenants have to know what is in their property, that absolutely builds good faith.

Responsive management builds good faith with tenants.

If management is responsive and has a history of being responsive...that builds good faith. I think a lot of this is common sense. You can walk onto a property and see how it looks. You can feel how it feels. You can talk to people. You will know almost immediately whether there is good communication and whether there is responsiveness due to how the property looks, due to how the people say they feel about living in that property.

I remember about one I went into in California in downtown San Diego for a property for the elderly. People were genuinely happy living there. The services were good, the management was responsive, and if there was a problem, it was taken care of. There was no retribution, and there was a residents' council that helped inform management on any concerns, and there was just a sense of mutual trust and mutual respect.

If there is something that needs to be emphasized, it is respect on both sides. Even though you're coming from different places, that goes so far.

Sunset Date for OMHAR

HDR: With the sunset date for OMHAR of September 30, 2001, nearing, is there enough time for projects to get into the process now and to actually complete it?

PEPPERCORN: Absolutely. The properties will not actually have to be completed by the sunset date. They have to be in here, and they have to hit certain milestones. I can't tell you right now what the specific milestones are, but the actual full restructuring doesn't have to be completed, signed, sealed, delivered, and closed by the 30th. They have to be in here, and there have to be certain milestones that have to be accomplished to do that.

If the property is in and has met those milestones, it can continue. The risk for an owner who does not come in before the 30th and the project HAP expires before the 30th is that we have the ability to reduce the rent, but we don't legally necessarily have the ability to offer the debt restructuring. So it is absolutely to an owner's advantage to bring the property in early.

That's one of the reasons we're bringing in larger owners and looking at their properties as a block so that together we can sit down and go through the analytics., look at the properties, give them streamlined processing and make sure that the restructuring can be done well and done on time.

HDR: Can you recall what the top two or three milestones are?

PEPPERCORN: There is a legal answer there and it has been resolved, but I don't want to put into publication anything that is misleading. The legal issues involves the commitment and at what point is it considered a commitment that is headed for closing. So again, people have a little breathing room because the actual deal doesn't have to be closed, but a restructuring plan has to be done by the sunset date.

It's not that you can submit a restructuring plan on September 28, but it means you have gone through the process far enough to know there is a real transaction.