



Credit Risk Ready Podcast

Host Linda Keith CPA With Rick Chess

CRE Triage as we Dip into the Recession

This is Linda Keith, CPA, with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community and regional financial institutions across the United States, their regulators and banking advisors to better understand and mitigate credit risk in any environment.

Today, we get to talk with Rick Chess of Chess Law Firm PLC. Rick has funded and managed billions of dollars of projects in the commercial real estate space. His resume includes Pennsylvania State Legislator, Director of Investments, Director of 1031 Transactions, audit committee chair, real estate manager, economic development director, and the list goes on.

Rick understands the investor, the owner, and the lender side of complicated commercial real estate deals. And better yet, he can explain the challenges and options in clear, concise language...my kind of a guy. Currently, Rick guides individuals and organizations through CRE triage, transformation, and triumph. In this interview, his focus is how to implement CRE triage to identify the biggest problems in your commercial real estate portfolio and decide which deals can even be saved.

Welcome, Rick.

Rick Chess:

I'm glad to be on the call with you today.

Linda Keith:

I am delighted to have you. You are one of the people that knows the most on this subject, which is why you are here. Now, I noticed that you say the end goal is triumph Rick, but as we speak, it's hard to even envision triumph. Would you give our listener an idea of the state of play right now, May 2020? What is going on?

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Rick Chess:

Well, I just got off the phone with an hour-long conversation with some senior people from CB Richard Ellis. I worked there many years ago. Here you are, you have some of the very best and brightest in the United States and across the country, and the bottom line, after all this conversation, the person who led the call said, "We're really not sure. We know it's different than it's ever been before, but we're really not sure."

Linda Keith:

And that's frightening, but it's absolutely true. The global pandemic and the economic impact of it is not something that we have faced for 100 years. And even what we learned from the great recession of 2008, which I think we all hoped would be the worst one we ever had to go through, it doesn't all apply does it, Rick?

Rick Chess:

Well, the good news. You're substantially younger than me so you may not remember the 2008, 1986, but there is a pattern of, as you go into recession, you're flat for a while and start coming back. There are skills that you and I and our listeners already have built into their system. They've had to do triage before, but the tricky part this time around is, the kind of information you used to be able to get, until the shutdown is completely over, you can't get. But scarier than that, lots of the information that your clients may have gotten to make the loan, or to put together a real estate trust isn't the same information you will need going forward.

Linda Keith:

Help me with both of those things. First of all, what is this information that we just can't even get our hands on right now?

Rick Chess:

Let's start with an easy one, with apartments. You can't go on the property to see what's going on because, to begin with, it's not normal. I mean, normally you could go to a property at 8:00 in the morning, 5:00, 6:00, and midnight, and you would just count the cars, which would give you a sense of what's the real occupancy of the property. Because maybe the property manager or the asset manager, the owner, you're not really sure if you're getting the straight scoop. So you have somebody do it. What's it mean now, when everybody's home all the time?

Linda Keith:

Right.

Rick Chess:

And the same type of thing as you apply it to each of the different property types of assets we'll go into, things that you have trained people for all of your career of how to underwrite loans. They have to start looking at things in a way they never looked at them before.

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Linda Keith:

Right. Well, and actually, a bunch of the people that we currently have in those roles, some of them were in middle school or high school during the great recession. So, whatever we think we'd train them in, they got trained in a flat interest rate environment when credit was relatively well organized. When the worst of the mess from the great recession maybe was cleaned up a little bit. It isn't even true that they know what we used to know because they never had to go through it. Does that make any sense?

Rick Chess:

Well, for instance, the "I" word, the frightening "I" word, inflation. Which we haven't seen for a long, long time, but you and I remember when inflation was moving so rapidly and interest rates were outrageously high, double digit interest rates, where you could not make a decision today for six months from now.

Linda Keith:

Right.

Rick Chess:

Let's think about what have we just gone through? We're spending trillions of dollars, far more than even the deficit we've had. And the last three times that we've spent this kind of volume was Vietnam, World War II, World War I and what happened after all three of those? Massive inflation. Something that most of your clients don't even have in their business models is this concept of inflation.

Linda Keith:

Wow. I don't know. I can't figure out what the cash infusion is actually going to do to inflation because the amounts we're doing and the way we're doing it, and the reason for them is even different. I don't think you can even apply the previous information or knowledge about how much inflation will be caused by a certain amount of insertion of money into the system. This is just so different. Can't get my mind wrapped around it.

Rick Chess:

We think back on 1986, where the S&Ls were lending way beyond the value of real estate. When there was a hiccup, like a house of cards, it all started falling down. Eventually the Federal Government stepped in using something called the RTC. They took over the S&Ls, savings and loans, and sold off their property. They liquidated the problem; the rest of the country wasn't devastated, and we weren't giving money away across the country.

Linda Keith:

Yeah.

Rick Chess:

Very different this time.

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Linda Keith:

Yeah, it is. Yeah, it is. Well, the other thing that you said about information, I believe you said that some things that used to be a concern are not a concern and vice versa. Did I get that right?

Rick Chess:

Yeah. We're on the right track here. I think as folks who were in the position of underwriting credit risk, and that's not just the banks, I mean, if you're a sponsor, so you have different investors in different deals, and you start looking at your portfolio, the same process your lenders are going through, not everything is going to survive. And some things because of the structure, if it's a Delaware Statutory Trust for 1031 purposes, you can't, as the sponsor, put any more money into it. They can't borrow any more money from you as the lender. And they can't do a call with the investor. It's not just what kind of asset and what kind of market, but what's the structure of how the asset is held? Which may, as a lender, might not have been that critical to you when you made the loan. It's good real estate. Is it a good market? It's growing up. But you'll look at it and say, "Well, okay, I understand the restrictions we as a lender put on the borrower, but what restrictions might the borrower have in the context of how that asset is held?"

Linda Keith:

These are restrictions that were imposed by the investor, or simply the way it was set up in the first place.

Rick Chess:

It was designed for a purpose, typically to satisfy a tax issue. But also it could have been joint venture partners. It could be that this asset that you have the first mortgage on, and there is no second mortgage on it. But they've pledged their interest, their value, whatever they, as the owner of the real estate have for some other deal.

Linda Keith:

Yeah.

Rick Chess:

It's not recorded. But what happens is if you think about post '86, if you think about post 2008 and it was musical chairs.

Linda Keith:

Yeah.

Rick Chess:

There were only so many chairs left when the music ended and you're the lender and you're feeling really good because you got commitments, you've got things that have been pledged to you by the borrower, et cetera. But that same borrower may have made the same pledge to five other people.

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Linda Keith:

Right.

Rick Chess:

You're dating somebody and they're dating five other people. Do you think that maybe the marriage is a little weak that you're going into? That's what we're facing right now.

Linda Keith:

Well, and if you hold the first mortgage though, does it matter how they've guaranteed other kinds of activities, if you really have the first mortgage or is it possible you somehow lose out? Unless they, of course, actually pledged it as collateral for two different things, which...wouldn't that be illegal? Excuse me for my ignorance here. But do you really get to pledge the collateral for two different loans without misbehaving?

Rick Chess:

They don't pledge the collateral. But think about it. If I have one property and I'm personally liable on the loan, I'm going to use everything I have to keep that property afloat. Because as the lender, you don't want the property back.

Linda Keith:

Exactly.

Rick Chess:

You made the biggest investment in that deal, much more so than the person who bought it, but you underwrote the property. You underwrote the market. You underwrote the person you're lending the money to.

Linda Keith:

Right.

Rick Chess:

This person you've lent the money to, the sense was, "Okay, they personally guaranteed, they're not going to let this under. If things are a little bit shaky, they're going to find ways to keep it going because they want to maintain the relationship with me". Okay, now you've got 20 properties and the person only has money to save two or three. Now, they're going to tell every single lender "things are fine. Trust me, we're working as hard as we can." Have you heard these phrases before?

Linda Keith:

Yeah.

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Rick Chess:

Right. What we're suggesting to you is things that may not have been critical to you when you lent the money, now may become very critical.

Linda Keith:

How do you find out what those are? I mean, let's go back to the triage idea, which is some of these deals are okay and we don't really need to pay a lot of attention to them. Some of them we really need to look closer and with some attention they can be saved. And then presumably the third is, "wow, that's pretty hopeless. We need to send that off to my special assets team." In terms of deciding which bucket they're in, do they need to look at every commercial real estate loan on their portfolio? What's a process or a strategy to deal with that?

Rick Chess:

One of the ways to start, and you only have so many hours in the day, even if you're just sitting home and watching YouTube, films, whatever, you still only have so many hours in the day.

Linda Keith:

Yeah.

Rick Chess:

Start with what I think is the true. Yes, you underwrite the real estate. Yes, you underwrite the community, but you mainly underwrite the borrower.

So you get on the phone with the borrower and you ask a few of the questions we're going to be bringing up here. And it's a weird conversation you're going to have, because it really isn't a one answer is the right answer. For instance, I bought 50,000 apartments. That's what I know well, we walked every single apartment. We took notes on every single tenant.

It wasn't just looking at their lease, confirming that they had a job when they came on board, but we walked the units. How do they live? Do they have a bed? Are they living in a sleeping bag? All cars that are on the property have to be registered. Is it a 30-year-old car that's falling apart? Is it a five-year-old car? One of the things that, if you're an apartment owner, asset manager, property manager, if you haven't done this in the last six weeks, somebody should just come fire you right now. Looking at the quality of your tenant in the following light because you can look at how many of them are working at restaurants. They're not getting paid.

Linda Keith:

That's right.

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Rick Chess:

How many of them were working for the government as a teacher? They're still getting paid even if they're home. It's not just quantifying your cash flow; it's qualifying your cash flow.

I guarantee you that 99% of the owners you talk to as a lender, they won't have an answer for what I'm talking about here. But if they come back to you and at least they've thought about it. They've been able to say, "Well, I do remember whenever we bought it, that probably two thirds of them had jobs we thought would never be..." Did they at least consider the issue? And I guarantee you, a lot of your really smart borrowers never did anything. They've done nothing to update it. You could have your maintenance person walk every unit once a year. With notice you can walk any unit, any time with about 24 hours notice. If you had somebody who had been a tenant or was a tenant and they were living in a sleeping bag and a year later they have a bed, that's a good thing.

Linda Keith:

Yes.

Rick Chess:

Is it in the system? I guarantee you, most of them don't have it. And they can't suddenly put it in place. But how is your borrower thinking about their tenants? Whether it's an apartment, a shopping center, an office, et cetera, what's their concerns? Now, they're going to try to be macho with you.

Linda Keith:

Yeah, sure.

Rick Chess:

"Oh yeah, we're fine, don't worry about it." That alone should scare you to death. If somebody is not scared right now, they're delusional. They're absolutely delusional.

Linda Keith:

Or they're definitely trying to pull your chain.

Rick Chess:

Yes, yeah.

Linda Keith:

Instead of the question, "How is it going?", if the question was, "So, when was the last time you vetted all of your tenants again" or something like that, so that it's more specific. Then, unless they're going to lie to you, they have to answer the question and you start to get a feel for... Or, one of the questions I'm actually having for the banking professionals is, what are you doing different right now to make sure that, in my case, your loans, in the apartment case, your tenants, are still solid, even though they might've been solid when you first rented to them. and just see what they're doing.

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If they have no answer at all, then I would be nervous. If on the other hand they said, "Well, I've got my managers out here and here's what they're doing and so forth." And they actually have a plan, and to your point, you may not have an idea of what their answer exactly should be, but you want to hear that they have an answer. Yeah?

Rick Chess:

Well, what I'm thinking is, I think about my wife, Diane. She learned the rules of being a mother. When I would travel to the West coast, I'd go to some conference or something, I'd come back in the house late. Now, I would tell her all the things that happened on the trip. She didn't know the details, but she asked, "Why did you say that?", knowing that I probably did say something stupid to somebody. My point being is that those same type of questions, as the lender, you're asking, too.

Say it's an office and you said, "Well, when you've looked at your property for breaking up the floor where you have your big tenant, how many spaces could you break that into? And what kind of cost it would be?" Now, you don't know that that big tenant is leaving, but if your borrower is on their game, they started looking at that six weeks ago.

Linda Keith:

Yes.

Rick Chess:

"Okay, if I lose this tenant. Here's what I have to do. If I have to move..." They should have this on the tip of their fingers. This is not "Well, let me go back and look at." It should be on the tips of their fingers because your deal with them, when you put up 70, 80%, whatever it was, of the money necessary to do the deal, was they were going to be on top of the property. They were going to be on top of the tenants. They were going to be on top of the market. Don't ask them questions you know that they don't have answers to, ask them questions that they **should** have an answer for and listen to how well they answer it. Do they give you specifics? That means they've been thinking about it. Do they make up something? They should be running for political office.

Linda Keith:

Well, if we're thinking in terms of what are some specific steps to decide which of your properties are probably still- the borrowers are doing what it sounds like they should be, which is, in the current environment, not so much knowing what's happening, but planning for the worst, I guess I should say. Number one, obviously talk to your borrowers, which means somebody's got to be on the phone and the somebody who has to be on the phone, in my opinion, may not be the person who originated that loan, because they may not have the experience yet to have this conversation. So, they have to pick who's going to make the phone calls.

But then, start asking questions to determine how much this borrower is doing to be ahead of the problem (as much as is reasonable at this point), and then simply listen to their plans or lack of plans. As you have those conversations, you'll start having them with numerous borrowers and you'll get some ideas from some of them that you think are good ideas. Maybe you can recommend those ideas to others as well. So, you can start being part of the solution and part of a resource, as opposed to simply "I'm calling because I'm really worried about this loan. What the heck's going on?"

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Rick Chess:

Because as soon as you say that, you put them on the defense.

Linda Keith:

Right.

Rick Chess:

At this point here, you as the lender, you're their biggest investor. You have more in this real estate than they do.

Yes, they're managing it, but it's your property. Last time I checked, 80% is bigger than 20%. And typically, the 20% isn't theirs anyway. They brought in some outside investors to do the deal.

And your comment about using somebody who didn't make the loan is absolutely critical. If you think back, particularly to 1986, when as a buyer I was with United Dominion, I was trying to buy properties. I found that if the person who made the loan was still making the decisions, nothing would happen because they didn't want to expose to the world that, "Whoops, I made a mistake".

But if you got somebody else involved, whatever happened, they weren't going to lose their job. They weren't going to be embarrassed. Things could get done. I'm not saying move everything out of lending, but you switch it. If I made the loan, then Linda, you're the one following up. And if Linda made the loan, maybe I'm the one that's following.

You don't have to throw it all over to special assets. Get somebody that still knows how to talk as a sales person without scaring the borrower. But whose job is to find some ideas. Let's see what's going on. Let's see how well the borrower is aware of the issues out there.

Have they come up with a plan for keeping it to 10 people on an elevator? Have they come up for a plan for scanning everybody for their temperature? What's their plan? It doesn't have to be right, but what's their plan.

Linda Keith:

Do they even have one?

Rick Chess:

Yes, yes.

Linda Keith:

Right. Well, Rick, these are great ideas for that first initial review. And I was thinking that, as a borrower myself, if I get a phone call from my banker, whether I think "Oh, great, I get to talk to Kathy" or, "Oh crap, they're on my list, too." It depends on the relationship we have, of course. And it turns out I have a great relationship with Kathy, but I wonder if when the lender called, they said something like, "We're taking a close look so that if it turns out you need more help, we've got everything in play and we can move more quickly." Does that sound like I'm just trying to make it sound good? Or is that an opening that you would appreciate?

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Rick Chess:

I'd work with the phrasing a little bit, but it's an opening that I appreciate. Because what you're saying is "I need you to succeed. I need you to succeed as much as you need to succeed."

Linda Keith:

Right.

Rick Chess:

"Let's talk about how we can help move this along and also I'm trying to get..."

This is the other way to play to their egos. "I'm looking for ideas of what you're doing that maybe some of my other borrowers could learn from." That usually brings down the barrier also.

Linda Keith:

Yes. Then if in the conversation you can share some ideas that this borrower hadn't thought of that would be helpful to them, at that point, you've basically reestablished that this is a mutually beneficial business relationship between the two of us and that's how we want it to stay. And that's why we're calling.

Rick Chess:

Good stuff.

Linda Keith:

Well, Rick, thank you so much for joining us on this triage piece, what to ask and what to listen for. In another segment, we're going to talk about how to transform those loans into success, should you have a commercial real estate deal that is on the ropes. Thanks for joining me, Rick.

Rick Chess:

Happy to be here.

Linda Keith:

Thanks for joining us on the Credit Risk Ready podcast. Subscribe, comment, or share on social media to stay connected and spread the word. Join me next time as we bring your bank, your customers, and your community through the recession, safe and sound. Take care.

BIO – Rick Chess

Rick Chess guides individuals and organizations through triage, transformation, and triumph!

Chess works with lenders, owners, and investors to help them better understand their challenges and options, in clear concise language.

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Chess served as a member of the Pennsylvania General Assembly and as President of REISA (now ADISA), a national alternative investment trade association.

He acquired 50,000 apartments and 10 retail centers for United Dominion Realty Trust (UDR), investing over \$2 billion.

Rick helped develop and take public – as a founding board trustee -First Potomac Realty Trust (FPO) and served its Audit Committee Chair.

He also serves as a transactional attorney, focused on commercial real estate, equity formation and capital gains tax planning.

Write him at rick@rickchess.com with a summary of your challenge. He will arrange a free 20-minute consultation, providing specific steps to start your process of triage, transformation, and triumph!

www.ChessLawFirm.com