HOW TO BROKER COMMERCIAL MORTGAGE LOANS

INCOME PROPERTY UNDERWRITNG MANUAL

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INTRODUCTION TO INCOME PROPERTY UNDERWRITING MANUAL

We have tried hard to reduce the subject of commercial mortgage underwriting down to a few, simple concepts. When you finish studying this manual, you may be tempted to ask, "Is this all?"

The answer is, "Yes!" Blackburne & Brown is one of the oldest commercial mortgage companies in California, and this manual is the exact same one that we use to train our loan officers.

When you have finished studying this manual, you will know everything important you need to know in order to underwrite commercial mortgage loans up to $5 million or more. So get out there and originate some commercial mortgage loans!

THREE RATIOS

Most of real estate lending can be boiled down to the results of three ratios:

1. Loan-To-Value Ratio (LTVR)
2. Debt Ratio
3. Debt Service Coverage Ratio (DSCR)

The bulk of the energy spent "processing" a loan is merely an attempt to verify the numbers that go into the numerator and denominator of the above 3 ratios.

The Loan-To-Value Ratio (LTVR) is defined as follows:

$$\text{Loan-To-Value} = \frac{\text{Total loan balances (1st mtg+2nd mtg+3rd mtg)}}{\text{Fair market value (as determined by appraisal)}}$$

Loan-To-Value Ratios seldom exceed 80% because the lender always wants some extra protection against default.

The second ratio that lenders use when "underwriting": i.e., qualifying, a loan is the Debt Ratio. The Debt Ratio compares the amount of bills that the borrower must pay each month to the amount of monthly income he earns. More precisely, the Debt Ratio is defined as:

$$\text{Debt Ratio} = \frac{\text{Monthly Debt Obligations}}{\text{Monthly Income}}$$

Obviously someone whose Debt Ratio is 150% is in trouble. A Debt Ratio of 150% would mean that a borrower's obligations are one and a half times his income. Debt Ratios seldom are allowed to exceed 40% in practice.

The final ratio used in lending is the Debt Service Coverage Ratio (DSCR). The Debt Service Coverage Ratio is a sophisticated ratio only used for large loans on income producing properties. It is defined as:

$$\text{Debt Service Coverage Ratio} = \frac{\text{Net Operating Income}}{\text{Debt Service}}$$

where Net Operating Income is the income from a rental property after deducting for real estate taxes, fire insurance, repairs, and all other operating expenses; and Debt Service is the mortgage payment on the property. Most lenders insist that this ratio exceed 1.0. A debt service coverage ratio of less than 1.0 would mean that the property did not produce enough net rental income for the owner to make the mortgage payments without supplementing the property from his personal budget.

Each ratio will be covered in more detail in a separate memo.

THE LOAN-TO-VALUE RATIO

The loan-to-value ratio is probably the most important of the underwriting ratios. The loan-to-value ratio is defined as:

$$\text{LTV ratio} = \frac{\text{Total Loan Balances (1st mtg + 2nd mtq + 3rd mtg)}}{\text{Fair Market Value of the Property}}$$

First let's look at the numerator. If the borrower is only applying for a first mortgage, and there will be no other loans on the property, then the beginning balance of the new loan requested should be inserted in the numerator. However, if the borrower is applying for a second mortgage, then the "underwriter" (the person who determines whether or not the loan qualifies) should insert the sum of the first and second mortgages in the numerator. Similarly, if the borrower is applying for a third mortgage, then the underwriter should insert the sum of the first, second and third mortgages into the numerator.

When the borrower is applying for a second or third mortgage, the loan-to-value ratio is often known as the combined loan-to-value ratio (CLTV ratio).

Now let's look at the denominator. Generally the fair market value of a property is determined by an appraisal. There is one important exception, however. When the proceeds of a mortgage loan are used to buy the same property that is securing the loan, then that mortgage known as a "purchase money loan". If the appraisal comes in lower than the purchase price in a "purchase money" transaction, then the lender will use the LOWER of the purchase price or appraisal.

Mortgage brokers are often asked by real estate agents and buyers to base their loan on the appraised value rather than the purchase price. Their claim is that they have negotiated a super deal and that the property is worth much more than what they are paying for it. Perhaps so (but generally untrue), but lenders always base their maximum loan on the lower of purchase price or appraisal. The lender's argument (it's their money, so there is really very little argument) is that an appraisal is really no more than an estimate of fair market value, no matter how competent or conscientious the appraiser may be. The only true indicator of value is the marketplace in which "a willing buyer and a willing seller, each in full knowledge of the salient facts, and neither under undue pressure, agree upon terms". If the property sells for "X", then it is probably only worth "X".

DEBT RATIOS

When analyzing the personal budget of a borrower, lenders use two different debt ratios to determine if the borrower can afford his obligations. These two debt ratios are:

1. Top Debt Ratio
2. Bottom Debt Ratio

The "top" debt ratio is defined as:

$$\text{Top Debt Ratio} = \frac{\text{Monthly Housing Expense}}{\text{Gross Monthly Income}}$$

By "total housing expense" we mean either the borrower's monthly rent payments, or if he owns his own home (virtually all our borrowers do own their own homes), the total of the following -

Monthly Housing Expense = 1st mortgage payment on his home plus

Real estate taxes (annual cost/12) plus

Fire insurance (annual cost/12) plus

Homeowner's association dues (if his home is a condo or townhouse) plus

Second mortgage payment (if any) plus

Third mortgage payment (if any)

You will often hear the term P.I.T.I. It refers to (P)rincipal, (I)nterest, (T)axes and (I)nsurance. While P.I.T.I. is not exactly the same as Total Housing Expense because it does not include homeowner's association dues, the two terms are often used interchangeably.

Lenders have learned over the years that a borrower's "top" debt ratio should not exceed 25%. In other words, a person's housing expense should not exceed 1/4 of their income. While lenders will often stretch this number to as high as 28%, traditional lending theory maintains that anyone with a debt ratio in excess of 25% stands a good chance of developing budget problems.

The second ratio that lenders use to determine if a borrower can afford his obligations is the "bottom" debt ratio. It is defined as follows:

$$\text{Bottom Debt Ratio} = \frac{\text{Total Housing Expense + Debt Payments}}{\text{Gross Monthly Income}}$$

The only difference between the two ratios is the inclusion in the numerator of "debt payments". Debt payments include the following:

Debt Payments = Car payments

Charge card payments

Payments on installment loans, for example, a payment on a washer & dryer that the borrower purchased

Payments on personal loans, for example, a signature loan from the borrower's bank

What is <u>not</u> included in "debt payments" is:

Utilities such as PG&E, water or telephone

Payments on real estate loans

Real estate loans are usually offset first by the net rental income from the property. If the borrower has a net positive cash flow from all his rentals, then the net income is usually added to his "gross monthly income". If the borrower has a net negative cash flow from all of his rental properties, then the amount of the negative cash flow is usually added to the numerator of the "bottom" debt ratio as if it were a monthly debt obligation, like a car payment.

Traditional lending theory maintains that a borrower's "bottom" debt ratio should not exceed 33 1/3%. In other words, the total of the borrower's housing expense and debt obligations should not exceed 1/3 of his income. Lenders often will stretch on this ratio to as high as 36%, and some have even been known to stretch as high as 40% or more. Obviously a loan with a debt ratio of 40% is a far more risky loan than a loan with a debt ratio of 32%.

DEBT SERVICE COVERAGE RATIO (DSCR)

The most important ratio to understand when making income property loans is the debt service coverage ratio. It is defined as:

$$\text{DSCR} = \frac{\text{Net Operating Income (NOI)}}{\text{Total Debt Service}}$$

To understand the ratio it is first necessary to understand the numerator and the denominator. Let's take a look at net operating income (NOI) first.

Net operating income is the income from a rental property left over after paying all of the operating expenses:

Gross Scheduled Rents	$100,000	
Less 5% Vacancy & Collection Loss	5,000	
Effective Gross Income:		$95,000
Less Operating Expenses		
Real Estate Taxes		
Insurance		
Repairs & Maintenance		
Utilities		
Management		
Reserves for Replacement		
Total Operating Expenses:		30,000
Net Operating Income (NOI):		$65,000

Please note that lenders always insist on some sort of vacancy factor regardless of the actual vacancy rate in an area to cover collection loss. In addition lenders always insist on using a management factor of 3.6% of effective gross income, even if the property is owner managed. Their logic is that they would have to pay for management if they took back the property. Finally, NOTE THAT WE HAVE NOT INCLUDED LOAN PAYMENTS AS AN OPERATING EXPENSE.

Next let's look at the denominator, Total Debt Service. This includes the principal and interest payments of all loans on the property, not just the first mortgage. NOTE THAT WE HAVE NOT INCLUDED TAXES AND INSURANCE. They were already accounted for above when we arrived at net operating income (NOI).

To calculate the debt service coverage ratio, simply divide the net operating income (NOI) by the mortgage payment(s). For the sake of simplicity, let us assume that there is only one mortgage on the property:

$500,000 First Mortgage
11% Interest, 30 years amortized
Annual Payment (Debt Service) = $57,139

Then:

$$\text{DSCR} = \frac{\text{Net Operating Income (NOI)} = \$65{,}000}{\text{Total Debt Service } \$57{,}139}$$

$$\text{DSCR} = 1.14$$

Obviously the higher the DSCR, the more net operating income is available to service the debt. From a lender's viewpoint, it should be clear that they want as high a DSCR as possible.

The borrower, on the other hand, wants as large a loan as possible. The larger the loan, the higher the debt service (mortgage payments). If the net operating income stays the same, and the loan size and therefore the debt service increases, then the lower the DSCR will be.

Life (insurance) companies and CMBS lenders are very conservative and generally require a 1.25 or 1.30 DSCR. This means that their loan-to-value ratios are low. Savings and loans (S&L's) generally only require a 1.25 DSCR, and sometimes will accept a DSCR as low as 1.10.

A DSCR of 1.0 is called a breakeven cash flow. That is because the net operating income (NOI) is just enough to cover the mortgage payments (debt service).

A DSCR of less than 1.0 would be a situation where there would actually be a negative cash flow. A DSCR of say .95 would mean that there is only enough net operating income (NOI) to cover 95% of the mortgage payment. This would mean that the borrower would have to come up with cash out of his personal budget every month to keep the project afloat.

Generally lenders frown on a negative cash flow. Some lenders will allow a negative if the loan-to-value ratio is less than around 65%, the borrower has strong outside income such as an electronic engineer, and the size of the negative is small. Lenders rarely allow negative cash flows on loans over $200,000.

LOAN CONSTANTS

Back in the old days, before they made hand held calculators, mortgage loan agents would use a "loan constant" to compute the monthly payment on a home loan. Some big mainframe computer would compute the monthly payment for 30 years on a loan of $1,000 at each given interest rate.

If interest rates increased from 4% to 4.5%, your branch manager would tell you that the new loan constant was $5.07. If the borrower was seeking a $20,000 loan, the loan agent would then simply multiply $5.07 times 20 to arrive at the buyers' new monthly payment of $101.34.

Whenever you discuss a debt service coverage ratio (DSCR) with a lender, you have to tell him what interest rate and amortization schedule you are using. Otherwise, the ratio would be meaningless to the lender.

For example, suppose the loan amount was $400,000 and the NOI was $65,000. Here are just a few of the different possibilities:

1.31 based on a 12.0%, 30 year constant

1.48 based on a 9.0%, 20 year constant

1.25 based on a 13.0% *interest only* constant

When you prepare your Loan Summary or cover letter to your lender, always show the debt service coverage ratio *in reference to some loan constant.*

HOW MANY DOLLARS CAN I GET?

The most important calculation made when underwriting an income property loan is the calculation to determine the maximum loan the income property can support. While interest rates and points are always important, the key issue in negotiating an income property loan is usually the size of the loan.

The maximum residential loan is usually determined by the loan-to-value ratio, often 80% LTVR. Most income property lenders claim they will lend to 70% LTVR, but few loans in practice are made at that high of a LTVR. Loan-to-value ratios of 60 to 65% are far more common. This discussion will describe how income property lenders arrive at the maximum amount they will lend. It is probably the most important topic in income property finance.

The key to determining the maximum loan a borrower can get is the DEBT SERVICE COVERAGE RATIO (DSCR). You will remember that the debt service coverage ratio is:

$$\text{DSCR} = \frac{\text{Net Operating Income (NOI)}}{\text{Total Debt Service}}$$

Also remember that Total Debt Service includes the P&I payments on all the mortgages that will remain on the property after your new loan is arranged.

Before proceeding let us review a little basic algebra. You will recall that if we have an equality; i.e. an algebraic expression separated by an equal sign, we can multiply or divide one side of the equation by anything we want, as long as we perform the identical operation to the other side of the equal sign. For example, let us start with the following equation:

$$\frac{6}{3} = 2$$

If we multiply both sides by 3, the equality holds:

$$6 = 2x3$$

Armed with this brief refresher, let's go back and use the debt service coverage ratio (DSCR) to determine the maximum loan our borrower can qualify for. Let's suppose that New York Life has a very attractive apartment permanent (long term 1st mortgage) available, but they want a 1.25 DSCR. If we use the same operating statement that we used in our discussion on the DSCR, we will see that we have a net operating income (NOI) of $65,000 per year available. Substituting our "knowns" into the definition of DSCR we find:

$$\text{DSCR} = \frac{\text{NOI}}{\text{Debt Service}} = 1.25$$

$$\frac{\$65{,}000}{\text{Debt Service}} = 1.25$$

Let's isolate Debt Service by first multiplying both sides by Debt Service. This leaves us:

$$\$65{,}000 = 1.25 \times \text{Debt Service}$$

If we now divide both sides by 1.25 we arrive at our answer:

$$\frac{\$65{,}000}{1.25} = \text{Debt Service}$$

or

$$\$52{,}000 = \text{Debt Service}$$

Don't worry if the algebra was confusing. In a little bit we are going to give you a simple formula to use. In the meantime, let's try to understand what we have actually calculated. What we have; $52,000; is the maximum annual payment that New York Life will allow us to have on our new apartment loan. With this maximum debt service number; i.e. the maximum allowable annual mortgage payment, we can work backwards to see how large of a loan New York Life will allow us (this is what we set out to find, remember?).

If we assume that New York Life is quoting 13.0% interest only, we can set up the following equality:

13% x New Loan Amount = $52,000 (annual debt service)

Dividing both sides by 13% gives us:

$$\text{New Loan Amount} = \frac{\$52{,}000}{13\% \text{ (or .13 if expressed as a decimal)}}$$

or

New Loan Amount = $400,000

At last! This is the maximum loan amount that New York Life will lend on our apartment project if they want a 1.25 DSCR.

IMPORTANT NOTE: If New York Life was writing 30 year fully amortized loans, you would have needed your financial calculator. Simply insert 13% for %i, $52,000 for PMT, 30 for N, and ask your calculator to determine what loan size is fully amortized over 30 years at 13% with annual payments of $52,000.

Looks tough, huh? It's not really, once you do a few. But let's give you those "plug and chug" formulas we promised.

TO CALCULATE THE MAXIMUM LOAN SIZE

STEP 1: Divide the NOI by the DSCR.

STEP 2: Insert the maximum permissible payment in PMT, the interest rate in %i, the amortization term in N, and compute PV (Present Value; i.e., the loan size).

IMPORTANT NOTE: If you are calculating the maximum permissible second mortgage, subtract the debt service on the first mortgage AFTER dividing by the DSCR. The net operating income must cover both the first and second mortgage with the extra "cushion", not just the second mortgage.

OPERATING EXPENSE RATIO

In negotiating an income property loan, the size of loan the borrower can obtain is usually more of a sticking point than the rate or the loan fee. Since income property loan sizes are generally limited by the debt service coverage ratio (i.e., cash flow) rather than the loan-to-value ratio, the operating expense figure that the lender uses in his calculations is critical.

Suppose a property has the following Pro Forma operating statement:

Gross Scheduled Rents		$100,000
Less 5% Vacancy & Collection Loss		5,000
Effective Gross Income:		$ 95,000
Less Operating Expenses		
Real Estate Taxes	$12,500	
Insurance	2,550	
Repairs & Maintenance	5,890	
Utilities	7,345	
Management	4,865	
Fees & Licenses	987	
Painting & Decorating	3,986	
Reserves for Replacement	1,900	
Total Operating Expenses:		40,023
Net Operating Income:		$54,977

Then we hereby define the operating expense ratio as follows:

$$\text{Operating Expense Ratio} = \frac{\text{Total Operating Expenses}}{\text{Effective Gross Income}}$$

or in this example,

$$\text{Operating Expense Ratio} = \frac{\$40,023}{\$95,000} = 42.1\%$$

Appraisers and professional property managers often keep track of the operating expenses of the buildings they appraise or manage, and publish their results. For example, the National Association of Realtors publishes the results of their surveys annually in several hardbound books including Income and Expenses Analysis-Apartments and Income and Expense Analysis Office Buildings.

Lenders have access to these type of publications and therefore are reluctant to accept at face value operating expenses supplied by the borrower when their operating expense ratios are less than those enced by similar buildings in the area.

While it might be possible to operate an apartment building IN THE SHORT RUN at an operating expense ratio of less than 30 to 45%, in the LONG RUN the end result will be a seriously deteriorated building. It might be possible to get a lender to accept an operating expense ratio as low as 28% on a very new building, if it had fewer than 10 or so units, and if it had no pool and very little landscaping, and if you had authentic source documents to back up your claim. But in general, lenders will very seldom accept an operating expense ratio on apartments of less than 30 to 35%, and have been often known to use 40 to 45%.

The following are factors that will influence the lender to use a higher operating expense ratio:

1. Lack of individual metering of utilities
2. Swimming pool
3. Elevator
4. Extensive landscaping
5. Low income area and/or tenants
6. Presence of families with children

The larger the project, the larger the required operating ratio. Large projects usually entail extensive recreational facilities and pools, and often require full-time on-site management teams.

Operating expense ratios are not as useful in evaluating most commercial or industrial properties. The reason why is because the space can be rented on a triple net basis, a net basis, or a full service basis.

NET LEASES VERSUS FULL SERVICE LEASES

Commercial and industrial properties can be leased in a variety of lease agreements. The tenant might be responsible for the real estate taxes, the insurance premiums, and the repairs; or the lessor (owner) may be responsible for all of them. Another possibility is for the owner to be responsible for taxes and insurance, and for the tenant to be responsible for the rest of the operating expenses. In fact there are a number of possibilities.

A full service lease is a lease in which the lessor (owner) is responsible for all of the operating expenses, including but not limited to taxes, insurance, repairs, and utilities.

A net lease is a lease in which some of the operating expenses are paid by the tenant. A net net lease is a lease in which the lessee (tenant) pays the two major expense items: taxes and insurance.

A triple net lease is a lease in which the tenant is responsible for "all" of the operating expenses. This includes the three most significant expense items: taxes, insurance, and utilities. Hence the term Net Net Net lease, or triple net. A true triple net lease is one in which the lessee (tenant) pays all of the operating expenses and lessor (owner) simply receives his one check every month. Unfortunately the term is often misapplied to leases in which the lessee (tenant) pays for most, but not all of the operating expenses. You are cautioned to read the lease carefully to determine which expenses each party is responsible for.

Expenses often paid by the lessor (owner) in so called "triple net" leases are management, common area maintenance, and common area utilities.

Many multi-tenant buildings are leased on a "triple net" basis where the real estate taxes, the insurance, the common area utilities, and the common area maintenance expenses are prorated among the tenants on a pro rata basis. The basis most commonly used is the net rentable square footage of each tenant's space as a percentage of the total net rentable square footage. By net rentable square footage we mean the space actually available for rent as opposed to the gross square footage which includes hallways, stairwells, elevator shafts and lobbies.

HOW TO PREPARE AN APARTMENT PRO FORMA

The term "Pro Forma" is short for Pro Forma Operating Statement. A Pro Forma is an annual operating budget for an income property, and it is probably the most important single document in an income property loan package. An experienced processor will always assemble the package with the Pro Forma as one of the very first items that the lender sees.

Because you have been provided a form entitled "Pro Forma Operating Statement" the actual preparation of a Pro Forma is merely a matter of filling in the blanks. The numbers you choose to insert, however, must be supportable and well documented. The stakes are high. If a lender does not accept your Pro Forma, he will not take the time to prepare one of his own. He will merely select a very conservative operating expense ratio such as 40 to 45%. Operating expenses of 40 to 45% will kill most deals. Remember, the loan size rather than the interest rate or points is usually the sticking point in income property negotiations.

At this time, please take a moment to review the attached Pro Forma Operating Statement form. Since this is a universal form, only a few of the blanks will be filled in for any individual property.

First let us discuss Gross Scheduled Rents. You should usually use the current actual rent roll. Insert in your rent roll the market of any vacant units. The only time a lender will accept projected rents is if the rent increase letters have already been sent. It is helpful, but not mandatory, to include a few samples of the rent increase letters that have been mailed. However, be careful not to scare your client away by asking for copies. If the increase letters have been mailed, footnote the Gross Scheduled Income as follows:

> Based on an announced rent increase effective 2/1/06.

The new rent level should be no further off than 90 days. Then if the lender objects, the Placement Officer can suggest that the file be put aside for a few weeks until the rent increase is in effect. Invariably the lender ends up accepting the projected rents now. Another time you can get away with projected rents is if the apartment building is located in a city with rent control, and the annual increases are scheduled to take effect within 90 days.

A typical footnote might be:

> Includes an 8% annual increase per San Jose rent controls scheduled for 2/1/06.

There were times in the late 1980's when lenders would consider in certain areas, such as the Bay Area, the greater Los Angeles area and the greater San Diego area, a Vacancy Allowance of less than 5%. Those days are gone. You must use at least 5% today.

The lender may insist on 7% to 10% for Sacramento, the Central Valley and most outlying California areas; however, you should still insert 5% for these areas and pray.

Borrowers will often protest with claims of actual vacancy rates of 2% to 3%. In these cases, remind your borrower that a Vacancy Allowance is really a shortened version of Vacancy and Collection Loss Allowance. Anyone in business eventually gets a few bounced checks and deadbeats.

Inserting the actual operating expenses is greatly simplified if a well done appraisal arrives with the package. In this case, simply insert the expenses as listed in the appraisal, and footnote them as follows:

> Based on the MAI appraiser's estimate.

However, you usually should not order an appraisal until the lender has reviewed the package and the borrower has accepted in writing the lender's proposal. Therefore you must be prepared to estimate the expenses yourself, and you should document them well.

Ideally you would like to insert the borrower's actual operating expenses for the last 12 months and footnote them as follows:

> Actual operating expenses for the last 12 months.

Few borrowers, however, keep records that current, and you must be careful not to scare the borrower away by demanding that he spend hours pouring over his records.

More frequently you will have his actual operating expenses for the last calendar year. In this case, simply insert the figures directly from his tax return and footnote them as follows:

2005 actual operating expenses.

On other occasions, you will be supplied the year to date expenses for the first half or first three quarters of the year. In this case, simply annualize the expenses and footnote them as follows:

Actual expenses for the first 9 months of 2005 annualized.

Be careful not to double count the insurance premium or real estate taxes by annualizing them. Remember that these expenses are just paid once or twice a year. The best source for the annual real estate taxes is the preliminary report. You might find the annual insurance premium in the previous year's tax return, or you might simply have to ask the borrower or the borrower's fire insurance agent.

Here are a couple of useful rules of thumb. Because of Proposition 13, real estate taxes in California are computed by taking 1.25% of the original purchase price. To compute an estimate of a fire insurance premium, use $5.50 per thousand dollars of coverage. Therefore if the sum of the existing 1st mortgage and your new 2nd mortgage is $787,000; you can take 787 times $5.50 to arrive at a very rough estimate of the new fire insurance premium.

There will be times where the borrower simply has only a few months operating history. Examples include properties taken back in foreclosure, and recent purchases. In cases like this, ask the borrower to prepare for you a Utility Statement. A Utility Statement is a breakdown of the building's various monthly utility expenses for the last 12 months or less. You can annualize these numbers for your Pro Forma.

The real estate taxes can be obtained from a prelim and the insurance premium from the borrower.

To estimate Repairs and Maintenance, use between 6-10% of Effective Gross Income, depending on the age of the property and the quality of the tenants.

In the absence of specific offsite management numbers, you should use 5% of Effective Gross Income. This is what most professional property management firms charge. Onsite management should be handled as follows. Show the full market rent of the resident manager's unit on your rent roll and on your Gross Scheduled Rents. Then list as an expense under Management Onsite the difference between the market rent of the unit and what the resident manager actually pays. This difference is know as a rent credit, and is fully taxable under the IRS codes. If the resident manager receives a small salary in addition to a rent credit on his unit, be sure to include this as well. Many small units do not have resident managers, and lenders will accept this. However, even if a building is owner managed, you should include an off-site Management expense of 5% of Effective Gross Income. The reason why is because in the event of a foreclosure, the lender will have to hire a professional property management firm to manage the property.

SAMPLE APARTMENT PRO FORMA OPERATING STATEMENT

INCOME:		
Gross Scheduled Income		$ 102,700 (a)
Tenants' Expense Contributions		
Laundry Income		1,196
Other Income: Parking		2,400
	Total Income:	$ 106,296
Less 2 % Vacancy Allowance		2,054
	Effective Gross Income:	$ 104,242
EXPENSES:		
Advertising	$1,346	
Cleaning	1,427	
Electricity	See PG&E	
Elevator Maintenance	896	
Fees & Licenses	327	
Gardening	1,220	
Gas	See PG&E	
Insurance	3,225 (b)	
Legal & Accounting	727	
Management Offsite	5,230	
Management Onsite	5,212 (c)	
P.G.& E.	2,345	
Painting & Decorating	896	
Payroll	See Mgmt.	
Payroll Taxes	682	
Pest Control		
Pool Maintenance	n/a	
Real Estate Taxes	10,280	
Repairs & Maintenance	6,250	
Reserve for Replacements		
Sewer	654	
Supplies	1,244	
Telephone		
Trash Removal	896	
Utilities		
Water	1,786	
Miscellaneous		
	Total Expenses:	44,643 (d)
	Net Operating Income:	$ 59,599

Notes:
(a) Current actual rent roll.
(b) Actual annual premium.
(c) 5% of effective gross income.
(d) 2005 actual expenses (annualized)

HOW TO PREPARE A COMMERCIAL OR INDUSTRIAL PRO FORMA

A commercial or industrial Pro Forma is prepared in a manner very similar to that of an apartment Pro Forma. The main difference is that in net leases, the tenant is responsible for some of the expenses.

First let us look at a full service lease. You will recall that in a full service lease the lessor (owner) is responsible for all of the operating expenses. Therefore, prepare your Pro Forma just like you would if the building were an apartment building. Use the current actual rent roll, inserting the market rent of any vacant space, and use the actual operating expenses.

We almost always use a Vacancy Allowance of 5% for commercial and industrial properties nationwide. In reality, office buildings are overbuilt and 10 to 15% would be more realistic.

You are reminded to use an Offsite Management expense of 3 to 5% of Effective Gross Income. Use 5% if the building is a multi-tenant building. You can sometimes get away with 3% if the building is large but there is only one tenant. The logic here is that 3% of a large rental income is enough where a property manager only has to deal with one tenant and no prorations are necessary.

In addition to Vacancy and Management, there is one other expense item you should almost always use, the Replacement Reserve.

The Replacement Reserve is used to repaint the exterior of the building, resurface the parking lot, and to replace the roof from time to time. Even under "triple net" leases the lessor (owner) is still responsible for these items, as well as for the structural soundness of the building. Therefore you should insert 23% of Effective Gross Income into the Replacement Reserve line of all of your commercial and industrial Pro Formas. Generally you should use 3%, unless the building is less than 3 years old. For these new buildings, you can often get away with 20.

Please refer at this time to the attached "Sample Triple Net Pro Forma Operating Statement". Note that a triple net Pro Forma is relatively simple to prepare.

When a unit is owner occupied, ignore any existing lease. Since the owner is both the lessor and the lessee, he is in a position to draw up any lease he wants. Simply ignore any existing lease and base all of your calculations and Pro Formas based the MARKET RENT of the owner's space or unit. Insert the market rent on both the Schedule of Leases and the Pro Forma, and footnote the entry with the words:

> Since this space is owner occupied, we have used a market rent of $ _____ dollars per square foot for that unit.

The only time commercial/industrial Pro Formas are difficult is when some of the units are leased on a net basis, and the others are leased on a full service basis. You cannot merely insert 100% of the operating expenses because some of those expenses are later pro rated to the tenants. When a tenant pays a pro rated portion of the operating expenses, it is known as a "tenant expense contribution". Unfortunately, when most owners prepare their income and expense statements for tax purposes, they generally combine the rents and the tenant expense contributions together, making your job particularly difficult.

In cases like this, you have no choice but to analyze each lease to first determine which tenants are responsible for pro rations and the expenses for which they are responsible. Then you must compute, generally based on net rentable square footage, what percentage of each expense is paid by each tenant. Show on your Pro Forma 100% of the operating expenses, but then recapture some of those expenditures in the Tenants' Expense Contribution line of the income section. See the "Sample Partial Net Pro Forma Operating Statement" for an example.

When a tenant is responsible for <u>increases</u> in an expense item over a certain base year, this is known as an "expense stop". The most common usage is for taxes and insurance. If a tenant were to make an addition to an existing improvement, the owner might be subject to a reassessment by the County. In this case the tenant would be responsible for 100% of the <u>increase</u> in real estate taxes and insurance as a result of the reassessment.

SAMPLE TRIPLE NET PRO FORMA OPERATING STATEMENT

INCOME:		
Gross Scheduled Income		$108,200 (a)
Tenants' Expense Contributions		
Laundry Income		
Other Income:		
Total Income:		$ 108,200
Less 5 % Vacancy Allowance		5,410
Effective Gross Income:		$ 102,790
EXPENSES:		
Advertising	$	
Cleaning		
Electricity		
Elevator Maintenance		
Fees & Licenses		
Gardening		
Gas		
Insurance	Tenants	
Legal & Accounting		
Management Offsite (5%)	5,139	
Management Onsite		
P.G.& E.	Tenants	
Painting & Decorating		
Payroll		
Payroll Taxes		
Pest Control		
Pool Maintenance		
Real Estate Taxes	Tenants	
Repairs & Maintenance	Tenants	
Replacement Reserve (3%)	3,034	
Sewer	Tenants	
Supplies		
Telephone		
Trash Removal	Tenants	
Utilities		
Water	Tenants	
Miscellaneous		
Total Expenses:		8,173
Net Operating Income:		$ 94,617

Notes:

(a) Current actual rent roll plus the market rent of the two vacant units.

SAMPLE PARTIAL NET PRO FORMA OPERATING STATEMENT

INCOME:		
Gross Scheduled Income		$102,700 (a)
Tenants' Expense Contributions		9,193 (b)
Laundry Income		
Other Income		
	Total Income:	$ 111,893
Less 5 % Vacancy Allowance		5,594
	Effective Gross Income:	$ 106,298
EXPENSES:		
Advertising	$ 1,346	
Cleaning	1,427	
Electricity	See PG&E	
Elevator Maintenance	896	
Fees & Licenses	327	
Gardening	1,220	
Gas	See PG&E	
Insurance	3,225	
Legal & Accounting	727	
Management Offsite	51230	
Management Onsite	5,212 (c)	
P.G.& E.	2,345	
Painting & Decorating	896	
Payroll	See Mgmt.	
Payroll Taxes	682	
Pool Maintenance	n/a	
Real Estate Taxes	10,280	
Repairs & Maintenance	6,250	
Replacement Reserve (3%)	3,189	
Sewer	654	
Supplies	1,244	
Telephone		
Trash Removal	896	
Utilities		
Water	1,786	
Miscellaneous		
	Total Expenses:	47,832 (d)
	Net Operating Income:	$58,466

Notes:

(a) Current actual rent roll.

(b) 58% of the space is leased on a net basis where the tenants pay a pro rated share of taxes, insurance and utilities.

(c) 5% of effective gross income.

(d) 2005 actual expenses (annualized)

RESERVES FOR REPLACEMENT

Roofs wear out. So do HVAC units, ovens and refrigerators. Parking lots need to be resurfaced every few years as well. Buildings need to be maintained, just like cars.

Every time a landlord receives a dollar in rent, he can't consider 100 cents of that dollar a return on his investment. Some of that dollar has to be ploughed back into the building to keep it going.

Almost every Pro Forma Operating Statement, therefore, will include a line item called "Reserve for Replacements". This is different and separate from "Repairs and Maintenance".

Multi-Family:

Traditionally replacement reserves are not included when preparing a Pro Forma operating on a multifamily property. They are considered included in the line item for repairs, typically 6% - 10% of effective gross income.

Conduit lenders, however, normally require a replacement reserve of $250 to $300 per unit per year.

Retail:

Traditional: 3 to 5% of effective gross income

Conduits: $0.20 per square foot per year

Office:

Traditional: 3 to 5% of effective gross income

Conduits: $0.20 per square foot per year

Industrial:

Traditional: 2 to 4% of effective gross income

Conduits: $0.15 per square foot per year

Self Storage:

Traditional: 2 to 4% of effective gross income

Conduits: $0.15 per square foot per year

Mobile Home Park:

Traditional: 3 to 5% of effective gross income

Conduits: $250 per pad per year

Healthcare:

Traditional: 3 to 5% of effective gross income Conduits: $250 - $300 per bed per year

Hotel/Motel:

Traditional: 5% of effective gross income (includes FF&E's)

Conduits: 5% of effective gross (includes FF&E's)

CAP RATES

A cap rate is nothing more than an investor's return on his money if he bought a property for all cash. It is defined as follows:

$$\text{Cap Rate} = \frac{\text{Net Operating Income}}{\text{Purchase Price}}$$

In arriving at the property's net operating income (NOI), be sure to include a factor for Vacancy *and Collection Loss*, a Replacement Reserve, an Offsite Management factor, and if the property is management intensive, an Onsite Management factor. Remember, investors value properties from the point of view of a passive investor, not as an active manager of the property.

Below are some typical cap rates on commercial properties:

Property Type	Typical Cap Rates
Office building or retail center	7.5% to 9.0%
Concrete industrial building	8.5% to 10.0%
Steel skinned industrial bldg.	9.5% to 11.0%
Motels & Hotels	9.5% to 11.0%
Office and industrial condo's	5.5% to 7.0%
Tiny office bldgs and converted SFR's	5% to 6.5%

Please note the extremely low cap rates on office condos, industrial condos, small freestanding office buildings, and houses converted to cute little office buildings. The reason why the cap rates on such properties are so low is because they are being purchased by owner-users, not as rentals. Owner users will pay a huge premium for small commercial properties because they seek the pleasure of owning their own building.

The prices per square foot commanded by office condos, industrial condos and tiny office or industrial properties cannot be justified economically. However, just as people everyday buy red corvettes for $65,000 - even though they immediately drop to $48,000 in value the minute the new owners drive the corvette off the lot - so will small business owners overpay for a property for their businesses. I call this the "Red Corvette Theory". People just want to own red corvettes.

Small apartment buildings (5 to 12 units) also often sell at ridiculously low cap rates: 5.0% to 7.5%. The reason why is because lots of people want to get started owning apartment buildings, but they can only afford to buy small buildings. Therefore the price of the small buildings gets bid up in price out of proportion to their income generating ability.

It is often difficult to finance small income properties with institutional lenders because they seldom cash flow at greater than 55% loan-to-value. The purchases of office and industrial condos are usually financed by the S.B.A.

NET-WORTH-TO-LOAN-SIZE RATIO

This ratio is defined as follows:

$$\frac{\text{Combined Net Worth of all of the Borrowers}}{\text{Loan Amount}}$$

This is a ratio that is closely observed by banks but is often ignored by S&L's and thrifts. Traditionally, this ratio had to be at least 1.0. In other words, the borrower's net worth had to be at least as large as the loan amount requested.

During the go go days of the mid nineteen eighties, however, $600,000 net worth borrowers were regularly obtaining $2 million loans form the S&L's. Not surprisingly, when the projects later got into trouble, these borrowers seldom had the financial wherewithal to carry the project. In other words, these borrowers didn't own anything that they could sell off to carry the negative cash flow. As a result, the S&L's lost billions.

After the S&L debacle, lenders began to pay more attention to this ratio. For almost a decade, 1.5 became the bank minimum. In other words, a borrower's net worth must be at least one and a half times larger than the loan he is seeking. Commercial mortgage money is so plentiful in 2005 that banks will now even look at commercial loans where the net-worth-to-loan-size ratio is slightly less than 1.0.

Nevertheless, if you have a deal where a $400,000 borrower is trying to borrow $1 million on a leveraged real estate project, you probably would not want to bring his loan to a bank.

TOXIC LIABILITY

Modernly, all commercial mortgage lenders (with the possible exception of small, unsophisticated hard money brokers) require some sort of toxic report on a commercial property before they will lend on it. The reason why is because various state and Federal laws now require the owner of a environmentally contaminated property to clean it up. This cleanup cost could run into the millions of dollars.

This liability is *strict liability.* In other words, the judge doesn't give a damn if you were even born when the contamination was created. You own the property. You clean it up. This includes mortgage lenders who take back properties in foreclosure.

Virtually all gas station sites are contaminated. The tanks were of single wall steel construction, and they all leaked. The average clean up bill can be as low as $60,000 if the water table is deep to $600,000 for a single rusted out tank if the water table is high to several millions of dollars if there were a number of tanks on the property. Clean up is performed by aerating the contaminated soil (the bad stuff evaporates!) or inserting oil eating bacteria (very expensive but cheaper than hauling) or hauling away all of the contaminated soil (very, very expensive.)

Old dry cleaning plants are a big problem too. The law used to allow them to pour their used cleaning solvents down the drain, until it was realized about 8 years ago that all the underground water pipes leaked at the joints. Watch out for old dry cleaners *down the street.*

Other common polluters are truck storage yards and heavy industrial sites. The solvents used by furniture refurbishers are also particularly nasty. Worst of all were circuit board manufacturers, who used water to clean off their work areas. The heavy metals from such manufacturers are extremely water soluble (they show up in the water table miles away) and they are very carcinogenic.

There is an exception to the rule of *strict liability*. If a landowner obtained a Level I toxic report (estimated cost $2,300 to $3,500) prior to buying the property and the report did not find any contamination or suggest that further research be conducted (drilling, testing, etc.), then the buyer has a *"safe harbor"* against future toxic contamination liability lawsuits.

Most commercial mortgage lenders always now require a clean Level I (also known as a Phase I) toxic report as a condition of making the loan.

A Phase II (typically $8,000 - $15,000) toxic report is usually only required by a lender if the Level I toxic report asks for drilling and soils analysis. If contamination is discovered after drilling, your deal will frequently be dead.

THE CONSTRUCTION LOAN PROCESS

Over 50% of all construction loans are made by commercial banks. A commercial bank is the best prepared lending institution because construction loans have short maturities, they are usually tied to the lender's prime rate which allows the commercial bank to match it's yield with it's cost of funds, they require a knowledge of the local market, and because commercial banks have the capability to easily monitor and control loan disbursements. Savings and loan associations make 37% of all construction loans, and make 55% of all construction loans for one to four family dwellings. The remaining construction loans are made by mortgage bankers, real estate investment trusts (REIT's), life companies, and pension funds.

The construction lender is always a local lender. The reason is two fold. First of all, construction loans are disbursed in stages. After each disbursement, an appraiser from the construction lender inspects the site to insure that the work for that stage has been completed according to the plans and specifications. Secondly, most commercial "takeout commitments" require a certain percentage of the project be leased at or above the Pro Forma rate in order to fund.

If the new commercial property does not lease at the Pro Forma rate, then the takeout loan will not fund, and the construction lender will be forced to either foreclose on the property or convert their loan to a permanent. Since construction lenders are usually only short term lenders, they do not want to be stuck for 5 years in one project when they could be rolling over their funds every 12 to 18 months and earning more loan fees. Therefore construction loans are usually made by local lenders who know there is a demand for that type of space and that it can be leased at the Pro Forma rate.

The construction loan process starts with the construction lender. It is the construction lender who analyzes the request and determines whether or not there is a demand for the space at the Pro Forma rent or higher. If the lender likes the project, the next question the construction lender will ask is how the developer plans to pay off the construction loan at maturity.

A "forward commitment" is a commitment by a lender or an institution to either deliver a permanent loan or purchase the property at some specific date in the future. In order for a forward commitment to be acceptable, it must be "bankable". In other words, it must be issued by a large, dependable institution. A forward commitment issued by a small mom and pop mortgage company would probably not be bankable. There are three types of forward commitments: a takeout loan, a standby loan, and a forward equity purchase commitment.

A "takeout commitment" is a promise to deliver a permanent loan at a specific date in the future that will be used to pay off a construction loan. A "permanent loan" is a first trust deed loan, usually amortizing, with a term of 5 years or more, that is secured by a "standing property". A "standing property" is one that has been completed. Unlike "standby loans", that we will discuss in more detail below, takeout loans have desirable interest rates and terms, and are likely to actually fund. Takeout commitments are issued by long term lenders, such as S&L's and life insurance companies, and usually cost the borrower 1 2 points at the time of issuance. Takeout lenders are becoming more and more reluctant to issue fixed rate forward commitments because when rates drop, developers usually refinance their construction loans through other lenders. Therefore many takeouts are now tied to 5 year Treasury Bonds, AAA corporate bond rates, or the Federal Home Loan Bank cost of funds index.

A "standby commitment" is also a promise to deliver a permanent loan at a specific date in the future, except that the terms are generally very expensive and the loan is not expected to fund. Standby commitments are issued primarily to satisfy the construction lender that a source of funds exists to repay his loan. Most standby commitments are issued by credit companies, although standbys are sometimes issued by banks and S&L's. Most standbys float 3 5% over prime, and they generally cost the developer between two and four points. It is fair to say that if a standby actually funds, the project is probably in trouble.

A "forward equity purchase commitment" is a promise by an institution to buy the property upon completion. They are usually issued by life insurance companies, and therefore usually only apply to properties of $10 million and above.

Many times a construction lender will not require a forward commitment. Takeout commitments of less than $1 million are often difficult to obtain, and when banks are flush with cash, they do not want to lose a good loan to a bank down the street by requiring a developer to pay for a standby. When a construction loan is made without a takeout commitment, it is known as being "open-ended" or "uncovered". Some construction lenders were hurt during the last recession when their loans matured and rates were so high that the developers could not qualify for takeouts. Rather than force the developer into bankruptcy, most construction lenders "worked out" extensions until rates settled down.

Many lenders, most of whom are S&L's, will provide the developer with a construction/takeout combination. The construction loan terms will be the same as an open ended construction loan: the interest rate will float 1 2% over prime, with a 1.5 2.5 point loan fee, a maturity date of 1 2 years, and possibly 1 or 2 6-month options to extend at 1/2 1 point each. The takeout loan is generally fixed for 5 years or adjustable for 10 30 years. The takeout commitment usually costs the developer 1 point at the closing of the construction loan, and another 2 points if the takeout actually funds. If the developer can find a better permanent on his own to pay off the construction loan at maturity, he usually does not have to accept the construction lender's takeout.

A popular form of construction/takeout combinations is the construction and "mini-perm" combination. These loans are most often arranged by S&L's and major credit companies. A "mini-perm" is generally a 3 year takeout loan used to allow the developer time to establish an operating history on the project so he can qualify for a traditional permanent from a long term lender. Mini-perms might be used for hotels or other business properties. Another use is when rents are expected to increase. The mini-perm is written as a "bow tie" or "level bill" in which the actual interest rate may be floating over prime but the payments are collected, and the loan is underwritten, at a fixed rate less than interest only constant. This allows the project to support and qualify for a slightly larger loan. Since bow ties involve negative amortization, obviously this cannot be allowed to continue indefinitely. Most bow ties have a cap of either 75% loan-to-value based on the original appraisal, or an accrual cap of, say, 10% of the original principal balance. When the loan reaches its cap, the loan converts to either interest only or amortizing based upon the note interest rate. Many bow ties

have provisions for annual increases in the collection rate until the collection rate catches up to the note rate. For example, the collection rate might be 7% in year one, 7.5% in year 2, 8% in year 3, and so on until the collection rate equals the note rate.

In summary, the developer goes first to a local construction lender, who analyzes his cost projections and the demand for the proposed space in the area. If the construction lender requires a takeout and is not prepared to offer one of his own, the developer next goes to a long term lender for a takeout commitment. The takeout lender analyzes the Pro Forma cash flow statement to determine if the project will generate enough income to support a permanent loan large enough to pay off the construction loan completely and at the same time have a debt service coverage ratio satisfactory to the permanent lender. If so, the takeout lender will issue a commitment subject to the property being built according to the plans and specifications and subject to the project leasing out at the Pro Forma rent or higher. The developer then takes his forward commitment to the construction lender, usually a local bank who is confident that the projected lease rates can be reached, who then funds the construction loan.

CONSTRUCTION COST BREAKDOWN

LAND

Balance Owing/To Clear Title $ _____
Developer's Downpayment/Equity _____

Cost/Market Value/Appraised Value of Land: $ _____

DIRECT (HARD) COSTS

Demolition $ _____
Excavation and Grading _____
Foundations _____
Masonry _____
Steel _____
Drywall _____
Heating & Ventilation _____
Plumbing _____
Electrical _____
Parking _____
Landscaping _____
Tenant Improvements _____

Total Direct Costs: _____

INDIRECT (SOFT) COSTS

Architectural Fees $ _____
Civil Engineering Fees _____
Soils Engineering Fees _____
Appraisal & Market Research _____
Legal & Accounting _____
Real Estate Taxes _____
Insurance & Bonds _____
Fees & Permits _____
Overhead _____
Loan Fees _____
Construction Period Interest _____
Marketing & Leasing _____
Escrow & Closing Costs _____

Total Indirect Costs: _____

CONTINGENCY RESERVE _____
(_____ % of direct & indirect costs)

TOTAL COSTS $ _____

LESS CONSTRUCTION LOAN _____

DEVELOPERS CONTRIBUTION $ _____

LOAN-TO-COST RATIO

The loan-to-cost ratio is defined as the ratio of the construction loan to the total cost of a construction project.

$$\text{Loan-to-cost ratio} = \frac{\text{Construction loan}}{\text{Land Costs + Hard costs + Soft costs + Contingency Reserve}}$$

$$= \frac{\text{Construction loan}}{\text{Total Project Costs}}$$

A low-to-cost ratio means that the developer has a lot of his own money into the project. A higher loan-to-cost ratio means that the developer has very little of his own money into the project.

Traditionally, this ratio was not allowed to exceed 80%. However, during the go-go days of the mid-2000's, this ratio is now allowed to increase to 85% to 90%... and sometimes to 95% to 100% of total project costs! These are wild times!

Many commercial banks still require that their loan-to-cost ratio not exceed 75%, although 80% remains the average.

The cost of a project should always be *at least* 15% less than the appraised value of the property upon completion, and preferably the total project cost should be 20% to 25% less. This means that the developer stands to earn a profit of at least 15% to 25% of the total cost of the project.

Watch out for deals where the finished value of the project is not significantly higher than its cost. Otherwise, the developer has little incentive to complete the project if costs end up totaling more than originally expected. Otherwise, the developer is likely to say, "Adios!" to the project and to the construction lender halfway through the project.

It is possible to have such a well-conceived construction project that the loan-to-value ratio is only 65% but, because the developer is trying to put very little of his own money into the deal, the loan-to-cost ratio is 95%. In this circumstance, "the book" says the lender should turn the deal down.

SITE INSPECTIONS

Income property appraisals are terribly expensive. Quotes of $5,000 are not uncommon from banks, CMBS lenders, and S&L's.

In addition, Federal regulations require Federally related lenders to order their own appraisals. If one bank orders a $5,000 appraisal from Mr. Reputable, M.A.I. and then turns the deal down, the next bank will have to order its own $5,000 appraisal!

In order to prevent unnecessary appraisal fees, and in order to get the digital photographs you need for your proposal submission package, you should always arrange for a site inspection of the property before ordering an appraisal. In fact, if you order the appraisal on your own, no Federally related lender will be allowed to use it.

If the property is out of your driving range, ask the borrower for a $50 site inspection check. Then order some digital photos and a quick, drive by verbal report from a local appraiser, realtor, real estate broker or friend. All you need are a number of attractive frontal photographs of the property, some street scenes, and a verbal report on the socio economic nature of the area.

Do NOT ask the borrower to take the pictures! You will lose the sale every time. The borrower will never send them, and while he is procrastinating, he will be justifying his procrastination by thinking of everything wrong with your loan. In addition, you would still need an independent third party to report on the socio economic nature of the area.

If you decide to take the pictures yourself, you must not ask for the $50 site inspection fee. Such a fee would constitute an illegal advance fee and could cost you your real estate license.

APPRAISERS

Not all appraisers are equally qualified. A fee appraiser is an appraiser for hire by the general public, as opposed to a staff appraiser working for a lender. As a general rule most lenders will not accept an appraisal from a fee appraiser unless that particular fee appraiser was designated in advance by the lender. This is to prevent collusion between the borrower and the appraiser to bring in an inflated property value.

There are certain professional "designations" that an appraiser can earn that will give him more universal acceptance by lenders and therefore increase the demand for his services. These designations are earned by a combination of classroom instruction and supervised work experience according to very strict standards established by professional associations of appraisers.

The most highly coveted is the M.A.I. designation, which stands for Member, American Institute of Real Estate Appraisers. Most lenders lending in a remote area that they are not familiar with will require that the appraiser be an M.A.I. This designation requires years of study and thousands of supervised appraisals, and is somewhat equivalent to the C.P.A. designation in accounting. Because of the demand for their services, M.A.I.'s often command appraisal fees of two and three times those of the average fee appraiser for appraising the same property, and most M.A.I.'s have work backlogs of at least 3 weeks. Because of the prestige and fee premium offered by an M.A.I. designation, few M.A.I.'s will risk their designation by conspiring with a borrower to over value a property. The M.A.I. designation is the one designation that most lenders will accept, even if they do not know the appraiser personally.

Another highly respected designation is the SREA designation. This designation stands for Senior Real Estate Appraiser and is issued by the Society of Real Estate Appraisers. In theory, the SREA designation is supposed to be directly comparable to the MAI designation, the only difference being that it is issued by a different trade group. There was even some talk several years back that the American Institute and the Society might merge. The merger fell through however, probably because the American Institute did not want to

share their special reputation. While in theory an SREA designation is supposed to mean expertise directly comparable to that of an MAI designation, the reality is that the SREA designation has never achieved the same universal acceptance.

The SRPA designation is just one step below that of an SREA designation, and stands for Senior Real Property Appraiser. This designation signifies that the appraiser is well qualified to appraise income property. It is often is good compromise, if discussed with the lender in advance, between a lender's desire for an MAI appraisal, and the borrower's desire for a more reasonable appraisal fee. The SRA designation stands for Senior Residential Appraiser, and is just one step below that of an SRPA. It is a respected designation, signifying expertise in residential and small residential income properties (apartments). SRA designated appraisers are often working hard on their SRPA designation, and therefore can produce good quality commercial appraisals at a very reasonable fee. It is even more important, however, to check with the lender in advance.

In compliance with Federal mandates, the State of California has recently created the Office of Real Estate Appraisers (OREA) which now certifies appraisers. Effective in 1993 all properties upon which loan will be placed that will be insured or sold by any Federal government agency must be appraised by a Certified Appraiser.

There are three levels of appraisers. The lowest designation is the Provisional Certified Appraiser. This appraiser has satisfied much but not all of his educational and experience requirements. He may appraise single family dwellings, but has only one year to complete his mandatory training.

The Residential Certified Appraiser designation is higher. This appraiser may appraise residences and some 2 4 unit buildings up to a certain dollar value.

The highest designation is General Certified Appraiser. This appraiser may appraise any type of property.

Appraisal fees on residential loans should always be collected in advance on residential loans. The collection of the appraisal fee in advance is a good way for a Loan Officer to verify that the borrower is sincere.

Appraisal fees on income property transactions should not be collected until a formal proposal has been issued by the lender and accepted by the borrower. Income property appraisals are simply too expensive to re-do if the lender refuses to accept the appraiser you selected. Borrowers should be encouraged to pay the extra amount required by an MAI appraiser because if the original lender turns the loan down, there is at least some chance that the next lender will accept the appraisal.

Loan officers should also insure that they emphasize to the appraiser that the appraiser is responsible for collecting his own fee, even if the Loan Officer calls in the appraisal order. It is unwise for a Loan Officer to guarantee checks or appraisal fees. Many Loan Officers have been sued by appraisers when their client's check bounces. Appraisers should collect 100% of their fee in advance. This prevents messy situations that arise when a borrower is disappointed in the value arrived at by the appraiser.

It is customary and proper to ask a new appraiser for a copy of his resume and references. All experienced appraisers have these already prepared and are happy to supply them upon request. Avoid any appraiser who refuses to supply a copy of his resume and references. It is a good policy to include a copy of the appraiser's resume and references directly behind the appraisal in a loan package. Most MAI appraisers automatically include their resume and references as an integral part of their appraisal package.

LOAN PROPOSALS

The processing of a commercial mortgage loan application involves a significant amount of paperwork. Often the amount of paperwork involved exceeds that of a residential mortgage loan by several fold. Therefore neither the lender nor the broker wants to waste a lot of time processing a deal that is not going to close.

It is therefore customary in commercial mortgage lending for the borrower or broker to initially submit to the lender a mini package in hopes that the lender will issue a loan proposal. (For instructions on how to prepare one of these mini packages, please see the training memo entitled "How to Prepare a Proposal Submission Package".)

A loan proposal is not a commitment. A loan proposal is merely an expression of interest by a lender in making the loan and an estimation of the eventual terms. Final loan approval will be subject to many factors, including a satisfactory appraisal, approval of the borrowers' financial statement and credit report, and a more detailed analysis of the property's cash flow. Therefore a loan proposal is legally worthless.

In practice, however, a loan proposal is very encouraging. Once a loan proposal has been issued by a lender and accepted by the borrower, there is an excellent chance your deal is going to close on terms very close to those agreed upon.

Sometimes loan proposals are in writing; slightly more often they are verbal. If issued in writing, they are often called "good faith letters", "conditional commitment letters", or "term sheets".

It is common for banks, S&L's, life insurance companies and CMBS lenders to ask the borrower to post a non refundable good faith deposit as evidence of his interest in the loan.

Unless the lender is a household name, however, the broker should investigate the lender thoroughly before tendering the borrower's deposit. Good faith deposit scams are rampant in the industry. As a result, it is illegal for a mortgage broker in California to collect a good faith deposit.

FHA 223(f) APARTMENT PROGRAM

One of the very best apartment progams in the country comes from the Federal government, more specifically the Federal Housing Administration (FHA). Section 223(f) of the National Housing Act authorizes HUD to provide funding programs for refinancing existing debt or for the acquisition of existing apartment or housing co operatives. *In English this means you can do both refis and purchase money deals on apartments.*

The lenders who originate these FHA 223(f) loans must be approved FHA lenders, and often these mortgage bankers are also FNMA DUS lenders. DUS stands for Designated Underwriter and Servicer, which means they can approve their own deals, and they service these loans as well. Normally FHA lenders and FNMA DUS lenders are huge nationwide mortgage bankers.

The program itself is fantastic! The borrower can get a **35 year fully amortized loan (35/35)** up to **85% loan-to-value**. In addition, **the rate is fixed** at only 1.25% over 10 year Treasuries. As of December of 2005 that works out to a fixed rate of around 5.75% for 35 years. Wow!

In addition, there are no tenant income requirements. In other words, *you do not have to rent to lowlifes* who are going to tear up your building. Nor is their any regulation of rental rates. In other words, the landlord can charge whatever rent the market will bear. **There are no rental controls**.

There are very few restrictions and disadvantages, and any disadvantages certainly do not outweigh the positives.

One of the few restrictions is that **the apartment building must be at least 3 years old.** Therefore a developer can't go out and build a brand new apartment building and get a FHA 223(f) takeout loan. (But see our memo on the FHA 221(d)(4) apartment construction program.)

A big condition to obtaining one of these loans is that **the property owner must remedy any deferred maintenance.** That's the bad news. The good news is that *the FHA will let you pay for the cost of these repairs out of the proceeds of the loan,* and they will base their appraisal on the finished value of the property after renovation. Now the cost of the repairs cannot exceed 15% of the finished value of the property, or $6,500 per unit, whichever is lower. In addition, only one major building component may be replaced.

The Federal government guarantees a portion of these loans. That is why the rate is so fabulous, fixed at only 1.25% over 10 year Treasuries. What the Federal government gets out of the deal is a renovated housing stock.

A buyer can obtain a new loan of 85% of the purchase price, and if the property needs repair, he can obtain 85% of the cost to acquire the property and to complete the repairs. This is true, as long as the loan amount does not exceed 85% of the appraised value of the property after renovation.

Cash out refinances are limited to 70% loan-to-value. But if the borrower needs to pay off existing debt and repair the property, he can obtain a loan to cover all of these costs, as long as the loan does not exceed *85%* of the appraised value of the property after renovation. *In plain English, a refi-borrower can usually get all the money he needs to renovate a property and pay off the existing debt, as long as he doesn't try to pull cash out - up to 85% of the finished value.*

From the proceeds of the loan, the lender will hold back enough funds to cover the cost of the required repairs. The borrower has up to one year to complete the repairs.

A reserve for taxes and insurance will be collected on a monthly basis. In addition, a reserve for replacements will be funded from the proceeds of the loan and out of the months payments. For example, if the apartment building will need a new roof in 4 years, and if the cost of the roof will be $80,000, the lender may hold back $60,000 out of the proceeds of the loan and may require the borrower to pay, along with his principal and interest payments, $5,000 each year to complete the funding of the roof replacement reserve. Other major reserves and anticipated repairs will be funded in the same manner, with a big, initial holdback and additional monthly contributions.

FHA underwrites these loans using 85% of the net income, which works out to a 1.175 debt service coverage ratio. At these low interest rates, the deals cash flow very well. Loan-to-value ratio will usually be the limiting factor.

Loan fees generally run between one to two points to the FHA approved lender, plus any broker points, depending on the size of the loan. A common minimum loan fee to the FHA lender is $30,000 to $40,000. Most FHA approved lenders will not look at FHA 223(f) loan requests of less than $2 million, although the FHA recently brought out a simplified program for smaller loans.

The loan is locked out (prepayment is prohibited) for the first five years, and there is a some sort of declining prepayment penalty thereafter, often 5% 4% 3% 2% 1% 0% The loan is assumable for a 1% fee.

Despite the involvement of the government, these loans generally do not take more than 90 days or so to fund. This is a *great* program, particularly for lower quality buildings in lower income neighborhoods and for properties needing maximum leverage to pay off ballooning debt.

LOAN PLACEMENT MATRIX

Life Companies

Life companies are picture postcard lenders.

Must take a gorgeous picture.

They are extremely risk adverse.

- Loan must cash flow 1.35x (1.25x rock bottom)
- Loan-to-value ratio should be less than 60% (65% absolute max.)

Loan must be over $1,000,000.

Property must be less than 5 years old (brand new preferred)

- Exception: Less than 10 years old and in very affluent area.

Must be a standard property type

- Office
- Retail
- Concrete industrial

High net worth borrower usually required

- Net worth should be 1.5 times the loan amount.

Borrower must have good credit.

They like fixed rate

- Their loans are either locked-out or have huge defeasance penalties.

Low points (1 or maybe even par)

NOTE:

In 25 years Blackburne & Brown has never closed a life company loan!

CMBS Lenders (Conduits):

CMBS stands for Commercial Mortgage-Backed Securities. CMBS lenders pool their loans, securitize them and sell them off to Wall Street. Therefore conduits have *unlimited cash* for deals not good enough for life insurance companies. Conduits are motivated by BIG profits to close deals with just a little bit of hair. Conduits only lend on specific property types that fit into their cookie cutter molds, but they have *lots* of molds:

Apartment buildings
Office buildings
Retail buildings and strip centers
Shopping centers
Industrial buildings
Hotels and motels
Mobile home parks (currently out of favor but coming back)
Mini-warehouses (currently out of favor but coming back)
Health care facilities, residential care homes, convalescent hospitals and congregate care (currently out of favor but coming back)

Loans as small as $100,000 to as large as $2 billion - Unlimited funds. Always hungry.

Debt service coverage ratios: 1.20 minimum.

Borrowers must have at least average credit (some tiny blemishes probably okay.)

Net-worth-to-loan-size ratio not officially computed but ideally should be reasonably close to 1:1.

Rate is almost always fixed, usually at some spread over 10 year treasuries.

Spreads over 10 year Treasuries usually about 1/2 higher than life insurance companies.

Loans are either locked in or have huge defeasance prepayment penalties.

Low points, usually 1.

Conduits will accept older, not so beautiful properties.

Conduits will make loans to 75% LTV and very often 80%! Best lender for max cash!

Savings & Loans

S&L's are real estate cash flow lenders.
Loan Must Cash Flow 1.25x.
Standard Property Types Only
- Office
- Retail
- Industrial (Concrete or brand new steel skinned)

Borrower need not have a big net worth.
Borrower must have good credit.
They write few fixed rate loans. They want floating rate loans.
Low points (usually 1)
Loans to 75% LTV common. 80% occasionally.

Banks

Banks are balance sheet lenders. They like liquid net worths.
Banks want a deposit relationship. Very important.
- Exception: Japanese and money centers banks (WFB, BofA)

Standard Property Types Preferred
- Office
- Retail
- Industrial (Will do older steel skinned)
- Business properties considered if business very successful
  - (as evidenced by large cash deposits)

Loan must cash flow 1.25x (in theory but this rule is frequently broken)
Borrower must have good credit
The Japanese and money center banks write fixed rate loans for resale as CMBS loans.
The small banks make 5 year loans with a 5 year rollover at market rates.
Low points - usually 1 to 1.5.

Credit Companies

Credit companies are tax return lenders.
Business properties financed regularly if debt service supported by the tax returns.
Borrower must have good credit
Property must cash flow 1.0 based on last years' tax returns
(Hard because most borrowers cheat a little)
If the tax returns are good, the closing ratio is excellent.
All of their loans are tied to Prime, usually Prime plus 3%.
Lowish points (2 to3)

Thrift & Loans

(Note: By 2005 all former thrift and loans have converted to banks.)
A special form of small bank found in California only
Common sense lenders
Maximum loan $1,000,000 (maybe $1.5MM if very cherry)
Very flexible on property type
Most active special use lender
Not dependent on tax returns
Will allow a negative cash flow if borrower can support debt.
Expensive
Good credit preffered but not essential. Common sense.
Loans are tied to Libor (usually 3% to 5% margins)
Healthy points (usually 1 to 2)
Terms of ten years and longer are now common

Hard Money

Hard money lenders are equity lenders
65% usual max
Credit not very important
Negative cash flow okay to 65% loan-to-value
Very expensive
Decent fixed rates (usually 12% to 14%)
Big Points (3 to 6)
Short term (1 to 5 years)

DOCUMENTS TO GATHER APARTMENTS

(In order of importance)

Remember: Always request as few documents as possible.
Never request something before it is needed.

To prepare a listing agreement we need:

1. Rent roll (includes address of each unit, the room count, and the current rent. The name of the tenant is helpful but not required.)
2. 2005 ACTUAL operating expenses.
3. An old financial statement on each general partner is useful but is not required.

To obtain a formal proposal we need:

1. Financial statement on each general partner.
2. 2005 and 2004 Federal Tax Returns (all pages) on each general partner. If a 2005 tax return is unavailable we will need:
    a. 2005 W 2 statement or P&L statement.
    b. 2003 Federal Tax Return (all pages).

To obtain a loan commitment we will need:

1. For PARTNERSHIPS-or LIMITED LIABILITY COMPANIES
    a. Partnership Agreement or Operating Agreement.
    b. Certificate of Limited Partnership (if applicable)
    c. 2005 and 2004 partnership tax returns (all pages). If 2005 is unavailable then we will need a P&L for 2005 and a copy of the 2003 return.
2. For CORPORATIONS-
    a. Most recent balance sheet (net worth statement).
    b. 2005 and 2004 corporate tax returns (all pages).
    c. Articles of Incorporation.
    d. Resolution to Borrow.

DOCUMENTS TO GATHER ~ COMMERCIAL/INDUSTRIAL

(In order of importance)

Remember: Always request as few documents as possible.
Never request something before it is needed.

To prepare a listing agreement you will need:

1. Old financial statement on each general partner. Do NOT ask the borrower to prepare an updated one. While he is procrastinating, he will be thinking of excuses why he shouldn't take your loan.
2. 2005 and 2004 Federal Tax Returns (all pages) on each general partner. If a 2005 tax return is unavailable you will need:

    a. 2005 W 2 statement or P&L statement.

    b. 2003 Fedral Tax Return (all pages).

To obtain a formal proposal you will need:

1. Schedule of leases (includes address of each unit, the name of the tenant, the net rentable square footage of each unit, and the current rent).

    or Copies of all leases.

2. 2005 ACTUAL operating expenses.

To obtain a loan commitment you will need:

1. Copies of all leases.
2. For partnerships or limited liability companies
   a. Partnership Agreement or Operating Agreement.
   b. Certificate of Limited Partnership
   c. 2005 and 2004 partnership/LLC tax returns (all pages). If 2005 is unavailable then we will need a P&L for 2005 and a copy of the 2003 return.
3. For corporations
   a. Most recent balance sheet (net worth statement).
   b. Fiscal year to date P&L Statement.
   c. 2005 and 2004 corporate tax returns (all pages).
   d. Articles of Incorporation
   e. Resolution to Borrow

HOW TO PREPARE A PROPOSAL SUBMISSION PACKAGE

Your loan package should be submitted in a legal size file folder. Book like packages are awkward for the lender to store and file. Your file folder should be labeled as follows:

APPLE COUNTRY MOTEL
Loan & Property Information

Notice the name of deal is a property name/project name - not the name of the borrower. Give every commercial deal a project name. Notice the name of the property is in all capital letters.

I prefer to photocopy every page on legal size paper, even if the original document is letter sized, like a tax return. The unused excess paper should be at the top. This creates a nice, smooth bottom. Alternating legal and letter sized copies look unfinished and unprofessional. Commercial lenders are too fickle to spend hours and hours preparing a book like package, but some attention to aesthetics is important.

You should organize your proposal submission package in the following stacking order:

1. Loan Summary
2. Picture page with photograph, property address, brief property description, and brief neighborhood description.
3. Goldenrod Divider Sheet

IMPORTANT NOTE: **Instead of using labeled tabs, which take hours prepare, I simply used colored sheets of paper to separate each major set of documents. This is fast and easy and works "good enough".**

4. Pro Forma Operating Statement

IMPORTANT NOTE: **The higher in the stacking order a lender finds your Pro Forma operating statement, the more respect he will have for you. Commercial loans almost always boil down to the debt service coverage ratio, and this ratio is computed using the Pro Forma.**

5. Rent Roll or Schedule of Leases

6. Statement of Actual Income and Expenses

7. Goldenrod Divider Sheet

8. Appraisal, if thin and already available. If an appraisal is available but thick, submit it in its own file folder. If you use a separate file folder for a thick appraisal, label the file as follows:

APPLE COUNTRY MOTEL
Appraisal

Caution: Never order an appraisal until a lender has issued a proposal and the borrower has accepted it. Under FIRREA a Federally insured lender is not allowed to accept an appraisal ordered by either the borrower or a mortgage broker.

9. Goldenrod Divider Sheet

10. Financial Statement on borrower (if available)

11. Front page of the borrower's 2005 1040.

Reminder: A proposal submission package is simply designed to see if your lenders are interested, and it is a good practice to have at least four lenders looking at each deal at all times. Since you will therefore need to send out four copies of the package, you don't want the packages too thick at this time. You just want to send out the essentials at this point. You can shuttle the complete 1040's to the lender if the lender expresses interest.

12. Front page of the borrower's 2004 1040.

13. Goldenrod Divider Sheet

14. Miscellaneous ESSENTIAL documents. (Avoid including anything else unless it is absolutely essential to the lender's understanding. Miscellaneous documents can seldom help you but can often kill your deal. Use the Gosh Darn Important Test. Never submit anything to a lender unless it is gosh darn important. Thicker is not better.

GLOSSARY

Effective Rent: If a landlord gives away free rent at the beginning of a lease term in order to sign a tenant, the "true" or "effective" rent is not the contractual rent after the free rent period, but some lesser number. Normally you total the rent for the term and divide it by the number of months. For example: Free rent for one year and then $1.50 per square foot for two more years equals an effective rent of $1.00 per square foot ($1.50 + $1.50 = $3.00 divided by a 3 years = $1.00/sf)

Stabilized Rent: Assumes the property is 100% occupied at current market rents. Most often used by commercial realtors when trying to market a building whose rents are less than market.

Recourse: A loan where the lender preserves the right to go after a borrower for a deficiency judgment if the borrower defaults, the lender forecloses and the lender loses money.

Non recourse: A loan where the lender and the borrower agree in advance that the lender has no right to go after the borrower for a deficiency judgment in the event of a foreclosure.

Carve out: An exception provision in a non recourse loan whereby the lender preserves the right to still seek damages for its losses. Non recourse lenders will frequently create carve outs for fraud and toxic contamination. If you defraud the lender or fail to disclose toxic contamination, the lender will therefore still be able to come back after you for its losses.

Third Party Reports: Reports from third part professionals such as appraisals, toxic reports, title reports, structural engineering reports, surveys, etc.

Loss of Yield Prepay: A huge prepayment penalty equal to essentially all of the interest until maturity, adjusted only slightly by the amount of interest the lender can earn in U.S. Treasuries between now and maturity.

Lock Out Clause: A provision in a mortgage or deed of trust that prohibits early prepayments. You walk in with a wheelbarrow full of money and dump it on the lender's desk. He counts it and mails you back a cashier's check for the amount of your prepayment with a note saying you can't pay off his loan early.

Due on Encumbrance Clause: A provision in a mortgage or deed of trust that prohibits junior financing. If you put a second mortgage on the property, the lender has the right to accelerate the loan and demand that you pay him off in full.

Tranche: When investment bankers take a pool of commecial mortgages and issue mortgage backed securities (securitization) based on the payments to be received on the pool of loans, they will often sell off different layers of risk at different yield. For example, they might take that portion of the loan that is between 0% and 30% loan-to-value and sell them off at 6.5%. Then they might take the layer between 30% LTV and 55% LTV and sell this off at 7.5%. Then they might take the layer between 56% LTV and 75% LTV and sell it off at 15%. In the event of a loss, the first investor to suffer the loss will be the owner of the layer between 56% and 75% LTV. Then if there is still more losses, the next highest layer looses. Each layer is called a tranche, and a typical securitization might have as many as 12 different tranches, each at a different yield and exposed to a different level of risk.

Defeasance: The modern prepayment penalty on most CMBS and fixed rate loan. The borrower replaces (defeases) his mortgage with U.S. Treasuries of equal term. The typical defeasance prepayment penalty is huge, often the equivalent of 10 to 12 points!