HOW TO BROKER
COMMERCIAL MORTGAGE LOANS

2006 UNDERWRITING MANUAL UPDATE

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INTRODUCTION TO CUMULATIVE UPDATE OF UNDERWRITING MANUAL

The manuals and the videos for my course, "How to Broker Commercial Mortgage Loans" were originally created in 1997, and they were updated in 2005. These training materials have been a smash hit, and we have received hundreds happy testimonials.

The commercial mortgage market, however, has changed somewhat since 1997, when the videos were first recorded. This Cumulative Update to the Underwriting Manual will bring you current.

In addition - and this is really cool - you will be able to stay continuously current with the commercial mortgage market by regularly reading our weblog, "Commercial Real Estate Loan Tips" at blog.c-loans.com Our weblog is the gift that keeps on giving.

George Blackburne

George Blackburne, III, Esq.

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COMMERCIAL CONSTRUCTION LOANS

Developers and Mortgage Brokers -
Learn How Apartment Construction Lenders
and Commercial Construction Lenders Underwrite

Here is how your apartment construction loan or your commercial construction loan will be underwritten. The first test is the Profit Test. Will your finished project be worth more than it will cost to construct?

A related test is the Loan-to-Value Ratio. After the project is completed and, say, your strip center is occupied, will the construction loan be less than, say, 75% loan-to-value.

Some of our construction lenders are so hungry for deals that they might even allow 80% loan-to-value. But if you still need more equity, it may be possible for you to obtain a mezzanine loan.

Apartment construction lenders and commercial construction lenders often will not trust the appraisal. Instead, they will look to the Loan-to-Cost Ratio. What percentage of the total cost is the construction lender being asked to cover?

Historically developers were asked to cover at least 20% of the total cost of the project, usually in the form of free and clear land. After all, the coonstruction lender wants the developer to have some skin in the game.

Modernly, however, apartment construction loans or commercial construction loans up to 90% of cost, or more, are possible. And if the developer needs even more leverage, a mezzanine loan is sometimes possible.

Will the apartment construction lender or commercial construction lender be able to get out of the deal? If you build your strip center, will the center make enough money to qualify for a takeout loan large enough to pay off the construction loan?

To determine if the takeout loan is large enough to pay off the apartment construction loan or the commercial construction loan, the construction lender will compute the Debt Service Coverage Ratio. The ratio must usually be larger than 1.25. In other words, the net income from the project must be 25% larger than the proposed payments.

Finally the apartment construction lender or commercial construction lender will look to the developer's Net-Worth-to-Loan-Size Ratio. Generally the developer's net worth should be at least as large the loan amount.

THE PROFIT TEST

The Developer Needs an Incentive to Complete the Project

Suppose a commercial property developer obtains an $850,000 commercial construction loan to build a small strip center. The project will cost $920,000 to build. Initially the developer expects to sell the strip center upon completion for $975,000.

Then the market for small strip centers tanks by 10%. The developer might say to himself, "Gee, even if I stick around to complete the project and sell it $875,000, the realtor's commission and closing costs will cost me another $60,000. There won't even be enough net proceeds to pay off the commercial construction loan. There is no profit incentive for me to stick around."

So the developer calls the bank and says, "Good luck collecting on my personal guarantee. I'm outa here. You can complete the project on your own."

Okay, obviously the commercial construction lender made a mistake when underwriting the loan. What did the commercial construction lender do wrong?

The commercial construction lender should have computed the developer's potential profit as a percentage of the total project cost; i.e., the Profit Test.

In this case the developer only stood to make a $55,000 profit if the deal went perfectly ($975K value minus $920K cost.) Expressed as a percentage of the total project cost, the developer only stood to make a profit of around 6% ($55K/$920K x 100%).

When underwriting commercial construction loans, the prudent commercial construction underwriter will require a profit percentage of at least 20%.

LOAN-TO-VALUE RATIO

When the Commercial Project is Completed, How Much Protective Equity Will the Commercial Construction Lender Enjoy?

The commercial construction project has now been completed. The property has been leased up and occupied. Where does the commercial construction lender now stand? Does the developer have plenty of equity that he will want to protect, or will he be tempted to simply walk away from the project and hand over his keys to the commercial construction lender?

This is the purpose of the Loan-to-Value Ratio calculation. You divide the construction loan amount by the appraiser's estimate of *fair market value* of the project upon completion and occupancy, and then multiply by 100%.

Suppose Jake and Beth Smith build a new office tower near Ground Zero in New York City. Suppose the construction loan is $90 million and the *fair market value* of the project after it is completed and occupied, according to the appraiser's estimate, is $140 million. The loan-to-value ratio would be 64.2%, a wonderfully low LTV.

So what is a reasonable loan-to-value ratio for a proposed commercial construction project today?

Multifamily (apartment) projects should not exceed 75% to 80% LTV. Retail is hot as of this writing (7/5/04), so you might be able to obtain a construction loan up to 75% loan-to-value. Industrial and self-storage are semi-hot: 70% to 75% LTV is reasonable.

Commercial construction lenders are cool to office buildings in most central business district locations, and commercial construction lenders are cool to assisted living projects located anywhere today. Ideally these commercial construction projects should not exceed 70% in most markets, but there are plenty of exceptions.

Hotels are cold after 9/11 (although no longer ice cold), so it will be difficult to get conventional commercial construction loan in excess of 65% loan-to-value. Sixty percent is more realistic. You will almost certainly need a mezzanine loan.

So what happens if your commercial construction project does not appraise out? The purpose of building is to to sell the project for more than it costs to build. If the project does not appraise for significantly more than it costs to build, it may simply be a poorly conceived project.

But if you are absolutely committed to the project, you may want to look into a mezzanine loan.

MEZZANINE LOANS

What in 'Tarnation is a Mezzanine Loan Anyway?

Mezzanine loans are similar to second mortgages, except a mezzanine loan is secured by the stock of the company that owns the property, as opposed to the real estate.

If the company (usually a LLC) fails to make the payments, the mezzanine lender can foreclose on the stock in a matter of a few weeks, as opposed to the 18 months it often takes to foreclose a mortgage in many states. If you own the company that owns the property, you control the property.

Our own hard money company once had to foreclose a mortgage in New York, and it took almost two years. Yikes! In contrast, a mezzanine loan is secured by the stock of a company, which is *personal property* and can be seized much faster.

Mezzanine loans are also fairly big. It is hard too find a mezzanine lender who will slug through all of the required paperwork for a loan of less than $2 million. It is occasionally possible to obtain mezzanine loans as small as $1 million.

In addition, mezzanine lenders typically want big projects. If the property you are trying to finance is not worth close to $10 million, you may have a hard time attracting the interest of any mezzanine lenders.

There are three typical uses for a mezzanine loan. Suppose the owner of a $10 million shopping center has a $5 million first mortgage from a conduit. The owner wants to pull out some equity, but he cannot simply refinance the shopping center because the first mortgage has either a *lock-out clause* or a huge defeasance prepayment penalty. In this instance, he could probably obtain a $2.5 million mezzanine loan to free up some cash.

Suppose an experienced office building investor wanted to buy a partially-vacant office building in a fine location. Once again, assume that the purchase price is $10 million (when the office building is still partially-vacant) and that the conduit first mortgage is $5 million.

This may surprise you, but the right mezzanine lender might be willing to lend a whopping $4 million! But isn't that 90% loan-to-value? Yes, but when the vacant space is rented - remember, our buyer is a pro - the property will increase to $12 million in value. Suddenly the mezzanine lender is back to 75% loan-to-value and his rationale is obvious. This kind of deal is called a *value-added* deal.

The third and final use of mezzanine loans is for new construction. Suppose a developer wanted to build a 400 room hotel across the street from Disneyland. Hotels today are out of favor, and a commercial construction lender might only be willing to make a loan of 60% loan-to-cost. If the total cost was $20 million, the developer would ordinarily have to come up with 40% of $20 million or $8 million. That's a lot of dough.

A $3 million mezzanine loan solves the developer's problem. The commercial construction lender would advance $12 million, the mezzanine lender would make a $3 million mezzanine loan, and the developer would "only" have to come up with $5 million.

THE LOAN-TO-COST RATIO

How Much of the Total Construction Cost is the Construction Lender Being Asked to Finance?

Remember - The Commercial Construction Lender Wants the Developer to Have Some Skin in the Game

The Loan-to-Cost Ratio is different than the Loan-to-Value Ratio. You are probably more familiar with the Loan-to-Value Ratio, where the underwriter uses the *fair market value* of the project after it is completed and occupied in the denominator.

The Loan-to-Cost Ratio only considers what it actually costs to build the project. For example, let's suppose that Jake and Beth Smith own a piece of land near Ground Zero in New York City that would be an ideal site to build a new office tower. The land alone is worth $10 million.

The Smith's want to build a new office tower to replace the one they were forced to demolish after 9/11. Including the $10 million value of their land, their contractor tells them that the total cost to build the proposed office tower will be $100 million.

Since Mr. and Mrs. Smith own the land free and clear, they only need $90 million more to build the new office tower. They could go to a commercial construction lender, most likely a bank, and ask for a $90 million commercial construction loan.

The commercial construction lender would then compute the Loan-to-Cost Ratio. The loan amount is $90 million and the total cost is $100 million, so the Loan-to-Cost Ratio is 90%.

Is 90% loan-to-cost too high? Traditionally commercial construction lenders will only lend up to 80% of cost. And if a property type is out of favor with investors, like assisted living, hotels, and office buildings located in many overbuilt central business districts, some commercial construction lenders might only want to go 70% loan-to-cost.

But loan-to-cost ratios are frequently stretched. If the Smith family was worth $100 million, and they were willing to personally guarantee the loan, many New York banks would probably be willing to make the loan at 90% loan-to-cost.

And if the Smith clan had been building office towers for three generations, in other words they had a ton of experience, an aggressive bank might even be willing to lend up them up to 95% loan-to-cost.

But what if a developer just can't come up with 20% to 30% of the total cost of the project? In that case, he will probably need to either bring in a partner with more equity dollars or obtain a mezzanine loan.

TAKEOUT LOANS

Takeout Loan: A Permanent Loan
That Pays Off a Commercial Construction Loan

A *permanent loan* is simply a long term first mortgage on a multi-family or commercial property. You own an office building. Your existing first mortgage is ballooning. You simply need a new permanent loan.

Any first mortgage loan on a commercial property with a term of at least 5 years is considered to be a permanent loan, even though it has a balloon payment. A 10 year term is about as long of a term as most commercial mortgage lenders will go.

Permanent loans are usually amortized over 25 years, unless the property is older. A lender might amortize a permanent loan on a 35 year old building over just 20 years, with a balloon payment after 5 or 10 years.

A *takeout loan* is simply a permanent loan that pays off a construction loan.

It's that simple. You build an office building with an *uncovered* construction loan; i.e., the lender does not require a forward takeout commitment. The building is completed. You shop around, now that the property is completed (standing) and leased, and you find a conduit that will give you a takeout loan to pay off your commercial construction lender.

Do not confuse a takeout loan with a *forward takeout commitment*. A forward takeout commitment is just a very expensive letter that promises to deliver a takeout loan in the future if the property is built according to plans and specifications and leased at the target rental rate. The typical forward takeout commitment will cost a developer one to two points, plus at least one additional point if the loan every funds.

There is so much construction money available today that very few commercial construction lenders require forward takeout commitments anymore. And when the project is completed, there are hundreds of hungry lenders who will give a developer a takeout loan to pay off his construction loan.

DEBT SERVICE COVERAGE RATIO

Will the Property Be Able to Carry the Payments?

Debt service is just a fancy term for your mortgage payments. We are just talking about principal and interest here, not taxes, insurance, or other impounds. Just remember debt service means your annual mortgage payments.

The *net operating income* of the property is just the income left over after operating expenses - like taxes, insurance, repairs, and management - and after setting a little aside every year to cover vacancy losses, collection losses, and replacements, like replacing roof or heater.

So will the net operating income property be able to *cover* the payments? Will the property just barely be able to cover the payments or will there be plenty of net operating income left over?

To compute the *debt service coverage ratio* simply divide the annual net operating income by the annual debt service (mortgage payments).

If the answer is less than 1.0, you are in big trouble. The property doesn't generate enough income to make the payments. Yikes!

If the debt service coverage ratio is 1.0, you are at *break even cash flow*. That's not enough for most lenders. Most lenders want a cushion. The net operating income has to be sizably larger than the proposed debt service.

Most commercial construction lenders will require a debt service coverage ratio of at least 1.25, based on the appraiser's estimate of future rents and expenses.

Fortunately, most proposed properties cash flow very well these days because of record low interest rates. Normally you will run into a loan-to-value ceiling before the debt service coverage ratio requirement becomes a problem.

NET-WORTH-TO-LOAN-SIZE RATIO

In a Perfect World the Developer's Net Worth Should Be as Large as the Construction Loan

Historically commercial construction lenders have required that a developer's net worth be at least as large as the construction loan that he is requesting. In a perfect world, if the developer is applying for a $5 million construction loan, he should have a net worth of at least $5 million. Fortunately commercial construction money is so plentiful today that many construction lenders are relaxing this requirement.

The test that commercial construction lenders apply is the *Net-Worth-to-Loan-Size Ratio*. Simply divide the net worth of the developer by the loan size. This result should be greater than 1.0. During recessions, banks will often require this ratio to be as high as 1.5.

What if there are several members of the development company with a decent net worth, but none of them alone satisfies this test? Answer: You can combine the net worth of the developers.

Commercial construction money is immensely plentiful today, so lenders are relaxing the Net-Worth-to-Loan-Size Ratio. How low will they go? Nothing is written in stone, but some commercial construction lenders may consider a Net-Worth-to-Loan-Size Ratio as low as 0.75.

But if the developer's net worth is not even 75% of the commercial construction loan that he is requesting, then the loan request is seriously flawed.

12/30/04

COMMERCIAL MORTGAGE FINANCING AND MEZZANINE LOANS

Mezzanine loans on commercial properties are becoming increasingly popular. Mezzanine lenders reported zero losses on mezzanine loans. Mezzanine loan rates are falling.

A mezzanine loan is a form of commercial loan used to finance a large commercial properties - typically tall office towers, large hotels, shopping centers and industrial parks.

Mezzanine loans are large loans, typically at least $3 million. They are generally placed behind large first mortgages of at least $8 million. Few institutional mezzanine lenders will consider mezzanine loans of less than $3 million, although a handful of expensive hard money lenders may consider mezzanine loans as small as $1 million.

For the sake of simplicity, you can think of a mezzanine loan as a form of second mortgage (although there are some important differences). Obviously you can't have a second mortgage without a first mortgage. You would never apply for a mezzanine loan in first position.

In the capital structure, the pecking order of priorities would be the first mortgage, followed by the mezzanine loan, followed by owner's equity in the property.

Mezzanine loans are different from mortgages in that the debt is secured not by a mortgage on the property, but rather by a security agreement against the owner's stock in the company that owns the property. If the borrower doesn't make his payments, the mezzanine lender will simply foreclose on the stock of the corporation or the membership interests of the LLC that owns the property.

Rates on mezzanine loans have fallen sharply this year as more mezzanine lenders have entered the market. Last year a mezzanine loan could easily have cost the borrower 18% and 2 points. Today most lenders are quoting 11% to 12% and 2 points.

The reason interest rates on mezzanine loans are falling is because mezzanine lenders are not losing any money. At a recent conference of mezzanine lenders, every lender reported a foreclosure rate of zero!

01/03/05

WHY ARE COMMERCIAL MORTGAGE LOAN RATES NOT INCREASING?

Rates on Commercial Loans Have Increased Only Modestly Despite the Fed's Actions

Over the past nine months the Fed has increased the Federal Funds rate by 1.25%, yet commercial mortgage loan rates on CMBS quality deals have increased less than 25 basis points. Ten year Treasuries currently yield 4.2%, just a stone throw's from where they sat nine months ago. Gold fell by over $8 per ounce yesterday. What gives?

Clearly the markets are anticipating less inflation than the news services are suggesting. The forces of deflation remain strong, as $33 trillion in US debt must be serviced monthly. This huge debt service requirement sucks money out of the money supply at a rate almost faster than the Federal Reserve can create and the Federal government can spend. There is a huge anchor around the neck of the American economy, and the bond markets are anticipating a sharp slowdown.

01/04/05

WHY MOST COMMERCIAL LENDERS FORBID SECOND MORTGAGE LOANS

*Most Commercial Lenders Will Not
Allow the Seller to Carry Back a Second Mortgage*

Suppose your client is trying to buy a commercial property with a down payment of just 10%. His plan is to have the seller carry back a second mortgage on the commercial property equal to 15% of the purchase price. He will then try to get a loan from a commercial bank for 75% of the purchase price.

Unfortunately the plan will not work. Most banks and all CMBS lenders forbid second mortgages on the property at the time of the purchase. (Many CMBS lenders WILL allow a mezzanine loan, however.)

So why are second mortgages forbidden on the sale of commercial properties. The reason is because commercial lenders fear that the property owner, if cash gets tight, will use the repair money to make the payments on the second mortgage rather than to maintain the property.

A good solution is to have the seller carry back the second mortgage on another property owned by the buyer, say a rental duplex or a different office building.

01/05/05

INTERNATIONAL COMMERCIAL LOANS ARE EXTREMELY DIFFICULT

In 30 Years of Commercial Mortgage Finance
I Have Never Heard of an International Loan Closing

Every day I run across developers seeking commercial construction loans in Mexico or Poland or some other far-off locale. To the best of my knowledge, none of them ever get funded by American lenders.

The problem is one of taxation. If a Chinese bank based in Hong Kong were to make a big loan here in the states, the US government would levy a foreign lender tax of 30% of it's interest income! Most countries do the same to foreign banks trying to lend in their own country. (The way this problem is solved is that the Chinese bank starts a subsidiary bank here in the US and the subsidiary makes loans in the US.)

So if you are seeking a loan in Mexico, go to a Mexican bank. Go local. It's generally the right way to go.

01/06/05

COMMERCIAL LENDERS USE THE LOWER OF PURCHASE PRICE OR APPRAISAL

Commercial Lenders Base Their Commercial Loan on Sales Price, Not the Appraisal

Almost every day I see new commercial loan agents with commercial loan requests where they want to get 90% or 100% LTV financing because the buyer is buying the property for less than market. They are *dreaming!* If a seller can get $1,000,000 for his commercial property, he is NOT going to sell it for $800,000.

As far as 99.999% of all commercial lenders are concerned, the purchase price is the best indication of the fair market value of the commercial property. Your commercial loan will be based on the lower of the two - purchase price or appraisal.

01/09/05

MOST LARGE COMMERCIAL CONSTRUCTION LOANS NOW NEED A MEZZANINE LOAN PIECE

Large Commercial Construction Lenders Prefer to Be Less Than 80% Loan-to-Cost

In the old days, if a developer wanted to build a $40 million office tower or hotel, he merely had to contribute $4 million towards the total project cost (10%). Some bank would then make a commercial construction loan that was 90% loan-to-cost.

Modernly most large commercial construction lenders want to stay around 80% loan-to-cost. Eighty percent?! Does this mean that the developer has to cover 20% of the total project cost ($8 million in our example above)?

No. The way deals are getting done is that the developer contributes his normal 10% of the total project cost and then obtains a mezzanine loan (which resembles a second mortgage) for 10% of the project cost. A typical mezzanine loan today might cost 11% and 1-2 points going in, with possibly a 1 - 2 point exit fee.

THE SYNDICATION OF LARGE COMMERCIAL CONSTRUCTION LOANS

Commercial Construction Loans Over $10 Million Are Often Made By a Syndicate of Commercial Banks

Suppose a mid-sized commercial bank gets a $15 million commercial construction loan request from a commercial property developer who is important to the bank. Fifteen million dollars, however, is an awfully large commercial construction loan for a commercial bank with just $400 million in assets, but let's say the commercial construction loan request is a good one.

What might happen is that our mid-sized bank might lead a small syndicate of friendly competitors to make the $15 million commercial construction loan. The loan may be priced at prime plus 1.5% floating with a 7.5% floor and a loan fee of 1.5 points. The lead bank might then sell off participations to other banks at prime plus 1% floating with a 7% floor and a loan fee of 1 point. The lead bank might take $3 million of the $15 million deal.

The lead bank would then earn prime plus 1% floating and 1 point on it's $3 million portion and would also earn a lead lender's fee of 1/2% interest and 1/2 point on the entire $15 million. The lead lender would then be responsible for disbursing the progress payments and handling any foreclosure on the commercial construction loan.

01/11/05

PREPARING PRO FORMA OPERATING STATEMENTS ON COMMERCIAL PROPERTY

How to Get Commercial Financing on a Newly Purchased Commercial Property

Your client buys a commercial property at a foreclosure sale and moves his own company into the building. The building is run down, so your client fixes it up very nicely. Then he wants to pull out his cash by refinancing the commercial building and obtaining a larger commercial mortgage loan.

The commercial bank to whom you have taken his commercial mortgage loan request asks for a pro forma operating statement, but you have a problem. Because your client has owned the property for just four months, you have no operating expense history on the building. What do you do?

The answer is to simply assume the commercial building is leased on a triple net basis. Just assume the tenant pays all of the expenses, except for reserves and management.

You can simply pull a figure out of the air and declare it to be the fair market triple net rent for the property. (The appraiser hired by the bank will eventually determine if your guess was accurate.) Take off 5% for Vacancy and Collection Loss to arrive at the Effective Gross Income. Then deduct, say, 4% of the Effective Gross Income for management and another 3% for Reserves for Replacements.

Voila! You have just produced a Pro Forma Operating Statement on a commercial property with no operating expense history. Sneaky and cool, huh?

HOW TO GUESTIMATE A COMMERCIAL TRIPLE NET LEASE RATE

What's a Fair NNN Rent for a
Commercial Property to Get Commercial Financing?

You are a commercial mortgage broker or a commercial mortgage banker. You are seeking a new commercial mortgage loan on an owner-used commercial property. The owner's tool company occupies the commercial property. You need to prepare a pro forma operating statement in order to apply for a commercial mortgage loan, but you don't know what lease rate to use.

No problem. Just work backwards from the commercial property's value. If you know the commercial property is worth $600,000, just assume a cap rate of 9%. Nine percent of $600,000 is $54,000 per year in net income, after operating expenses.

If we assume the property is leased on a triple net basis, then the only operating expenses are replacement reserves (say, 3% of effective gross income) and management (say, 4% of effective gross income). We therefore multiply the $54,000 in net operating income by 107% (3% plus 4%) to arrive at the effective gross income of $57,780.

The effective gross income is just the gross rental income less 5% for vacancy and collection losses. Finally, simply take $57,780 and divide it by 95% to get the triple net annual gross rental income of the commercial property!

01/26/05

COMMERCIAL FINANCING ON SMALL APARTMENT BUILDINGS

Are Loans on Fourplexes Considered Commercial Loans?

Fannie Mae and Freddie Mac will buy loans on homes, duplexes, triplexes, and fourplexes. These loans are referred to as one-to-four family dwellings. Loans on one-to-four family dwellings are usually not considered to be commercial loans.

However, if an apartment building has five or more units, a loan on such a property is usually considered to be a commercial loan.

The terms "commercial loans" and "major loans" are often used interchangeably by banks. The same loan officers who make the commercial loans for the bank also make the major loans. Major loans includes not only commercial loans, but also land development loans and residential subdivision construction loans.

01/31/05

PREPAYMENT PENALTIES ON COMMERCIAL MORTGAGE LOANS

*If You Try to Pay Off a Commercial Mortgage Loan
Your Penalty Might Be 20% of the Balance!*

Most commercial mortgage lenders making fixed rate commercial mortgage loans charge a prepayment penalty. The reason why is because the investors who buy commercial mortgage backed securities (CMBS) want a certain yield that is locked in. Why? Imagine you are a pension plan making actuarial projections to be sure you have enough money to pay your retirees. You need to know that you will earn a certain amount of interest. This is why you buy commercial mortgage backed securities.

The most common form of prepayment penalty is a defeasance formula. The legal definition of defeasance is, "A provision in an instrument that nullifies it if certain acts are performed."

When a borrower wants to pay off a fixed rate commercial mortgage loan, he must perform an act; i.e., he must give to the lender a bundle of U.S. Treasuries that provides the lender with the same stream of interest payments and the same balloon payment as the original mortgage.

Buying and assembling these U.S. Treasuries is immensely expensive, often on the order of 15% to 20% - and sometimes 25% - of the principal balance on the loan! Watch out for loans with a defeasance prepayment penalty.

02/09/05

UNDERWRITING COMMERCIAL CONSTRUCTION LOANS

A Developer Usually Has to Contribute 20% of the Total Cost of a Commercial Project

Suppose a developer wants to build a commercial project, say a large retail center. The commercial construction lender, typically a bank, is not going to cover 100% of the costs and take all of the risk. The developer has to have some skin in the game.

In order to get construction financing on a commercial project, the developer is typically required to cover 20% of the total cost of the project. This contribution often takes the form of equity in the land. Since the land usually represents around 20% of the value of an improved property, the bank usually wants the developer to contribute the land free and clear of any mortgages.

Many times, however, the developer may have a small mortgage on the land, and the developer's equity may take other forms. He may have paid for all of the architectural and engineering work out-of-pocket. His own construction company may have graded the property. Finally, the developer may be required to simply bring cash into the deal at closing. For example, Blackburne & Brown recently approved a $2 million construction loan on a condo project. One of the conditions of this commitment was that the developer had to bring in $250,000 in cash at the closing.

02/14/05

THE ABUNDANCE OF COMMERCIAL MORTGAGE MONEY

*MBA's Commercial Real Estate Finance Conference
Revealed Overflow of Money*

I just returned from the Mortgage Bankers Association's annual conference on commercial mortgage finance. This year's conference was held in the fabulous Gaslamp District of San Diego. I came away stunned by the amount of money chasing commercial mortgages.

And the lenders were really rolling out the red carpet for commercial borrowers. One company was offering 25 year fully-amortized commercial mortgages for no points, no appraisal fee, no toxic report fees, and no closing costs. You'll find this lender on C-Loans.

Another lender was a huge residential mortgage banker that had just entered commercial. They were packaging commercial mortgages in the same fully-documented style as home loans destined for sale to FNMA. The impressive thing about this giant was that they already had an installed base of 20,000 residential mortgage brokers.

One lender was offering no income verification, no asset verification commercial mortgages at rates only 75 basis points higher than normal bank commercial mortgages.

Never in the history of commercial mortgage finance has so much money been chasing commercial mortgages.

02/16/05

THE BIG YEAR AHEAD FOR COMMERCIAL MORTGAGE FINANCE

Commercial Mortgage Loans Written
Ten Years Ago Are Ballooning

Ten years ago over $25 billion worth of CMBS loans (Commercial Mortgage Backed Securities) were written, and these older loans are now maturing.

Another wave of CMBS loans, with five-year lock-out clauses (which prohibit prepayments), are now free to prepay. Even though these loans are still subject to a painful defeasance prepayment penalty, experts say that 10% of them will still prepay, typically in the 4th through the 7th year.

As a result, CMBS lenders expect a banner year.

02/16/05

THE COMMERCIAL FINANCE TERM "STANDING PROPERTY"

A Standing Property is the Opposite of a To-Be-Built Project

I was training one of my loan officers today and he asked, "When do I use a loan-to-value ratio and when do I use a loan-to-cost ratio?"

The answer is that it depends on whether this is a construction loan or a loan on a *standing property*. A standing property is obviously one that has already been built.

The loan-to-cost ratio is only used for development projects. Perhaps the borrower is a developer who wants to build an office building or a residential subdivision (housing tract). In this case the commercial mortgage underwriter would want to look at the cost of the project and make sure that the developer is contributing at least 20% of the total cost of the project. Put another way, the underwriter would want to make sure that the loan-to-cost ratio does not exceed 80%.

In contrast, if you are financing a standing property, then the only applicable ratio is the loan-to-value ratio.

02/28/05

WATERFALLS IN COMMERCIAL MORTGAGE BACKED SECURITIES

The Waterfall Determines Which Investor in a Commercial Mortgage Backed Security Gets Paid First

When commercial mortgage loans are securitized, they are assigned to a trust that assembles these commercial loans into a large pool of around $1 billion. The trust then sells bonds backed by the commercial loans in this pool.

But not every investor (bond buyer) gets the same yield. A nervous insurance company may be willing to accept a much lower yield in return for the right to be the very first lender to receive his principal and interest in the event of a shortfall. This Nervous Nellie insurance company may buy some of the AAA-rated bonds (the lowest risk "tranche").

A more aggressive bank may be willing to take more risk in return for a higher yield. This bank may buy some of the AA-rated bonds and would be second in line to be paid in the event of a shortfall.

The process continues until only the very risky "B-piece" remains. The bonds in the B-piece tranche are typically unrated, but they may offer a yield as high as 16% to 20%! Of course, if there are any losses in the pool, the first class of bonds to take the hit will be B-piece.

The procedure that describes which investor gets paid all of his principal and interest first, and then who gets paid second, third, fourth, etc., if there is any money left over, is known as the waterfall.

A waterfall can get quite convuluted in a structured financing deal where there is a mezzanine loan and some preferred equity behind a conduit (CMBS) loan. The rents come in from the property, and the first lender to be paid will be the conduit first mortgage.

Then the mezzanine loan piece might get paid a coupon rate of 10%. Next the preferred equity holders may be paid a 12% coupon, and then the owners may be paid up to 8% on their original downpayment, and finally any excess may be paid to the mezzanine loan lender.

The waterfall is the provision in the Intercreditor Agreement that details where the payments go.

03/01/05

UNDERSTANDING THE HARD COSTS OF A COMMERCIAL CONSTRUCTION PROJECT

Hard Costs Are the Brick and Mortar Expenses

The total cost of a commercial construction project includes the land cost, the hard costs, the soft costs, and the contingency reserve, which should be about 5% of hard and soft costs.

But what does the term “hard costs” mean? Included in hard costs are all of the costs for the visible improvements, line items like grading, excavation, concrete, framing, electrical, carpentry, roofing, and landscaping . Another way to describe hard costs are the “brick and mortar” expenses.

SOFT COSTS

Soft Costs Are the Non-Brick and Mortar Expenses

When underwriting a commercial construction loan, ther are four major categories of costs: the land cost, the hard costs, the soft costs, and the contingency reserve reserve.

The soft costs are the costs that you cannot visibly see. Soft costs include the architect's fees, the engineering reports and fees, the appraisal fee, the toxic report fee, any government fees - including the plan check fee, the cost of the building permit, any assessments, and any sewer and water hook-up fees - plus the financial costs, such as construction period interest and loan fees.

LAND COSTS

How Much is the Land Worth That the Commercial Property Developer is Contributing?

When underwriting a commercial construction loan, the commercial property developer will often say something like, "I only paid $400,000 for the land but it is actually worth $1,000,000."

As a general rule, a commercial property is only worth what the seller could get for the property. If the property really was worth $1 million, the seller never would have sold the commercial property for just $400,000. As a result, the wise commercial construction loan underwriter will only use the actual purchase price.

But there are exceptions. Suppose the commercial property developer bought the land while it was still zoned agricultural and successfully convinced the city or county to rezone the land for office or multi-family (apartments) use. In this case, the commercial property developer has added value to the land. In this case, even the conservative underwriter would be justified in using the new value of the land due to the successful zoning change.

Another exception would be if the commercial property developer purchased the land a number of years earlier or if the developer had the land under an option contract for several years and the value of real estate in the area appreciated sharply in the meantime.

Generally commercial construction lenders want the commercial property developer to bring the land to the deal free and clear of any liens. If there is a mortgage on the land, the commercial construction lender will usually ask the commercial property developer to contribute enough additional cash to the deal so that the commercial property developer is covering at least 20% of the total cost of the commercial construction project.

03/27/05

THE CONTINGENCY RESERVE

Use 5% of Hard and Softs Costs

When underwriting a commercial construction loan request, the wise commercial mortgage underwriter will analyze all four of the major elements of the total construction cost. The major elements are the land cost, the hard costs, the soft costs, and the contingency reserve.

In any commercial construction process, there are always cost overruns. The contingency reserve builds in a cushion in the commercial construction budget to cover these cost overruns.

What is the proper formula for computing a contingency reserve? There is nothing written in stone. I have seen underwriters use 10% of hard costs, but the formula I find the most logical is 5% of hard and softs costs.

Why not include the land cost in the above formula? The land cost is usually known in advance and is fixed. It is unlikely that there will be a cost overrun connected to the purchase of the land itself.

Now of course the cost of grading, excavating, or cutting the roads may be higher than the commercial property developer has budgeted for, but each of these costs are part of hard costs.

03/27/05

BLANKET COMMERCIAL LOANS

Commercial Mortgage Lenders
Usually Prefer Not to Blanket Several Properties

I saw a commercial loan application on C-Loans recently for $10 million loan where the commercial mortgage broker was trying to obtain a blanket loan over 10 different commercial properties owned by the same borrower but spread out all across town.

A blanket loan is one where there is just one promissory note (I promise to pay $10 million ...), but the note is secured by several different mortgages on several different non-contiguous parcels. If the parcels were contiguous (touching), it is customary for the lender to use just one mortgage and to include each of the contiguous parcels in the legal description of the property. Where the properties are clearly different and separated from each other, it is customary to use a separate mortgage for each separate property.

So why would a borrower want to get a blanket mortgage? He might think that he is saving money on closing costs by making the loan just one big deal. In addition, the larger the commercial loan, the slightly lower the interest rate.

But commercial lenders in general do not like to blanket properties, especially if the properties have different uses. Few commercial mortgage lenders would jump at the opportunity, for example, to make a blanket loan across an apartment building and an office building. This is especially true if the commercial mortgage lender loved apartment loans but hated office building loans becasue they are over-built, or vice versa.

Blanket commercial loans are messy and complicated. They are also very difficult for a commercial mortgage lender to re-sell in the secondary market. Certainly conduits and life companies would rarely make a blanket loan. Most banks would pass as well.

Some commercial mortgage lenders will indeed blanket different properties, but they will usually only do so if they feel insecure. Certainly hard money lenders and the occasional bank, lending for its own portfolio will consider a blanket loan. The most common blanket loan you will see, however, is one where the commercial mortgage lender blankets the borrower's personal residence.

So if you get a request for a blanket commercial mortgage loan, be smart. Split the deal up into several smaller loans.

SINGLE ASSET ENTITIES

Most Large Commercial Lenders
Prefer Properties to be Owned by a Single Asset Entity

A single asset entity (SAE) is usually a limited liability company (LLC) that owns only one commercial or multi-family property. You will often see Subchapter S corporations formed to own a single property, especially in New York where a New York state court case from the 1970's imputed personal liability to the owner when a tenant was injured. A regular C-corporation or a limited partnership will sometimes be formed to hold title to commercial property, although the limited liability company (LLC) is now far more common.

The reason why major commercial mortgage lenders prefer SAE's is because if the borrower files a personal bankrupty, perhaps as a result of a traffic accident, the commercial mortgage lender is not "stayed" (ordered to refrain) from commencing or completing its foreclosure.

03/29/05

SMALL BUSINESS LOANS

The SBA Does Not Guarantee Loans on Mixed Use Properties

Today a C-Loans user wrote to us that C-Loans was totally worthless and a waste of his time. He had applied for an SBA loan on a mixed use property, and he was immensely frustrated when the C-Loans system could not suggest a single suitable commercial lender.

A mixed use property is one that has both a commercial component and a residential component. The most common example can be found in inner cities, where there will be a storefront on the ground floor and maybe one or two apartment units on top.

The reason why no commercial lenders appeared for this frustrated user is because the SBA does not guarantee loans on mixed use properties.

Mixed use properties are classified as investment properties, and the SBA is not chartered to help investors become more wealthy. Instead the SBA is chartered to help small businesses grow and hopefully hire more workers.

COMPUTING THE INTEREST RESERVE

The Interest Payments During Construction
Come Out of an Interest Reserve

Let's suppose you are building an apartment project, and you paid cash for the land. You therefore own the land free and clear.

You then obtain a $2 million commercial construction loan from your bank. The grading subcontractor finishes removing the tree trunks and grading the property. He hands you an invoice, which you hand over to the bank. The banks sends a progress inspector out to verify that the grading has been done and then pays the invoice. Let's further suppose the bank pays the concrete subcontractor and then the rough carpentry subcontractor later that month.

Guess what? At the end of the month, the commercial construction lender (your bank) is going to demand an interest payment (7% annual rate) on the funds they have already advanced! You owe interest on the construction loan during construction. "But George, I don't have any more money. I spent every dime I had to buy the land, and the property isn't generating any rent yet!"

The interest on the construction loan during construction is paid out of an interest reserve, which is a special savings account funded out of the proceeds of the construction loan. Think of your interest reserve as one of the line items in your construction cost budget, like the Finish Electrical Cost or the Sewer Hook-up Fee. As long as you can complete your apartment building and get good tenants paying rent before your interest reserve runs out, you are golden.

How do you compute the amount of money that needs to be set aside in the interest reserve? At the moment that the construction loan funded, you had not yet drawn down a dime. By the end of the construction term, say one year, you will almost certainly have drawn down the entire construction loan amount. Roughly, therefore, on average, about 50% of the loan funds will have been drawn down.

Therefore to compute a reasonable interest reserve, simply take the construction loan amount ($2 million) times the annual interest rate (7%) times the term of the loan (1.5 years). Then, since on average only 50% of the construction loan will be outstanding, you multiply the total interest cost by 50% to get a reasonable estimate of the interest reserve.

On large projects construction lenders will prepare a Construction Loan Budget, complete with a Schedule of Disbursements, on a spreadsheet. The lender will then compute the actual anticipated interest expense and use this figure in the Interest Reserve.

On smaller projects, however, the construction lender will merely assume that only 50% to 60% of the construction loan on average will be outstanding.

USING MEZZANINE LOANS AND PREFERRED EQUITY

Mezzanine Loans and Preferred Equity Are Used to Achieve High Leverage

Mezzanine loans and preferred equity investments only come into play on very large commercial projects. Lenders will seldom make mezzanine loans and preferred equity investments on commercial projects worth less than $15 million.

Mezzanine loans and preferred equity investments are used to achieve very high leverage on large commercial projects. Normally conduits, banks, and life companies will not exceed 80% loan-to-value when making commercial mortgage loans. Mezzanine loans and preferred equity investments are stacked on top of big construction loans or a big permanent loans to achieve loan-to-cost ratio's as high as 95% and loan-to-value ratio's as high as 90%.

A mezzanine loan is a loan secured by the membership interests of a limited liability company (LLC) that owns a commercial property. If the LLC fails to make it's payments, the lender quickly does a UCC foreclosure (a fast process) on the stock. If the lender owns the stock, it owns the commercial project as well.

A preferred equity investment sounds quite different than a mezzanine loan, but it accomplishes almost the exact same thing. The lender makes an investment of equity with a preferred return in the LLC that owns the big commercial project. If the managment of the LLC fails to pay the preferred member the promised return, the old managment is ousted and the common members of the LLC (the former owners) lose their voting rights, dividends, and right to the distribution of any profit.

Why would a lender make a preferred equity investment rather than a normal mezzanine loan? Some permanent loan documents prohibit mezzanine loans, so the lenders are forced to make a preferred equity investment.

04/26/05

WHEN PREFERRED EQUITY DOESN'T GET PAID

Preferred Equity is Like a Mezzanine Loan in Sheep's Clothing

The preferred equity member in an LLC is a member, whose rights are guided by the LLC Agreement. The agreement will dictate what happens if the preferred return is not paid. Sometimes the preferred return HAS to be paid (like interest on a mezzanine loan), other times it could be accrued or paid when available.

If it has to be paid, and is not, this will trigger a default under the LLC Agreement and afford the preferred equity member certain rights and remedies that may include some or all of the following: (1) immediate replacement of the GP with a new GP of its choosing; (2) adjustment of the ownership percentages within the LLC to give the preferred equity member a higher ownership share and/or a higher preferred rate; (3) the unpaid preferred distribution becomes a high-rate partnership loan from the preferred equity member to the LLC which may have a due date or not.

There is no foreclosure procedure; the change is automatic as dictated by the LLC agreement. This is sometimes the reason why some lenders are choosing to making preferred equity investments rather than mezzanine loans, but there are usually other factors involved as well.

INTERVIEWING THE DEVELOPER

The Wise Mortgage Banker Asks the
Right Questions Before Investing Too Much Time

Suppose a developer begins his search for a commercial construction loan. His construction lender or commercial mortgage banker will have some important early questions. The wise developer will be prepared for them.

Applicant-Developer Initial Questionnaire

- What is the reason, if any, that local bank financing could not be obtained?
- Who else are you working with and why can't they get your project funded?
- Do you have a previous background in developing this size and type of project before?
- Do you have an independent, third party feasibility study that says that this development is a good idea?
- Do you have control of the land, by what means, and for how long?
- What are the total hard and soft costs for all phases (in USD)?
- How much of your own money have you put in or are going to put into this project?
- What is the combined net worth of all Principals who own at least 10% of the project? How much is liquid?
- Will all Principals provide current Personal Financial Statements? Will they guarantee the loan?
- Do you have all government approvals? What approvals remain?
- Do you have preliminary architectural drawings?
- What is the name of the project? What is the location?

05/03/05

CONDO CONVERSIONS INVOLVE ENTITLEMENT RISK

There is No Guarantee the Condo Map Will be Approved

When a developer buys an apartment building and wants to convert it to condo's, there is significant amount of ***entitlement risk***. Entitlement risk is the risk that the various government agencies with jurisdiction will not issue the required approvals for the construction project to proceed.

A Condo Map, a Tentative Map, a Condo Declaration, and a Subdivision Map all mean the same thing when you are talking about a condo conversion project. The entitlement risk associated with a condo conversion is the same as getting a tentative map approved on a subdivision that has zoning. The risk is unique to the jurisdiction of wherever the deal is, like any political risk.

If the apartment project is zoned for condominiums, recording a subdivision map and getting DRE approval to sell units is a matter of timing risk.

But there is some Political Risk associated with condo conversions. Generally the Political Risk involves market/subsidized rental housing advocates challenging the rental supply with conversion approvals but before the planning commission vote.

Certain jurisdictions permit conversion without public forum approval. Again, this is a geographic political thing.

COTERMINOUS LOANS

A Loan That is Coterminous Matures
on the Same Date as the Senior Loan

Suppose you are making a $3 million mezzanine loan or second mortgage on an office tower. How long should the term of the junior loan run?

Many mezzanine lenders and second mortgage lenders schedule their loans to mature on the same date as the first mortgage. Then, when the first mortgage balloons, the commercial property owner can refinance both the first mortgage and the junior loan at the same time with a new, larger first mortgage.

When a junior loan matures on the same date as the senior loan, the junior loan is described as ***coterminous***.

COMMERCIAL FINANCING AND C.V.'S

Construction Construction Lenders
Carfully Review a Developer's Curriculum Vitae

Curriculum vitae is latin for course of life, and in practice a CV is more than just an employment resume. A good CV will include, in addition to the developer's educational and employment history, a list all of the projects completed by the developer and any related construction expereince.

The commercial construction lender will look carefully at the developer's CV to verify that the developer has had prior experience developing the type of real estate project in question. If the developer lacks experience, he will need to hire an unusually experienced general contractor with a very impressive track record.

A good construction loan package will contain a CV on both the developer and the general contractor.

LAND DEVELOPMENT FINANCING AND HORIZONTAL IMPROVEMENTS

Before Construction of Any Buildings
the Horizontal Improvments Must Be Near Completion

You will often hear commercial construction lenders and commercial property developers use the term horizontal improvements in connection with land development loans.

The horizontal improvements include any zoning changes, the subdivision map, clearing the ground, cutting the roads, installing the utilities (water lines, sewer lines, power lines, cable TV lines, etc.), and paving the roads, sidewalks and gutters.

At this point a land developer will often sell off the homesites or commercial pads. A pad is a fully-improved site for a commercial building; i.e., it already enjoys streets, gutters, sidewalks, and utilities.

06/03/05

AMORTIZATION SCHEDULES FOR COMMERCIAL MORTGAGE LOANS

Most Commercial Mortgages are Amortized Over 25 Years

In the commercial mortgage financing world, most commercial mortgages are amortized based on a 25 years schedule. In contrast, home loans are fully-amortized over 30 years. If the commercial property is older than 35 years old, a bank may choose to amortize the loan over just 20 years.

Commercial mortgage loans are seldom fully-amortized. Typically they are partially amortized over a 20 to 25 year schedule and have a term of either 5 years or 10 years. A ten year commercial mortgage loan is considered a very long term commercial loan.

The typical borrower will be very unhappy if the commercial mortgage lender insists on amortizing his commercial loan on his older property over just 20 years. The problem is not just the fact that the borrower's payments will be higher. The shorter amortization schedule will also reduce the size of the loan for which the borrower can qualify.

06/04/05

COMMERCIAL FINANCING, UNITS, DOORS, AND KEYS

In the Vernacular of Commercial-ese Keys and Doors Mean Units

A commercial property developer may sometimes refer to a 200-unit apartment building as a multi-family project with 200 doors. It means the same thing. The slang term, “doors”, is used in connection with apartment buildings.

A hotel developer may describe a 200-room hotel as a hotel with 200 keys. The need for the term keys arose when hotels started to contain more suites. A suite has two or more rooms, so use of the term rooms in connection with a hotel became confusing. A hotel with 160 regular rooms and 40 suites would be described as having 200 keys.

COMMERCIAL FINANCING AND FLAGGED HOTELS

A Flagged Hotel is One That Belongs to a National Franchise

Hotel and motels are either flagged or unflagged. A flagged hotel is one that belongs to a nationwide franchise, like a Hilton or a Holiday Inn.

Flagged (franchised) hotels have the advantage of a uniform standard of appearance, cleanliness, layout, room sizes, relative pricing, and amenities (pool, restaurant, exercise room, etc.). Business travelors frequently use the same hotel franchise whenever they travel to a new city. For example, this author usually stays in a Hilton Hotel.

Fagged hotels enjoy the benefit of a nationwide reservation system. A business travelor can call Holiday Inns, for example, and find a Holiday Inn in almost every major city in America.

A hotel franchise costs money. A franchisee might pay 8% to 10% of its room rents to the franchisor for the use of the name, group buying power, and national advertising.

It is such an advantage for a hotel to be flagged that many commercial mortgage lenders will not lend to unflagged hotels and motels.

COMMERCIAL FINANCING AND THE UNIT MIX BREAKDOWN

A Unit Mix Breakdown Gives the Lender a List of Each Type of Unit

Commercial lenders will sometimes ask for a unit mix breakdown. A unit mix breakdown lists the number of each type or size of unit, along with the rent sought or being receiving from this type or size of unit.

For example, if we talking about an apartment building (multifamily project), a unit mix breakdown might lay out for the lender that the project has 35 2-bedroom, 2-bath units renting for $425 to $510 per month plus 75 2-bedroom, 1-bath units renting from $390 to $450 per month, and 12 studios renting for $300 to $345 per month.

If we were talking about a ministorage project (self storage project), the unit mix breakdown might reveal that the project has 120 10x12 units renting for $100 per month and 65 5x12 units renting for $60 per month.

Why would a lender care? In a soft apartment market, 2 bedroom, 1-bath apartment units might not be in demand. The lender may elect not to finance a building with an unfortunate mix of units.

06/08/05

COMMERCIAL REAL ESTATE FINANCING AND THE DEBT SERVICE COVERAGE RATIO

The Custom is to Express the DSCR to One-Hundredths

In commercial mortgage underwriting, the debt service coverage ratio (DSCR) is customarily computed to two places to the right of the decimal point.

In other words, a debt service coverage ratio of 1.346 would be rounded to 1.35. A debt service coverage ratio of 1.1 is customarily expressed as 1.10.

Interestingly, a breakeven cash flow is customarily shown on the Executive Loan Summary as 1.0 - notwithstanding the custom to express a DSCR to two places to the right of the decimal point.

One of our new loan officers recently expressed a DSCR as one-point-twenty-seven. Oops. Busted. She just revealed to her lender that she is a rookie. She should have said one-point-two-seven.

06/13/05

INTEREST-ONLY CONDUIT LOANS

*Hungry Conduit Lenders Are Now Making
Commercial Loans With No Amortization*

A prudently underwritten commercial mortgage loan normally has a 25 year amortization. If the commercial property is older than 25 years old, it used to be quite customary for a commercial mortgage lender to insist on an amortization schedule of just 20 years. This increased the monthly payments and usually resulted in a smaller loan.

Several years ago the big conduit lenders, however, in a desperate attempt to win more commercial loan business, started to offer commercial mortgage loans that were interest-only for the first year and then amortized over 25 years thereafter. And they got away with it. Although the rating agencies complained a little bit, these loans were allowed into the securitized pools.

Then some conduit lenders last year started to offer loans that were interest-only for TWO years and then amortized over 25 years thereafter.

Now some conduit lenders are making commercial loans that are interest only for the first THREE or FOUR years! It's arguably foolhardy, and some bond holders will eventually suffer for it, but these interest-only conduit loans are now becoming commonplace.

06/13/05

UNDERSTANDING CONDUITS

What is a Real Estate Mortgage Investment Conduit?

A conduit is short for a REMIC, which is the acronym for a Real Estate Mortgage Investment Conduit.

About ten years ago Congress passed a law that said if a bunch of commercial mortgages were contributed to a trust, and the trust did not make new mortgages or modify the old ones, the trust could then issue bonds backed by the mortgages in the pool and the trust would not have to pay income taxes on the mortgage income. Only the bondholders would have to pay taxes on their interest income.

This new tax law was huge. In effect, it created the wonderful commercial mortgage securitization market that thousands of commercial borrowers now enjoy. The trust described above is the REMIC; i.e., the conduit through which securitized commercial mortgages now pass tax-free.

However, in the venacular of the industry, the mortgage bankers or investment banks that originate the commercial mortgages that go into the REMIC's are now called conduits or conduit lenders.

OPTION AGREEMENTS

When an Option Expires, the Party is Over

Suppose you are a commercial mortgage broker. You are working on a commercial mortgage loan for a guy who has an option to buy a commercial property. You must not let that option expire by even one minute!

The drop-dead-date in an option agreement to purchase commercial property is just that - if your commercial property buyer does not close by the time prescribed in the agreement, the optionee (your buyer) is dead. The seller does not have to sell!

Suppose your commercial borrower has been leasing an office building for ten years. The lease contains an option to buy the property for $600,000. Over the years, partly because your commercial borrower put $200,000 in renovations into the property, the value of the commercial property has increased to $1 million. Remember, the optionor is not an idiot. He really-really doesn't want to sell his $1 million building for just $600,000.

Further suppose the commercial borrower comes to you for a commercial mortgage loan with just 35 days to run on his option agreement. You and he have a BIG problem. If your commercial mortgage loan does not close within 34 days, 23 hours, and 60 minutes - your commercial borrower is toast! The commercial property owner has every right to refuse to sell that $1 million property for $600,000.

Option dates are DROP DEAD dates. Do not miss them!

ENTITLEMENT RISK

Entitlement Risk is the Risk That the Government Will Never Let You Build

Commercial mortgage brokers and commercial property developers frequently come on to C-Loans.com and apply for a land development loan to pay for an environment impact report or a traffic study or to draw up preliminary plans or to finance the cost to apply to the city or county for a zoning change or a change to the master plan.

In other words, the developer does not yet have preliminary approval to build. In many cases, the government will never allow the proposed project to be built. Perhaps the project will create too large of a traffic snarl. Perhaps the neighbors will demonstrate at the planning commission meeting saying, "Not in my backyard!". Perhaps the triple breasted golden butterfly makes its only breeding ground on your land. A million obstacles could arise to prevent the developer from receiving preliminary government approval.

As a result, institutional and even hard money lenders will rarely take on "entitlement risk", the risk that the government will never allow you to build.

In order to get the funds required to obtain preliminary government approval, the developer will either have to use his savings, borrow against other assets (rental houses, his office building, etc.), or go to private investors to raise equity dollars. An investor who contributes equity dollars becomes a part owner, and the equity holders are the first ones to suffer a loss if the project heads south. Hence equity dollars can often cost 35% or more annually.

CHAPTER 11

It is Possible to Finance a Project in Bankruptcy - But Only With the Court's Permission!

Suppose the Jones family is in the business of manufacturing widgets. The Jones family owns the industrial building occupied by Jones Widgets, Inc. The property is worth $1 million.

Suppose further that Hometown Bank has an existing $400,000 first mortgage on this industrial building, and the loan has matured. The Jones family therefore has to obtain a new first mortgage to pay off the $400,000 balloon payment.

Peter Jones therefore applies to First National Bank of Hometown for a new loan to pay off the balloon. Several months go by, and the maturity date comes and goes; but Mr. Jones assures Hometown Bank that his refinance is almost completed.

Suddenly, for no justifiable reason, First National Bank of Hometown decides not to make the loan. (Peter Jones' teenage boy dated the daughter of the president of First National and broke her heart.)

Now Peter Jones is in trouble. Hometown Bank has foreclosed, the foreclosure sale is in one week, and he is in danger of losing a $1 million property for a lousy $400,000 loan!

Fortunately the government has a procedure where creditors (lenders) can be held at bay while a solvent family or business rearranges its finances. This procedure is called a Chapter 11 Reorganization Bankruptcy. While filing bankruptcy will smear the credit and good name of the Jones family, it sure beats losing $600,000 in equity.

Now the $24,000 question. Can the Jones family get a loan to pay off Hometown Bank while they are in a Chapter 11 Bankruptcy? The answer is yes, as long as they get the court's permission.

While a debtor, here the Jones family, is in a Chapter 11 Bankruptcy, they are no longer the legal owners of their assets. Those assets are owned by the bankruptcy court trustee in trust for the unpaid creditors. Fortunately the Jones family gets to keep living in their home, driving their cars, and Jones Widgets, Inc. gets to stay in the industrial building while the Jones family is in Chapter 11 Bankruptcy. This is because there is a presumption that the Jones family will be able to sell off some of their assets and pay all of their creditors. Therefore they get to keep their stuff ... at least for awhile. They are called debtors-in-possssion (of the assets).

While a hard money commercial mortgage lender (like Blackburne & Brown 574-936-6387) would be happy to make a $400,000 loan on a $1 million building to pay off Hometown Bank, Peter Jones no longer has title to the industrial building in order to give the lender first mortgage title.

But all is not lost. The hard money lender merely issues a commitment letter that the Jones attorney will take to the bankruptcy court. The court will smell the deal, make sure that there is enough money to pay everyone, and then give it's legal blessing (in the form of an order). The Jones attorney will give a copy of the order to the hard money lender and the title insurance company, and the hard money mortgage company will make the loan.

07/28/05

COMMERCIAL LOANS WHERE THE SELLER IS GIVING THE BUYER CREDITS

The Sales Price of a Commercial Property May Not Be the Sales Price

Let's say a commercial mortgage lender will make commercial loans up to 80% of the sales price. What if the seller of the commercial property and the buyer agree as follows: "The sales price of this commercial property is $1,000,000 but the seller will give the buyer $100,000 credit towards the purchase price because the roof is old and in need of replacement."

Can the buyer of this commercial property obtain a new commercial loan of $800,000? After all, the purchase price is $1,000,000 and 80% of $1,000,000 is $800,000. The new commercial loan is 80% loan-to-value, right?

No-no-no! These credits for deferred maintenance on a commercial property are just smoke and mirrors. "I'll sell you my commercial property for $1 million but you only have to give me $900,000." Helloooo? What is the real purchase price? Nine hundred thousand dollars, right?

A loan of 80% LTV on a $900,000 purchase price is just $720,000. Don't get fooled by credits for deferred maintenance.

08/05/05

UNDERWRITING COMMERCIAL LOANS ON HOTELS

Commercial Lenders Will Lend
Up to 65% to 70% LTV on Hotels

Commercial mortgage lenders are hungry for commercial loans on flagged hotels these days. Occupancy levels are historically very high right now because most new hotel construction ended on September 11th.

Typically commercial banks today will lend up to 60% of cost to build a new major-flagged hotel. Commercial developers will usually contribute 15% of the total cost and obtain a mezzanine loan for the balance.

Commercial banks will make permanent commercial loans on standing flagged hotels up to 65% to 70% of appraised value.

When underwriting a loan on a flagged hotel or even older, unflagged motel, here is a great rule of thumb:

Hospitality properties typically sell for around three times their gross annual rents. A motel bringing in $1 million a year in revenue will sell for around $3 million. If it is a gorgeous, newer hotel, it might sell for 3.5 times it gross annual income.

A disproportionate number of folks from India are in the hospitality business, and a great many of them have the last name of Patel. These folks are usually not related to each other. The word "Patel" simply refers to the state in India where they, or their parents, once lived. Many times their first names are very, very long. Using this custom, I might be called Georgeblackburne California.

08/08/05

LARGE COMMERCIAL CONSTRUCTION LOANS AND THE IMPORTANCE OF THE MARKETING TEAM

Commercial Construction Loan Underwriters
Look Carefully at the Marketing Team

If you are applying for a large commercial construction loan, be sure to include a CV (business resume), a nice color brochure, and a sales blurb on the brokerage firm you hire to market your condo's, office space, timeshares, or whatever. The underwriters who review large commercial construction loans will place a lot of weight on the team you have chosen to market the commercial space. It may be worth the extra money to hire a nationally renowned company.

Your loan package should include some sizzling words ("the sizzle") on the marketing team that might read as follows:

"Steamboat Plaza Associates has retained the nationally known company CB Commercial to market our innovative office condo project. Steve Jones has been the sales leader for the Denver branch of CB Commercial for three of the last four years. In the past four years Mr. Jones has successfully closed $345 million in commercial property sales. He will use a combination of print advertising, pay-per-click internet advertising, and his huge network of personal contacts in the investment community to move these office condo's quickly"

LAND LEASES

Commercial Land Owners Will
Sometimes Lease Their Land for 99 Years

Suppose Dr. Smith owns the hottest corner parcel in the city. The parcel is vacant, and Dr. Smith refuses to sell. "I'm saving it for my grandchildren," he tells every real estate broker who approaches him with a purchase offer.

Then an enterprising developer approaches Dr. Smith and suggests, "Hey, if you won't SELL me your land, will you at least lease it to me for the next 50 years?" Dr. Smith says, "Sure, the grandkids need the cash flow to pay for their college educations." So then the developer leases the land (land lease) for the next 50 years for, say, $2,000 per month.

Then - get this - the developer errects a nice new commercial building on the land that he doesn't even own. Helloooo? What happens to the building when the land lease expires? It reverts back to land owner, which by then will probably be the grandkids.

Is the commercial property developer crazy? Why build a brand new office building on someone else's land? Because the developer may be able to lease out the building for $30,000 be month. He might have only $10,000 per month in expenses, and after paying the $2,000 per month in land lease payments, he pockets the remaining $18,000 every month for the next 50 years! Maybe this commercial property developer is not so stupid after all.

Can the developer get a construction loan, and later a permanent loan, on this land that is on a land lease. Absolutely! Many banks will finance commercial buildings resting on land leases, as long as the remaining term of the land lease is 10 to 15 years longer than the amortization of their loan.

Obviously, the longer the land lease, the better from a lender's point of view. However, the longest legal land lease is for 99 years. If a land owner mistakenly leases his land for longer than 99 years, the courts will deem it an outright sale.

08/24/05

THE FOUR BASIC FOOD GROUPS

*The Four Basic Food Groups -
Multifamily, Office, Retail and Industrial*

If you need a commercial loan from a commercial mortgage conduit, you need to speak the lingo. In the language of commercial mortgage-ese, the four basic food groups are (1) multifamily (apartments), (2) office buildings, (3) retail properties (includes shopping centers, strip commercial centers, and free-standing retail store buildings), and (4) industrial buildings.

Generally conduits will usually only finance a commercial property if it is a member of the four basic food groups. Hotels, however, are hot right now and conduits are regularly making hotel loans.

Self-storage properties are sometimes in favor with conduits and sometimes out of favor. It may be possible to get a fully-occupied, newer self-storage project financed through a a conduit right now.

Health care properties - congregate care, assisted living, and convalescent hospitals - were once in favor with the conduits. They became over-built, however, about seven years ago and have been out of favor with the conduits ever since.

The main point today is the term, the four basic food groups. This includes multifamily, office, retail, and industrial.

BANKING RELATIONSHIPS AND ONE-OFF DEALS

One-Off Means a Single Occurance with Little Chance of Repeating

Suppose a dentist-borrower inherits an in-fill parcel from his father's estate and seeks a commercial construction loan to build 12 spec houses.

A busy banker looking at this deal might say to himself, "This is a one-off deal. If I make this guy a commercial construction loan, he'll probably never come back to me for another commercial construction loan. I'm really busy right now. I can't service everyone. I think I'll take care of the Joe Builder, the local developer, instead because if I develop a banking relationship with Joe Builder, he'll come back to me year-after- year for new commercial construction loans."

By the way, an in-fill parcel is a parcel where all of the surrounding parcels have been developed into completed condo's, apartments, strip centers or whatever. An in-fill parcel stands in contrast to a parcel located just outside of town where all of the surrounding parcels are still used for agriculture.

A spec project is one built on speculation with no pre-sales. A spec house therefore would be a house being built for immediate re-sale without a specific buyer in mind. The developer is speculating that he can find a buyer before the interest payments on the empty house or the empty building eat him alive.

So what should a borrower on a one-off project do if all of the local banks are too busy to handle his deal? One strategy might be to ask the bank for the name of the bank's favorite mortgage broker. The borrower could take the project to the mortgage broker and have the mortgage broker bring the deal to the bank. The mortgage broker is not a one-off client but rather a repeat source of business for the bank. While the borrower will have to pay the mortgage broker a brokerage commission, at least the deal will get done.

COMMERCIAL MORTGAGE BROKERS VS. COMMERCIAL MORTGAGE BANKERS

The Distinction Becomes Blurred in Commercial Mortgage Finance

A commercial mortgage broker is an independent loan originator who can take his clients' commercial mortgage loan requests anywhere. He is not a corresponent for any particular lender.

It doesn't take a lot of capital to establish a commercial mortgage brokerage operation. All a broker needs is a desk, a phone, a computer, a copier, and a fax machine. In fact many very successful commercial mortgage brokers work out of a bedroom in their homes.

In addition, most states do not require a license to broker commercial mortgage loans. As a result of this ease of entry into the business, at least ten thousand men and women become commercial mortgage brokers every year. They are ubiquitous (everywhere).

A borrower will use a commercial mortgage broker to help him locate the cheapest commercial mortgage loan in the marketplace for his particular deal. Since every commercial mortgage loan is slightly different from the next, and since just about every commercial mortgage loan has a black hair (flaw), many commercial mortgage borrowers in fact need the help of a commercial mortgage broker.

Commercial mortgage portals, like C-Loans.com, however, are making it easier and easier for commercial mortgage borrowers to find obscure but attractive commercial lenders on their own. This saves the cost of a loan brokerage commission that must often be paid to a commercial mortgage broker.

In contrast, a commercial mortgage banker requires a much larger operation. True commercial mortgage bankers either fund the deals using their own money and/or service the loans after the commercial loans are made.

The most common type of commercial mortgage banker is the life insurance company correspondent. A life insurance company (often abbreviated to life company) may be based out of Hartford, Connecticut but may be willing to make loans nationwide. Rather than set up expensive loan offices nationwide, the life company will often choose a local commercial mortgage banker in each of the major cities targeted by the life insurance company.

These commercial mortgage bankers will serve as the correspondents for the life insurance company. The word correspondent means, “One that has regular business dealings with another, especially at a distance.” Banks and life companies are very careful before designating any commercial loan originator as its correspondent because a lender is liable for the acts of its correspodents.

The local correspondent will enjoy an exclusive territory. If your property is in Los Angeles, for example, and you want to get a loan from Dog Catchers Life Insurance Company (imaginary company), your deal will be sent to the Los Angeles correspondent for Dog Life for underwritting. The Los Angeles guys know the L.A. market and will make sure the life company doesn’t end up making a loan in an economically-depressed war zone.

After the loan is made, the Los Angeles correspondent for Dog Life gets to service the loan for Dog Life for 12.5 basis points (one-eighth of a percent) annually. This doesn’t sound like a big deal at first, but 12.5 basis points on a $10 million loan is $12,500 annually just for collecting the payments.

Another type of commercial mortgage banker is the true CMBS (conduit) lender. The commercial mortgage banker will fund its loans using its own money and then hold the loans in inventory until it has enough loans to put them into a pool and securitize the loans.

Unfortunately many commercial mortgage brokers will masquerade as commercial mortgage bankers because they close the deal in their own names and then immediately - in the same escrow - sell the loan off to a long-term buyer. This is called table funding. Because the loan is sold off immediately, the commercial mortgage broker really doesn’t have his own money at risk. He is not really “banking” the loan.

This situation is so misleading that the State of California has actually made it illegal to table fund a commercial loan. So many commercial mortgage brokers were running around, boasting to the world that they were commercial mortgage bankers, taking good faith deposits (and keeping them), when they lacked true Loan Commitee authority, that the State of California put it’s foot down and banned the practice.

To further blur the distinction between commercial mortgage brokers and commercial mortgage bankers, many top level commercial mortgage finance executives, out of respect, use the term "commercial mortgage banker" to describe any commercial loan originator!

But to be precise, a commercial mortgage banker is one who either funds his loans using his own money (genuinely has money at risk) and/or who services the loan for his investor.

LIFESTYLE CENTERS

What is a Lifestyle Center Anyway?

In South Bend, Indiana, they have recently torn down an indoor mall to build a lifestyle center. The new lifestyle center looks like a college campus and sports about a dozen national stores and a half-dozen upscale national restaurants. Lifestyle centers make little sense to me because it is darn cold here in Northern Indiana in the winter, but lifestyle centers are all the rage.

Here is a definition of lifestyle centers:

Most often located near affluent residential neighborhoods, this center type caters to the retail needs and "lifestyle" pursuits of consumers in its trading area. It is an open-air configuration and typically includes at least 50,000 SF of space occupied by upscale national chain specialty stores.

Other elements help the lifestyle center serve as a multi-purpose leisure-time destination, including: restaurants and entertainment, design ambience and amenities such as fountains and street furniture that are conducive to casual browsing; and often one or more conventional or fashion specialty department stores as anchors.

THE CONCEPT OF EQUITY

*Equity Can Mean a Lot of Different Things
Depending on the Context*

The concept of equity is far more complicated than you probably think. But if you want to play in the big leagues of commercial mortgage finance and structured finance, you need to be able to understand the dozen or so different meanings of the word, equity.

Let's take an easy example first - the equity in your home. Your house is worth $400,000. You have a $250,000 mortgage against it. The difference between the value of your house and what you owe against it is your equity - or $150,000 in this case.

But what if you own a business? Let's say your mortgage business is worth $2 million because you have a huge book of repeat clients. The company owes $30,000 on a car loan, $75,000 on your furniture loan, and another $95,000 to the bank on its line of credit. The difference between the value of company ($2 million) and the debt against the company ($200,000) is the owner's equity in the company ($1,800,000). So you can have equity in a company, just as you can have equity in real estate.

In fact, investment bankers (think: stockbrokers) are in business of raising both debt (think: loans) and equity (think: investments by outsiders) for corporations. In order to raise equity dollars for a corporation, an investment banker will find buyers for the corporation's stock. The difference between the assets of a corporation and its liabilities is called the stockholder's equity.

Now the wonderful thing about equity is that equity has no required payments. If you borrow from the bank to grow your company, you might have to make payments of, say, $9,000 per month. If the economy goes into a severe recession, you may not be able to make your $9,000 monthly payments. The bank might foreclose and wipe you out. You could lose your company.

But if you were able to raise the money to expand your business or to renovate your apartment building by selling equity, you would be far better off in a recession. There are no required payments on equity investments. You do not have to declare a dividend to the stockholders if the company is struggling. The investors in common stock cannot foreclose on your company if you cannot afford to pay them a dividend. They just have to wait until better times to get a return on their investments.

Equity investments are risky because the equity investors are the last to be paid if the company or project fails and the assets are sold off to pay the creditors.

Suppose you cannot afford to make the monthly payments on your house. You can't even afford repairs. The house deteriorates, so it is now only worth $360,000. The mortgage has been unpaid for months, and with interest and penalties, the balance grows to $290,000. The house sells at the foreclosure sale for only $300,000 because hardly anyone ever bids at foreclosure sales in real life. Guess what? The bank gets their entire $290,000 and the owner - the equity investor - only gets $10,000.

The equity investors are the last to be paid when a business or a piece of real estate is sold off to pay the debt. The equity investors take the biggest risk.

Equity also is an important concept in construction financing. Suppose a project will cost $10 million to build. The bank will usually insist that the owner of the project (the developer) must put up 20% of the total cost of the project, or $2 million in this case. This $2 million is the developer's equity contribution and can consist of his equity in the land, any costs he has pre-paid (architectural fees, engineering fees, etc.), and the cash he can bring to the loan closing.

What if the developer doesn't have enough equity dollars in the project? The developer can sell part-ownership of the project to some rich doctors that he knows in order to raise more equity.

Another alternative would be to get a mezzanine loan (kinda like a second mortgage) behind the construction loan.

Finally, the developer can go to a company that specializes in raising equity dollars for real estate projects. You can think of real estate equity investors as venture capitalists who help provide the equity required by construction lenders. In return for their equity investments, these investors typically require a preferred return (they get paid before the developer gets paid anything), as well as a large share of the ownership of the project.

As you can see, equity means a lot of different things, depending on the context. But the important concept to understand is that equity provides a protective buffer for the lender, and from the lender's point of view, the more equity, the better.

STRUCTURED FINANCE AND VENTURE EQUITY

Pension Funds Will Loan
Up to 90% of a Developer's Required Equity

When a developer applies for a construction loan, the bank will normally require that he contribute 20% of the total cost to build the project. In other words, if the total cost to build a condo project is $30 million, the developer will be expected to cover the first $6 million of the cost. The bank will provide a construction loan in the amount of $24 million to cover the balance of the cost.

But very few developers have an extra $6 million laying around to put into a project. The developer will then seek either a mezzanine loan, a preferred equity investment, or venture equity, typically from a pension fund or a mezzanine lender.

Let's say the developer has $3 million of his own money into the $30 million deal, which is 10% of the cost of the project. Three million is a sizeable investment. The developer may not be willing to give up part-ownership (equity) or even a percentage of the profits (equity kicker) in order to attract another $3 million in capital.

In a case like this, the additional $3 million investment by an outside investor may be structured as a mezzanine loan. Because the loan-to-cost ratio of 90% is high, the investment is very risky. Such a high mezz loan might be priced at 12% and 2 points, with an exit fee of 1 to 2 points.

Sometimes the underlying construction lender will be uncomfortable with a mezzanine loan behind them. Mezzanine loans have payments. If the developer defaults on these payments, some strange mezzanine lender from out-of-state and with no roots in the community will take over the project. The construction lender may therefore object to the mezzanine financing and refuse to sign an inter-creditor agreement.

In cases like this, the $3 million investment from the pension fund or mezzanine lender may be structured as preferred equity. A preferred equity investment is technically not a loan. If a preferred equity investor is not paid his agreed return, however, the preferred equity investor can still take over the project. The effect is little different than a mezzanine loan.

Let's assume in our example that the developer has a great project, but he lacks the cash to put up more than $600,000 or so. In a case like this, the developer will need to seek venture equity. A venture equity investor, often a pension plan, will sometimes contribute up to 90% of the developer's required equity!

In our example, the total project cost was $30 million. The developer's required equity is 20% of $30 million or $6 million. The venture equity investor may be willing to contribute up to 90% of that $6 million - or $5.4 million.

Venture equity is very, very expensive. A venture equity investor may demand a preferred return of 8%. In other words, before the developer makes a dime for all of his vision and hard work, the venture equity first gets a minimum of 8% on its investment. Then the venture equity investor may get 50% of all of the remaining profit.

VALUE-ADDED DEALS

Value-Added Means That the Property
Will Be Improved By More Than the Loan Amount

Mezzanine lenders and commercial mortgage lenders that make renovation loans on commercial real estate will often use the expression value-added.

A value-added deal is one where the commercial property is improved using the proceeds of the loan. If the project is well-conceived, the value of the commercial property will increase by more than the amount of money spent improving it. In other words, the property may increase in value by $700,000 after an investment in renovations of only $400,000.

Value-added lenders will often base their loan-to-value calculation on the anticipated value of the property after the renovation is done. Suppose a run down property is only worth $10 million today, and the borrower owes $8 million on his first mortgage. A valued-added lender may make a $3 million mezzaine loan on the project (110% LTV!) if the anticipated value of the property is $15 million upon completion and leasing.

In contrast, a purchase money deal is one where the proceeds of the loan are used to actually buy the property. A refinance or cash-out deal is one where the borrower already owns the commercial property. The borrower is merely pulling cash out of the deal for other purposes, such as to pay his taxes or to make an investment in another piece of property.

Another example of a value-added deal is where the borrower buys a run-down independent hotel, fixes it up, and then flags the hotel (obtains a national hotel franchise like Holiday Inn or Best Western).

11/24/05

INTEREST-ONLY COMMERCIAL LOANS FROM CMBS LENDERS

Conduits Are Competing By Offering
Interest-Only Loans for the First Five Years

The competition for commercial mortgage loans among CMBS (conduit) lenders is so fierce that many of them are now offering ten year loans that are interest-only for the first two to five years.

At first the rating agencies, such as Moody's Investors Services, Standard and Poor's, and Fitch ICBA, howled in protest when CMBS lenders tried to add such loans to securitized pools. The rating agencies eventually relented and started to allow interest-only loans, but only if the interest-only portion of the loan lasted no longer than the first two years. Then the loan had to be amortized over just 23 years for the remaining eight year term.

But recently aggressive CMBS lenders have begun stretching the interest-only portion of the loan to three years and then out to four years. In a few case some CMBS lenders have even tried to stretch out the interest-only period to five years, but only where there was a very good story, such as a major lease that is significantly below market rent.

By making the loan interest-only for the first few years, the CMBS lenders have been able to get their loan customers a larger loan. Most borrowers will take a larger loan, even if the rate is 10 to 20 basis points higher.

REFLAGGING AGING HOTELS IS A POPULAR VALUE-ADDED PLAY

Reflagging Means Changing the National Hotel Franchise

There are great benefits to a hotel owner to belonging to a national hotel franchise. Having a flag means the hotel or motel has passed rigorous tests for cleanliness, and the lodging facility enjoys certain modern conveniences, such as telephones, access to the internet, cable television, rooms of a comfortable size, and in some cases a pool, a spa and a restaurant.

One of the major advantages of enjoying a flag is the national reservation system. A travelor can call a toll-free telephone number, or visit the franchisor's web site, and locate the most convenient hotel in the chain to the city he is visiting. He can also make reservations.

For example, when I (George Blackburne) travel, I usually will stay at a full-service Hilton Hotel. I like full-service hotels because they have restaurants, and I don't have to brave the elements or wander the streets of sometimes danagerous Central Business Districts (CBD's) looking for food. If I therefore travel to Baltimore for a conference, the local Hilton owner greatly benefits for belonging to the Hilton Hotel franchise because he will win my business almost automatically.

Hotel owners that belong to a hotel franchise will pay an annual franchise fee of 3% to 6% of their room rents to the national franchisor for the use of the name, access to the national reservation system, the enjoyment of group purchase discounts (soaps, sundries, etc.), and national media advertising. In addition, the hotel will be subject to regular quality inspections. If the hotel repeatedly fails these inspections, the hotel will lose its franchise. This happens very regularly.

A hotel or motel without a flag is known as an independent hotel. Indepedent hotels are at a great competitive disadvantage. Travelors, especially business travelors, need to be able to count on finding lodging with a reliable level of service when they arrive in a strange city. Independent hotels are unknown to strangers and therefore enjoy far less of their patronage.

Many bridge loans and mezzanine loans are made to hotel owners in order to reflag (change national franchises) their hotels. Perhaps the hotel owner has lost his flag or has been given an ultimatum by the hotel franchisor to modernize his hotel.

In other cases, a hotel owner will want to upgrade his flag, maybe from a Best Western to a Holiday Inn. This may involve major renovations, and the bridge loan or mezzanine loan is likely to be structured with an interest reserve to cover the payments during the renovation.

THE PARTIAL SUBORDINATION

This Trick Has Saved More
Commercial Loan Deals Than Any Other

Let's suppose you own a commercial property worth $1 million. Your existing first mortgage loan of $780,000 is ballooning. In order to net $780,000 from the proceeds of a new commercial mortgage loan, the gross new loan would need to be around $800,000 in order to cover the loan fees and closing costs.

The problem lies in the fact that the cash flow from the commercial property will not support a new loan of $800,000. Let's suppose the largest loan available to you, the borrower, is one for only $680,000. You are short $180,000 - and you do not have an extra $180,000 lying around in cash with which to pay down the existing loan. What do you do?

One solution is the partial subordination. A subordination is when an existing mortgage holder allows a new mortgage lender to jump in front of him in terms of seniority. A partial subordination is when you pay down the existing mortgage holder and ask him to subordinate the unpaid portion of his loan to a new lender.

For example, in our example you can only obtain a new commercial mortgage loan of $680,000. Out of this loan amount you will have to pay points and closing costs of around $20,000. You will net only $660,000 from your new commercial loan of $680,000.

Here is one solution: You could go to the holder of the existing $780,000 first mortgage and ask him to accept $660,000 now and another $120,000 at a later date. He will have to agree to subordinate his remaining $120,000 mortgage to the new first mortgage for the deal to work.

You will be shocked how often the existing mortgage holder will agree to subordinate his existing loan in return for a large paydown of his loan balance now - especially if the mortgage holder is a private individual. The lure of hundreds of thousands of dollars in cash now is almost irresistable.

In reality, a partial subordination is extremely risky for the existing mortgage holder. If you, the borrower, default on your new first mortgage, the second mortgage holder will have to keep the payments current on this huge, new first mortgage while the second mortgage holder forecloses. This can often take a year or two, especially if the original borrower (you in our example) declares bankrupty. Very few private investors can afford to carry the payments on a $680,000 mortgage for two years.

Despite the very serious risk (I would argue almost suicidal risk), more than half the time private lenders will agree to subordinate their existing first mortgages in return for a partial paydown.

EXIT FEES

An Exit Fee is a Loan Fee Charged When the Loan Pays Off

Most commercial property investors and commercial mortgage bankers are used to loan fees being charged up-front. But did you know that some commercial mortgage lenders, mezzanine lenders, and preferred equity investors charge a fee when the loan or equity investment pays off? This kind of fee is known as an exit fee.

An exit fee is different than a prepayment penalty. An exit fee is charged regardless of whether the loan (or preferred equity investment) is paid off early, paid off exactly on time, or paid off late. It is owed when the relationship is over, and the exit fee serves to enhance the yield of the lender or investor.

The typical exit fee is one or two points, but some hard money lenders charge an exit fee as large as ten points!

So why would a lender or preferred equity investor structure a deal with an exit fee? Exit fees are most commonly found on value-added deals, where the proceeds of the loan are being used to fix up the property and/or improve its cash flow.

When the value-added loan (think: renovation loan) is first made, the operating budget of the property is tight. The property may not even be generating any income at all. But after the property is renovated and re-leased, there may be plenty of cash flow to service a much larger loan, with which the borrower can easily afford the exit fee.

MERCHANT BANKING

*Merchant Banking is When a Financial Institution
Makes an Equity Investment in a Non-Financial Company*

What exactly does **merchant banking** *mean?*

First of all, when someone speaks of raising ***equity***, we normally think of registered securities (stock) being sold to the public by an investment banker (stockbroker).

But stock doesn't have to be registered with the SEC to be sold, as long as it is sold privately to very sophisticated and suitable (think: rich) investors. For example, an ***angel investor*** (a private venture capital investor) making an investment in a start-up company buys unregistered stock privately.

Merchant banking is when a bank or financial institution privately negotiates with the owner of a company and then makes a private equity investment in the unregistered securities of a privately held or public company.

Usually it is the holding company of a bank that is making the investment. For example, let's say that twenty years ago a few doctors and wealthy investors got together and said, "Let's form a bank". They first form a bank holding company, and then they form the bank as a subsidiary. Suppose the bank prospers and makes a ton of dough. The profits are passed up to the parent company, and now the parent company is sitting on a big pile of money.

Now the bank holding company could use the money to make loans, but that is really boring. The owners of the bank are already rich, and what they really want are even larger yachts. So they start making higher risk investments in the stock of promising companies. If the venture fails, no problem. They will still have plenty of money left. But if the company succeeds, they might own 25% to 50% of the next Wal-Mart. They hit a home run. So merchant banking involves private equity investments.

Private equity is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. Categories of private equity investment include leveraged buyouts, venture capital, growth capital, angel investing, mezzanine capital and others.

The reason that merchant banking is relevant to those of us in the commercial real estate finance field is that the money for mezzanine loans, preferred equity, and venture equity often comes from merchant banks.

By the way, it has been my experience that the term "merchant banker" is often used by flim-flam men trying to pass themselves off as direct lenders. So few people actually know what the term merchant banking means that these con men seldom get questioned about their legitimacy. So when you hear that term being thrown around, be careful. The guy may be legitimate ... but maybe not.

TWO LARGE MEZZANINE LOAN CONFERENCES IN NEW YORK CITY

This Was a Conference of the Most Powerful Bankers in Commercial Mortgage and Mezzanine Loan Finance

I just returned from New York City where I attended two different conferences on mezzanine loans and structured finance. The first conference was entitled "Structured Finance" and was put on by RealShare. The second conference was entitled "Mezzanine Loans" and was put on by the Information Management Network.

Folks, the attendees at these conferences were the big boys. I remember chatting up a very polite banker from one of the larger international banks. "C-Loans.com will close 200 commercial loans this year totaling $200 million," I boasted. "George," he replied, "$200 million is our average deal size. We did one loan this year for $1.3 billion." Yup, these were the big boys.

The general consensus of the two mezzanine loan conferences was this: 1. Every mezzanine fund in the country has money coming out of its gills (they are very "liquid"). 2. Commercial real estate is fully-valued, if not over-valued. 3. Good mezzanine loan requests are very difficult to find. 4. Even though reasonable, cash-flowing deals can no longer be found, the pressure to lend out the assets of these mezzanine loan funds is so great that virtually every fund intended to keep doing deals. 5. Most panelists expected a severe correction in commercial real estate values very soon. Some even feared a "train wreck." 6. Nevertheless the mezzanine loan funds intended to keep lending.

MEZZANINE LOANS AND PROFIT PARTICIPATION

Profit Participation is Sometimes Known as an Equity Kicker

Construction lenders will comfortably lend up to 75% to 80% of the total cost of a project. If a developer lacks the equity to cover the remaining 20% to 25% of cost, the developer will frequently seek a construction mezzanine loan. A construction mezzanine loan, or more simply "construction mezz" loan, is a mezzanine loan behind a construction loan.

If the developer is prepared to cover 15% of the cost of the project, a construction mezz lender will not usually ask for profit participation. Profit participation is when the lender asks for 10% to 50% of the profit on the project when the property is completed and the units, often condo units, are sold off.

If the developer needs the construction mezz lender to go higher than 85 to 90% of cost, he can expect to be required to give up an equity kicker (profit participation) of 10% to 25% of the profits. On more risky deals, he may be required to give up to 50% of the profits.

The typical mezzanine loan on a standing property is priced today around at 11% interest and one point. The payments may be collected at 7%, with the balance accruing and deferring. There will often be an exit fee of 1 point.

The typical construction mezzanine loan that goes up to 90% of cost may be priced at 11% interest, one point, and a profit participation (equity kicker) of 10% to 25% of the profits.

Whereas many mezzanine loans do not require a profit participation, virtually all preferred equity investments require the developer to give up profit participation.

INTERCREDITOR AGREEMENTS, MEZZANINE LOANS, AND COMMERCIAL FINANCING

Without an Intercreditor Agreement the Senior Lender Can Foreclose on the Mezzanine Lender

First mortgage lenders on commercial properties usually do not want their borrowers to put additional financing on the property. The reason why is because the additional loans have interest payments. The borrower may use the limited amount of positive cash flow from the property to make the payments to the second mortgage holder or the mezzanine lender rather than keep the property in good repair.

If a first mortgage lender failed to put a due-on-encumbrance clause in its mortgage, the first mortgage lender might foreclose on a heavily encumbered property, only to find that the property was a run-down rat hole. A due-on-encumbrance clause allows a first mortgage lender to demand that its entire loan balance be immediately paid in full if the borrower put an unauthorized second mortgage or mezzanine loan on the property. Such a demand is called an acceleration of the note. The painful issue for the borrower is that this required prepayment would invoke the prepayment penalty clause, and ten-point prepayment penalties on $15 million mortgages are common. Ouch!

Mezzanine loans are a form of junior loan, and they are prohibited according to the language of most modern commercial first mortgages. Mezzanine loans are only allowed if the first mortgage lender permits them. The agreement reached between the commercial first mortgage lender and the mezzanine lender that permits a mezzanine loan is called an intercreditor agreement.

The terms of an intercreditor agreement have to be negotiated to allow the mezzanine lender to execute a UCC foreclosure on the stock of the company that owns the real estate. The first mortgage lender has to agree to stand still while the mezzanine lender completes its UCC foreclosure and takes control of the property. This part of the intercreditor agreement is called the standstill agreement. In the standstill agreement the first mortgage lender agrees not to exercise its due-on-alienation (sale, change of ownership, etc.) clause.

The intercreditor agreement will also provide for notice to the mezzanine lender if the borrower defaults on the first mortgage in any way. The intercreditor agreement will also allow the mezzanine lender to cure any defaults on the first mortgage and to step into the shoes or to replace the borrower in the event of a default.

Many intercreditor agreements will allow the mezzanine lender to buy out the first mortgage note. The question then remains, at what price? Does the first mortgage lender get to charge its defeasance or yield-maintenance prepayment penalty? Some of these prepayment penalties can be immense. These are the types of matters that have to be negotiated.

For several years it was very time-consuming to negotiate an intercreditor agreement with the servicer of a CMBS loan. Negotiations could often take three months or longer. Can you imagine the frustration of the borrower?

Fortunately a standard intercreditor agreement has emerged known as a CMSA form intercreditor agreement. As a result, intercreditor agreements with CMBS loan servicers can now be negotiated in less than a month.

There is a good reason why CMBS lenders and life companies are now willing to allow mezzanine loans on their properties. Mezzanine loans usually come from financially strong investment funds or huge investment banks. They serve as a secondary source of repayment. If the borrower goes belly-up, the mezzanine lender will usually step up and bring the first mortgage current.

The reason why investors and mortgage bankers need to know about intercreditor agreements is because some commercial loan documents from CMBS lenders and life companies on loans made in the late 1990's specifically prohibit mezzanine loans. The borrower will be unable to put additional debt on the property because the mezzanine lender will be unable to get an intercreditor agreement. In cases like this, it may be possible to obtain a preferred equity investment.

STRUCTURED FINANCE AND THE PRICING OF MEZZANINE LOANS

*Mezzanine Loans Are More Costly Than Mortgages
But Far Cheaper Than Equity*

There are two main types of mezzanine loans - mezzanine loans on standing property and mezzanine loans on construction projects. We shall use the terms ***standing mezz*** and ***construction mezz***.

Let's suppose an investor bought an office building 8 years ago for $10 million, and the building is now worth $18 million. He originally obtained a $7.5 million permanent loan from a CMBS lender that is paid down to $7 million. Therefore he owes just $7 million on an $18 million property, and he wants to pull out some cash to buy another building.

CMBS lenders do not permit second mortgages, and their prepayment penalties are ghastly. Therefore the investor will need to get a mezzanine loan to pull out his equity. Today mezzanine lenders are very agressive, so he should be able to easily obtain a standing mezz loan of $7.4 million (80% LTV).

What would this loan cost him? He has two options. One option would be to get a floating rate, standing mezz loan. The other option would be a fixed rate loan.

A floating rate deal would probably cost him one-month LIBOR plus 400 to 500 basis points (bps). Lenders sometimes use the expression, "400 to 500 bips over". In structured finance, one-month LIBOR is so common that lenders don't even have to make reference to the name of the index. Today one-month LIBOR is around 4.4%, so the cost of his loan would be 8.4% to 9.4%.

The typical loan fee would be one point, plus maybe an exit fee of one point.

The term of the standing mezz loan would be ***coterminous*** with the first mortgage; i.e., they would mature on the same date. Since the original CMBS loan had a term of ten years, and since the CMBS loan was originated eight years ago, the standing mezz loan would have a term of two years.

Standing mezz loans typically have a term of one to three years, but extention options are often available. Some mezzanine lenders are even willing to go out five to ten years.

In our earlier example, the total ***debt stack*** on the office building was 80% loan-to-value. The debt stack includes all of the mortgages, mezzanine loans, and preferred equity investments directly or indirectly secured by the property. Did you know on some very large commercial projects that there will be a first mortgage piece, a senior mezz piece, a junior mezz piece, and a preferred equity piece? That pie is sliced and diced every which way from Sunday.

If a new buyer wanted to buy the office building and assume the $7 million first mortgage loan, he might want a mezzanine loan up to 90% of the purchase price. This way he would only have to put 10% down.

A mezzanine loan of 90% loan-to-value is more risky than one that is 80% LTV. Mezzanine lenders will often use the term loan-to-cost here because appraisals are mistrusted and the building is actually costing the buyer $18 million. A mezzanine loan of 90% LTC might cost 500 to 700 bips over. In this case the cost to the buyer would be 9.4% to 11.4%.

Fixed rate standing mezz deals are typically priced at 450 to 550 basis points over ten-year Treasuries. Ten year Treasuries today are around 4.5%, so fixed rate mezzanine loans up to 85% LTV might cost the borrower 9% to 10% interest. If a buyer needed 90% LTC financing, a fixed rate mezzanine loan might cost 550 to 750 bips over 10-year Treasuries, or 10% to 12% interest.

Construction mezz is typically priced on a floating rate basis with some sort of profit participation. The developer almost always needs at least 90% LTC financing. Therefoore a typical deal might be priced at 600 to 700 bips over with a 10% to 25% participation. Since one-month LIBOR is 4.4%, the interest rate might be around 10.4% to 11.4%, plus the profit participation.

Sometimes mezzanine lenders may even go up to 93% to 95% of cost, but these loans are so risky that they are almost joint ventures. As a result, they are very costly. The developer will pay at least 11% to 13% interest plus up to 50% of the profits.

Equity investments from partners and merchant bankers usually cost in the range 18% to 30% annually; therefore in most cases mezzanine debt is much cheaper than equity.

12/12/05

LAND CONTRACTS ON COMMERCIAL PROPERTY

A Reader Has a Question:

What is a land contract? Is it a purchase or refinance?

In the Midwest, ***land contracts*** or ***contracts of sale*** are very common in the sale of small commercial properties, as well as in the sale of homes and land. A land contract is first created when a seller finances the sale of his property.

For example, a retiring insurance salesman might sell his small office building to a young salesman taking over his practice. The sales price of the office building might be $150,000. The young buyer might only be able to put down $10,000 - which is far too little to qualify for a bank loan. The old guy might have faith in the young man, however, so he might carry back a $140,000 contract of sale on the building. The young man will make payments for five years and then refinance the balloon payment due at that time.

So how is a land contract or a contract of sale (the terms are identical) different than a regular mortgage? Until the young man in our example pays off the contract of sale, title to the property is still vested in the name of the old guy. During the term of the land contract, the old guy is known as the ***legal owner*** and the young man is known as the ***equitable owner***.

The equitable owner of a property enjoys virtually all of the rights of ownership - the right to use the property, the right to exclude others (Get the &^%@ off my property!), the right to collect rents, and the right of quiet enjoyment of the property. These rights are what is known as the ***bundle of rights***. Think of them as arrows in a quiver. The only right the equitable owner does not yet enjoy is the right to have his name listed as the legal owner.

What effectively is the difference between a land contract and a normal mortgage carried back by a seller? Not much. Many years ago the legal owner of a property sold under a contract of sale could foreclose out the equitable owner faster than by foreclosing a mortgage. He could foreclose out the buyer in, say, three months versus the seven months it often takes in court to foreclose a mortgage. Over the years state legislatures and courts, however, have extended the cure period for equitable owners to almost rival that for mortgagors. The difference between a land congtract today and a mortgage is mainly one of form.

Land contracts can often be assumed, especially if the interest rate is higher than what the original seller can earn on his money if he gets paid off. Let's suppose the interest rate on a land contract is 10%, and the banks are only paying 3.5% on deposits. You can bet that the former seller will often gladly allow his land contract to be assumed. Junior financing behind land contracts is also possible. As a practical matter, there is little difference between a land contract and a mortgage.

12/15/05

YIELD SPREAD PREMIUMS ON COMMERCIAL REAL ESTATE LOANS

When a Mortgage Broker Bumps the Rate,
He Gets a Rebate From the Commercial Lender

A reader asks: What is a yield spread premium?

A ***yield spread premium*** (YSP) is a rebate from a commercial lender to a commercial mortgage broker for delivering a commercial loan with a higher interest rate than the lender required.

For example, suppose ABC Finance is making subprime commercial loans at 9% today. If a mortgage broker delivers a borrower prepared to pay 10%, ABC Finance will pay the mortgage broker, at the close of escrow, a rebate of up to two or three points.

Is this fair to the borrower? Isn't this rebate a kickback? A yield spread premium should definitely be disclosed to the borrower, both for legal and ethical reasons. Nevertheless, many times a YSP makes good sense for all concerned.

For example, let's suppose a borrower needs a maximum loan on the refinance of his office building worth just $200,000. A loan of 75% is just $150,000 - and that's the *gross* loan amount.

Commercial loans are much harder to close than home loans, and the loan amount is tiny. The mortgage broker has to legitimately have a chance to make at least $4,500 - otherwise it makes little sense for him to accept the assignment.

But the borrower cannot afford to have $4,500 come out of the proceeds of the loan. He needs every cent possible from the proceeds of the loans to pay off the existing first mortgage and to buy this special machine for his business.

Therefore the mortgage broker might say to his client, "If we raise your rate from 9% to 10%, I'll make my three point fee on the ***backside***, as a rebate from the lender, rather than take $4,500 out of the proceeds of the loan." This arrangement works for everyone.

Commercial lenders cannot pay yield spread premiums, however, unless the loan has a prepayment penalty; otherwise the loan could pay off the next day and the lender would be out his three point rebate.

Yield spread premiums are rather new to commercial mortgage finance. They have been common in home loan finance for a decade, but they didn't appear in the commercial mortgage finance business until the last two years.

Banks rarely offer yield spread premiums. In fact, I have never heard of any banks offering them. If any of our readers know of any banks offering yield spread premiums on commercial loans, would you please write to me at George@Blackburne.com?

The type of lender offering yield spread premiums on commercial loans are the sub-prime lenders who bundle their loans into pools and sell off bonds secured by the loans in the pool. You can think of these lenders as the "B" lenders, the lenders who make the deals that are not quite good enough for the bank but the deals are too good for a hard money lender. They key issue to understand is that these lenders all have huge prepayment penalties.

COMMERCIAL CONSTRUCTION LOANS AND THE GENERAL CONTRACTOR

The Financial Strength and Experience of the General Contractor That You Choose is Very Important

When a bank looks at any commercial construction loan request, especially a large request, they will usually look very closely at the general contractor.

The first question the bank is likely to ask is whether the general contractor has the experience to complete the project.

Construction loan applicants should be sure to include in their loan package both a CV and a sales brochure on the general contractor.

As a lender, it is always impressive and helpful to receive a color glossy sales brochure on the general contractor with a description of the projects built by the general contractor and color photos of the completed buildngs.

The construction lender will also ask whether the general contractor has the financial resources to cover any cost overruns and construction disruptions, like supply shortages, weather issues, and labor disruptions.

The construction loan applicant should therefore include a financial statement on the general contractor.

Most banks financing large commercial projects will require the general contractor to sign an ***AIA Fixed-Price Contract*** with the developer and then assign that building contract to the bank.

Cost overruns are becoming serious concerns these days, with the cost of asphalt, steel, and land increasing at 15% annually. It is the financial responsibility of the general contractor to absorb these cost overruns. Therefore the financial strength of the general contractor is a very serious concern.

COMMERCIAL FINANCING AT PAR

Par Means the Lender Charges No Points

It is expensive for a commercial mortgage lender to underwrite a commercial real estate loan. That's why the overwhelming number of commercial lenders charge at least one point. The typical hard money lender charges between three to six points for a commercial loan.

Some lenders, however, make loans at par. Par means the lender charges zero points.

Ten years ago the only type of lender that made loans at par was a life insurance company. Today more and more commercial lenders are making loans at par so that their mortgage brokers can add one point and still be competitive. For example, many Wall Street investment bankers will buy loans from their CMBS conduits at par. A CMBS conduit is a mortgage banker that books CMBS loans destined for sale to investment banks and banks.

But there is a problem. There is no free lunch. Those lenders making loans at par almost always charge a prepayment penalty. And prepayment penalties on commercial loans today are typically very expensive. I have seen prepayment penalties as large as $1 million on a $10 million commercial loan!

01/08/06

COMMERCIAL CONSTRUCTION LOAN AND THE SOURCES AND USES OF FUNDS STATEMENT

The Wise Commercial Loan Broker Places It High in the Stacking Order

If you apply for a commercial construction loan, one of the first items your commercial construction lender will look for in your package is the ***Sources and Use of Funds Statement***. The Sources and Use of Funds Statement will list on one side where every penny of the construction budget will be used (spent). The other side of the statement will list the source of the funds, be it from the developer's own pocket, from the proceeds of the construction loan, or from any subordinate financing.

The reason this statement is so important is because it shows exactly how much skin the developer has in the game. Is the developer covering the customary 20% of the total project cost, or is he trying to get the construction lender to cover 97% of the cost or is he (illegally) trying to use purchase deposits of future condo buyers as part of his required equity?

As a construction lender I spent half my time on projects trying to ferret out how much dough a developer has in the deal. You would be amazed at how much subterfuge developers and mortgage bankers will go through to hide or disguise the developer's lack of equity dollars.

Therefore bankers and other construction lenders greatly admire the package which displays the Sources and Use of Funds Statement as one of the first documents in the ***stacking order*** of the package. The stacking order is merely the order in which documents appear in a loan package.

COMMERCIAL REAL ESTATE LOANS FROM CONDUITS = PROBLEM #1

CMBS Loans All Have Immense Prepayment Penalties

CMBS stands for Commercial Mortgage Backed Securities. Commercial real estate loans that are originated for the CMBS market are known as ***CMBS loans***, and the mortgage bankers, investment banks, and commercial banks that originate CMBS loans are known as ***conduits***.

CMBS loans have terrific, long-term, fixed interest rates. These loans are typically quoted as some small margin or spread over either 10-year Treasury bonds or swap spreads. But CMBS loans have a bunch of problems.

The biggest problem is that these CMBS loans typically have a five-year lockout clause and a huge prepayment penalty. A ***lockout clause*** simply prohibits an early prepayment. Let's suppose you win the lottery. You walk over to the office of the conduit with a wheelbarrow full of cash and dump it on the floor of the conduit. "I am hereby paying off the $2 million mortgage on my office building."

A week later you will get a certified check in the mail for $2 million from the conduit. The letter will say, "Sorry, sir, but you are not allowed to pay off this loan for the next 42 months." Yikes.

Okay, so you wait 42 months, and then return with your wheelbarrow full of cash. "Sorry, sir, but your $2 million is not enough to pay off your $2 million loan." (What the *%$#?)

"Your loan has a ***defeasance prepayment penalty***. To defease this loan you will need to go out and buy a bundle of Treasury bonds and Treasury bills that will pay us the exact stream of monthly payments, plus the balloon payment, as the payments we expected to receive from your mortgage."

"Okay, I can do that," you think. So you call your local investment banker or a company like Commercial Defeasance (http://defeasewithease.com/) to supply you with the required Treasuries.

Now the folks at Commercial Defeasance couldn't be nicer, but they explain that your CMBS mortgage had an interest rate of 7% with six years remaining on its term. Unfortunately U.S. Treasuries with a six year term are only yielding 4.5%. Therefore you are going to have to buy a bunch of *extra* Treasury bonds to make up for the shortfall in yield.

Two million dollars worth of Treasury bonds is not enough. You might have to buy around $2,240,000 in Treasury bonds! A good rule of thumb when paying off a loan with a defeasance prepayment penalty is that you will have to pay an extra 2% per year for each of the remaining years of the loan.

Ouch!

COMMERCIAL REAL ESTATE LOANS FROM CONDUITS = PROBLEM #2

CMBS Loans All Require Huge, Monthly Impounds

Few commercial mortgage borrowers appreciate when they first apply for a commercial mortgage loan that conduit lenders all require huge ***impounds*** that must be funded monthly. An impound is an extra sum that must be included with the normal principal and interest payment every month.

Homeowners will recognize impounds from their own home loans when the lender required that they send along some extra dough with every house payment to cover the taxes and insurance.

But these impounds are tiny compared to the ones that CMBS lenders require. Not only will the borrower have to send in extra money every month to pay for real estate taxes and insurance, he will also have to send in a huge chunk of money to fund a reserve for repairs. To get the money to make any repairs, the owner will have to fight with the servicing company for the conduit to get them to release the repair money.

But that's not all. The borrower will also have to send in a huge sum of money every month to fund the ***replacement reserve*** - sort of like a savings account to replace the roof in six years, resurface the parking lot in three years, and to replace the HVAC system in eight years - and so on and so on. And the lender always asks, "Hey, where is all of the dough in this replacement reserve that you should have been saving for the past nine years since you first bought the property?" Since almost every borrower will shrug his shoulders and say, "I don't have it," the servicing company will say, "Well gee, you're really far behind in funding this replacement reserve, so every month we need you to send in a whole bunch *more* money with your monthly payment." As the Church Lady might say, "Well, isn't this special?"

But it gets better! Suppose you have a lease coming up for renewal in four years. Did you know that you will need a bunch of cash on hand to pay for the ***tenant improvements*** (TI's) required by the new tenant? A tenant improvement is the cost to build special walls, to install special plumbing and other fixtures, and to paint and re-carpet the unit. And you will also need a lot of cash to pay a big leasing commission to the real estate broker who brings you the new tenant. So guess what? You get to pay even more into your impound account to build a ***reserve for re-tenanting***.

The bottom line is this: The conduit borrower often thinks that he is going to enjoy this wonderful improvement in his cash flow because he is obtaining a nice, ten-year fixed rate loan from a conduit at only 6.75%. Oops. When he gets to the close of escrow, he will sadly discover that, because of the impounds, his monthly cash flow is much, much worse. Yikes.

COMMERCIAL REAL ESTATE LOANS FROM CONDUITS = PROBLEM #3

CMBS Lenders Forbid Second Mortgages

Suppose you are a commercial real estate investor, and you buy a $5 million office building using a new $4 million loan from a conduit. You put $1 million down in cash.

Four years goes by, and commercial real estate appreciates handsomely. Your $5 million office building appreciates to $8 million. You would like to pull out some cash.

Guess what? You have a problem. Second mortgages are forbidden on CMBS loans. If you put a second mortgage on the property, this ***bad boy act*** triggers an acceleration of the loan, the obligation to pay the huge defeasance prepayment penalty and a springing personal guarantee of the loan, despite the fact that the loan was originally a non-recourse loan.

A bad boy act is one of a number of breaches of the mortgage covenants that results in the scary legal consequences described above. Bad boy acts include fraud, toxically polluting the property, placing junior financing on the property without permission, declaring bankruptcy to delay a foreclosure, allowing the insurance to lapse, and commiting waste (intentionally or negligently trashing the property).

Okay, so even though you have tons of equity, you cannot pull out your equity by placing a second mortgage on the property.

What about refinancing the first mortgage? All modern CMBS loans have a punishing defeasance prepayment penalty. The original ten year loan has six years to run, so if we use 2 points per year of remaining term as our rule of thumb for computing a defeasance prepayment penalty, you are looking at a prepayment penalty of 12 points on a $4 million loan or $480,000! Refinancing is definitely out.

What about a mezzanine loan? This would be the perfect alternative except mezzanine lenders will seldom bother with loans of less than $3 million. Your property won't carry a $3 million mezzanine loan behind a $4 million first mortgage.

So what can you do? You could sell the property, but the buyer would have to put down a whopping $4 million in cash and assume your existing $4 million loan. Who is going to do that? The number of buyers willing to put 50% down is miniscule. As a result, you would either have to reduce your purchase price to just $7 million to find a buyer ... or more likely just suck it up and pay the $480,000 prepayment penalty.

If all of these options sound terrible to you as an investor in commercial real estate, you are starting to understand some of the problems of conduit financing.

COMMERCIAL REAL ESTATE LOANS FROM CONDUITS = PROBLEM #4

Conduits Won't Let You Improve Your Own Commercial Property

Suppose you own a downtown, twelve-story office tower upon which you have a conduit loan. The vacancy rate among office buildings in c***entral business districts*** (CBD's) right now is on the order of 20%, especially if the office building is older than 15 years old. A central business district just means the downtown area of a larger city where most of the buildings are tall. Your office building is 45 years old, and the building is 33% vacant.

But you suddenly have an epiphany. You can convert the property to a ***mixed use*** project. A mixed use property is one where the property has both a commercial component (retail or office or both) and the property has a residential income component (apartments). Mixed use projects are all the rage these days because young college graduates are fed up with long commutes from the suburbs. They want to live close to work, and by living in the central business district they can either walk to work or take a tram or bus.

The idea is brilliant. You can convert the bottom floor to retail, maybe a convenience market and coffee shop. You can convert the second floor to a health club. The area is desperate for one. And the top ten floors you can convert to apartments. Your net operating income will triple! The value of the conduit's collateral will triple. Everyone wins.

So you sit down with the conduit and lay out your plan. The loan servicing officer sadly shakes his head. "I'm sorry, Mr. Investor, but I cannot allow you to make any structural changes to the property." You shout at him, "Are you nuts? This will triple the value of your collateral!" The loan servicing officer replies, "I believe you. That's not the problem. My trust documents require me to forbid structural changes to the property."

What on earth is going on here? The problem is a tax problem. A commercial mortgage-backed security (CMBS) is a bond secured by a pool of mortgages. Someone has to own that pool of mortgages. That pool of mortgages generates millions of dollars in interest income every month. If a corporation or a limited liability company owned this pool of mortgages, they would pay millions of dollars in taxes on that income. Then, when the bondholders got their interest checks, they would have to pay taxes a second time on that income. They would suffer double taxation.

In order to foster the growth of an organized market for commercial mortgages, the Federal government created an exemption for passive trusts that merely hold the mortgages for the bondholders. If the trust remains passive, the trust does not have to pay millions of dollars in taxes. ***HOWEVER, IF THE TRUST GETS INVOLVED IN THE ACTIVE MANAGEMENT OF THESE MORTGAGES, THE TRUST LOSES ITS TAX-FREE STATUS ON EVERY LOAN IN THE POOL.*** Holy mackeral. Now you can see why the conduit loan servicing officer had no ability to use common sense.

The bottom line is that if an investor accepts a loan from a conduit, he is giving up his right to make any structural changes to the property ... unless he negotiates the right to make the exact structural changes before the loan closes. Once the loan closes, it is too late to go back and amend the documents.

WHERE DEVELOPERS FIND THE EQUITY FOR THEIR PROJECTS

Normally a Dveloper Has to Contribute
Equity Equal to 20% of the Total Cost of a Project

Suppose a developer wants to build a $10 million office building. Normally the bank making the construction loan will require that he contribute, one way or another, 20% of the total cost of the project ... or in this case, $2 million.

Two million in equity is alot of dough. Not too many developers have an extra $2 million laying around in their spare change drawer. Where does the typical developer get this kind of equity money?

One way for the developer to contribute $2 million towards the project is to have $2 million in equity in the land. He may have purchased the land seven years ago for $800,000 and then the nearby city expanded out to his property. Now the land is worth $2 million, and he has no loans against the land. Hence he has $2 million in bona fide equity in the land.

More commonly the developer bought the land for $800,000 just three years ago, but he managed to get the property rezoned from agricultural land to residential land. Even though three years is a very short period of time for a property to appreciate from $800,000 to $2 million - most lenders will accept such a rapid appreciation if the developer got the land ***entitled***. Entitled means that the land has the right to be developed into homes or commercial buildings.

But the new construction loan underwriter must not fall for the old line, "I was able to buy the land for $800,000 but I got a really-really good deal. The property is actually worth $2 million." Yeah, right. If the property was really worth $2 million, the seller would have sold it to someone else for $2 million.

One way the developer could raise $2 million is for the existing landowner to subordinate. Suppose the land owner is asking $2 million for his land. The developer could ask the land owner to carry back a $2 million second mortgage that would be subordinate to the construction loan from the bank.

Another way for the developer to raise the $2 million in required equity would be to obtain a mezzanine loan of, say, $1 million. Then the developer would only have to raise the remaining $1 million. Unfortunately most mezzanine lenders will not make mezz loans of less than $3 million. Mezzanine financing would work on a $30 million project but probably not a $10 million project.

A very common way for developers raise their equity dollars is to syndicate a small group of their friends into an LLC. Each private investor might put up $100,000 and there might be 20 investors in the LLC. But the developer has to be very careful that he does not violate securities laws. He cannot publicly advertise the formation of this investment LLC. This means he cannot buy ads in the newspaper or send out mailing circulars to wealthy strangers. The developer must also be careful that he does not assemble more than 35 non-accredited investors into the LLC. An ***accredited investor*** is someone who either has enjoyed a huge salary for at least two straight years or who has a net worth in excess of $1 million.

The final way for a developer to raise equity dollars is to go to a mortgage banking firm that specializes in placing equity investments. Many of the very largest commercial mortgage banking firms have contacts with equity funds.

An ***equity fund***, in this context, is a fund that specializes in providing equity dollars to developers so the developers can build large commercial projects. The kinds of investors that invest in equity funds are college endowment funds, pension plans, and the holding companies of banks and life insurance companies. These go-go investors expect returns of 20% to 35%, so equity dollars are very, very expensive.

Unfortunately for the smaller developer, equity funds seldom invest in real estate construction deals smaller than $20 million or so. The typical developer trying to build a $4 million project and who needs $800,000 in equity dollars is not experienced enough to qualify with an equity fund. Only the really large, sophisticated developers qualify for equity dollars. It's kinda like the old saying, "The bank only wants to lend me the money when I don't need it." Equity funds only want to invest with developers so wealthy that they don't really need the equity dollars.

HOLDBACKS AND EARNOUTS

Holdbacks and Earnouts Are a Way to Get a Commercial Lender to Make a Bigger Loan

A ***holdback*** in a commercial real estate loan is when a commercial lender holds back part of the proceeds of a loan when a commercial real estate loan closes.

For example, suppose a commercial real estate lender funds a $2 million loan on an office building. At the time of the closing, one important new tenant was just in the process of moving into the building. Maybe the lease is signed, but the new tenant is still working on his tenant improvments.

A loan of $2 million is prudent IF the new tenant actually completes his move-in and starts paying rent, but until then the commercial real estate lender is not comfortable advancing the full $2 million. Therefore the commercial real estate lender and the borrower might agree that the lender will hold back $400,000 for sixty days until the tenant actually moves in.

The loan documents will actually say $2 million and the borrower might actually be paying interest on the $400,000 being held back. For this reason, a holdback is intended to be a short-term arrangement.

An ***earnout*** on a commercial real estate loan is similar to a holdback, but it is slightly different. An earnout is a promise by a commercial real estate lender to loan a commercial mortgage borrower more money on his new commercial real estate loan if the borrower successfully increases his scheduled rents.

For example, a borrower goes to a lender and says, "This apartment building used to be run by an old and sickly owner. His rents are 30% below market. Please give me a loan of $2 million today to buy the property and promise me that you will loan me another $400,000 if I raise the rents by 30%." This agreement is known as an earnout.

In an earnout, the commercial real estate loan is <u>not</u> written at $2.4 million, with the commercial lender merely holding back $400,000. Instead, there is just a promise from the commercial real estate lender to increase his loan to $2.4 million if, and there is no guarantee that the borrower will be successful, the borrower can raise his rents by 30%.

When the commercial lender does increase his commercial real estate loan by $400,000 - the borrower is typically only charged points on the $400,000 of ***new money***. If, instead of using an earnout, the commercial lender merely refinanced its old $2 million loan and made a new $2.4 million commercial real estate loan, the borrower would have to pay new points on the entire $2.4 million. This is the big advantage of an earnout.