Start making sense: Real-estate finance 101

By Chad Thomas Hagwood, senior vice president, GMAC Commercial Mortgage

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Since the bursting of the tech-stock bubble and the continuing less-than-spectacular returns from the stock market, many investors have sought better yields elsewhere. In fact, many of these investors have turned to commercial real estate, making it one of the hottest investment opportunities today.

The result has been a surge of investors trying their hand for the first time in what can be a perplexing industry, especially when it comes to commercial-real-estate financing. The commercial- mortgage industry is replete with a dizzying array of financing alternatives that can be overwhelming to newcomers and veterans. It is equally challenging to understand the relationship of who's involved, the difference between real-estate loans and business loans and how loans are determined.

The players

Multiple institutions participate in the commercial-mortgage community. They include portfolio lenders (pension-fund advisers, life-insurance companies and commercial banks), Wall Street conduits (commercial-mortgage-backed security, or CMBS, issuers), agencies (Fannie Mae, Freddie Mac and the Federal Housing Administration) and mortgage-banking institutions, for multifamily apartments.

Unlike single life companies or conduits, which only offer their source of funds, a mortgage-banking firm offers a variety of programs. These programs can include several life-insurance companies, conduits and agency programs. The result is a more-favorable deal for the borrower because one lender is pitted against another.

Commercial-real-estate lenders judge the quality of a property by two basic criteria: 1. many different tenants can use the property; and 2. the property can be leased or managed by different owners. These criteria reduce a lender's risk associated with any single tenant or manager.

The property types that owners and lenders seek most frequently include apartment complexes, retail centers, office buildings, industrial properties, hospitality (hotels and motels), self-storage facilities, manufactured-housing communities, and health-care and related properties (assisted living and senior housing).

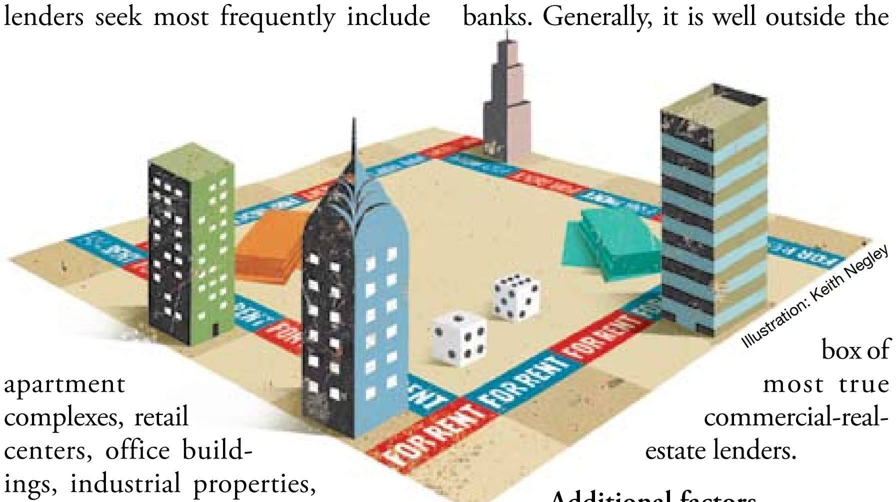

Illustration: Keith Negley

Real-estate vs. business loans

What about other property types, such as restaurants, gas stations, convenience stores and bowling alleys? These properties might have loans secured by real estate and in most cases, the borrower's personal guarantee. However, there is an important difference between making a real-estate loan and making a business loan secured by real estate.

The major difference in the commercial-real-estate lender's eyes is that the income for many single-tenant or owner-occupied buildings and specific-use projects depends on that business' revenue source. For example, a movie theater relies on box-office receipts and concession sales. Lending on potential business income rather than potential rental income makes it a business loan, not a true commercial-real-estate loan.

The underwriting consists of two separate and distinct areas of banking. Underwriting a business loan historically has been the purview of commercial banks. Generally, it is well outside the box of most true commercial-real-estate lenders.

Additional factors

Other basic factors differentiate true commercial-real-estate loans from traditional bank loans secured by real estate. Unlike real-estate loans made by most banks, commercial-real-estate lenders' loans typically do not provide for any form of personal guarantee to the loan. Therefore, they are called nonrecourse (no-guarantee) loans. Although the borrower's credit history and financial strength are important elements in the transaction and are evaluated carefully, the property largely determines the loan's viability.

The loan becomes a recourse loan

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only if the borrower commits fraud, misrepresents or misappropriates funds. For example, Mr. Borrower burns down his property and absconds to the islands with the insurance money. The exceptions to the non-recourse provisions often are called "carve-outs" or "bad-boy provisions." Borrowers must be dishonest for these provisions to kick in, so they often are a non-issue.

Another differentiating factor is call or prepayment protection. Commercial mortgages usually have excellent call protection. This creates average life stability for the lender. Typically, the loans are closed to prepayment for some portion of the term and open up to prepayment subject to yield maintenance, defeasance or a declining percentage-prepayment formula. This protects the lender or investor from reinvestment risk.

As a rule of thumb, as reinvestment rates rise to a level in excess of the borrower's note rate, the prepayment penalty declines. Inversely, if reinvestment rates fall, the prepayment penalty increases. It is extremely rare for a commercial-real-estate loan to not have some form of prepayment protection.

A third factor includes amortization and term. Commercial-mortgage loans may or may not amortize. Most do, typically on a 25- to 30-year schedule. Most commercial-mortgage loans, however, mature or balloon after seven to 10 years. At this time, the outstanding principal balance is due. Shorter or longer terms are readily available, depending on the needs of a particular property or borrower.

Banks historically have offered shorter amortization periods to ensure faster repayment. Commercial-real-estate lenders, however, are less sensitive to the quick repayment and are likely to have longer amortization periods. These periods maximize the borrower's cash flow and return on equity. In addition, the terms generally are longer, in some cases as long as 30 years, vs. the shorter terms offered by banks.

Finally, both fixed- and adjustable-rate mortgages are available on the market. Fixed-rate loans, however, dominate the commercial-mortgage market. Interest rates are expressed as a basis-point "spread" added to an index (often a U.S. Treasury), which bears a term corresponding to the loan term. A 10-year loan is priced over the 10-Year U.S. Treasury Security issue.

The spread charged on the loan is determined primarily by the loan-to-value (LTV) and debt-service-coverage ratio (DSCR). A property with a greater LTV and lower DSCR is riskier to the lender; therefore, the borrower will be charged a higher interest rate.

Loan determinants

So how does a real-estate lender determine the amount it will lend on a property? The two most-important indicators of credit quality of the collateral securing the loan are DSCR and LTV. The primary indicator is the DSCR (net-operating income divided by mortgage payment). LTV is less reliable because the value of the property will change significantly depending on the cap rate used (the discounting term for the property's cash flows).

Required LTVs and DSCRs vary for different property types and from lender to lender. General industry standards are a maximum 80 percent LTV and a minimum 1.25 times the DSCR; the net operating income must be at least 125 percent of the mortgage payment. It is important to note that on acquisition loans, the lender will be constrained by the lower of loan-to-value or loan-to-cost, assuming the loan is not DSCR-constrained.

Borrowers commonly request that the property be appraised for a higher value than what they are paying for it. "Give me 80 percent of the appraised value," they say. Lenders generally respond, "Congratulations on your shrewd negotiating skills. You still have to put 20 percent cash in the deal."

Financing is a critical element to the long-term economic success of a property. With research and diligence, a program suited to borrowers' needs and the needs of their real-estate assets can be found. For the term of the loan, reputable lenders treat borrowers as partners, not as adversaries.

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In today's market, competition among lenders is fierce, which is good news for borrowers. Rates also still are so far below historical levels that it is simply staggering — more good news.

But remember, as the saying goes, "All good things come to an end."

Chad Thomas Hagwood is a senior vice president and branch manager of the Birmingham, Ala., office of GMAC Commercial Mortgage. He can be reached at (205) 991-6700, ext. 8190, or at chad_hagwood@gmaccm.com. Visit the company's Web site at www.gmaccm.com.