Underwriting Doesn't Conform to Static Rules

The goal posts for commercial-property loan approvals tend to move with the times

By Stephen A. Sobin

Changes in the economic climate often cause changes in the guidelines used by commercial loan underwriters. When the economy is robust and growing, lenders and underwriters are often more willing to bend the rules.

When the economy slows, however, lenders and underwriters often tighten the reins and pull back on their willingness to approve more difficult transactions. The past banking crisis caused many lenders — and their regulators — to permanently change the way they looked at borrowers and loan requests.

There are a number of current hot-button topics that affect underwriting and loan approvals in today's market. Having an understanding of these trends can help brokers put their best foot forward when seeking loan approvals for their clients.

Projections and equity

In years past, lenders were willing to base their underwriting and loan decisions on pro forma numbers — or projections of income and expense. If a property had vacancies, for instance, a lender might have relied on potential rents that the owner anticipated receiving upon the signing of a lease. In addition, lenders in the past also assumed that rental rates would continually increase and would assume that future rents would exceed current rents.

Almost all cash-flow or credit-based lenders today, however, scrutinize rents and expenses carefully. They look at in-place rents and not potential rents. They look at projections, but base their decisions on past or historical data.

If a projection shows full occupancy, but the historical data shows a 10 percent vacancy factor, underwriters use the past data to underwrite the loan. Likewise, if a projection shows high potential rents, but the historical data shows lower in-place rents, the underwriter considers the current market numbers.

Loans that rely on projection-based underwriting are now more commonly considered by private, hard money or bridge lenders. These lenders often consider cash-flow transactions, or transactions that institutional lenders no longer consider.

It also used to be common to see lenders offering high-leverage loans where borrowers made downpayments of 10 percent or less. Other than owner-occupied transactions financed through the U.S. Small Business Administration's (SBA's) 7(a) and 504 programs, these types of low-downpayment commercial-property loans are no longer commonly available.

Lenders want to see that their borrowers have "skin in the game," or money invested in the project. If borrowers have made a minimal investment in the transaction, it is often easy for them to walk when problems arise. Investors that have a sizable personal stake in the deal usually work hard to make it work.

Broader look

Borrowers are used to preparing a profit-and-loss statement detailing a particular property's income, expenses and cash flow. Lenders today, however, want to look globally at the borrower's other properties, other income and personal expenses to adequately assess a borrower's overall cash-flow position.

If the subject property has an adequate cash flow, but the owner owns other non cash-flowing properties, the likelihood for rejection is high. Residential lenders always have used the debt-to-income ratio in approving loans. Commercial lenders are starting to focus on the overall cash flow as well.

A borrower's net worth, liquidity and credit score always have been at the top of the list when a lender or underwriter evaluates a transaction for approval. Many lenders today expect to see borrowers' resumes as well.

What experience do the borrowers have? Have they managed similar properties before? Do they have knowledge of the market, or are they investing out of state for the first time?

Have the borrowers experienced any setbacks before? Importantly, how were these situations handled? Did the borrowers do everything possible to avoid lender losses?

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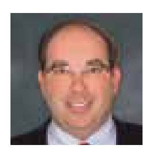

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Lenders understand setbacks in the past. The past banking and economic crisis caused a lot of investors to fail. Lenders do not reject a borrower outright because of past problems, but they expect a complete and honest explanation of what happened. They ask questions and want satisfactory responses.

Not in favor

Many institutional lenders no longer consider construction loans or loans to rehab a property. The lack of in-place income and concern about reliance on projections have made these loans difficult for lenders that require cash flow.

Lenders often worry that a borrower will not complete the project as planned or might experience trouble attracting tenants once completed. These lenders do not want to be in the position they were in some years ago when they were forced to take back properties and liquidate them at a loss. This has opened up the market considerably for private, hard money and bridge lenders that are eager to consider riskier loans at higher rates.

In addition, certain property types are potential problems for lenders. Others have proven reliable year after year.

Lenders often reassess the properties they consider based on economic and market conditions. Apartment properties have performed consistently well for investors and lenders. Many well-managed apartment properties in areas with strong demand factors (jobs, transportation, etc.) maintain consistently low vacancy factors.

Small, unanchored retail centers on the other hand, are a source of concern these days. With online shopping and the competition from large malls, many small strip centers have high vacancy factors and declining rents.

Lenders and underwriters are cautious when looking at these properties because many of the tenants are local (as opposed to national credit tenants), have short-term leases and usually do not have strong financial statements.

Single- or special-use properties also are difficult for many lenders to consider. A bowling alley or skating rink is almost a sure turndown from many institutional or cash-flow lenders. The unpredictability of the future success of the underlying business is too much for the average lender. In addition, if a single-use property is vacated, it could take many months and lots of renovation before a new tenant could resume paying rent.

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The past banking crisis — as well as federal regulators — have caused many institutional lenders to continually update the way they assess and assume risk. Mortgage brokers who understand the current “hot buttons” and can address lenders’ concerns upfront have a much higher chance of having their loans approved. Be prepared to address these topics in your loan-submission package or cover letter to the lender. ■