

COMMERCIAL REAL ESTATE

LOAN UNDERWRITING MANUAL

UNDERWRITING MANUAL

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INTRODUCTION

Underwriting a commercial real estate loan is not as easy as it sounds and can be very complex depending on the property type, loan type, borrower condition, borrower cooperation, timing required, and the specific need or request of the borrower. Underwriting a commercial loan is more an art than a science.

This manual will give you a basic understanding of the type of commercial real estate lenders out there, what they are looking for and how they underwrite a loan for approval. It also will help you better understand and appreciate the value a qualified mortgage broker can add to your investment when it comes to finding the best financing option available.

FOUR KEY UNDERWRITING RATIOS

Most of real estate lending can be derived from the results of four ratios:

- A. Loan-To-Value Ratio (LTVR)
- B. Loan-To-Cost Ratio (LTCR)
- C. Debt Service Coverage Ratio (DSCR)
- D. Debt Ratios (used mainly in Residential Underwriting)

The bulk of the energy spent “processing” a loan is merely an attempt to verify the numbers that go into the numerator and denominator of the above 4 ratios.

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

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

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

The second ratio that lenders use when “underwriting” (i.e., qualifying) a loan is the Loan-Cost-Ratio. This is most often used for construction loans. The Loan-to-Cost Ratio is defined as the ratio of the loan to the total cost of the project:

$$\text{Loan to Cost Ratio (LTC)} = \frac{\text{Total Loan Amount}}{\text{Total Project Costs}}$$

Typically lenders like to see no more than 85% LTC Ratio. Usually the LTC Ratio is used on newer properties or properties recently purchased.

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

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

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

The final ratio that lenders use when “underwriting” is the Debt Ratio. The Debt Ratio compares the amount of bills that the borrower must pay each month to the amount of monthly income he earns. This is used primarily in underwriting residential loans. More precisely, the Debt Ratio is defined as:

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

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

Each ratio will be covered in more detail in the following pages.

LOAN-TO-VALUE RATIO

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

$$\text{LTV ratio} = \frac{\text{Total Loan Balances (All debt Secured by the property)}}{\text{Fair Market Value of the Property}}$$

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

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

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

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

LOAN-TO-COST RATIO

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

$$\begin{aligned}\text{Loan-to-cost ratio} &= \frac{\text{Construction Loan}}{\text{Land Costs} + \text{Hard Costs} + \text{Soft Costs} + \text{Reserve}} \\ &= \frac{\text{Construction Loan}}{\text{Total Project Costs}}\end{aligned}$$

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

Traditionally, this ratio is not allowed to exceed 85%.

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

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

It is possible to have a well-conceived construction project where the loan-to-value ratio is only 65%, but because the developer is trying to put very little of his own money into the deal, the loan-to-cost ratio is 95%. It is important to make sure the developer has a vested interest to stay in the project so if it doesn't go as planned, the developer will stay in the deal.

DEBT SERVICE COVERAGE RATIO (DSCR)

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

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

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

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

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

Please note that lenders always insist on some sort of vacancy factor regardless of the actual vacancy rate in an area to cover collection loss. In addition, lenders always insist on using a management factor of 3-5% of effective gross income, even if the property is owner-managed. Their logic is that they would have to pay for management if they took back the property. Finally, NOTE THAT WE HAVE NOT INCLUDED LOAN PAYMENTS (P&I) AS AN OPERATING EXPENSE.

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

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

\$500,000 First Mortgage
8% Interest, 30 years amortized Annual Payment (Debt Service) = \$44,025

Debt Service Coverage Ratio

Then:

$$\text{DSCR} = \frac{\text{Net Operating Income (NOI)}}{\text{Total Debt Service}} = \frac{\$55,000}{\$44,025}$$

$$\text{DSCR} = 1.25$$

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

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

Life (insurance) companies are very conservative and generally require a 1.25 or 1.30 DSCR. This means that their loan-to-value ratios are low. Most lenders require a 1.25 DSCR; however, banks will allow closer to 1.10 DSCR on owner-occupied properties.

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

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

Generally lenders frown on a negative cash flow. Some lenders will allow a negative if the loan-to-value ratio is less than around 65%, the borrower has strong outside income, and the size of the negative is small. Lenders rarely allow negative cash flows on loans, and if they do, there must be some compensating factor acceptable to the lender.

DEBT RATIOS

When analyzing the personal budget of a borrower, lenders use two different debt ratios to determine if the borrower can afford his obligations. The debt ratio is used primarily in underwriting personal loans or residential loans. These two debt ratios are:

1. Top Debt Ratio
2. Bottom Debt Ratio

The “top” debt ratio is defined as:

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

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

$$\begin{aligned} \text{Monthly Housing Expense} = & 1^{\text{st}} \text{ mortgage payment on his home plus} \\ & \text{Real estate taxes (annual cost/12) plus} \\ & \text{Insurance (annual cost/12) plus} \\ & \text{Homeowner’s association dues (if his home is a condo or} \\ & \text{townhouse) plus Second mortgage payment (if any) plus Third} \\ & \text{mortgage payment (if any).} \end{aligned}$$

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

Lenders have learned over the years that a borrower’s “top” debt ratio should not exceed 25%. In other words, a person’s housing expense should not exceed $\frac{1}{4}$ of their income. While lenders will often stretch this number to as high as 28%, traditional lending theory maintains that anyone with a debt ratio in excess of .25% stands a good chance of developing budget problems. Given Lenders have set these standards, many lenders today have loosened up on their standards allowing higher ratios in order to close loans.

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

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

Debt Ratios

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

Debt Payments = Car payments
Charge card payments
Payments on installment loans, for example – a payment on a washer & dryer that the borrower purchased
Payments on personal loans, for example –signature loan from the borrower's bank

What is not included in “debt payments” are —

Utilities (power, water or telephone)
Payments on real estate loans

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

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

LOAN CONSTANTS

Loan constants are not used as frequently as they once were due to the ease of calculating payments with a calculator. They were used to quickly calculate a monthly loan payment by multiplying the loan constant by the loan amount. Since multiplying is always faster and more convenient than dividing, particularly when decimals are involved, the loan constant makes it easy to calculate the monthly payment once you know the loan constant.

The loan constant is calculated as follows:

$$\text{Loan Constant} = \frac{\text{Loan Payment (using a 20 year amortization and 8\% rate)}}{\text{Loan Amount}}$$

$$\text{Loan Constant (Annual)} = .1004 \quad \frac{\$10,037 \text{ (Annual Payment)}}{\$100,000 \text{ (Loan Amount)}}$$

Loan Constant (.1004) x Loan Amount (\$100,000) equals Loan Payment (\$10,037).

You need to make sure you know whether you are using a monthly or yearly loan constant so you when you go multiply the loan constant you know whether it results in a monthly loan payment or annual payment.

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

For example, suppose the loan amount was \$400,000 and the NOI was \$55,000. Here are just a few of the different possibilities:

1.31 DSCR based on a 9.5%, 25 year constant

1.48 DSCR based on a 6.98%, 20 year constant

1.25 DSCR based on an 11.0% *interest only* constant

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

HOW MANY DOLLARS CAN I GET?

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

The maximum residential loan is usually determined by the loan to-value ratio. Most income property lenders claim they will lend to 80% LTV, but few loans in practice are made at that high of a LTVR. Loan-to-value ratios of 60-75% are far more common. This discussion will describe how income property lenders arrive at the maximum amount they will lend. It is probably the most important topic in income property finance.

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

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

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

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

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

If we multiply both sides by 3, the equality holds: $6=2 \times 3$

Armed with this brief refresher, let's go back and use the debt service coverage ratio (DSCR) to determine the maximum loan for which our borrower can qualify. Let's suppose that New York Life has a very attractive apartment permanent loan (long-term 1st mortgage) available, but they want a 1.25 DSCR. If we use the same operating statement that we used in our discussion on the DSCR, we will see that we have a net operating income (NOI) of \$55,000 per year available.

Substituting our "knowns" into the definition of DSCR we find:

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

How Many Dollars Can I Get?

$$\frac{\$55,000}{\text{Debt Service}} = 1.25$$

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

$$\$55,000 = 1.25 \times \text{Debt Service}$$

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

$$\frac{\$55,000}{1.25} = \text{Debt Service}$$

Or

$$\$44,000 = \text{Debt Service}$$

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

If we assume that New York Life is quoting 7.0% interest-only, we can set up the following equality:

$$7.00\% \times \text{New Loan Amount} = \$44,000 \text{ (annual debt service)}$$

Dividing both sides by 7% gives us:

$$\text{New Loan Amount} = \frac{\$44,000}{7\%} \text{ (or .07 if expressed as a decimal)}$$

Or

$$\text{New Loan Amount} = \$628,571$$

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

IMPORTANT NOTE: If New York Life was writing 30 year fully-amortized loans, you would have needed your financial calculator. Simply insert 7.00% for %i, \$44,000 for PMT, 30. for N, and ask your calculator to determine what loan size is fully-amortized over 30 years at 7.00% with annual payments of \$44,000.

How Many Dollars Can I Get?

TO CALCULATE THE MAXIMUM LOAN SIZE

- STEP 1: Divide the NOI by the DSCR.
- STEP 2: Insert the maximum permissible payment in PMT, the interest rate in %i, the amortization term in N, and compute PV (Present Value; i.e., the loan *size*).

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

OPERATING EXPENSE RATIO

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

Suppose a property has the following pro forma operating statement:

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

Then we hereby define the operating expense ratio as follows:

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

or in this example,

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

$$= 42.1\%$$

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

Operating Expense Ratio

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

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

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

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

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

Operating expense ratios are not as useful in evaluating commercial or industrial properties because depending on the type of lease the landlord may not have to pay a majority of the operating expenses. The reason why is because the space can be rented on a triple net basis, a net basis, or a full service basis.

NET LEASES VERSUS FULL SERVICE LEASES

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

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

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

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

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

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

HOW TO PREPARE AN APARTMENT PRO FORMA

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

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

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

Based on an announced rent increase effective date.

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

Most all lenders regardless of the actual vacancy factor in the given market will use 5%.

Apartment Pro Forma

Borrowers will often protest with claims of actual vacancy rates of 2% to 3%. In these cases, remind your borrower that a Vacancy Allowance is really a shorten version of Vacancy and Collection Loss Allowance.

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

Based on the MAI appraiser's estimate.

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

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

Actual operating expenses for the last 12 months.

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

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

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

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

Apartment Pro Forma

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

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

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

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

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

**SAMPLE APARTMENT
PRO FORMA
OPERATING STATEMENT**

INCOME:

Gross Scheduled Income		\$ 102,700 (a)
Tenants' Expense Contributions		
Laundry Income		1,196
Other Income: <u>Parking</u>		2,400
	<u>Total Income:</u>	<u>\$ 106,296</u>
Less <u>2% Vacancy Allowance</u>		<u>2,054</u>
	<u>Effective Gross Income:</u>	<u>\$ 104,242</u>

EXPENSES:

Advertising		\$ 1,346	
Cleaning		1,427	
Electricity		See PG&E	
Elevator Maintenance		896	
Fees & Licenses		327	
Gardening		1,220	
Gas		See PG&E	
Insurance		3,225	(b)
Legal & Accounting		727	
Management-Offsite		5,230	
Management-Onsite		5,212	(c)
P.G. & E.		2,345	
Painting & Decorating		896	
Payroll		See mgmt	
Payroll Taxes		682	
Pest Control			
Pool Maintenance		n/a	
Real Estate Taxes		10,280	
Repairs & Maintenance		6,250	
Replacement Reserve	3%		
Sewer		654	
Supplies		1,244	
Telephone			
Trash Removal		896	
Utilities			
Water		1,786	
Miscellaneous			
	<u>Total Expenses:</u>		<u>44,643 (d)</u>
	<u>Net Operating Income:</u>	<u>\$</u>	<u>59,599</u>

Notes:

- (a) Current actual rent roll.
- (b) Actual annual premium.
- (c) 5% of effective gross income

HOW TO PREPARE A COMMERCIAL OR INDUSTRIAL PRO FORMA

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

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

Use a Vacancy Allowance that is supportable in the local submarket but in no case will an underwriter use less than 5% for commercial and industrial properties. Most often office buildings use a vacancy allowance from 7-12% depending on the market.

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

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

The Replacement Reserve is used to repaint the exterior of the building, resurface *the* parking lot, and to replace the roof from time to time. Even under "triple net" leases the lessor (owner) is still responsible for these items, as well as for the structural soundness of the building. Therefore you should insert 1-3% of Effective Gross Income into the Replacement Reserve line of all of your commercial and industrial pro formas. Generally you should use 3%, unless the building is less than 3 years old. For these new buildings, you can often get away with 1-2%.

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

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

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

Commercial and Industrial Pro Forma

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

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

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

**Sample Triple Net
Pro Forma
Operating Statement**

INCOME:

Gross Scheduled Income		\$ 108,200 (a)
Tenants' Expense Contributions		
Laundry Income		
Other Income:		
	<u>Total Income:</u>	<u>\$ 108,200</u>
Less	5% Vacancy Allowance	<u>5,410</u>
	<u>Effective Gross Income:</u>	<u>\$ 102,790</u>

EXPENSES:

Advertising		\$	
Cleaning			
Electricity			
Elevator Maintenance			
Fees & Licenses			
Gardening			
Gas			
Insurance		Tenants	
Legal & Accounting			
Management-Offsite	5%	\$ 5,139.50	
Management-Onsite			
P.G. & E.		Tenants	
Painting & Decorating			
Payroll			
Royroll Taxes			
Pest Control			
Pool Maintenance			
Real Estate Taxes		Tenants	
Repairs & Maintenance		Tenants	
Replacement Reserve	3%	\$ 3,083.70	
Sewer		Tenants	
Supplies			
Telephone			
Trash Removal		Tenants	
Utilities			
Water		Tenants	
Miscellaneous			
		<u>Total Expenses:</u>	<u>8,223</u>
		<u>Net Operating Income:</u>	<u>\$ 94,567</u>

Notes:

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

**SAMPLE PARTIAL NET
PRO FORMA
OPERATING STATEMENT**

INCOME:

Gross Scheduled Income		\$ 102,700 (a)
Tenants' Expense Contributions		9,193 (b)
Laundry Income		
Other Income:		
	<u>Total Income:</u>	\$ 111,893
Less	5% Vacancy Allowance	5,595
	<u>Effective Gross Income:</u>	\$ 106,298

EXPENSES:

Advertising		\$ 1,346	
Cleaning		1,427	
Electricity		See PG&E	
Elevator Maintenance		896	
Fees & Licenses		327	
Gardening		1,220	
Gas		See PG&E	
Insurance		3,225	
Legal & Accounting		727	
Management-Offsite	5%	5,230	
Management-Onsite		5,212	(c)
P.G. & E.		2,345	
Painting & Decorating		896	
Payroll		See mgmt	
Royroll Taxes		682	
Pool Maintenance		n/a	
Real Estate Taxes		10,280	
Repairs & Maintenance		6,250	
Replacement Reserve	3%	3,189	
Sewer		654	
Supplies		1,244	
Telephone			
Trash Removal		896	
Utilities			
Water		1,786	
Miscellaneous			
	<u>Total Expenses:</u>	47,832	(d)
	<u>Net Operating Income:</u>	\$ 58,466	

Notes:

- (a) Current actual rent roll plus the market rent of the two vacant units.
- (b) 58% of the space is leased on a net basis where the tenants pay a pro rated share of taxes, insurance and utilities.
- (c) 5% of effective gross income
- (d) Actual expenses (annualized)

Reserves For Replacements

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

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

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

Most banks don't require a reserve for replacements in underwriting the loan unless it is an old property in obvious need of repair. Life Companies and Conduit Lenders typically require reserves regardless of the age of the property.

Multi-Family:

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

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

Retail:

Traditional: 3-5% of effective gross income for replacement reserves.

Office:

Traditional: 3-5% of effective gross income.

Industrial:

Traditional: 2-4% of effective gross income
Conduits: \$0.15 per square foot per year.

Self-Storage:

Traditional: 2-4% of effective gross income.

Mobile Home Park:

Traditional: 3-5% of effective gross income.

Healthcare:

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

Hotel/Motel:

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

CAP RATES

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

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

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

The return investors are willing to accept is reflective of what alternative investments are available in the market and at what risk. Cap rates have varied over the years and are usually lower when the economy is good and rise during a recession when real estate is down. Cap rates also vary in different regions of the country depending on supply and demand.

Below are some typical cap rates on typical properties in typical markets:

Property Type	Typical Cap Rates
Office	7.00% - 9.00%
Retail	6.50% - 8.50%
Concrete-Tilt Industrial building	7.50% - 9.00%
Steel Industrial building	8.00% - 9.50%
Motels & Hotels	9.00% -11.00%
Office and Industrial condos	6.00% - 8.00%
Small office buildings & converted SFR's	6.00% - 7.75%
Apartments	5.00% - 7.00%

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

The prices per square foot commanded by office condos, industrial condos and tiny office or industrial properties cannot be justified economically. However, just as people everyday buy red corvettes for \$55,000 - even though they immediately drop to \$38,000 in value the minute the new owners drive the corvette off the lot - so will small business owners overpay for a property for their businesses. I call this the "Red Corvette Theory." People just want to own red corvettes.

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

It is often difficult to finance small income properties with institutional lenders because they seldom cash flow at greater than 55-65% loan-to-value. The purchases of office and industrial condos are usually financed by the S.B.A.

NET-WORTH-TO-LOAN-SIZE RATIO

This ratio is defined as follows:

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

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

Banks are typically as concerned about the borrower's credit behind the loan as they are about the real estate; therefore, the net-worth to loan size ratio is important to Banks. Life Companies are concerned about the credit of the borrower, but they look more to the real estate as their primary source of security behind the loan. Conduits are typically non-recourse loans so they place the least importance on the borrower and most on their security in the real estate. Private lenders also rely most heavily on the real estate as their security with the borrower's credit as secondary importance.

The typical bank will require a 1.5 Net Worth to Loan Size ratio. In other words, a borrower's net worth must be at least one and a half times larger than the loan he is seeking.

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

ENVIRONMENTAL LIABILITY

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

This liability is *strict liability*. You own the property. You clean it up. This includes mortgage lenders who take back properties in foreclosure.

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

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

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

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

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

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

THE CONSTRUCTION LOAN PROCESS

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

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

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

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

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

The Construction Loan Process

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

A "standby commitment" is also a promise to deliver a permanent loan at a specific date in the future, except that the terms are generally very expensive and the loan is not expected to fund. Standby commitments are issued primarily to satisfy the construction lender that a source of funds exists to repay his loan. Standby commitments are expensive and not used very often.

A "forward equity purchase commitment" is a promise by an institution to buy the property upon completion. They are usually issued by larger institutions in unique situations on properties of \$10 million and above.

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

Many lenders, most of whom are Banks, will provide the developer with a construction/takeout combination. The construction loan terms will be the same as an open-ended construction loan: the interest rate will float .5% - 1.50% over Prime, with a 1.0 -2.0 point loan fee, a maturity date of 1-2 years, and possibly 1 or 2, 6-month options to extend at 1/2 point each. The takeout loan is generally fixed for 5 years or adjustable for 10-30 years.

The Construction Loan Process

The takeout commitment usually costs the developer 1 point at the closing of the construction loan and another 1 point if the takeout actually funds. If the developer can find a better permanent on his own to pay off the construction loan at maturity, *he* usually does not have to accept the construction lender's takeout.

A popular form of construction/takeout combinations is the construction and "mini-perm" combination. These loans are most often arranged by Banks and major credit companies. A "mini-perm" is generally a 3 year takeout loan used to allow the developer time to establish an operating history on the project so he can qualify for a traditional permanent from a long-term lender. Mini-perms might be used for hotels or other business properties. Another use is when rents are expected to increase.

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

CONSTRUCTION COST BREAKDOWN

LAND

Balance Owing/To Clear Title \$ _____

Developer's Downpayment/Equity _____

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

DIRECT (HARD) COSTS

Demolition \$ _____

Excavation and Grading _____

Foundations _____

Masonry _____

Steel _____

Drywall _____

Heating & Ventilation _____

Plumbing _____

Electrical _____

Parking _____

Landscaping _____

Tenant Improvements _____

Total Direct Costs: _____ 0

INDIRECT (SOFT) COSTS

Architectural Fees \$ _____

Civil Engineering Fees _____

Soils Engineering Fees _____

Appraisal & Market Research _____

Legal & Accounting _____

Real Estate Taxes _____

Insurance & Bonds _____

Fees & Permits _____

Overhead _____

Loan Fees _____

Construction Period Interest _____

Marketing & Leasing _____

Escrow & Closing Costs _____

Total Indirect Costs: _____ 0

CONTINGENCY RESERVE 0% (of direct and indirect costs) _____ 0

TOTAL COSTS \$ _____ 0

LESS CONSTRUCTION LOAN _____

DEVELOPERS CONTRIBUTION \$ _____ 0

SITE INSPECTIONS

Income property appraisals are expensive and take up 3 to 6 weeks to complete. Quotes of \$5,000 - \$7,000 are not uncommon.

In addition, Federal regulations require Federally related lenders to order their own appraisals. Lenders can assign appraisals to other lenders only, but it has to be an appraiser that is on the Lender's approved list.

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

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

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

APPRAISERS

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

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

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

Another highly respected designation is the SREA designation. This designation stands for Senior Real Estate Appraiser and is issued by the Society of Real Estate Appraisers. In theory, the SREA designation is supposed to be directly comparable to the MAI designation, the only difference being that it is issued by a different trade group. There was even some talk several years ago that the American Institute and the Society might merge. The merger fell through however, probably because the American Institute did not want to share their special reputation. While in theory an SREA designation is supposed to mean expertise directly comparable to that of an MAI designation, the reality is that the SREA designation has never achieved the same universal acceptance.

The SRPA designation is just one step below that of an SREA designation, and stands for Senior Real Property Appraiser. This designation signifies that the appraiser is well qualified to appraise income property. It is often a good compromise, if discussed with the lender in advance, between a lender's desire for an MAI appraisal, and the borrower's desire for a more reasonably priced appraisal.

Appraisers

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

LOAN PROPOSALS

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

It is therefore customary in commercial mortgage lending for the borrower or mortgage broker to initially submit to the lender a mini-package in hopes that the lender will issue a loan proposal. A qualified mortgage loan broker who does this on a regular basis will give the borrower the best chance of obtaining the most attractive loan proposal available.

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

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

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

It is common for banks, conduits, life insurance companies and credit companies to ask the borrower to post a non-refundable good faith deposit as evidence of his interest in the loan.

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

LOAN PLACEMENT MATRIX

Life Companies:

Life companies are insurance companies acting as lenders by investing peoples premiums into commercial mortgages.

- Life companies are picture postcard lenders.
- They are extremely risk adverse.
- They like new properties.
- Loan must cash flow 1.35x (1.25x min.).
- Loan-to-value ratio should be less than 65% (70% max.).
- Loan must be over \$500,000.
- Property must be less than 5 years old (brand new preferred).
- Exception: Less than 10 years old and in very affluent area.
- Must be a standard property type Office, Retail, Industrial, Multi-Family.
- High net worth *borrower* usually required.
- Net worth should be 1.5 times the loan amount.
- Borrower must have good credit.
- They like fixed rate loans and will do fully amortized loans.
- Their loans are either locked-in or have huge prepay penalties.
- The interest rates are the best next to conduits.
- Require Low points (most are par).

Conduits:

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

- Apartment buildings.
- Office buildings.
- Retail buildings and strip centers.
- Shopping centers.
- Industrial buildings.
- Hotels and motels.
- Mobile home parks.
- Mini-warehouses.
- Health care facilities - residential care homes, convalescent hospitals and congregate care.
- One conduit will even accept nationwide franchise restaurants.

Loan Placement Matrix

Conduits – continued:

- Loans as small as \$100,000 to as large as \$50MM - Unlimited funds.
- Debt service coverage ratios: 1.20 minimum
- Borrowers must have at least average credit (some tiny blemishes probably okay).
- Net-worth-to-loan-size ratio not officially computed but ideally should be at 1:1.
- Rate is almost always fixed, usually at some spread over 10 year treasuries; Spreads over 10 year Treasuries usually at or slightly less than life companies and are usually locked in or have huge loss-of-yield prepayment penalties.
- Low points - usually 1 point.
- Conduits will accept older, not-so-beautiful properties.
- Conduits will *often* make loans to 75% LTV and occasionally 80%! Best lender for max cash!
- Will do long amortizations – 30 years.

Banks:

- Banks are balance sheet lenders. They like liquid net worth.
- Banks want a deposit relationship. This is very important.
- Standard Property Types Preferred.
- Business properties considered if business very successful (as evidenced by large cash deposits).
- Loan must cash flow 1.25x (in theory but this rule is frequently broken).
- Borrower must have good credit.
- Owner-occupied properties looked at favorably.
- Will do fixed rate loans no more than 5 years.
- Like short amortizations 15-25 years.
- Flexible on prepayment penalties.
- The small banks like short term mini-perms (3-5 years) tied to Prime.
- Low points - usually 1.0 – 1.50%.

Loan Placement Matrix

Credit Companies:

- Credit companies are tax return lenders.
- Business properties financed regularly if debt service supported by the tax returns.
- Borrower must have good credit.
- Property must cash flow 1.0 based on last years' tax returns. (Hard because most borrowers cheat a little.)
- If the tax returns are good, the closing ratio is excellent.
- All of their loans are tied to Prime, usually Prime plus 3%.
- Low points (2.5 - 3).

Hard Money (Private Money):

- Hard money lenders are equity lenders (real estate is the most important).
- 65% LTV ratio max.
- Borrower's Credit not very important. (Bad credit OK).
- Negative cash flow okay to 65% loan-to-value.
- High interest rates usually fixed (11% -15%).
- Short Terms (1-3 years).
- Usually interest only.

GLOSSARY

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

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

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

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

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

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

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

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

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

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