# Nick’s Apartment Loan Handbook

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## About the author

My name is Nick Schoch and I specialize in financing apartment properties in San Diego. I have worked in commercial real estate banking since 2007 for a large regional bank. I had various roles during my tenure, ranging from managing relationships with large regional developers, REITs, funds, and individual investors to overseeing origination of the Bank’s commercial mortgage product and pricing while supporting a team of loan officers. I am a licensed broker with the California BRE 01999411.

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# Preface

## Who should read this

I wrote this handbook for investors in apartment properties that are interested in financing a purchase of a new investment property or refinancing a loan on an existing property. The market defines multifamily apartments as having more than 4-units. I won't address smaller 1-4 unit or owner-occupied property financing within this handbook.

After 14 years in banking, I have seen the information asymmetry in the market where unsuspecting apartment owners rely on a broker or, worse just one lender, to get them the best loan on their property. As an owner, it's important you have at least a basic understanding so that you can ask the right questions and provide the best answers to get the ideal loan for your property. Part of this is learning to think like a lender while understanding the inherent conflicts of interest that brokers and banks have that may put them at odds with your objective of finding the best loan.

Whether you intend to contact lenders directly or use a broker, I believe it is important for you to understand the market and the process so you get the best financing for your needs. Lenders and borrowers (you) are both looking for the best rate and credit structure. However, you're on opposite ends of the spectrum in many areas of the loan terms and structure. For example, you want a low rate, but the lender wants a higher rate. But, there are many other areas of give and take that ultimately comprise the final loan. Once you are more aware of each of these areas, you'll be better positioned to negotiate the loan terms.

## Current apartment financing market and updates

2017 proved to be another strong year of multifamily financing. The real estate expansion continues nearly 10-years after the last downturn. Many lenders are wondering when the next shoe will drop, yet the demand for yield keeps them in the market competing with non-recourse, interest-only, and other "aggressive" structural features. Low leverage borrowers continue to command the best pricing with relationship lenders.

Looking forward to 2018, we should expect the Federal Reserve to continue increasing the Federal Funds Rate, putting upward pressure on short term interest rates. While the longer term rates have remaining relatively flat, I don't expect the market to tolerate a flat yield curve for long, meaning commercial mortgage rates will likely show an increasing trend over the next couple of years.

# Things you should know before you begin

## Terminology

The commercial real estate business uses terminology that the average person is not familiar with. It gets worse with banks. A good example of this is the notation “MM.” Many banks use “MM” for million. So if you had a $5 million loan, a bank might denote this as “$5MM.” I broke out a few key terms below, and I may cover the terms again in more detail in the appropriate sections that follow.

### Terms to know

**1031 Exchange**
A tax deferment strategy allowed by section 1031(a)(i) of the Internal Revenue Code. The section provides that one does not recognize a gain or loss on like-kind exchanges of property used in business or investment. The exchanging entity must identify the like-kind replacement property within 45-days after selling the old property, and close must happen within 180-days of after selling the old property. A “reverse” 1031 exchange is where you acquire the new like-kind property before selling the old property. Most lenders will accommodate 1031 exchange financing once they understand the process. However, many lenders shy away from reverse exchanges because they are not saleable. This leaves portfolio lenders (e.g. banks) rather than CMBS or agency as potential financing sources.

**All-in rate**
The rate you pay on the loan. This includes the lender’s spread (what they focus on) and the index or cost of funds. This is not equivalent to APR or Annual Percentage Rate since it does not include fees charged for origination.

**Amortization**
Generally refers to repayment of principal over a defined schedule. Most multifamily loans amortize over 25-30 years.

**Assumability**
If a loan is assumable, it means that another borrower can step into the shoes of the existing borrower with the same rate and terms. Assumability is useful to borrowers who intend to sell the property without paying off the loan. This may be attractive to buyers if the loan has a below market interest rate. Lenders generally retain the right to evaluate the new borrower and charge a fee.

**Basis point (bp/bps)**
1/100 of 1%. For example, 12.5 bps = 0.125%. Basis points are useful to indicate changes in interest rates without confusing your audience, e.g. “rates are up 10 basis points today” makes it clear the rate increased from say 4.00% to 4.10% instead of increasing 0.10% of 4% to 4.004%.

**Capitalization or cap rate**
Property net operating income divided by the purchase price or market value provides the cap rate. By implication, a property’s net operating income divided by the market cap rate provides an indication of market value.

$$Market\ Cap\ Rate = \frac{Net\ Operating\ Income}{Market\ Value}$$

$$Market\ Value = \frac{Net\ Operating\ Income}{Market\ Cap\ Rate}$$

**Carveouts or non-recourse carveouts**
Exceptions to a non-recourse loan where the guarantor becomes liable for lender losses. Exceptions that trigger liability include misappropriation of funds, environmental issues, voluntary bankruptcy, and other “bad acts” where the loan parties act to impair the collateral property. Also referred to as “bad boy” carveouts.

**Commercial Mortgage-Backed Securities (CMBS)**
Commercial Mortgage-Backed Securities, or CMBS loans, is a type of commercial real estate loan that is packaged with other commercial real estate loans into a pool that is then securitized and then sold to investors. CMBS loans are also referred to as conduit loans.

**Debt service coverage ratio (DSCR)**
Property net operating income divided by the loan payment or debt service for the same period. The greater the DSCR, the lower the apparent risk. Lenders don’t like risk, so higher DSCRs help you get better pricing and structure.

$$DSCR = \frac{Net\ Operating\ Income}{Debt\ Service}$$

**Debt yield**
Net operating income divided by loan amount. This is an increasingly popular measure since it allows lenders to quickly determine the debt servicing capacity of a property despite low interest rates. By debt servicing capacity, I mean how big a loan your apartment income can support. Debt yield is independent of the interest rate, providing a rate-neutral comparison between income and loan amount.

$$Debt\ Yield = \frac{Net\ Operating\ Income}{Loan\ Amount}$$

**Guaranty**
An entity other than the borrower can provide a guaranty, which means if the borrower entity defaults on the loan, then the lender can demand repayment from the entity that provided the guaranty. This reduces the risk for the lender and allows for better pricing.

**Holdback**
Loan proceeds that the lender will not release to the borrower until the borrower satisfies certain conditions. Example: holdback for repairs.

**Hybrid ARM loan**
Hybrid refers to a loan wherein the interest rate is fixed and floating over the loan life. Generally, this consists of an initial fixed period for 3, 5, 7, or 10 years followed by an adjustable/variable period for the remainder of the loan term.

**Loan-to-Value (LTV)**
The ratio of the loan amount to the property market value. For purchases, many lenders will use the lower of purchase price (cost) or appraised market value at the time of loan origination.

$$LTV = \frac{Loan\ Amount}{Property\ Value}$$

**Net operating income**
Property rent less stabilized/normalized operating expenses. Expenses exclude debt service, amortization, and depreciation. Most investors are already familiar with this term but often arrive at different operating expense values. For example, lenders typically make adjustments that most owners don't consider such as management expense even if you don't pay that cost.

**Non-recourse**
Non-recourse, or nonrecourse, debt is a feature where the lender expects to rely on the property in the event of default with no "recourse" or ability to ask for repayment from the principals/owners. In other words, the principals do not guarantee repayment. With the exception of carveouts, as noted above.

**Single-purpose entity (SPE)**
Many lenders require that a single-purpose entity or Single Asset Real Estate (SARE) hold title to the collateral property. This means that the borrower entity is a business entity that exists only to hold title to the property with no other material assets or business. This is to ensure that the property is bankruptcy remote from other assets of the principals/sponsors. The lender sees this as a way to lower the risk that a bankruptcy elsewhere in the owners' world affecting their loan. This is also referred to as "bankruptcy remote."

**Sponsor**
The entity, typically an individual, that is the driving party and decision-maker behind the transaction from the lender's perspective. A simple example: Michael Scott owns 10 apartments each in their own LLC. A lender on each apartment would consider the LLC as the borrower entity and Michael Scott as the sponsor. The sponsor is not always the same as the guarantor.

There can be multiple sponsors/guarantors, in which case the lender will generally treat the sponsor as the individual with whom the lender has a relationship.

**Spread**
The difference between the interest rate on the loan and the benchmark or index such as Treasury yield, swap rate, or bank cost of funds. The lender focuses on the spread since this is where they make money. The lender may not disclose this figure, but you can estimate it by looking at the appropriate index for your desired fixed rate period.

**Step-down prepayment**
Predefined prepayment penalty that decreases over the life of the loan. For example, 5% of the prepaid amount if prepaid in year 1, 4% if prepaid in year 2, 3% if prepaid in year 3, and so on. This is a common alternative to yield maintenance. Many lenders will charge a premium for this structure since provides a defined, decreasing prepayment premium that exposes the lender to prepayment risk.

The table below shows a sample prepayment schedule:

| **Prepay in year** | **Prepayment premium** | **Amount required to payoff loan** |
|---|---|---|
| 1 | 5% | Current outstanding balance + 5% of the balance |
| 2 | 4% | Current outstanding balance + 4% of the balance |
| 3 | 3% | Current outstanding balance + 3% of the balance |
| 4 | 2% | Current outstanding balance + 2% of the balance |
| 5 | 1% | Current outstanding balance + 1% of the balance |
| 6 and thereafter | 0 | Current outstanding balance |

**Underwriting interest rate floor**
A hypothetical interest rate used to size a loan relative to a minimum debt service coverage ratio. Lenders rely on underwriting interest rate floors in low interest rate environments to ensure an increase in interest rates doesn’t result in the property being unable to support refinance.

**Yield maintenance**
A prepayment penalty based on the loss the lender incurs from the early payoff of a loan. Lenders calculate yield maintenance prepayment penalty by comparing the interest rate on the prepaid balance to the treasury yield at the time of prepayment. The alternative is a step-down prepayment.

# The financing process

1. Find a lender
2. Agree on terms (e.g, pricing, structure)
3. Provide documentation

4. Wait for completion of third party reports (e.g, appraisal, environmental, property condition assessment)
5. Wait for lender to underwrite and approve the loan
6. Provide final documentation
7. Sign loan documents
8. Close escrow

Simple, but not easy. There are many pitfalls within each of the steps above.

# Find a lender

There are various types of lenders, each offering numerous products in an effort to win the opportunity to finance your property. It is important to be familiar with the lenders to ensure that you find the right lender for your property. Otherwise, you risk trying to fit a square peg into a round hole, which means less desirable loans terms (i.e. higher pricing) and more headache throughout the origination process. Each lender has a risk appetite or deal profile that they are targeting. Lenders often differ in their preferences regarding location or building types. For example, your apartment in Redlands isn't attractive to one lender, but it might be the ideal candidate for another lender. So, the first step for you, the borrower, is to identify the best-fit lender for your property.

We'll start by reviewing the different lender types and then discussing how to find a lender that fits your needs.

## Types of lenders

There are a handful of debt providers in the market. They fall into a few categories:

1. Government-Sponsored Enterprises (GSEs) like Fannie Mae and Freddie Mac
2. Mortgage conduits/Commercial Mortgage Backed Securities (CMBS)
3. Insurance companies and real estate investment companies
4. Portfolio lenders like banks, credit unions, and thrifts (Banks)

Let's first look at understanding each of these categories and then compare them.

### Government-Sponsored Enterprises (GSEs)

Fannie Mae (Federal National Mortgage Association or FNMA) and Freddie Mac (Federal Home Loan Mortgage Corporation or FHLMC) offer multifamily financing, each with a handful of programs. Many market participants refer to them as "the agencies." They have a dominant share of the market with an increasing share over the past few years as they introduce programs to compete for small balance loans ($1-7.5 million). This is consistent with their government mandate of increasing available capital to finance housing and decrease the cost of housing.

Fannie Mae generally relies on delegated underwriting and servicing (DUS) lenders who they authorize to underwrite, close, and service loans. Whereas Freddie Mac relies on a network of correspondent lenders they call “seller/servicers.” Fannie shares risk with the DUS lenders, so Fannie is able to delegate more decisions to the DUS lender. On the other hand, Freddie retains most of the decision making and approval authority. This means that any requests outside the norm like pricing adjustments may require more time with Freddie since the seller/servicer has to get approval from Freddie.

Both GSEs are offering increasingly competitive programs with features like fixed-to-floating, step-down prepayment penalties, early rate lock options, and non-recourse. The FHFA (Federal Housing Finance Agency) that regulates GSEs, imposes an annual volume cap on Fannie and Freddie. Their position relative to this cap will drive their rate competitiveness: lower rates to drive more business when they feel they have room against the cap; higher rates near the end of the year once it’s clear they are approaching their cap. Fannie and Freddie can get around this issue by chasing “uncapped” business such as properties in LMI (low-moderate income) areas or loans funded under their “green” programs wherein the borrower increases water or energy efficiency.

### Mortgage conduits/Commercial Mortgage Backed Securities (CMBS)

A Commercial Mortgage Backed Security (CMBS) loan is a type of commercial mortgage that issuers package into a pool and then securitize (sell shares of) to institutional investors on the secondary market. This is just like what Fannie and Freddie do, except non-agency CMBS doesn’t include the Fannie/Freddie guarantees on lower risk tranches.

Prepayment on a CMBS loan is much different than other financing types as it typically means dealing with defeasance. Defeasance allows the borrower to provide substitute collateral for the CMBS loan. Typically, this means purchasing US Treasury securities. This can be a painful process that causes many borrowers to avoid CMBS. Furthermore, CMBS loans typically have higher origination costs thanks to required legal counsel review of the documentation.

CMBS loans generally preclude second-lien financing, but they allow assumption if you sell the property to another investor.

If you have a loan larger than $7.5 million, you’re seeking higher leverage, or you want non-recourse, a CMBS loan may be a good fit. The borrowing entity must be a single-purpose, bankruptcy remote entity.

### Insurance companies and real estate investment companies (Financial/Insurance)

Life insurance companies and pension funds looking to invest their capital have long used commercial real estate as an avenue to generate consistent returns. Life companies typically focus on larger transactions of at least $10 million with lower leverage (lower loan-to-value or LTV). Life companies tend to focus on high quality (Class A and B) properties that are newer (less than 20-years old). Life insurance companies may offer some of the lowest pricing if your property is attractive to them.

### Portfolio lenders like banks, credit unions, and thrifts

Portfolio lenders have the greatest range of options. Unlike many of the aforementioned lenders that ultimately securitize their loans, portfolio lenders tend to hold your loan on their own balance sheet, as the name “portfolio lender” implies. This means they all have different return targets and risk appetites without as much clear influence from the market.

My experience is greatest with this segment since I worked for a bank. This is important because this segment has the least standardized approach and therefore offers more opportunity to negotiate terms and develop mutually-beneficial relationships.. While agency and CMBS lenders will generally land within a stone’s throw of each other, Banks can vary wildly. If you catch the right bank at the right time, you will get some great terms and pricing. They key thing is to understand each Bank’s profile and what types of deals they want. This is one advantage of having a broker assist you with finding a lender since they’re constantly in the market and know which lenders are looking for what.

If you’re willing to offer recourse or have a low leverage opportunity, Banks offer some of the best financing.

**Hard money lenders**
Hard money lenders are a subset of portfolio lenders. Hard money loans are basically higher interest rate loans on properties that are tougher to finance through conventional methods. By higher, I include anything 300 bps or more than the typical bank rates (7%+ in the current environment). Though rates can go much higher (12%+) depending on the circumstances of the loan request. Some situations that can make it difficult to get bank or conventional financing include: bankruptcy, low credit scores, lack of ownership history/management experience, higher loan leverage (LTV >80%), property has a history of irregular cash flow, or any combination thereof.

### Lender comparison table

| Lender Type | GSEs | CMBS | Financial/Insurance | Banks |
|---|---|---|---|---|
| Loan Sizes | $1 million+ | $10 million+ | $10 million+ | Various |
| Average LTV | Up to 80% | Around 75% | Around 65% | Around 60% |
| Pros | +Available outside major cities<br><br>+Competitive pricing especially in lower-income areas or in-process efficiency renovations | +More aggressive structures (non-recourse; 75% LTV)<br><br>+Focused on property not sponsor repayment capacity | +Aggressive pricing<br><br>+Flexible structure | +Flexible structures<br><br>+Less extensive third party and reporting |

| | | | | |
|---|---|---|---|---|
| Cons | -Extensive third party inspections and reporting requirements<br><br>-Subject to securitization market volatility<br><br>-Origination Cost | -Extensive third party inspections and reporting requirements<br><br>-Subject to securitization market volatility<br><br>-Costly origination for smaller loans<br><br>-Defeasement (hard to release collateral before maturity) | -Larger loans only (>$10 million generally))y<br>-High quality properties only (Class A or B and less than 20 years old) | -Strong desire to sell additional products like deposits before offering competitive rates (i.e. build a relationship) |

## Finding the best lender for you

You can either hire help or do it yourself.

### Using a broker

If you are thinking finding a lender is the hardest part of the process, you're right. Keeping track of lenders and their offering is not easy. You might not have kept your finger on the pulse of the market after your last financing deal, and if it's been anywhere from a few months to a few years, the key players and appetites may have changed. Or maybe you do have an idea of the lending market today, but it can change quickly. Lenders move in and out of the market depending on a variety of factors. Chase, the 800-pound gorilla in the multifamily financing market, generally is the most price-competitive option. However, rumored changes in Chase's organization and risk appetite at the executive level resulted in Chase increasing pricing by 10-20 bps (0.10%-0.20%) in 2017. This is great news for competitor lenders who can better compete with Chase. For the borrower, however, this is like Walmart increasing prices. Competitors follow suit and you pay more. A broker will mitigate the knowledge gap and help you find the best deal.

**Broker referral payments or "rebates"**

Keep in mind that some lenders pay rebates or payments to brokers that bring them business. Unlike consumer residential mortgages (1-4 unit), commercial loans or loans on residential 5+ units do not fall under the Real Estate Settlement Procedures Act (RESPA). Referral payments introduce a conflict of interest that may lead to some brokers leaning towards the rebate-paying lender. This is a sensitive topic and many brokers will claim intangible benefits like better process or certainty of execution to support their recommended lender. The best way to mitigate this as a borrower is transparency: ask the broker to explain how they get paid and if there are any rebates paid by the lender. Keep in mind that some lenders do not disclose the rebate payment to their customers (you). See screenshot below for an example from a marketing email from a lender.

Also, we can handle property related challenges:

- No historical operating history
- Low historical collections
- Deferred maintenance
- Atypical mixed-use property
- Single room occupancy (SRO)

As a reminder, we continue to offer broker rebates – up to 2.0 points paid at funding (some restriction apply). The rebates are undisclosed.

Loan products offered (nationwide platform where population exceeds 100k in a stabilized market):

- Multifamily, student housing, SRO (single room occupancy), brick, master metered, mobile home parks and mixed-use (minimum loan amount for multifamily $300k)

Broker compensation generally ranges from 0.50%-2.00% (or 50-200 bps). This range depends on the loan size (larger loan, lower fee %) and complexity. Again, make sure you understand your broker's compensation up front to avoid an uncomfortable situation at loan closing.

A loan broker should do all of the following for you:

- Understand your wealth strategy and how commercial real estate helps you meet your goals
- Develop a plan to finance your property with a loan structure that fits your goals
- Update you on current commercial real estate trends and how they affect you
- Explain the financing process and set your expectations accordingly
- Provide transparency into the financing process and keep you up to date as your loan progresses
- Translate banking jargon into language you understand
- Advocate on behalf of you and your property to get you the best terms from lenders

Ultimately, your broker should serve as an advisor that helps you understand the loan market, lender appetite, and your property's fit therein. After reaching out to the lenders with the best product, the broker should compare your options and provide pros/cons with a recommendation based on his/her understanding of your needs. With that in mind, it is important that you make your needs clear to the broker so he/she can best serve your interests.

Brokers typically provide a summary or Request for Proposal (RFP) to potential lenders to gauge lender interest and solicit LOIs. This summary will include basic information such as the following:

- Property address
- Purchase price
- Any renovation costs to date
- The sponsor's (you) estimated credit score
- The sponsor's experience with owning and managing commercial property
- Desired loan amount

- Intended use of proceeds

This is not a full loan package, but it will help lenders gauge the opportunity and express interest quickly. You should ask to see this presentation to ensure that it meets your expectations. You will also want to ensure the broker discloses any issues upfront. Not doing so and letting the issues arise in underwriting, if at all, is unwise. If the issue comes up down the road, the lender could refuse to fund the loan or fund but under unattractive terms that you wouldn't have had to deal with if you were honest with a different lender. Either way, you end up wasting time and potentially the lender's perception of your character.

### Finding a lender on your own

Once you have an idea what type of lender you're interested in working with, then you need to find a few specific lenders to get quotes on your asset.

As an example, let's say you have determined your apartment would be a good fit for a bank given the smaller loan size. First, I would reach out to your existing bank where you keep deposits or have other loans. They have an incentive to retain your business and offer you a competitive rate. When I was granting competitive pricing concessions for a bank, I could offer the best pricing for customers with lots of "cross-sell." That is, customers with more products at the bank got the best deals. Sometimes I would offer a rate discount that was conditional on the customer bringing deposits or other business to the bank before closing. Either way, banks will generally be flexible on pricing when there is more business at stake.

After reaching out to your bank, you will want to contact a few other banks in your area. You might think of contacting large regional or national banks like Wells Fargo or Bank of America. These banks are OK, but they may not have the most competitive pricing if you're outside a major metropolitan area. The local bank or credit union to your property might have more competitive pricing. If you value a relationship feel, a bank might be your best bet.

Another resource is the Scotsman Guide. Scotsman is a monthly magazine that provides residential and commercial mortgage industry information. In addition to mortgage industry news, Scotsman ranks top mortgage originators in the United States. You can refer to this ranking to learn more about lenders and find one that fits your needs.

**Lenders that compete in the small balance space**
I have listed below (in no particular order) some of the active lenders in the small balance space:

- First Foundation
- Chase
- MUFG Union Bank
- Bank of the Internet (BofI)
- Provident
- Homestreet

- Umpqua
- Luther Burbank

These are some of the major names I competed against in the small balance space on the west coast. However, there are countless names as you will see in the Scotsman Guide.

## Agree on terms

Your lender will quote preliminary terms based on their cursory review of your property and your financial profile. They may do this in the form of a Letter of Intent (LOI), Expression of Interest (EOI), or a simple email laying out the terms. Expect a give and take negotiation on terms, so it's important to understand and prioritize which terms are most important to your situation. Say for example, you like the quote, but you wanted non-recourse, then you should expect the lender to increase the rate slightly or add other structural features. If you have a competing quote and want to use it to get a better rate from your preferred lender, expect the preferred lender to ask to see the competing quote. Not only does your preferred lender want to ensure the quote is legitimate but they also want to see that the terms are comparable or "apples-to-apples." If the competing quote had a much longer prepayment premium or required onerous covenants, your preferred lender won't feel as much pressure to accommodate without adding similar features.

The most important factor for most people is around the interest rate. For the borrower, the all-in rate; for the lender, the spread. Lenders generally charge more spread when they feel they are taking more risk. Risk is a topic worth a book on its own, but key factors lenders look for:

- Leverage: both cash flow (DSCR) and value (LTV)
- Property quality
- Sponsor quality

These fall under the "5 Cs of Credit" (sometimes "5 Ps of Credit") that bank training programs instill in their staff to gauge creditworthiness of potential borrowers. The 5 Cs/Ps are:

- **Character/Person.** Lenders want to know that you intend to repay them. Your personal and business credit history are strong indicators to lenders whether or not you pay your debts. This is typically the first C or P because the other factors are irrelevant if you have an uncooperative borrower who does not intend to repay. Honesty is important. Some lenders will even refuse to do business with someone for unrelated issues such as bad press relating to unsavory matters.
  In simple terms: You will have a tougher time getting a loan if you give lenders any indication that you declared bankruptcy, caused a lender loss, are going through a divorce, or are having a Harvey Weinstein-level reputation melt down.

- **Capacity/Payment.** Capacity relates to the borrower's ability to repay a loan by comparing the primary repayment source to the debt service.

In simple terms: Lenders will offer better rates and terms the lower the Loan-to-Value (LTV) and greater the Debt Service Coverage Ratio (DSCR). Generally, 75-80% is going to be the highest LTV you'll see lenders comfortable with. You can get higher leverage with mezzanine or other structured products but it will cost you more. DSCR ranges are typically at least 1.20x against the greater of actual or the lender's underwriting floor. Underwriting floors typically range between 4-6% depending on location and property type.

- **Capital/Principal.** Capital relates to "skin in the game" or equity contributed toward a project. Lenders view cash equity as a strong incentive to keep borrowers from defaulting. Consider two scenarios: one property you just purchased for $5 million with a $4 million loan and $1 million cash vs. another property you purchased for $5 million with a $4.9 million loan and $100 thousand in cash. You're willingness to protect your $1 million is likely much greater than a $100 thousand investment. Lenders recognize this and like to see cash equity. This also explains why some lenders are hesitant to lend on market appreciation, i.e. an increase in the property value simply because of market trends, since that value didn't "cost" you anything and you may not be willing to protect it. In simple terms: Lenders will offer better terms and pricing the more equity, especially cash equity, you have in a deal. This ties into LTV and DSCR mentioned above.

- **Collateral/Protection.** For commercial real estate loans, this relates to the lender's lien against your property. If you default, the lender gets comfort knowing they have a valuable piece of real estate to foreclose on, sell, and collect their principal investment. In simple terms: Lenders will offer better terms and pricing for more attractive collateral with lower leverage.

- **Conditions/Purpose.** This is an expansive category that covers interest rates, economic performance, and other factors that influence the lender's desire to finance the borrower's opportunity. Lenders want to understand how the borrower will use the loan proceeds and what the economic conditions are. Proceeds used to buy another property sounds better than proceeds used to support a struggling business since the risk associated with the former is much less.
  In simple terms: Lenders get comfort with the wise use of loan proceeds. Money is fungible, so it's hard to attribute where you use the proceeds, but don't make it obvious you're planning to use the proceeds to build a figurative bridge to nowhere.

If you're still with me, the reason I bring up the 5 Cs isn't to teach you to be a lender. Instead, I want you to be able to think like a lender. Any aspect of your loan request can be thought of in terms of the 5 Cs. If you want to increase your requested loan amount, that decreases the debt service coverage ratio and increases LTV, which means it decreases the capacity to service the loan request. This means more risk, which means a lender will either add structure, increase pricing, or both.

## Locking rate

Once you have signed the term sheet or letter of intent (LOI), many lenders will allow you to forward lock the interest rate on the loan. Most people should be familiar with this forward lock concept since most residential mortgage lenders offer the same feature. The difference with many commercial lenders is that they will ask for a deposit (0.50-2.00% of the loan amount) and will require you to sign a contract that may make you liable for costs that arise from breaking the agreement. Thus, if you cancel the loan after locking the rate, the lender may have the right to keep your deposit.

Most lenders provide rate locks up to 60-days with the option to buy additional time with an additional fee or increased deposit.

**Should I lock rate as soon as possible?**
It's up to you whether to lock now or later. If you are uncomfortable with the idea of losing the rate you have today, lock the rate. This is a bit of speculation (i.e. gambling) in the sense that market rates can go up or down. If market rates increase, you'll appreciate the interest rate lock or wish you had locked. If market rates decrease, you'll appreciate having let it float or wish you hadn't locked, especially if you paid to lock the rate. Keep hindsight bias in mind. If it were me, I'd lock as soon as I got comfortable with the terms of the loan (i.e. concurrently with signing the LOI).

## What to focus on when negotiating structural terms

As I mentioned at the outset of this guide, I am focusing on a conventional commercial mortgage loan secured by an apartment property. As such, the terms I show below are typical for these types of loans.

**Sample rate sheet**
The rate sheet below is for the Freddie Mac Small Balance multifamily loan program. You can see the terms above expressed in an easy-to-read table format so you can estimate your rate based on your desired structure. Keep in mind that lenders can provide better pricing than their rate sheets depending on the circumstances.

| | HYBRID ARM (Fixed + Float) | | | FIXED-RATE LOAN | | |
|---|---|---|---|---|---|---|
| **LOAN TERM** (yrs) | 5 + 15 | 7 + 13 | 10 + 10 | 5 | 7 | 10 |
| **AMORTIZATION** (yrs) | 30 | 30 | 30 | 30 | 30 | 30 |
| **PREPAY DURING FIXED** <br> ** see Alternative Prepay Options below* | 5-4-3-2-1% | 5-5-4-4-3-2-1% | 5-5-4-4-3-3-2-2-1-1% | 5-4-3-2-1% | 5-5-4-4-3-2-1% | 5-5-4-4-3-3-2-2-1-1% |
| **BASE LOAN PRICING** | | | | | | |
| TOP MARKETS | 4.09% | 4.27% | 4.51% | 4.14% | 4.27% | 4.51% |
| STANDARD MARKETS | 4.79% | 4.57% | 4.71% | 4.54% | 4.57% | 4.71% |
| **LTV PRICING ADJUSTMENTS** | | | | | | |
| ≤ 70% | -0.04% | -0.04% | -0.04% | -0.04% | -0.04% | -0.04% |
| ≤ 65% | -0.08% | -0.08% | -0.08% | -0.08% | -0.08% | -0.08% |
| ≤ 55% | -0.12% | -0.12% | -0.12% | -0.12% | -0.12% | -0.12% |
| **DCR PRICING ADJUSTMENTS** | | | | | | |
| ≥ 1.30x | -0.04% | -0.04% | -0.04% | -0.04% | -0.04% | -0.04% |
| ≥ 1.40x | -0.08% | -0.08% | -0.08% | -0.08% | -0.08% | -0.08% |
| ≥ 1.50x | -0.12% | -0.12% | -0.12% | -0.12% | -0.12% | -0.12% |
| **I/O PRICING ADJUSTMENTS** | | | | | | |
| 1 YR | 0.04% | 0.04% | 0.04% | 0.04% | 0.04% | 0.04% |
| 2 YR | N/A | 0.08% | 0.08% | N/A | 0.08% | 0.08% |
| 3 YR | N/A | N/A | 0.12% | N/A | N/A | 0.12% |
| FULL TERM I/O DURING FIXED | 0.15% | 0.20% | 0.30% | 0.15% | 0.20% | 0.30% |
| **YSP** (50bps) | +0.13% | +0.10% | +0.08% | +0.13% | +0.10% | +0.08% |
| **QUALIFIED UNCAPPED LOANS** (>50% of units) | | | | | | |
| TOP MARKETS | -0.20% | -0.15% | -0.25% | -0.20% | -0.15% | -0.25% |
| STANDARD MARKETS | -0.10% | -0.20% | -0.30% | -0.10% | -0.20% | -0.30% |
| **QUALIFIED VLI LOANS** (>50% of units) | | | | | | |
| TOP AND STANDARD MARKETS | -0.10% | -0.10% | -0.10% | -0.10% | -0.10% | -0.10% |
| **RATE LOCK COSTS** (no add for 90-day rate lock) | | | | | | |
| ERL LOCK 90–120 DAYS | +0.08% | +0.08% | +0.08% | +0.08% | +0.08% | +0.08% |
| **ALTERNATIVE PREPAY OPTIONS** | | | | | | |
| YIELD MAINTENANCE [1] | YM, 1% | YM, 1% | YM, 1% | YM | YM | YM |
| Pricing Adjustment | -0.15% | -0.20% | -0.20% | -0.15% | -0.20% | -0.20% |
| SOFT STEP DOWN | 3-2-1-1-1,1% | 3-3-2-2-1-1-1,1% | 3-3-3-2-2-2-1-1-1-1,1% | 3-2-1-1-1% | 3-3-2-2-1-1-1% | 3-3-3-2-2-2-1-1-1-1% |
| Pricing Adjustment | +0.15% | +0.15% | +0.15% | +0.15% | +0.15% | +0.15% |
| MODIFIED STEP DOWN | 3-1-0-0-0% | N/A | N/A | 3-1-0-0-0% | N/A | N/A |
| Pricing Adjustment | +0.20% | N/A | N/A | +0.20% | N/A | N/A |

**FEES**

At application: $7,000 for third-party reports (appraisal, eng, env, O&Ms) plus 10 bps Freddie Mac processing fee (waived in Top Markets).
At closing: $5,000–$6,000 in estimated fees to cover lender legal costs, admin, docs.

**NOTES**

[1] The 1% prepay after the fixed rate period may be waived if the borrower (a) sells the property or (b) refinances with Freddie Mac.

**For Hybrid ARMs:**

- 7YR/10YR Hybrid: Floating rate coupon is based on 6-month LIBOR + 275 margin; floor rate is equal to the initial fixed rate
- 5YR Hybrid: Floating rate coupon is based on 6-month LIBOR + 325 margin; floor rate is equal to the initial fixed rate
- During the floating rate period, rate is reset every 6 months and amortization is recalculated

### Amortization

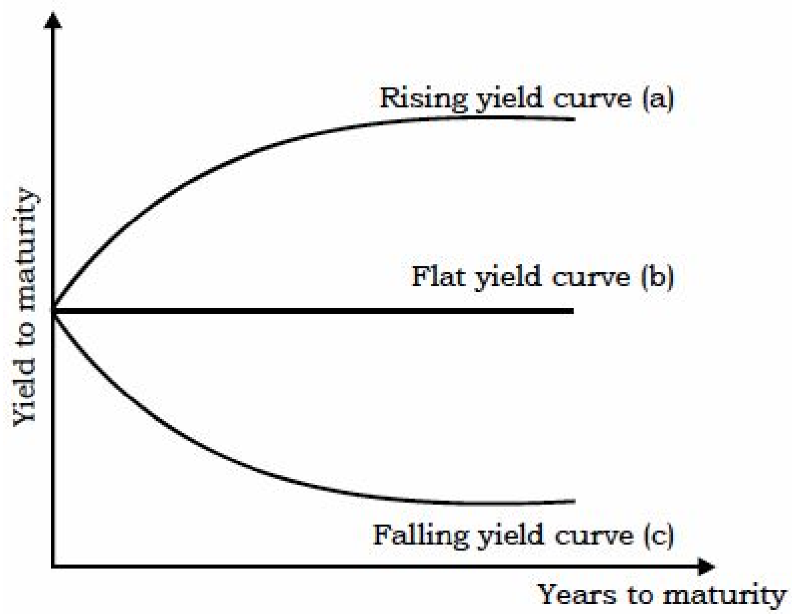
Most lenders offer amortization over 30-years. If you have a riskier asset, the lender may seek to accelerate this schedule to 20-25 years.

### Term/Maturity

In this sense, term refers to the length of the loan before maturity. You can find terms up to 30-years that are fully amortizing, which means there is no bullet repayment due at maturity. Most borrowers end up refinancing near the end of their fixed rate period, so I would not compromise on other loan terms to get a longer loan maturity.

**Fixed rate term**
This is how long the loan's interest rate is fixed. Most commonly, this is a period of 3, 5, 7, or 10 years. With a normal yield curve, the cost of funds increases over longer periods, meaning the all-in rate or coupon you pay will increase the longer your fixed rate term. This assumes your lender holds their spread constant. It is possible the lender may have a lower spread for a longer period loan since they can spread the origination costs over a longer expected life.

The chart below shows three types of yield curves: rising, flat, and falling. The yield curve explains the relationship between interest rates and time to maturity. In a rising rate environment, interest rates increase with longer maturities or fixed rate periods. Conversely, in a falling or decreasing yield environment, the rate decreases with longer fixed rate periods. You can also refer to the falling yield curve as "inverted." The "normal" yield curve is rising given that most sources of capital need greater return for tying up their capital for longer periods of time.




**ARM margin**
The Adjustable Rate Mortgage margin is the amount you pay over the index defined in your promissory note. I have seen this rate vary between 2.00% to 3.50%. Most borrowers don't focus on this rate since they intend to refinance near the end of the fixed rate period. Many banks and agencies cap the increases to 1-2% per year with a lifetime maximum rate generally 5% over the start rate. Some lenders also include a floor that ensures the floating rate remains at least as much as the starting fixed rate.

**Minimum debt service coverage**
Most lenders require a debt service coverage ratio of at least 1.15-1.20x. That said, you get better pricing if your debt service coverage ratio is better, say 1.40-1.50x.

**Maximum loan-to-value (LTV)**
The maximum LTV is generally 75-80%. Like debt service coverage, the better the LTV, the better pricing you can get. You can get higher with higher cost debt such as mezzanine or hard money loans. I don't cover those types of loans in this guide.

**Prepayment premium**
Prepayment premium is another way to say "prepayment penalty." For most bank and agency loans, there are two options: pre-defined declining/step-down and yield maintenance.
Step down prepayment provides you a pre-defined premium during each period of the loan that you would have to pay for any amounts prepaid. Some lenders will allow partial prepayments as an exception, if you ask.

The alternative is yield maintenance in which the lender calculates the amount required to maintain the same yield as if you had not paid off the loan early. This amount varies with market interest rates. For example, if you are paying off a loan with a 4% interest rate and 5-years remaining, the lender would look up the 5-year Treasury note to determine their reinvestment rate. Let's say the 5-year Treasury is at 5%, then you would be required to pay the present value of the 1% difference for the remaining 5-years at the time of prepayment. This amount ensures the lender does not experience economic loss from your prepayment. Yield maintenance changes depending on prevailing/market interest rates. As such, yield maintenance makes it hard to plan prepayment costs. Furthermore, the calculation on its own can be difficult to understand.

I recommend sticking with the step down prepayment since it is easy to understand and provides you flexibility. Also ask if the lender will waive any of the prepayment premium if you sell the property to a third party or refinance with them. If so, ensure that your lender includes this provision in your loan documents.

**Interest only**
Sometimes referred to as "IO" or "I/O." The further we get away from a real estate downturn, the more willing lenders are to offer interest-only. I don't think interest-only necessarily indicates more risk if the initial advance was conservative. Most interest-only structures allow the borrower to delay paying principal amortization for 1-5 years. Lenders generally charge a premium of 5-15 bps or more depending on the length of the interest-only period. I imagine this increase is to offset the perception of increased risk as the lender makes more interest income given the average outstanding balance is greater over the loan term, all else equal. Assuming no additional cost, I would recommend taking advantage of interest-only on your commercial loans since it maximizes your cash flow and may increase the amount of time until you need to refinance to get more proceeds. Most apartment owners are on a constant churn of refinancing at the end of their prepayment or fixed rate periods.

**Recourse**
I would get the non-recourse structure if there is no cost. It keeps the loan simple and indicates that the lender is focused on the property as the repayment source. On the other hand, some banks will look for recourse to give you the best pricing. Assuming you're not highly levered, I

don't see this as a big risk. In my experience with defaulted loans, it is a lengthy and costly process to pursue a guarantor for a deficiency. As a lender, I didn't find much comfort in a guaranty because I knew it would be unlikely that we could force the guarantor to pay. I preferred to have a well-structured loan at the outset with lower leverage that reduces the likelihood I would ever have to rely on a guarantor for support later.

## Provide documentation

Lenders will offer initial terms (pricing, structure) based on their programs with just the property rent roll and operating history. However, once you start down the path with a lender and begin the application process, your lender will want more information. Much more.

Items may include:

1. Their application forms completed
2. Vesting instructions
3. Customer Identification Program (CIP) disclosures
4. Personal financial statement with schedule of real estate owned
5. Liquidity verification statements
6. Tax returns (past 2-3 years)
7. IRS Form 4506-T
8. IRS Form W-9
9. Driver's license or other personal identifying documents
10. Preliminary title report
11. Most current rent roll
12. Current operating statement
13. Past fiscal year operating statements
14. Purchase agreements (if financing a purchase)
15. Environmental questionnaire
16. Entity documentation, e.g. articles of incorporation, partnership agreements, trust certifications

In addition to the above, the lender may ask for other documents to satisfy questions that arise during their diligence and underwriting process. This is open ended but it's the nature of the process where you want to borrow their money and they want to get comfortable that you will repay them.

### Sharing Documents

Once you pick your lender, you should identify this requirements early with a checklist from the lender. Gather your documents and try to send them over all at once to avoid confusion and misplaced items. You will want to send these documents securely and not over unsecured email. This is to protect your sensitive information. I recommend encrypting the files or using a secure file sharing service to share the documents. If you're using a broker, you may send your files to him/her first and they will relay them to the lender. Don't hope the broker is transferring your files securely--ask. I recommend organizing your documents on a secure file sharing service then adding both the broker and ultimately the lender so you control how the information is shared.

Secure file sharing services:

- Google Drive
- Dropbox
- Intralinks

Some lenders or brokers have their own file sharing software. I would trust Google or Dropbox's security over a small file sharing service, but something is better than nothing.

You may be tempted to fall back to physical transfer of documents (i.e. print and mail via USPS, FedEx, UPS, DHL), but I don't recommend it. It is less secure, it takes longer, and it costs more. I have heard firsthand stories of identities stolen because someone broke into a drop box that contained sensitive personally identifiable information. While working at the bank, we even had a couple incidents where misdelivered boxes filled with sensitive customer information.

My recommendation: use a secure online file sharing provider and opt for control on who can access it.

Once you have signed the letter of intent and the lender has a complete application, the lender will order third party reports.

## Wait for completion of third party reports

For most loans, the appraisal and environmental reports take the longest. Generally, two to three weeks. Some larger lenders have a staff of internal appraisers that can complete an appraisal in as little as two weeks. Other lenders that rely on third party appraisers can take three to four weeks.

Some lenders will not require much environmental due diligence on properties where the improvements have always been apartments/residential or if the loan is smaller. Larger loans (>$3-5 million) will generally require more diligence, including more in depth environmental review. These reviews include reaching out to government agencies that can take a while to respond. The timeline for an environmental phase I site assessment is generally three weeks. The environmental due diligence is a necessary step to ensure there are no issues that would affect the lender's ability to foreclose on your property/their collateral.

**Why does my lender want an environmental report on my property?**
Lenders want to limit their exposure to environmental liability. Lenders become exposed when

they appear on a property's chain of title. This happens when they foreclose and take ownership of the property. As such, lenders want to make sure before they fund a loan that the property doesn't have environmental issues that would preclude foreclosure. Otherwise, the collateral is potentially worthless and the lender takes a much greater loss on the loan. The alternative of foreclosing on environmentally compromised collateral is not an option for most lenders. Clean up is expensive and can take a long time. The environmental risk team at the lender I worked for often reminded us of a clean up case from the 1980s they were still dealing with that continues to cost the bank millions of dollars for ongoing remediation.

Lenders will order a preliminary title report on your property to review liens, easements, or other matters that could affect their ability to secure your property as collateral with a first lien position. You may want to ask to see the preliminary title report so you can be prepared to answer any questions. It happens all too often where the lender neglects to review title until later in the process when they discover a nasty surprise that delays closing. Address these issues early since clearing up title can take a long time given that it involves working with other institutions and/or government entities to remove items on title.

During this time the lender should be taking care of other underwriting matters like analysis of sponsor capacity, BSA/AML compliance, and title review. Many lenders will wait to draft documents until approval to ensure they don't have to draft documents twice.

## Wait for lender to underwrite and approve the loan

Once the lender receives the appraisal, they start finalizing their underwriting and drafting their credit recommendation.

The approval authority generally lies with the capital provider. In the case of a bank, the approval authority lies within the bank, whereas with an agency lender, your lender may have to contact the agency to obtain final approval of your loan.

During this step of the process, the approver may ask additional questions that did not come up during underwriting. Some of these questions will make their way back to you in the form of requests for additional information or additional structural terms. If your value came in less or some issues came up, you may have to reduce your requested loan amount. The best case scenario is that you get an approval with no feedback from the approver. The worst case scenario is a declination. Declination is unlikely since most lenders understand their appetite well enough not to take in a deal that won't ultimately be approved. The middle ground is more fuzzy. The approver could delay the process by asking the underwriter or loan officer for more information. Worse, the approver could alter the loan terms. For example, the approver could add a remargin covenant that you find disagreeable. If a credit approver finds a deal unpalatable, they'll generally add conditions or covenants that make you, the borrower, look for alternative lenders rather than outright decline it. This is to preserve their reputation. Ostensibly, they were willing to fund, it's just you didn't like the ultimate terms.

### How do lenders underwrite my property's income?

Bringing back the 5 Cs of Credit, lenders focus on the property's capacity to support the request loan. In other words, the lender will evaluate the property's rent roll and historical operating statements for the quality of the cash flow. Quality property cash flow is recurring and robust, meaning that the cash flow will likely remain stable to increasing. Lenders avoid lending on properties where they think the cash flow will decrease.

**Potential Rent**
Lenders generally review the current rent roll and annualize it. Lenders will consider vacant units at the market rent but may exclude down/unavailable units and un-permitted units.

**Concessions**
If you have any concessions or discounts (like first month free), the lender will likely adjust the market rent to include an estimate of the average concession.

**Vacancy**
The lender will adjust the gross potential income by a vacancy factor. Lenders consider historical vacancy at your property, submarket vacancy, and the current rent roll. For most metro-area markets, lenders typically assume an average vacancy factor around 5%.

**Bad debt**
Lenders will include any historical collection loss/bad debt in their analysis. In other words, if your trailing twelve month operating statements indicate collection loss, the lender will likely adjust the potential gross income down by that amount.

**Miscellaneous income**
Lenders will include non-rental income (e.g. pet fees, laundry) if they believe it is likely to continue (i.e. it is regular and recurring). Lenders will look back 3-12 months and annualize the average income.

**Expenses**
After estimating effective gross income, lenders then evaluate the operating expenses for your property. The baseline is your trailing twelve month expenses as shown in the operating statement. Lenders will look to normalize expenses, which means adjusting to exclude any non-recurring charges (e.g. one-time costs or costs that should be amortized) and include any recurring charges that should appear on the operating statement like management expense and property taxes.

Lenders will also compare your project to other properties in the market. So if you're running a tight operation with extremely low expenses, the lender may adjust your expenses up, resulting in less available cash flow to support the loan amount (i.e. you may get less loan dollars). Most lenders will expect expenses plus reserves to be at least 30% of effective gross income.

Regarding property taxes, the appraisal's income capitalization analysis will include property taxes assuming a sale. So in California where property tax increases are limited, the appraised taxes may be much greater than actual taxes paid. This is to reflect how another investor would value the project if they were to buy it since they'd have to pay the higher tax bill. That said, most lenders will give you the benefit of the lower taxes in your cash flow analysis since that cash flow is available to pay debt service.

Regarding insurance, lenders may adjust the insurance to match a revision to the policy if needed as part of funding the loan.

Regarding repairs and maintenance, lenders may remove capital improvement items from your expenses to normalize them. That said, many lenders will deduct reserves for future capital expenditures, ranging from $200-300 per unit depending on apartment quality.

Regarding management fees, most lenders use the greater of contract (actual) or market. For smaller projects, 5% is a usual minimum. Institutional or larger projects may be as low as 3%. So if you manage your own property, the lender will add their estimate of outside management cost to your expenses.

## Provide final documentation

After receiving credit approval, your lender will send a commitment letter or some other notice indicating that your loan is approved with a final summary of the loan terms. Your lender may ask for another round of documents to address any credit conditions. These are generally not a big deal. Keep in mind, the lender has done a lot of work up to this point. They are invested and they don't want to lose your business.

In the unlikely event the lender changes the terms of the deal at this point, you will have to decide whether to comply or walk away and find a new lender. Starting the process over can be painful. Even if you find a new lender to accept the last lender's appraisal and environmental reports, you'll still have at least another month before you're back to this point. In addition, if the new lender is aware that you're walking from another lender late in the process, they may become suspicious. They will want to know what caused you to walk away and if they should be concerned about the same issue. If they are, you'll be right back where you started from but 20-30 days later.

## Sign loan documents

The lender will send a package of documents to you for execution. You will need a notary to acknowledge your signature on any documents that will be recorded. Some lenders will send a notary to you with the documents similar to a residential loan closing.

Some lenders are investigating more e-signature options, but until more county recorders allow for e-notarization, you will still have to deal with physical signatures.

## Close escrow

After receiving and reviewing the executed documents, the title insurance/escrow officer (often one and the same) will inform the lender to fund into escrow. After confirming all conditions have been met and receiving all the funds necessary to close escrow, the escrow officer will send the documents for recording. In short order you will see the proceeds deposited to the account you specified in the escrow instructions.

See this document from the California Bureau of Real Estate for more information about escrow.

# Conclusion

My objective with this guide is to demystify the apartment financing process. You can definitely finance your property on your own especially after finding a lender that wants your business. It's in their interest to explain the process and help you through it. However, if you're short on time or value the industry familiarity a broker provides, I hope the guide helps you ask the right questions and avoid getting taken advantage of by unscrupulous brokers. Feel free to reach out with questions, especially if you're looking to finance a property in Southern California.

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