Nick’s Apartment Loan Handbook

April 2022

About the author

My name is Nick Schoch and I wrote this guide to help apartment investors finance their own properties. I started my career in commercial real estate 15-years ago with a large regional bank where I had various roles, 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 have underwritten apartments, manufactured housing communities, industrial, retail (single-tenant net-leased to regional malls) and special use property types.

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Preface

Who should read this?

I wrote this handbook for apartment investors who are interested in financing the 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 15 years in the industry, I continue to see information asymmetry in the commercial real estate finance market. As an owner, it's important you have at least a basic understanding of commercial real estate financing so that you can ask the right questions to get the best loan for your property. Part of this requires 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 financing process, so you get the best loan 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, which leads to a natural give and take relationship. For example, you want a low rate to save expenses, but the lender wants a higher rate to increase their income. Once you understand this relationship, you'll be better positioned to negotiate the loan terms.

Current apartment financing market and updates

With the pandemic in the rearview mirror for most investors, inflation and rising rates are the focus. The Federal Reserve approved a 25 bps rate increase to the discount rate in March 2022, the first since December 2018. Yet, long term rates remain below the CPI inflation range of 7-9%.

Residential mortgage rates are entering the 5% range, yet commercial rates are slow to increase with rates mostly in the 4% range. The attitude in the market resembles the pre-pandemic timeframe in 2019.

Tenor	6/20/2022	Month Ago	Year Ago
Prime	3.50%	3.25%	3.25%
1 mo. Term SOFR	0.58%	0.31%	0.03%
1 mo. LIBOR	0.63%	0.45%	0.11%
3-year Treasury	2.78%	2.32%	0.32%
5-year	2.86%	2.33%	0.80%

7-year	2.88%	2.35%	1.23%
10-year	2.84%	2.30%	1.56%
30-year	2.88%	2.53%	2.26%

Things you should know before you begin

Terminology

The commercial real estate business uses terminology or jargon 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 explain some common jargon below. I may cover the terms again in more detail in the relevant 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. To use this tax deferment, the exchanging entity must identify the like-kind replacement property within 45-days after selling the old property. Close of escrow must happen within 180-days 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. However, many lenders shy away from reverse exchanges because they make the loan more difficult to sell. Thus, a reverse exchange may limit your financing options to portfolio lenders like banks.

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

Amortization
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 investor 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 for the assumption (usually at least 1% of the loan balance).

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. For example, “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 rate 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.

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

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

Carve-outs or non-recourse carve-outs
These are exceptions to a non-recourse loan where the guarantor becomes liable for lender losses. The 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. The industry also refers to these exceptions as “bad boy” carve-outs since bad actions trigger the liability.

Commercial Mortgage-Backed Securities (CMBS)
Commercial Mortgage-Backed Securities (CMBS) are a type of security backed by one or many commercial real estate loans. The loan 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 debt service for the same period. The greater the DSCR, the more income available to cover the payments, which indicates lower 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 much loan an apartment’s 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. Many lenders ask the principal owners to guarantee the loan if an LLC or other business entity holds title to the property.

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 converts to 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 manage the property yourself.

Non-recourse
Non-recourse debt is a feature where the lender expects to rely solely 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 except for carve-outs 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 means to lower the risk that a bankruptcy elsewhere in the sponsor’s world would affect the lender’s loan. A single-purpose entity is also referred to as a “bankruptcy remote” entity.

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. Spreads vary depending on the risk profile of the loan with the best spreads in the low-100 bps range.

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 charge a premium for a declining prepayment structure since it is convenient for the customer and 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 at underwriting 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 refinancing at maturity, which could lead to default. E.g., rates are at record lows, the loan closes, then rates increase significantly such that the property can no longer support refinancing at maturity or the new debt service when the rate adjusts.

Yield maintenance
A prepayment penalty based on the opportunity cost 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 prepayment structure is a step-down prepayment. In a decreasing interest rate environment, yield

maintenance can make it prohibitively expensive to prepay a loan. On the other hand, in an increasing rate environment, the prepayment cost under yield maintenance may be minimal.

The financing process

1. Prepare for refinancing (if you already own the property)
2. Find a lender
3. Agree on terms (e.g., pricing, structure)
4. Provide documentation
5. Wait for completion of third-party diligence (e.g., appraisal, environmental reports, property condition assessment)
6. Wait for lender to underwrite and approve the loan
7. Provide final documentation
8. Sign loan documents
9. Close escrow

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

Prepare for refinancing

If you are refinancing a property you already own, then preparing for the refinancing process is crucial to ensure that you get the loan you deserve. If you are not prepared, it could hurt you with a higher interest rate, lower loan proceeds, and an agonizing experience. Consider these five concerns:

Property has deferred maintenance
Is the paint peeling on your property or is there a couch in the alley? What does the street view on Google Maps look like? Have tenants posted negative reviews on Yelp or Google? If a lender sees your property in a negative light, they may delay closing or withhold funds until you address their concerns. Some lenders may decline the loan entirely or increase the interest rate to offset the perceived risk associated with your property. In addition to eliminating any health and safety risks, lenders want their collateral to look attractive and be well-maintained. While increasing your maintenance costs may be undesirable in the short run, it will benefit you in the long run with lower financing rates and potentially higher rents. A poorly maintained property could drive your interest rate up by 25 basis points (0.25%) or more. So, if you have a $2 million outstanding loan, that additional 25 bps translates to $5,000 of additional interest expense every year. Review your property condition and address maintenance issues early, especially before applying to refinance your property. Not only does this help avoid potentially compounding maintenance problems, but you’ll create a better impression with potential lenders. An ounce of prevention is worth a pound of cure.

Limited liquidity
How much cash and marketable securities do you keep on hand? If you're an astute investor, you probably maintain only what you need since you like to keep your money working for you.

Unfortunately, lenders want to see more liquidity. They see extra cash as cushion that reduces risk in case sudden repairs are necessary or your property experiences prolonged vacancy. Many lenders like liquid balances that are at least 10% of your total liabilities and enough to cover at least 9-months of amortizing debt service. As always, exceptions can be made, but they may come at a cost in the form of a greater interest rate or requiring a personal repayment guarantee. Increase your liquidity before seeking financing. Remember that most lenders give partial (50-75%) credit for retirement accounts and marketable securities.

Existing prepayment premium

How much will it cost to prepay your current loan? Unfortunately, I have seen some investors find out at the last minute that there is a 1-3% prepayment premium. If this happens, they can either pay the premium or cancel the refinance in process. The choice boils down to the math. Compare the cost of prepayment versus the interest differential on the new loan and the cost of unwinding the loan in process (i.e., the rate lock deposit and any third-party costs incurred to date). In addition to monetary costs, don’t forget time. Imagine spending the last 60-days gathering financial information, negotiating loan terms, and answering questions only to find out that it was all for nothing and may end up costing you thousands of dollars in lender and third party charges. Avoid this issue by reviewing your existing loan documents to understand the cost of prepaying your current loan before starting the refinancing process.

Poor application preparation

The first documents lenders need to quote a loan are the rent roll and historical operating statements for the proposed collateral. Lenders use this information to estimate the maximum loan amount your property can support and determine the best pricing they can offer (since LTV and DSCR tend to indicate risk and risk drives pricing).

If your operating statement blends nonrecurring expenses or otherwise understates the expected Net Operating Income of your property, the lender will size the loan accordingly and you may not get the loan amount you need. After this, it will be tough to explain or recharacterize your nonrecurring expenses to get the loan amount you want. The horse is out of the barn.

Review your operating statements for the last 3-years before submitting them to the lender. You want these statements to provide the most realistic perspective on your property's recurring cash flow and debt service ability so that you get the loan you deserve. In addition, ensure you can explain any material differences between the operating statements and your tax returns.

Low credit score

While a credit score is primarily a consumer credit-driven metric, most lenders will pull your credit score. Lenders believe your personal credit score indicates your ability and willingness to perform on your credit obligations. Freddie Mac's Small Balance Program will trigger an exception around a 650 score. Many other lenders require a score of 675 or more. Consider that a low score may not kill your loan, but it could still cost you. When I managed a loan program at a large regional bank, we added at least 12.5 basis points (0.125%) to the rate if the credit score was under 700. Doesn’t seem like much? On a $2 million loan this is $2,500 per year and adds up to $12,500 over the average 5-year fixed period of most loans.

Pull your credit report. If your credit is under 700, take steps to boost it so you can avoid any potential issues or rate increases. There are free tools like annualcreditreport.com and creditkarma.com that help you track your credit history and scores. In addition, it is good practice to monitor for identity theft and credit reporting errors.

Find a lender

There are various types of lenders, each offering numerous products to win your business. 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 fewer desirable loans terms (such as 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 as 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

While there are numerous debt providers in the market, they fall into a few categories:

1. Government-Sponsored Enterprises (GSEs) or "agencies" like Fannie Mae and Freddie Mac
2. Mortgage conduits/Commercial Mortgage Backed Securities (CMBS)
3. Insurance companies
4. Portfolio lenders like banks, credit unions, and hard money lenders

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 through a network of designated lenders. Each offers handful of programs. Many market participants refer to them as "agency" lenders. They have a dominant share of the market with an increasing share over the past few years (38% in 2019) 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. In contrast, Freddie Mac relies on a network of correspondent lenders they call "seller/servicers." Fannie shares risk with the DUS lenders, so Fannie can 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 agencies 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.

Another agency that is often treated separately is HUD (Housing & Urban Development). HUD's loan programs are competitive with non-recourse, higher leverage, lenient prepayment premiums, and attractive rates. However, HUD usually requires a lengthy underwriting timeframe of 6-months or more.

Agency loans are attractive for many investors looking for interest-only, higher leverage loans, especially if the property is located outside of a major metro area. Basically, anywhere banks aren't as competitive. The downside with agency loans is the additional reporting and origination cost.

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 securities/tranches.

Prepayment on a CMBS loan is much different from 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 loan documents.

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 to be eligible for CMBS.

Insurance companies

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 insurance companies compare the returns of many asset classes, including real estate loans. Despite still historically low interest rates, commercial real estate loans offer higher returns than high-quality bonds. As such, life insurance companies continue to lend in the commercial real estate space. 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 hard money lenders

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. The 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 have the most appropriate product at the best price.

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

Hard money lenders
Hard money or “private” 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 because of the elevated risk profile. When I say “higher interest rate,” I include anything 300 bps or more than the typical bank rates (8%+ 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.

Private capital can be a great short-term or “bridge” that allows investors to reposition a property before seeking conventional financing.

Lender comparison table

Lender Type	GSEs	CMBS	Financial/Insurance	Banks
Loan Sizes	$1 million+	$5 million+	$5 million+	$500k+
Average LTV	Up to 80%	Around 75%	Around 65%	Around 60%
Pros	+Available outside major	+More aggressive	+Aggressive pricing	+Flexible structures

Lender Type	GSEs	CMBS	Financial/Insurance	Banks
	metro areas +Competitive pricing especially in lower-income areas or in-process efficiency renovations	structures (non-recourse; interest-only) +Focused on property not sponsor repayment capacity	+Flexible structure	+Less extensive third party and reporting
Cons	-Extensive third-party inspections and reporting requirements -Subject to securitization market volatility -Origination Cost	-Extensive third-party inspections and reporting requirements -Subject to securitization market volatility -Costly origination for smaller loans -Defeasement (hard to release collateral before maturity)	-Larger loans only (>$10 million generally) -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 (that is, their goal is to build a relationship)

Finding the best lender for you

You can hire a broker to help or do it yourself. Either way, you'll want to consider a few questions:

1. **Is your property stabilized or are you constructing/renovating/repositioning the property?**
   If your property is not stabilized (i.e., 90%+ occupied with no expected interruptions in rental cash flow), then you'll need a lender that considers these types of properties. Most lenders focus on stabilized properties with a subset that offer loans for these situations. If your renovations will be completed quickly, many permanent loan lenders will still consider your property. However, if it takes longer than a month or two, you may need to find a bank or private capital that will offer a bridge loan solution.

2. **Are you willing to personally guarantee the loan, putting your other assets at risk?**
   If you are unwilling to guarantee the loan, you are looking for a non-recourse loan. All lender types offer non-recourse, but banks are more selective, offering it selectively or at an additional cost.

3. **How long are you planning to own the property?**
   If you intend to hold for more than 10-years, you may want to consider HUD financing that

offers up to 35-years of loan term with similar fixed interest rate periods. You won't be as worried about prepayment penalties. If on the other hand, you're looking to cash-out or sell down the road, you may want to seek bank financing or agency financing with a shorter prepayment penalty.

4. **Do you want to maximize cash flow or pay off the loan?** Interest-only is a helpful loan feature to maximize cash flow. All lender types offer interest only, but banks are more selective and may charge more for the feature.

Using a broker

If you think that finding a lender is the hardest part of the process, you're right. Keeping track of lenders and their products is not easy. You might not have kept your finger on the pulse of the market after closing your last loan, and if it's been anywhere from a few months to a few years, the key players and appetites may have changed. 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, like any bank, Chase's appetite for commercial real estate will wax and wane. 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.

A loan broker should do all the following for you:

- Understand your wealth strategy and how commercial real estate helps you meet your goals
- Demonstrate expertise in the type of financing you need
- 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.

Specialist or generalist?

A commercial mortgage broker can originate many different types of loans such as apartments, shopping centers, medical office, cold storage, net leased retail, hotels, and more. Add the wide range of property types to the range of capital sources and it seems unlikely that a generalist broker will be as effective as a specialist for the relevant property type.

Consider that specialists originate the same types of loans over and over. This means they bring a larger volume of loans to lenders, which means they are more likely to get better pricing and terms. These lending relationships also mean the specialist is familiar with underwriting standards that allows them to quickly size and qualify loans. Furthermore, the specialist can focus on the particulars of their lending market, ensuring that they bring your loan to the lender with the most competitive program.

To be clear, I recommend finding a specialist for your needs if you decide to work with a broker.

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 (i.e., 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 of a lender marketing their undisclosed rebates to brokers.

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

Broker compensation generally ranges from 0.50%-2.00% (or 50-200 bps) of the loan amount. 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.

How do brokers work with lenders?

Brokers typically provide a summary or Request for Proposal (RFP) to potential lenders to gauge lender interest and solicit Letters of Intent/Interest (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 is unwise. When 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.

I have templates you can use for the summary/request for proposal package on my website.

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 lenders will offer a rate discount that is conditional on the borrower 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.

Lastly, if you can access title data, you can see lenders who have recently closed loans on similar properties in your area. If you need help obtaining this data, reach out to me for more information.

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
- Axos (formerly known as 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 many more names, as you will see if you read 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/Interest (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 that 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 the key factors lenders look for are:

- 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 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 experiencing negative press that a lender would want to avoid associating with their name.

- **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 1.15x against the greater of the proposed actual interest rate or the lender's underwriting floor interest rate. Underwriting floor rates typically range between 4-7% depending on location and property type. Underwriting rates for apartments are lower than commercial property types.

- **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:

Scenario	More skin in the game	Less skin in the game
Purchase Price	$5,000,000	$5,000,000
Debt	$4,000,000	$4,900,000
Cash Equity	$1,000,000 (20%)	$100,000 (2%)

One property you just purchased for $5 million with a $4 million loan and $1 million cash compared to another property you purchased for $5 million with a $4.9 million loan and $100 thousand in cash. Your willingness to protect your $1 million is likely much greater than a $100 thousand investment. Lenders recognize this and so they want to see more cash equity. This also explains why some lenders are hesitant to lend on market appreciation, such as an increase in the property value simply because of market trends, since that value didn't "cost" you anything and you may be less 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. The property condition and appearance weigh heavily into the lender's evaluation of the loan because a property in poor condition could struggle to maintain occupancy, or worse, cause injury to occupants and expose the owner to expense negligence claims.

  In simple terms: Lenders will offer better terms and pricing for more attractive collateral with lower leverage that provides a greater value cushion vs. their loan amount.

- **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 from the wise use of loan proceeds. Money is interchangeable, 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 or letter of interest (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 (that is, 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 was my loan, I'd lock as soon as I got comfortable with the terms of the loan (that is, concurrently with signing the LOI) and assuming it didn't cost me anything.

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. (This rate sheet is old so the rates not relevant now.)

	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 ** 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

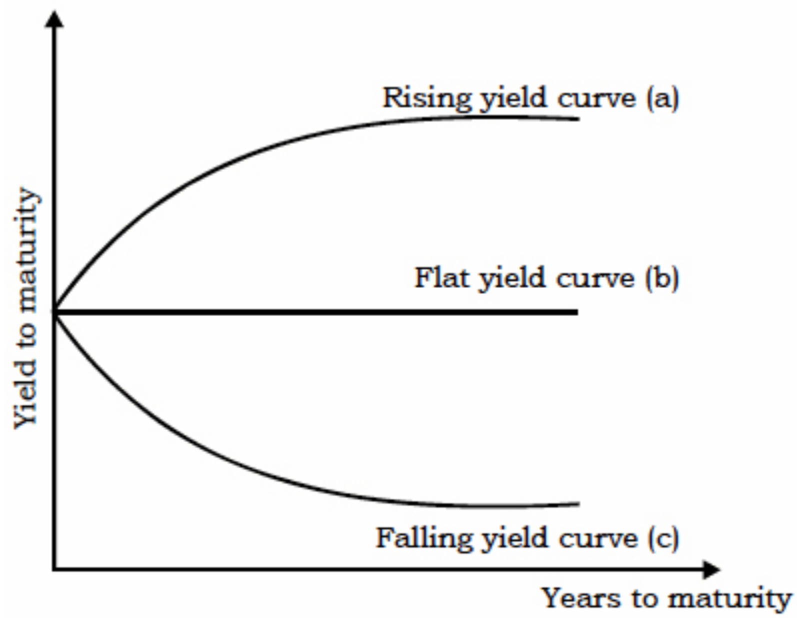
Most lenders offer amortization over 30-years. If you have a riskier asset, the lender may seek to accelerate this schedule to 20-25 years.

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. Many pundits see an inverted yield curve as the harbinger of a recession.



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. Most 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. As a reminder, you calculate debt service coverage ratio by dividing the net operating income by the debt service. Lenders may use a greater interest rate or underwriting floor to calculate the debt service when determining the supportable loan amount.

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. In addition, 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 leverage 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 since interest-only benefits the lender, too. Specifically, 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 your equity back out of the property. Most apartment owners are on a constant churn of refinancing at the end of their prepayment or fixed rate periods. As such, anything that increases the time between refinancing can save you money.

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 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. Nonetheless, recourse is expected for most bank and credit union loans.

Interest Calculation AKA Accrual Method

Lenders can calculate interest a few ways: 30/360, Actual/365 (or 365/365), and Actual/360 (or 365/360). Pay attention to this jargon because it could save you thousands in interest over the life of your loan. Most lenders will not state up front which method they use to calculate interest. If you would select a different lender because of a 5 bps (0.05%) difference in rate, then you'll want to ask each lender how they calculate interest. The table below compares the calculation methods.

Calculation Method	Quoted Rate	Effective Rate
30/360	4.000%	4.000%
Actual/365 (365/365)*	4.000%	4.003%
Actual/360 (365/360)	4.000%	4.056%

*During leap years, actual/365 has an extra day of interest, making the average calculation 365.25/365.

Actual/360 is clearly the best deal for the lender and the worst for you, the borrower. By adding 5 days to the numerator (6 during leap years) and not the denominator, you are effectively paying the bank extra days of interest. While this seems deceptive, courts have allowed lenders to use this approach. However, it seems obviously deceptive not to disclose this choice of calculation when trying to win a borrower's business. Nonetheless, lenders do not disclose this, often not even in the fine print. You must ask the lender when gathering soft-quotes and before signing a Letter of Interest.

"5-6 bps or 0.056%? What's the big deal?" Consider that on a $1,000,000 loan at 4%, it works out to be about $500-600 per year of extra interest or about $3,000 over the average 5-year fixed period. By using the Actual/360 calculation, the lender charges you more.

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. Insurance/ACORD statement of covered perils (be sure to clear up any flood insurance requirements early!)
17. Entity documentation, for example, 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 their 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
- Microsoft OneDrive

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 (such as 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 FedEx misdelivered boxes that were 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 four 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 recounted a cleanup 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 should 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 often depends on 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 issue an LOI on a deal that won't ultimately be approved. The middle ground is fuzzier. 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 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 (for example, pet fees, laundry) if they believe it is likely to continue (in other words, 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 (for example, 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 upward, resulting in less available cash flow to support the loan amount, which means 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. 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 so long as you continue to own the property.

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%. 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 like 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 escrow officer 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.

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