eastern union
FUNDING

The Eastern Way

Commercial Real Estate Financing
Based on the Methodology of Eastern Union President

Ira Zlotowitz

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Foreword

In May of 2001, a small office with four brokers opened in Brooklyn, NY, focusing on limited types of commercial real estate financing. This was the beginning of Eastern Union Funding, founded by myself and my partner, Abraham (Abe) Bergman. By May 2002, just one short year later, the company had grown to twelve full-time brokers working in a new office. Now fifteen years later, Eastern Union Funding is a nationally recognized brand with offices in four states and brokering over 3 billion dollars in annual financing. Our clients span the continental United States. Eastern Union runs loan programs for all types of commercial financing including multi-family, office, industrial, retail, shopping centers, regional and power malls, hotels, construction, new development, hard money loans, and bridge loans.

As part of the broker training at Eastern Union, new employees were given a pamphlet I wrote to serve as a guide to the mortgage finance broker. Over 500 staff members have gained the tools they need to navigate the business independently.

After witnessing how this pamphlet successfully explained the basics of financing to the uninitiated, I expanded the pamphlet into a book to reach and serve a broader market. The goal of this book is to offer a comprehensive overview of commercial real estate financing and to open the field to anyone who chooses to work in the field of commercial real estate. The primary focus of *The Eastern Way* is the financing of income-producing commercial properties. It is geared for the beginner commercial mortgage broker. Common financing situations are explained, detailed examples provided, and current real estate lingo is defined.

A book of this sort can never be considered a complete work; the business of commercial financing is constantly evolving and new associates with innovative ideas continually change the field.

All roles in the book, such as borrower, tenant, and lender are referred to in the male gender. No discrimination is meant by this; it is merely a tool of convenience to avoid interrupting the smooth flow of language which may distract the reader from the concepts being explained.

None of the statements in this book are intended to be used as statements of facts or as legal or accounting advice.

It is my hope that this book will assist anyone entering the real estate field and serve as a stepping stone to their success.

Ira Zlotowitz, President
Eastern Union Funding
August 2016

Acknowledgments

The information and experience distilled in the pages of this book have been culled from the myriad people I encounter in the field: bankers, clients, leasing agents, my employees, and even competing brokers. This book, indeed much of my success, is to their credit. Each one deserves individual mention, an impossible task. May you all attain much success in all your future endeavors.

I wish to express my gratitude to all the brokers, secretaries, underwriters, and support staff at Eastern Union Funding for their dedication and commitment to the success of the company. Among their accomplishments are the contributions they have made to the production of this book.

Special mention must be made of the hundreds of people to whom I have had the opportunity to teach the business of commercial real estate over the years. My students always give me fresh insights into the industry. After achieving great heights themselves, many have come back and shared their experiences with me and their secrets of success. .

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I must thank my family and close friends individually and from the bottom of my heart. They have always been at my side, encouraging me when I failed, and applauding me when I triumphed. I would like to express my deepest gratitude:

TO my dear parents, Rochel and Meir, who have instilled in me the confidence and drive to pursue my dreams. My business sense, passion, and prudence are gifts from my father whom I admire for these attributes and so much more. From my mother, I have learned to never earn success from another's failure and to lend a hand to anyone in need. The combination of these qualities continues to give me all that I need to venture into the world and shape a path of my own.

TO Abe Bergman, my business partner and founding member of Eastern Union Funding, for standing beside me from the beginning as we continue to build up the company. Abe took the risk by leaving a solid job to found Eastern Union Funding with me. He anticipated what we could accomplish as a team and he shared my dream. His integrity, character, honesty, and spirit are the lifeblood of our company.

And finally,

TO my dear wife Rochi - my partner in life - for creating a beautiful home of comfort, serenity, and joy for ourselves and our children. It is only her love that enables me to continue to grow, both in the financial sphere and as a human being. She is my inspiration and my incentive. My aspirations and achievements are all a reflection of her support.

Thank you.

INTRODUCTION

A broker provides a service for two parties by bringing them together for their mutual benefit. The commercial mortgage broker is no different. As a commercial mortgage broker, you must understand the needs of the borrower, the objectives of the lender, and arrange a deal which is satisfactory to both.

The arrangement of this book reflects this three-fold role of the broker. **Part I, the Borrower**, introduces you to the basics of real estate investment. Understanding the components of real estate investment will give you the ability to properly service your client, the real estate investor. **Part II, the Bank**, explains the foundations of financing, from the lender's source of funds to the bank's approach to maintenance fees. Finally, **Part III, the Broker**, discusses the practical aspects of the broker's job such as how to speak to your client, how to negotiate with a lender, and how to find and structure the right loan.

Before you go on to Part II, you may want to go back and reread part or all of Part I. The material in Part II is assumes a clear understanding and familiarity with the concepts and terms explained in Part I. Similarly, Part III is based on the foundation laid in the first two parts.

While it is the goal of this book to provide you with a working knowledge of commercial real estate financing and brokering, real expertise in the field cannot be learned from a book. The only way to become proficient at this job is to get involved in the actual day-to-day activities of a broker and to observe the workers around you. No teacher is better than real life observation and hands on experience. As you progress in your career, you can continue to use this book as reference and refresher of the basic principles of the field.

PART I

THE BORROWER

CHAPTER 1

REAL ESTATE PRINCIPLES

Anyone who has been involved in real estate investment has heard that classic pitch, "Have I got a deal for you!." At one time or another, you've probably heard about deals that sounded good or bad for one of the parties. However, as you get more involved in real estate, you will see the truth in the saying, "There is a buyer for every property in America."

Everybody has different reasons for buying and selling. A property that one person wants to get off his hands might be exactly what someone else is looking to purchase. Often a seller will tell you that he was thrilled about his selling price. Perhaps he bought the building many years ago at a very low price and he is now ready to retire. Or perhaps the building's neighborhood and condition required too much money and management and he just wants to walk away with what he perceives to be a fair price. Speaking to the buyer in the very same deal, you may hear that he sees the building as a great acquisition. He may have the ability to invest energy, time and money into the property and eventually raise its income and value.

In this chapter, you will learn the elements that comprise the financial foundation of every real estate venture and explore the variables that can turn a good investment into a great deal.

Objectives

- To understand the concepts of Return on Investment and Cash-on-cash return, and how they are calculated
- To understand how these formulas are used
- To become familiar with other variables that are taken into account in assessing a purchase

1.1 Return on Investment

	Monthly	Annual
Rent: $1,200 x 2 =	$2,400	$28,800
Mortgage:	$1,400	$16,800
Other Expenses:	+ $550	+ $6,600
Total Expenses:	$1,950	$23,400
Total Income:	$2,400	$28,800
Total Expense:	- $1,950	-$23,400
Net Cash Flow:	$450	$5,400

A Good Deal

A two-family house went up for sale in your neighborhood for $160,000. How would you decide if it is a worthwhile investment? Naturally the first thing you want to find out is the amount of profit that the building could bring you. Suppose your initial inquiries yield the following information: According to the prevailing market, each apartment could be rented for $1,200 per month. Monthly payments for the **mortgage** (the loan for the acquisition of the building), are $1,400. All other expenses for maintenance and repair of the building are estimated at $550 per month, bringing the total expenses to $1,950. With a total income of $2,400 per month, (2 apartments at $1,200), and expenses of $1,950, the **Net Cash Flow** is $450 per month.[1] The Net Cash Flow

[1] Details on income and expenses are more complicated than this and will be discussed in future chapters; this case is simplified for clarity.

is the bottom-line profit of a building and is calculated by subtracting all expenses from the gross effective income.

Net Cash Flow should not be confused with Net Operating Income (NOI). The Net Operating Income is calculated BEFORE the mortgage payment. In this example, the Net Operating Income would be $1,850 per month, which works out to $22,200 per year.

An additional $450 in your pocket every month certainly sounds good but does it necessarily mean that it is a worthwhile investment? To find out, you must apply the **Return on Investment**[1] [**ROI]** percentage. The ROI is the basic measure of a good investment. It measures the annual percentage of the original actual investment that returns to the buyer as profit. This number is the most reliable indicator of how profitable a deal is. The higher the ROI, the stronger your money is working for you.

Applying the ROI Formula

In calculating the Return on Investment, only money that the buyer actually laid out for the deal is considered. The mortgage represents funds that the bank loaned for the purchase, not money spent by the investor, so it is not included. Money spent on closing costs (the fee for finalizing the deal) or any other actual outlay of money is included

For example, we can apply this formula to the case described above. Typically the buyer must put down 25% of the purchase price as the **"down payment"**. On a purchase price of $160,000, this comes to $40,000 (.25 x $160,000). Assuming that the closing costs are $7,500, the total actual investment is $47,500. With an NOI of $5,400 ($450 x 12), the annual return on investment is 11% ($5,400 ÷ 47,500). This means that each year, the buyer receives 11% of the amount he initially invested. Matters staying as they are, his initial investment will be recouped in less than 9 years.

The ROI only measures how profitable a particular deal is, not how much money the investor actually walks away with. Money produced by the property that is not available as cash—whether it is set aside as reserves (see chapter 10.2) or for any other purpose - is included in the ROI.

Cash-on-Cash

An investor also wants to predict how much cash he can earn from the deal and how quickly he will receive it. Most investors do not have unlimited cash reserve and want to know how quickly cash will become available so that the money can be used for future deals. The ROI takes into account all net profits from a property, including those unavailable as cash, cannot provide this information. For this information he needs to look at the **cash-on-cash return**.[2]

The cash-on-cash return is defined as the percent return on the buyer's actual out-of-pocket costs, including down payment, and closing costs minus the annual operating expenses, reserves, and annual debt service payments. Since the cash-on-cash considers all destinations of outgoing cash (such as reserves) as expenses, it is an accurate indicator of the cash that is actually available annually.

Once an investor decides on a cash-on-cash return that he is comfortable with, he can then use that percentage to weed out any deals that are not appropriate for his investment needs. For example, an investor whose target cash-on-cash return is 10% is approached with an offer to buy a building with a gross rent of $205,200total expenses of $132,233 per year, and therefore- an NOI of $72,967. Deducting the mortgage payment ($42,967) from the NOI will give the buyer an available net cash flow of $30,000 a year. Since he would like to receive a 10% cash-on-cash return, he would consider this property only if his total cash investment (down payment plus closing costs) will not exceed $300,000 ($30,000 ÷10%).

[1] Sometimes referred to as **Return on Equity**.
[2] Also called equity dividend.

This does not mean that the cash-on-cash percentage is used as a means of arriving at a fair value for the property (see chapter 2, Appraisals). It is a tool that can be used by an investor to choose the investments that will produce a rate of return that fits his particular needs.

Other Variables

The return that an investor usually seeks for a minimal risk investment is 12% to 15% cash-on-cash. The cash-on-cash percentage and the ROI, however, are not the only factors that are taken into account in an investment. There are countless angles to take into account on each deal and different investors approach investments from different perspectives. Here are 4 of the most common factors which affect any investment.

- Safety of investment
- Development potential
- Financial instincts
- Location

➢ Safety of Investment

The safer an investment, the lower the return that an investor will demand. For example: If a six-family house became available next door, despite only an 8.5% ROI, it could still be considered a good investment since your familiarity with the area makes it a safer than average investment. Over time you can build up equity, meaning that the value of the building will likely increase. In this case, you might invest even without making your 12% to 15% goal.

➢ Development Potential

A buyer may consider a property at a price of $1,100,000 and make the following calculation: “This building has an NOI of $72,967 and may only be worth $1,000,000. However, if I do certain improvements such as upgrading certain items or extending the building, within a year it can be worth $1,500,000.” This buyer would be willing to overpay today with a price of $1,100,000 and then invest an additional $200,000 towards renovations since he hopes to increase the NOI and bring the overall worth of the property to $1,500,000. The $100,000 extra that he paid for the building plus $200,000 in renovations will have been well worth it.

➢ Financial Instincts

An investor may disregard the actual number of the ROI in his conviction that the building is worth more than the NOI indicates. He may be relying on his years of experience in the field or based on owning other similar properties in the neighborhood, he may how much such a building will sell per square foot.

➢ Location

A buyer may overpay because he is planning on using his purchase as an owner-occupied property and this location will give him a higher natural value. The same principle is illustrated by the sale of single-family homes where the price is based on location, not on the potential income that a given house could produce.

➢ The Individual Investor

The dominant factor that affects every deal is the unique personality and situation of the investor. Everyone invests his money in different places based on his own perception of risk vs. reward. A deal that seems risky for one investor may seem reasonable to another. All investors have different budgets, circumstances, and outlooks. What an older investor might consider an undue risk might be considered by a younger investor to be a great opportunity.

As a broker, it is important to recognize with whom you are dealing. Knowing the individual client and his situation is the first requirement in best representing his interests.

Maintaining Value

Despite projections for healthy profits, an experienced investor only goes forward with a purchase if he is convinced that he can recoup the initial purchase price if he has to sell the property. In order to assure this, the prospective buyer must have an **appraisal** (estimation of value) done on the property. The appraiser will tell him what the real value of the building is at the present and give an estimate of its future value. The process and methods of the professional appraisal will be discussed at length in chapter 2.

CHAPTER 2

APPRAISALS

An appraisal is a professional estimate of the value of a property. Appraisals are crucial for the purchaser and seller for determining a reasonable selling price. Lenders rely on appraisals to ascertain the present and future value of a property, to determine the risk in lending on a particular property, and to calculate the loan amount (see chapter 11.1).

This chapter presents a brief overview of the methods and procedures of a professional appraisal as it applies to the finance broker.

Objectives

- To understand the three approaches used in determining value
- To learn how the cap rate is calculated, and how it is used to show value
- To become familiar with the methods of the appraiser in confirming and adjusting the numbers

2.1 Approaches to Determining Value

There are three methods commonly used in appraising properties. An independent appraisal service reports the value indicated by each of the three methods. A buyer will normally bid somewhere between the lower and the higher result of the methods. When ordering an appraisal for the purpose of a loan, some banks will favor one method over another and some just use the method that yields the lower amount.

The three methods are:

- Market Comparison Approach
- Cost Approach
- Income Capitalization Approach
    - Multiple Income Approach Variation

Market Comparison Approach[4]

The market comparison approach determines value by using comparisons of recent real estate sales prices in the area of the property being appraised. The properties used for comparison must be similar in type, size, age and condition. For example, the recent sale of an apartment building in Bronx, NY containing twenty units for $1,000,000 dictates that a similar building with the same amount of apartments in that market will also be valued at $1,000,000.

In the case of residential properties this is a relatively easy task. There are usually enough recent sales in a given neighborhood to work with and plenty of **comparables** or near comparables. Finding comparables is a much more difficult task when it comes to commercial properties. Commercial sales are comparatively less frequent than residential sales and typically have many more variables in their physical and financial setup. For example, an appraisal is sought for a 5,000 square foot 10 year-old suburban retail complex

[4] Also called market data approach

situated in a poor location for retailers, having five tenants with different lease renewal dates. To use the market comparison approach, it is necessary to find a direct comparable sold recently enough to be an indication of the present market. In many cases this is simply impossible. Instead, an appraiser must come up with sales that are as close to the conditions of the appraised property as possible and then make adjustments to take into account differences such as the timing of the lease renewals, location, and age of the buildings.

- **Cost Approach**

The cost approach calculates the value of a property by estimating the amount it costs to rebuild a building from scratch at current prices (replacement cost) and then adding the current value of the land. To appraise a 15 year-old factory building situated on a 10,000 square foot lot, the following calculations would be made: The total cost to construct a factory building similar to the one on the lot, including material and labor, is $1,000,000 or $100 per square foot. The value for the land itself, without any building on it is $500,000, bringing the total costs to $150 per square foot. You now have a value of $1,500,000 ($150 x 10,000 sq. ft.).

One more adjustment must be made before arriving at the final value. The calculation used above gives you the amount it would cost to build a brand new building. However, the building that you are actually appraising is 15 years old. The appraiser must estimate an amount that represents the fifteen years of physical deterioration, and subtract that from the final value.

Besides physical deterioration, there are also other factors which must be adjusted for when comparing a new building with an older one. For example, the product that this factory has been manufacturing may be produced more efficiently today with an upgraded design or technology that the present building does not support. This **functional obsolescence** is estimated with a dollar figure and subtracted from the final value.

The formula for a cost approach appraisal is:
(reproduction costs + site value) – (physical deterioration + functional or economic obsolescence) = value

- **Income Capitalization Approach**

This approach applies the **capitalization rate** (Cap rate) to the Net Operating Income of a property to arrive at an appraised value. In today's environment, this is the most common way of determining value and is typically considered the most important method for appraising apartment and office buildings, hotels, and shopping centers. Before illustrating the application of this approach, a comprehensive explanation of what a cap rate is, how it is calculated, and what it indicates, is needed.

What is a Cap Rate?

The cap rate is the annual return on the total investment into a property, expressed as a percentage. It is arrived at by dividing the net operating income from the building (before expenses such as mortgage payments and income taxes) by the total price of the building. The purchase price includes both the down payment and the amount loaned by the bank. For example, a building with an NOI of $72,000, and a market value of $1,000,000, has a cap rate of 7.2%. This means that the building produces 7.2% of its value in profit every year.

Unlike the Return on Investment above (1.1), where the investment included only the down payment and not the money loaned by the bank, when calculating the cap rate, the total market value of the building is used. This is because these formulas are used for different purposes. The ROI shows how profitable a particular investment is for the investor. To show this, the amount that represents his personal investment must be used. The cap rate, on the other hand, is focused not on a specific investment but on the overall value of the building compared to its profits. This value does not change based on the amount of money that is borrowed or laid out in a particular sale.

Applying the Cap Rate

In the above example, we have used the NOI and the known market value to arrive at a cap rate. When using the cap rate approach to appraising a property, the reverse is done. A cap rate is first determined for a particular area. This is done by looking at recent sales of comparable properties in relation to their NOIs. For example, if comparable buildings with NOIs of $90,000 sold recently for $1,000,000, this translates into a cap rate of 9% (or, “a nine cap”) for that market.

This cap rate can then be applied to the NOI of the building being appraised to arrive at a value. Thus, the estimated value of a building whose NOI is $250,000, in a market with a cap rate of 9%, is $2,777,777 ($250,000 ÷ .09).

Income Approach Variation

A simpler version of the income capitalization approach is the **multiple income approach**, in which the price of the building is expressed as a multiple of the gross annual income. If properties are selling for five times the rent (five times the total income from rentals) in a particular market, a building with an annual income of $200,000 will be priced at $1,000,000. This variation became the accepted method in certain markets due to the simplicity of its calculation.

Cap Rates and Investment Security

In the commercial real estate market, cap rate is used as a barometer of how secure the property and location are in a particular market. The rule is - the lower the cap rate, the higher the level of security and the more value the property has. This may sound counterintuitive at first so consider the following example:

A shopping district has a cap rate of 7.2%. This means that buildings selling on the market for $1,000,000, are producing $72,000 per year in net operating income. If consumer traffic increases in the neighborhood and starts producing more income, the NOI of the building will go up. However, this alone will not change the cap rate. As the NOI increases, the building itself becomes more expensive due to its higher income. Conversely, if profits in a given area decrease, the prices of buildings will also decrease. This market adjustment will ensure that the cap rate, which is the ratio of the NOI to the overall cost of the building, will remain more or less constant.

The main factor which affects cap rate is **investment security**. It is a basic principle of investing that the higher the risk of a given investment, the lower the price of that investment. Conversely, an investment that is very secure will be more expensive since there is less doubt that a profit can be made. In real estate, investors are willing to pay comparatively higher prices for a lower annual return in an area that is a secure investing environment. In time, the long-term value will outpace the smaller return. Thus, a low cap rate is an indication of an area in which investors are willing to accept lower NOIs for more expensive properties because of the stability of the neighborhood. Consequently, while an average shopping district in a healthy market may have an 8% cap rate, Manhattan is a consistently secure area of investment and has an average cap rate of about 4.5%.

Confirming Property Values

The actual job of the appraiser starts well before the cap rate can be applied. An appraiser must confirm that all the income and expense numbers that he is given are indeed accurate. The appraiser verifies these numbers by looking through the leases, bills and city tax records.

After all the relevant numbers of a property are verified, the appraiser must then make adjustments for the prevailing market conditions. Even if an apartment is fully occupied, it is still appraised as having the average vacancy rate of the neighborhood in which it is situated. This is because the local market of the building is usually a better indicator of future vacancy than the building's present occupancy level. Similarly, an appraiser looks at what comparable buildings are collecting for rent per square foot, as well their various expenses.

It is important to remember that these are not rigid formulas. In making these comparisons, an appraiser will take into account any aspects of the building which make it unique. For example, if it can be argued that the reason that this building has a lower vacancy rate is its lower rent or better upkeep, the appraiser may apply a lower vacancy rate than the market average..

CHAPTER 3

TYPES OF PROPERTIES

The first two chapters of Part I dealt with the basics of investments: what makes an investment a good one and the different ways of looking at the value of a property. Now we can address the actual properties. What are the options available to the investor in terms of type and size of properties, and what are the specific advantages and disadvantages of each? These questions are addressed in this chapter.

Although the primary focus of this book is on commercial properties, it is important for the finance broker to be aware of all of the property types on the market, and to understand the risks and benefits specific to each type.

Objectives

- To become familiar with the three general property types and their relative safety of investment
- To understand how the size of a property affect its bottom line

3.1 Types of Properties

There are three basic property types dealt with in real estate transactions:

- Residential
- Commercial
- Mixed-Use

➢ Residential Properties

In the real estate industry, residential property refers to properties used primarily as dwelling places. This may be a single family home or a **multifamily property**. A multifamily may be a **duplex** (2 unit), **triplex** (3 unit) or **quadruplex** (4 unit). A property with five or more units is considered an apartment building. Residential properties can be tenant-occupied, owner-occupied or mixed.[5]

➢ Commercial Properties

A commercial property is designed for use by a retail or wholesale establishment, office, hotel or industry.

➢ Mixed-Use Property

A mixed-use property contains more than one of the above property types, e.g., a property that has stores on the ground level and apartments above it.

A commercial property, as defined above refers to all non-residential properties. This is indeed the most common reference in the real estate industry at large. However, in the technical language of financing,

[5] In certain contexts, the term 'residential properties' refers only to owner occupied housing.

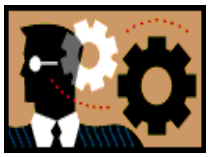
multifamily buildings that contain more than four units are also regarded as commercial properties. All properties require a commercial loan except for residential properties with less than five units,

3.2 Security vs. Profits

The decision to invest or lend on residential properties versus commercial properties is often based on more security versus greater profits. Residential properties represent greater security due to the different attitudes that a commercial renter and a residential renter have towards the mortgage payments.

A business owner going through a bad period may decide that the rent on one of his offices can wait in favor of some other, more pressing, expense. In a more severe situation, he may give up on a particular factory or business that is not covering its costs and let it go into **foreclosure** (repossession of a property by the lender). On the other hand, a tenant whose primary dwelling is in a rented property or a homeowner who is responsible for a monthly mortgage payment will always give the monthly rent or mortgage payment his absolute highest priority. Shelter, along with food and clothing, is the most basic of human needs. Even when times are hard and other bills may be pushed off, the tenant or homeowner will make sure to first pay his monthly rent or mortgage. Payment on a residential property is income that a landlord or lender can rely on. Thus, although the potential profit from residential properties is generally less than from commercial properties, residential properties are considered to be the safer of the two investment choices.

Primary Residence



Two people apply to a bank for a mortgage. One is a first-time home buyer and the other is applying for a second or third home. Who receives better terms for the loan? One might suppose that the one applying for a mortgage for the second time is in a better position. After all, he has already proven himself to be a person with the means to buy a home and pay back the mortgage, while the first time home-buyer is a financial unknown. However, banks are actually more willing to lend to a first time home buyer than to one who already has a home. The principle behind this is the same as that discussed above regarding the security of residential properties. For the first time home buyer, this home will become his primary residence; he does not have any other place to go to get out of the rain. Even in a crunch, his mortgage payments are his first priority every month. To the bank, this represents a high level of security that they will receive their payments in a timely fashion.

On the other hand, should someone who owns multiple homes fall upon difficult times and can no longer pay all his mortgages, he may decide to risk foreclosure by stopping payments on one of his mortgages while he stays dry in one of his other homes.

3.3 Size of Properties

Size is another factor that investors take into account when deciding on a property. The larger the property and the more tenants, the more profit the property can produce. Large properties are also usually a safer investment. In a property with a lot of tenants, each individual expense is a smaller percentage of the overall profits. If a costly repair becomes necessary or one of the tenants defaults on payment, that expense is offset by the large number of rents that can still be expected monthly.

Paying for utilities is more economical in larger properties since many tenants can be serviced by the same infrastructure. For example, in an apartment building with sixteen apartments,, tone boiler needs to be purchased and maintained whereas if the same tenants were spread out over four smaller properties, then four separate boilers would have to be bought and maintained.

CHAPTER 4

THE TENANTS

After the physical and functional aspects, the most important aspect to look into before investing in a property is the tenants. The quality and characteristics of the tenants can make or break a property. In this chapter, you will learn about the types of issues that can arise from a weak tenancy and the qualities that landlords look for in prospective tenants.

Objectives

- To appreciate how a property is impacted by the actions of each tenant
- To understand how credit and anchor tenants are beneficial to a property

4.1 Downsizing

When a tenant enters into a space, a **lease** is signed. A lease is a contract between the tenant and the landlord specifying the details of the agreement. These details include: the exact space that the tenant will occupy, for how long, the rent amount, and the arrangement of expenses. As the expiration of the lease draws near, the two parties will discuss terms for renewal. At that time, any changes to the original agreement will be negotiated.

When business is good, a tenant will generally not change much of the original terms. However when profits are not covering costs, the tenant will look to change the terms to enable him to pay the monthly rent. One of the most common changes is to **downsize -** to reduce the amount of space that a company occupies. For example, a company may halve its rent expense by arranging to have two employees occupy one office instead of each employee having his own private office.
As long as the downsizing happens at the time of the lease renewal, it is a relatively simple process. When a company feels the need to downsize in the middle of a lease contract, it is a bit more complicated. A company cannot just "walk away" from a lease. Usually the rent is guaranteed by the tenant for the entire period of the lease. Larger companies are guaranteed by their parent holding company and smaller companies offer personal guarantees. What options remain for a company in this predicament?

One way of downsizing in the middle of a lease is to **sublet,** or sub-lease, all or some of their space. A company that closes its doors and sub-leases its entire space is known as a **dark tenant.** Subletting isn't always allowed by a landlord and is usually something that is negotiated upfront when the lease is signed. The landlord often has restrictions regarding to whom the tenant can sub-lease the space and usually maintains the prerogative to approve or reject a prospective tenant. Other aspects of a sub-lease are negotiated upfront as well, such as whether the original, or **master**, tenant will collect all the rent from the new tenant or split it with the landlord.

Implications for the Landlord

It goes without saying that a tenant who stops paying his rent and leaves in the middle of a lease due to financial crisis negatively affects the landlord's bottom line. In the case of a sublease, however, the landlord continues to receive the full rent every month. The same is true when the vacating company, or its parent company, can still afford to pay its rent as per their guarantee, even after vacating. One might suppose that in these cases the landlord does not suffer any loss from the tenant's downsizing. Actually, it is possible for one vacating tenant to cause the financial collapse of an entire property, even if the tenant continues to pay rent until the end of the lease,
The importance of each tenant is not merely the amount of rent that it brings in. Tenant occupancy also affects traffic and appearances. For example, in a shopping center each tenant has its own customers that come to that

particular area for that specific store (see **anchor tenant**, section 4.2). If a popular tenant **goes dark**, overall consumer traffic diminishes to that center and all the other tenants in the center suffer. These tenants may then reconsider renewing their leases once they come due in favor of another, more attractive area. In this case, the failure of one important tenant causes an entire property to go sour by starting a "domino effect."

It is imperative to look at the entire picture when considering a property. It is critical to know who the parent or master companies are in order to be sure that the rent is guaranteed. It is equally important to ascertain which companies are actually occupying the space in order to anticipate the level of consumer traffic.

4.2 The Tenants

An investor, who wishes to avoid unnecessary risk to his investment will make sure that a large portion of the property is occupied by two types of tenants:

- Credit tenants
- Anchor tenants

➢ Credit Tenants

A credit tenant is a tenant with a good credit rating by a reputable rating agency, such as **Moody's** or **Standard and Poor's** (see Basics of Rating, below). Ratings for companies are a measure of their ability and willingness to repay debt. A landlord can feel confident that a tenant with a good credit rating will not go bankrupt or stop paying his rent. Usually a tenant with strong credit will have income from operations from other stores or have solid financial backing. Even if one particular store is forced to close, the company will still have the ability to carry out its financial commitments and pay the rent for the remainder of the lease.

➢ Anchor tenants

An **anchor tenant** is the main tenant in a shopping center and serves as a draw for consumer traffic, thus giving maximum exposure to the **ancillary** (non-anchor) **tenants**, or smaller satellite stores. In a large center, there may be more than one anchor tenant. Since an anchor tenant is so desirable for landlords, they are given better terms for rentals. (See section 7.3 for the concept of lower rent per square foot for an anchor tenant. See also **TI Negotiations** in section 5.2).

Sometimes the anchor tenant is situated in a property owned by a different owner than the rest of the stores in the center. The anchor is then known as a '**shadow anchor'**. While the landlord of the ancillary tenants does not collect rent from the shadow anchor, he still has all the advantages of the anchor in terms of draw of consumer traffic.

A landlord typically looks for at least one anchor tenant, or that 40-60% of the property be occupied by credit tenants. The income of the anchor or credit tenants normally covers all the costs of operating the property. Today's prime example of both an anchor and a credit tenant is Wal-Mart. Wal-Mart is a famous name and a big draw for consumers and other businesses to an area. It is also rated AA by Moody's[6] (see 'Basics of Rating below).

[6] check

Basics of Rating

There are three major agencies that are involved in credit ratings for the investment world:: Moody's, Standard and Poor's (S&P's) and Fitch IBCA. Each of these agencies provides rating systems to help investors determine the risk associated with investing in a given company.

Long–term credit ratings are denoted with a letter: a triple A (AAA) is the highest credit quality, and C or D (depending on the agency issuing the rating) is the lowest, or junk, quality. Each rating is further divided into degrees. Depending on the agency, these are denoted by either a plus or negative sign or by a number. For Fitch IBCA, "AAA" rating signifies the highest investment grade and means that there is very low credit risk. "AA" represents very high credit quality; "A" means high credit quality, and "BBB" is good credit quality.

The chart below gives an overview of the different ratings symbols that Moody's and Standard and Poor's issue:

Moody's	**Standard & Poor's**	**Risk**
Aa	AAA	Lowest Risk
Aa	AA	Low Risk
A	A	Low Risk
Baa	BBB	Medium Risk
Ba, B	BB, B	High Risk
Caa/Ca/C	CCC/CC/C	Highest Risk
C	D	In Default

CHAPTER 5

LEASES

Aside from knowing who the tenants are, it is also important to know how long they are likely to stay in the space that they occupy. Attracting new tenants to a property and facilitating their occupation can be very costly. Even renewing a lease with an old tenant can be expensive. In this chapter, a breakdown of these expenses is listed, along with a brief explanation of how they are calculated. In addition, you will learn how a prospective landlord can best judge the chances of the tenants staying or vacating their space.

Objectives

- To learn the expenses incurred in getting and keeping tenants
- To know how these expenses are calculated
- To learn how an investor can avoid the risk of buying expiring leases

5.1 Costs of a New Tenant

There are several costs for a landlord when leasing space. Some of the most common costs are: marketing, attorneys' fees, architecture, consultants, engineers, space designers and art designers. The costs that apply to any particular property are specific to the type of property and the individual needs of the tenant. In most cases, however, there will be at least two major expenses:

- Leasing Commissions
- Tenant Improvements

➢ Leasing Commission

Leasing commission (**LC**) is the commission paid to the leasing broker for finding the tenant to fill the space or for arranging the details of the agreement. Brokers can be independent or work for a specific company or business. Even when the broker works for the tenant, the commission is typically paid by the landlord.

Though the commission structure depends on the market for the property, it is usually a sliding scale based on the number of years for which the lease is signed. For example, a commission may be 7% of the lease for each of the first three years, and 3% for the remaining years.

➢ Tenant improvements

Tenant Improvements or **TI'**s, are the costs that an owner has to pay to prepare space for a new tenant, expressed in dollars per square foot. This expense is seen primarily in commercial properties. Typically, when a commercial tenant leases space, it is given to them "raw," - the entire space is void of walls, ceilings, floors, and even electricity or an HVAC (Heating/Ventilation/Air-Conditioning) system. In order to attract good tenants, a landlord will offer to **build out** - to pay for the construction of the space to the tenant's specific needs. The amount of TI's offered is a very important consideration for a tenant when considering a potential lease.

5.2 Renewing a Lease

Even when both tenant and landlord want to renew a lease, it is usually not without some negotiations for changes on either side. Usually the negotiations are handled through the tenant's leasing broker. When all the points are worked out and a deal is reached, the broker takes a fee from the landlord for his job. This is one of the costs to the landlord upon renewing a lease.

Renewal TI's

As a company's needs and functions change over the years, it may want to rearrange its space or refurnish to meet the demands of its present situation. A company may also just want to update up its appearance. The landlord has an interest in encouraging existing tenants in their property to renew the lease when it expires. In most cases, the landlord will allocate money towards **renewal TI's**.

Renewal TI's are an important negotiation point. The amount of renewal TI's is not as much as that of initial TI's. A new tenant considering a space can demand high TI's since there is nothing binding him to this particular place. If he is not happy with the offer, he can find another place to rent. However, it can be very costly for an existing tenant to relocate. There is the cost of moving and the cost of the interruption of operations during a move. In addition, it is usually disadvantageous for a company to move out of the place in which it has established itself and to which customers are accustomed to patronizing. Therefore, the renewing tenant is not in a position to demand very much from his landlord. The landlord can respond to a large demand by telling the tenant to find another place to rent - something that the tenant does not want to do.

On the other hand, the landlord cannot push this point too far. It is more costly for a landlord to get a new tenant than to stay with an existing tenant. Although there are leasing commission fees for renewals, they are much less than the fees for finding a new tenant. Furthermore, there is no certainty that another tenant will be found immediately to rent the space should the old tenant leave. It may be a few months before he can begin collecting rent from a new tenant. Thus, the tenant considering renewal does have some leverage with threatening to move out – a move that could add expenses and risk for the landlord.

Negotiations for renewal TI's usually result in a lower TI amount for an existing tenant than for a new tenant. The TI's that the landlord provides is used for painting, new furniture and freshening up the space. Any additional renovations that the tenant wishes to do must be done at his own expense. When a tenant wishes to remain but desires increased space, a landlord will typically offer higher TI's per square foot for the new space and lower TI's for the space already occupied by the tenant.

Renovations

Sometimes a tenant is in a position to request higher than usual renewal TI's, similar to TI's that a new tenant would require. This occurs when a tenant has been leasing for a long time and feels the need to entirely redo his space. Undergoing an entire renovation can be very stressful. Under such circumstances, the prospect of having to start from scratch somewhere else may not seem much harder than renovating. The tenant may even benefit from moving because as a new tenant he would be able to negotiate higher TI's and possibly a rent free period to make up for his expense. In this scenario, the landlord does not have the usual leverage of threatening a tenant with having to move. Even if he must give a high TI rate to this tenant at renewal, a new tenant will certainly demand as much. Therefore, the landlord must be flexible and give the tenant the required TI's.

TI Negotiations

TI's are not subject to set rules, just like everything else in the lease conditions. The negotiations are based on myriad details that are specific to the conditions and circumstances of each individual lease. Many factors can affect the amount of TI dollars offered in any given lease. For example, in a tenant-driven market, the tenant is in a

position to request high TI dollars since the landlord needs the tenant and will not easily find another tenant. The amount of TI's offered may even exceed the amount that the tenant needs to improve his space. In a competitive market, if one local landlord is offering $7 per square foot, a competing landlord will have to offer the same $7 per square foot even if it will only cost the tenant $5 per square foot to re-carpet and paint. In these cases, the landlord will often determine the TI dollars so that the tenant can use it towards other expenses, such as moving and relocating.

In a landlord-driven market, if $30 per square foot in TI's is being requested, a landlord may only offer $25 per square foot. The landlord knows how desirable his building is and that the tenant will most likely pick up the difference of $5 per square foot (an almost 17% difference) just to be in the desired location.

The quality of a tenant is another important factor that a landlord considers. If a landlord wants to attract a top credit tenant, he may be willing to pick up the cost of additional TI's needed by the tenant. The landlord can make that money back in a variety of ways. If the lease is long-term, which is likely, the landlord will eventually make back much more than he originally laid out. If the tenant is an anchor tenant, the TI expenditures will be recouped from other tenants who will pay more for a space near the anchor. Furthermore, when the landlord refinances, the lender will look at the building's income and lend him the maximum dollars possible due to the strength of the tenant. (Refinancing is discussed in depth in chapter 16.)

In an alternative arrangement, the landlord gives the higher TI's to the valuable tenant but also charges a higher rent. This arrangement is beneficial to both sides. The tenant is willing to pay a higher rent throughout the time of the lease and have a finished, ready-to-move-in space, rather than pay a large sum up front for the improvements. The tenant is in effect paying out the amount of the improvements over the course of the lease. The landlord, while paying a large amount for the TI's, recoups the amount over the course of the lease in rental money, in addition to having gotten a solid tenant for his property.

5.3 Buying Expiring Leases

It is risky for a landlord to buy a property that has many tenant leases expiring in the first few years after the acquisition. If many of the tenants do not renew, it will usually detrimentally affect the landlord. Aside from the actual expenses involved in finding new tenants, the long term success of a property is dependent upon keeping tenants for long periods of time. Potential tenants like to see a landlord with tenants that continuously renew their space. This tells future tenants that the landlord satisfies his tenants and that the tenants are not likely to go on rent strikes due to poor management. Eventually, a favorable cycle of existing tenants renewing and new tenants joining is established. This is the hallmark of a premier property.

When the average rent being paid by tenants occupying a building is below current market rent prices, it may be advantageous for a landlord to purchase a property with many expiring leases. The landlord will anticipate a potential growth of the bottom line when the leases are renewed since the rents will be adjusted to the average market rent. (See Base Year in chapter 6.2 for exceptions to this concept.)

Checking the Lease Dates

A prospective property owner obtains the **rent roll** to determine the state of the leases in the property. The itemized rent roll is a listing of all tenants leasing space within a building along with their lease start dates, end dates, and rental amount for each space. (There is other important information on the rent roll, which will be explained in detail in chapter 7.) To ascertain the risk of vacating tenants, these important dates are checked:

- Lease End Date
- Lease Start Date
- Move In Date

- **Lease end date**

The landlord checks the percentage of the leases that are expiring in the near future. If there are a large number of leases coming due in proportion to the amount of tenants occupying the property, there is reason to be wary. The landlord must also take note of the size of the space occupied by tenants whose leases are expiring. It is just as harmful if only a few tenants leave if they take up a large portion of the space in the property.

- **Lease start date**

The lease start date gives the lender or buyer an idea of the likelihood of each tenant remaining or leaving. The longer a tenant has been fulfilling the terms of the lease at the current location, the more likely that the tenant will remain. When determining the risk, the start date is a very good indicator of which way the tenant will go when their lease expires.

- **Move-in Date**

Many documents will show the move-in date for each tenant, rather than the lease start date. This date can be a stronger indication of a tenant's inclination to stay. A tenant who just renewed his lease does not have a very early lease start date, but may have actually occupied the property for a long time under previous leases. The length of time that a tenant is in the same place says a lot about the strength and consistency of the tenant. Retail tenants rely heavily on their location for consumer traffic and are more likely to stay at a location that they have occupied for a long time.

CHAPTER 6

TENANT'S REIMBURSEMENTS

There is one more major area of concern which a prospective landlord must investigate upon considering a building- the expenses that the property demands of the landlord each year. First, he must find out which expenses apply to the particular property and how much they amount to. After that, it must be ascertained how much of those expenses are the responsibility of the landlord. Typically, the landlord is compensated for some or all of the expenses by the tenants, depending on how the tenant's reimbursements are structured for the particular lease. Although there are no set rules as to how the reimbursements are set up, there are a few basic methods usually employed in one form or another. These methods will be explained in this chapter, along with a list of the expenses commonly affecting most properties.

Objectives

- To become familiar with some of the common property expenses
- To learn the methods used in calculating the tenant's share in these expenses

6.1 Expenses

In order to get a complete picture of the expenses of a particular property one must read the **income and expense sheet** prepared for that property. The income and expense sheet details all the recent expenses of a property, as well as financial projections for the future. It is made available to an interested investor so that the property can be properly evaluated. A full description of the income and expense sheet and a line-by-line explanation appears in chapter 7.

Following is a list of the common expenses which apply to most commercial properties, and a brief explanation of each.

- **Utilities** - These include water, sewer, gas, electricity and telephones.
- **Repairs and Maintenance** - The cost of the day-to-day repairs and upkeep of a property.
- **Management fee -** The fee a company or individual charges to collect rent, oversee workers, and take care of any issues arising at the property. A buyer usually calculates the management fee as 5% of the effective gross income. For a larger property, 4% may be used.
- **Payroll -** The labor cost of a full or part-time super or maintenance worker on or off the premises
- **Insurance -** The cost to insure the building. This may include hazard insurance, liability insurance, or both.
- **Real Estate Taxes**

Reimbursements

In addition to the rent, tenants usually pay a certain amount per month to cover the operating expenses of the building. Which expenses the tenant reimburses and the amount of the reimbursements varies according to the type of property and the particular arrangement with the landlord. In an apartment building, the landlord usually pays the water, sewer and electricity costs for the building. In some multifamily properties, tenants have individual

meters and pay for their own utilities. In this case the landlord only pays for the common areas of the building (see more in chapter 7.1, income and expense).

With office buildings and shopping centers, it is common to have tenants reimburse the landlord for their share of all the expenses. Each tenant keeps separate meters and pays for the utilities used by his space of the property. However, the general building expenses, such as taxes and insurance, cannot be apportioned so simply. A reasonable amount is set and agreed upon as the amount the tenant is responsible to pay regardless of any fluctuation in the actual cost for that expense.

Taxes and insurance are usually reimbursed with the following two methods:

- Pro-rata
- Escalation Payment

➢ Pro-rata

The simplest method of reimbursement is to pay for all expenses **pro-rata**, or proportionately. The share for each tenant is calculated as the percent of the building that their space occupies. For example, if the total insurance bill for a property is $20,000 and Verizon occupies 15% of that property, Verizon's share of the insurance bill is $3,000 ($20,000 divided by 15%).

➢ Escalator clause

Using the escalator clause, a tenant will reimburse a landlord only for any increase in expenses above a given **base year**. The base year is the year that all future calculations are based on and is usually the year that the lease commences, although it can vary from lease to lease. A full calendar year of expenses is considered as the base year and any expenses above that amount is the tenant's responsibility in proportion to the percentage of space that the tenant occupies. This can be the arrangement for the real estate taxes, insurance expenses, or for all of the reimbursements of a building. (The method most commonly used for each expense will be noted in chapter 7 as part of the breakdown of the income and expense sheet.)

For example, a tenant who occupies 15% of a shopping center agrees to pay the real estate taxes on an escalator scale. The base year taxes for the property are $185,000. The following year, the tax amount increases to $200,000. This tenant is thus liable to pay $2,250, which is 15% of the increase ($15,000 divided by 15%).

Base Year

In chapter 5.3, we discussed the possible advantage of purchasing a property despite the fact that many leases are coming due because the current average rent is lower than the market rent. As explained above, the landlord anticipates raising the rents and benefitting from the new leases. There is one caveat to this calculation. It is not so simple to say that a building with an average rent of $18 per square foot in a market of $24 per square foot will automatically increase the gross income by $6 a foot when the lease is renewed. The new leases will carry with them lower reimbursements because the base years will be reset for the current year's expenses, which are probably higher than the expenses of the year in the original lease. The reimbursement income will decrease and the gross rent will increase with the ultimate net increase less than the $6 per foot increase anticipated.

Capped reimbursements

Sometimes a lease stipulates a cap on reimbursements. For example, a tenant may stipulate that they will pay their pro-rata share of any increase above the base year, but only up to 5% above the previous year's expenses. In this way, the tenant is protected from any dramatic rise in expenses from year to year.

Gross vs. Net

A **gross lease** is an arrangement in which the landlord is responsible for all of the expenses of the building and the tenant does not contribute towards any of the reimbursements. The landlord pays the real property taxes, owner's insurance, liability insurance and maintenance.

In a **net lease**, the tenant is responsible for a portion of the expenses. This classification is further divided into **net**, **double net**, or **triple net**, reflecting different levels of tenant responsibility for the expenses. The best setup from the landlord's point of view is the triple net lease (**NNN**), where the tenant pays all of the expenses associated with the property's operation, from utilities to license fees. In a NNN setup, the landlord is only responsible for expenses that are not directly related to the use of the building, such as income taxes and debt service (payments for the mortgage).

The details regarding the exact setup of reimbursements change from lease to lease and are the subject of negotiations between the tenant and landlord. See chapter 17.2 regarding possible discrepancies that can come up with regard to reimbursements.

Percent Rent

Another expense that a tenant may pay his landlord is **percent rent**. In a percent rent arrangement, the tenant pays the landlord a percentage of all of his profits above a certain dollar amount, in addition to a fixed rent per month. The percent rent fluctuates from month to month. This arrangement is most common in shopping malls.

The fixed portion of the monthly rent is referred to as the **base rent**. The tenant must give this amount regardless of how much profit is made that month. After the tenant brings in an agreed upon amount of income for the month, the landlord starts collecting a percentage. This point is called the **break point**, or break-even point. The break point is estimated at the amount with which the tenant is guaranteed to cover all his expenses and walk away even. Anything that the tenant makes above that amount is considered profit, of which the landlord takes a share.

CHAPTER 7

The Income and Expense Sheet

As we have seen in the preceding chapters, there are many facts and figures about a property that an investor must find out in order to make a balanced decision about a purchase. What is the source of this information and how does an investor go about finding it?

A serious potential buyer is given a set of documents regarding the property that he is considering, referred to as ***the setup****. The documents are the Income and Expense Sheet and the Rent Roll. The figures which appear on these documents are the lifeblood of the building. They are the numbers that are used in determining the value and purchase price of the building, the NOI, and the cap rate.*

A broker must be familiar with these documents, know which numbers to look at and how to understand them. This chapter explains the basics of the Income and Expense Sheet. The rent roll is explained in the following chapter.

Objective

- To understand the components of the Income and Expense Statement

7.1 What is the I/E?

The income and expense (I/E) statement, or the **financials,** is a summary of the annual net income of a property broken down into the individual sources of income and expenses. Typically, each of the categories of income and expense are listed for the present year as well as for some preceding years. The information for the previous years is documented to highlight any emerging patterns in a specific category. It is important for a potential buyer (as well as any present owner) to recognize trends in all of the sub-categories of income and expense. In addition, when information for each category for a few consecutive years is aligned, any anomaly in a specific category becomes obvious. The ability to spot such an anomaly is clearly very valuable to a present owner or potential buyer.

There are times that an income and expense sheet will include a forecast for the next year based both on previous trends and on forecasted expenses (see 7.3). The statement may also include a brief description of the property, and other basic information.

7.2 Sample I/E

Below is a sample income and expense statement for a commercial property. The numbers on the left side of the document were inserted for reference purposes and are not part of the I/E. All numbers reflect annual figures.

Statements of Operation For the Year Ended:

		Actual 08/31/02	Actual 09/30/03	Actual 09/30/04	Actual 09/30/05
	Gross Income				
[1]	Base Rent	$540,881	$654,743	$696,675	$722,340
[2]	Percentage Rent	132,487	149,307	130,091	131,066
[3]	CAM Rent	18,597	18,531	22,575	23,288
[4]	Insurance Rent	4,613	3,563	6,453	6,020
[5]	Real Estate Tax Rent	14,731	6,325	20,493	15,328
[6]	Miscellaneous	249	7,000	31,602	9,939
[7]	TOTAL GROSS INCOME	$711,558	$839,469	$907,889	$908,035
	Operating Expenses				
[8]	Utilities	11,557	4,848	1,774	1,954
[9]	Repairs & Maintenance	4,155	8,907	8,109	10,960
[10]	CAM	39,529	52,817	45,317	46,436
[11]	Taxes & Licenses	40,297	40,842	40,012	36,658
[12]	TOTAL OPERATING EXPENSES	$ 95,538	$174,775*	$95,212	$96,008
[13]	NET INCOME (Before Interest and Depreciation)	$616,020	$732,055*	$812,677	$812,027

[* see 9.2]

Line by Line

The above income and expense sheet is divided into two sections: The **Gross Income** broken down into individual components and the **Operating Expenses** divided into individual components. The four columns of numbers are for the three previous years and for the present year, as labeled.

Following is a line by line explanation of the numbered rows:

[1] …… **Base Rent** - Explained in 6.3

[2]……..**Percentage Rent** - Explained in 6.3

[3]……..**CAM Rent** or **Common Area Maintenance Rent** – This is the income from the tenant's reimbursement of the cost to maintain the common area of the property. The common area is any area of the building not rented out to a specific tenant but used by all, such as hallways, stairs, elevators, lobbies, and parking lots. CAM is often paid by each tenant pro-rata. Sometimes it is paid using the escalation clause (see 6.2). Another popular method for CAM reimbursement is to charge each tenant a fixed amount each month.

[4]……..**Insurance Rent** - See 6.1. Both pro-rata and escalation approaches are used, however, the pro-rata approach is more common.

[5]……..**Real Estate Tax rent** – This is the tenant's reimbursements for the landlord's real estate taxes. This is arranged using the pro-rata or the escalation methods.

[6]……..**Miscellaneous** or **other** - This represents any income that comes from sources other than the rent of space to tenants. The most common examples are parking, laundry, and antenna roof leases.

[7]……..**Total Gross Income** - The sum of all the sources of income listed above.

[8]……**Utilities** – See 6.1. Some I/Es list the fuel and the water-sewer expenses separately. In that case, the Utilities listing refers only to the electricity.

[9]……**Repairs and Maintenance** – See 6.1. Only day-to-day repairs such as repairing a boiler are included in this entry. *Replacing* a boiler or any other large cost improvements to a building is referred to as **Capital Improvements**.

[10]……**CAM** – See [3] above. The numbers listed here represent the total amount spent on maintenance, including the amount reimbursed by the tenants. In the section for expenses, all of the expenses must be listed in full. The net cost to the landlord for the CAM (the amount not covered by tenant reimbursements), is reflected in the Net Income, line [13].

[11]……**Taxes and Licenses** – In regards to reimbursements, the taxes and license fees are calculated using either the pro-rata or escalation methods, as 6.2.

[12]……**Total Operating Expenses** – The sum total of all the expenses listed in the previous four rows.

[13]……**Net income** (**Before Interest and Depreciation**) – also called, **net operating income (NOI)** – This is the effective gross income minus the total operating expenses. **Interest** refers to the amount paid toward the interest on the loan. **Depreciation** refers to dollar amount deducted off the original value of capital assets.

While a large portion of the annual profits goes toward the mortgage payments, they are not included in the income and expense statement. The I/E is a tool to show the profitability of a property in comparison to other similar properties. The mortgage payments for the building do not reflect the inherent profitability of the property. There are many ways that a mortgage can be set up, depending on the individual needs and capabilities of the borrower. Two properties may be similar in every way, yet one uses most of its income to pay the mortgage and the other uses only a small percentage of its income for the mortgage. The fact that the owner of the second property is walking away with more cash (for now), does not mean that his building is inherently more profitable. In order for the I/E to compare apples to apples, (the profitability of similar properties), it must present the NOI before debt service.

7.3 Pro Forma

The I/E statement shows actual income and expense for present and previous years. Another document, the **pro forma**, focuses on predicting future value and income for the building. To make this projection, past income and expense patterns are evaluated, as well as any planned renovations or investment into the building. Outside factors, such as a rising real estate market or an expected increase in consumer traffic, are also taken into account.

CHAPTER 8

RENT ROLL

The rent roll is a list of all of the spaces leased in a given property, along with specific information pertaining to each space and tenant. The rent roll gives a general feel for the property and its tenants and delineates the information on the income and expense statement. It is imperative to examine the rent roll in conjunction with the I/E statement.

Rent rolls for residential and commercial properties differ from one another. Due to a larger number of variables and details, the rent roll for a commercial property contains much more information than a residential rent roll. This chapter contains a sample rent roll of both a residential and a commercial property. A line by line explanation is provided for the commercial rent roll to explain any unfamiliar terms.

Objective

- To understand the components of the Rent Roll

8.1 Residential Rent Roll

The residential rent roll contains a list of all of the apartments and basic information about each one. The information included may vary from rent roll to rent roll. Typically, the number of rooms, amount of rent per month, and lease end date are supplied. By reviewing this information, an investor can make some basic calculations regarding future profits. For example, it is important for an investor to know the number of apartments that have many rooms. In the event of a down market, these spaces will typically rent first. He can then anticipate his potential losses or gains. See chapter 5.3 regarding the importance and significance of the lease end date.

Below is a sample of a basic residential rent roll.

APT #		ROOMS	MONTHLY RENT	ANNUAL RENT	LEASE END
1	A	4.5	$823.10	$9,877.20	12/31/2003
1	B	4.5	$1,600.00	$19,200.00	6/30/2003
1	C	3.5	$880.00	$10,560.00	6/30/2002
1	D	4.5	$937.04	$11,244.48	7/31/2003
1	E	4.5	$1,560.00	$18,720.00	6/30/2003
2	A	5.5	$1,157.52	$13,890.24	6/30/2002
2	B	4.5	$1,150.00	$13,800.00	12/31/2003
2	C	3.5	$176.15	$2,113.80	12/31/2003
2	D	4.5	$1,056.28	$12,675.36	7/31/2002
2	E	4.5	$1,023.25	$12,279.00	7/31/2002
3	A	5.5	$1,196.08	$14,352.96	6/30/2002
3	B	4.5	$941.20	$11,294.40	12/14/2003
3	C	3.5	$636.52	$7,638.24	12/31/2003
3	D	4.5	$893.94	$10,727.28	2/28/2004
3	E	4.5	$1,600.00	$19,200.00	6/30/2002
4	A	5.5	$1,400.00	$16,800.00	6/30/2002
4	B	4.5	$771.89	$9,262.68	10/31/2003
4	C	3.5	$1,300.00	$15,600.00	9/30/2003
4	D	4.5	$772.85	$9,274.20	10/31/2003
4	E	4.5	$1,030.00	$12,360.00	11/30/2002
5	A	5.5	$954.00	$11,448.00	6/30/2003
5	B	4.5	$820.08	$9,840.96	11/30/2002
5	C	3.5	$752.25	$9,027.00	6/30/2002
5	D	4.5	$1,700.00	$20,400.00	3/14/2002
5	E	4.5	$1,600.00	$19,200.00	8/14/2002
B	1	5.5	$1,000.00	$12,000.00	7/31/2002
26		117.0		$332,785.80	

8.3 Commercial Rent Roll

Below is a sample commercial rent roll for the fictional “Belk Shopping Plaza”. This rent roll is typical for most commercial properties, with some details unique to shopping centers. The columns have been numbered (in red, above each column) for reference. All numbers are annual.

1 2 3 4 5 6 [7a 7b] [8a 8b 8c] 9 10 11 12 13 14

BELK SHOPPING PLAZA
RENT ROLL

TENANT NAME	SUITE NUMBER	Sq. Ft.	% OCC'D	LEASE START DATE	LEASE END DATE	BASE RENT CURR. YR.	BASE RENT PSF.	REIMBURSEMENTS CAM	REIMBURSEMENTS TAXES	REIMBURSEMENTS INS.	RENT STEPS & OPTIONS (INCLUDING ESCALATION SCHEDULE)	% RENT BREAK PT.	% RATE	Current Year % RENT PAID	CURRENT YR. SALES PSF	FOOT NOTES
ANCHOR TENANTS																
BELK	4	51,490	31.4%	10/22/86	10/21/06	$141,597	$2.75	$5,149	$0	$0	7, 3 YR OPTIONS				$96.01	1, 2
FARMERS FOODS	2	22,638	13.8%	06/01/02	05/31/13	$50,172	$2.22	$0	$0	$0	1, 5 YR OPTION					
GOODY'S	400	21,980	13.4%	11/18/99	11/30/09	$120,890	$5.50	$5,495	$5,412	$1,319	2, 5YR OPTIONS				$112.01	
CVS/PHARMACY	5	15,400	9.4%	11/21/72	11/30/07	$32,340	$2.10	$0	$0	$0	1, 5 YR OPTION				$353.69	2
NON-ANCHOR TENANTS																
ADVANCE AUTO	10	9,842	5.9%	01/01/93	12/31/07	$77,136	$8.00	$600	$1,639	$579						
FAMILY DOLLAR	600	8,333	5.1%	06/26/02	12/31/07	$50,000	$6.00	$0	$0	$0	3, 5YR OPTIONS	$300,000	25.3%	$131,067	$98.15	
FURNITURE DIRECT	100	6,532	4.0%	08/01/03	07/31/08	$32,016	$4.90	$1,829	$1,502	$653						
SHERWIN-WILLIAMS RETAIL	3	4,000	2.4%	10/01/97	09/30/08	$28,000	$7.00	$1,188	$0	$0	1, 5 YR OPTION					2
SHERWIN-WILLIAMS	3.22	753	0.5%	09/01/98	09/30/08	$1,600	$2.39	$0	$0	$0	1, 5 YR OPTION					2
KELLY RENTALS - RETAIL	200	4,000	2.4%	09/01/98	08/31/10	$44,800	$11.20	$2,172	$1,584	$696						
TOPS CHINA - RETAIL	41	2,475	1.5%	10/01/02	09/30/12	$19,008	$7.68	$1,064	$687	$281						
GLEN-MORE CLOTHING	42	2,400	1.5%	03/01/05	02/28/08	$18,000	$7.50	$816	$576	$264						
SHOE SHOW	43	2,400	1.5%	11/01/97	12/31/06	$13,680	$5.70	$1,320	$552	$252					$160.00	
MEMORIAL PROPERTIES, INC	83	2,180	1.3%	06/01/04	05/31/09	$17,440	$8.00	$981	$501	$218	1, 5YR OPTION					
LORI'S CARDS & GIFTS	45	1,900	1.2%	10/01/02	09/30/07	$17,575	$9.25	$648	$418	$171						
VACANT	44	1,800	1.1%			$19,530	$10.85	$0	$0	$0						
CHECK 'N GO OF VIRGINIA	33A	1,700	1.0%	08/01/02	07/31/07	$14,500	$8.53	$850	$374	$153						
WINDMILL FARM BAKESHOP	33B	1,500	0.9%	09/01/02	08/31/07	$12,000	$8.00	$500	$440	$180						
PARKS FINANCE SERVICE	81	1,200	0.7%	12/01/99	11/30/09	$12,000	$10.00	$300	$216	$72						
UNIQUE STYLING SALON	8	1,000	0.6%	03/01/05	02/28/10	$8,000	$8.00	$340	$240	$110						
BACKDOOR TANNING SALON	82	640	0.4%	03/01/03	02/28/08	$5,760	$9.00	$160	$141	$58						
Total		163,963	100.0%			$736,244	$4.49	$23,412	$14,283	$5,005		$300,000		$131,067	$818.86	

FOOT NOTES:
1. BELK has indicated that they will be renewing. Their lease however, does not require them to excersize their option until 3 months prior to lease expiration.
2. Tax is based on Base Year which we don't have available to us yet.

Rent Roll Summary:

	Sq. Ft.	Percent of Total
Total Space	163,963	100.0%
Total Occupied	162,163	98.9%
Total Anchor	111,508	68.0%

The above rent roll is divided into 14 columns (17 with sub-columns) and 22 rows. The rows are divided in two sections: The first four rows contain information about the anchor tenants. The following 17 rows contain the non-anchor (ancillary) tenants. The last row is the total for each column.

Line by Line

The numbers below correspond to the numbers printed in red above each column:

1 **Tenant Name** - A prospective buyer of a commercial property will first scan the list of tenant names to familiarize himself with the type of tenancy occupying the property. He wants to see how much of the tenancy is comprised of brand- tenants. The success of a shopping center is proportionate to the strength and drawing power of its brand- name tenants.
2 **Suite number** – This identifies the space that each tenant is occupying.
3 **Sq. Ft.** (Square Feet) – The number of square feet that each tenant occupies. Naturally, the tenants that take up a large area must be given the closest scrutiny.
4 **% OCCD** (Percent Occupied) – This gives the amount of space that each tenant occupies as a percentage of the space of the entire property. It is another way of judging the size and relative importance of each tenant.
5 **Lease Start Date** – See 5.3 regarding the importance of the lease start date. Many rent rolls give the move-in date instead of the lease start date since it is more telling regarding the staying power of the tenant than the lease start date.
6 **Lease End Date** – The date that each tenant's lease expires. See 5.3 for the significance of this date.
7 **Base Rent** – The set amount of rent for which each tenant is responsible for the present year. Sometimes the monthly rent of each tenant will also appear. In a rent roll, the entry for 'rent' usually refers to the base rent and does not include reimbursements. See also line 11 in this rent roll for 'percent rent'. The base rent number is expressed in two ways:

7a……**CURR. YR** (Current year) – The amount of rent to be paid for the current year.

7b……**PSF** – The amount of rent to be paid by the tenant **P**er **S**quare **F**eet. This is the rent divided by the square footage that the tenant occupies. For example, Belk has a rent of $2.75 psf. This is $141,507 (the base rent, column 7a) divided by 51,400 (square footage for Belk, column 3). This number is given based on the annual rent, not the monthly rent. [See end of this section for the significance of the PSF figure.]

8 **Reimbursements** – The annual amount of reimbursements paid for each of the subdivisions – CAM (8a), Taxes(8b), and Ins. = insurance (8c). See 7.2, column 3,4,5 for an explanation of these charges. At times the reimbursements are also expressed PSF.
9 **Rent Steps and Options** – Typically, a tenant's rent does not remain constant over the lifetime of the lease. It increases annually in **steps**. **Step-ups** may be a predetermined fixed amount or a percent increase over the previous year's rent. The nature of the step-up in each tenant's lease is listed here. For example, "3.75% incr. annually" means that each year the rent is raised 3.75% above the previous year.

'Options, refers to the agreement with the tenant that after the lease expires, the tenant has the privilege to extend the lease for another term as specified. For example, the 'options' box may contain the following information: "One 5-yr. @26 – 2@ $28.50". This means that the tenant has the option of renewing for one 5-year term with a $26 psf. rent and two additional 5-year terms for $28.50. This information is an important supplement to the lease end date. Although a particular lease may be expiring soon, the possibility of the tenant taking advantage of his options must also be taken into account.

10 **% Rent Break Point** (Percent Rent Break Point) – an agreed upon percentage of any profits above this point is paid to the landlord in a 'percent rent' system. See 6.3 for details of how the 'percent rent' system works.
11 **% Rate** – This is the percentage of the profit that is paid in the percent rent system, see above, line 10.
12 **Current Year % Rent paid** – This is the amount of the percent rent paid to date for the current year.
13 **Current Year Sales PSF** – Used in determining the percent rent.
14 **Footnotes** – These are details which do not fit neatly into any of the above categories yet are important enough to affect the general picture of the property. See the notes corresponding to these numbers on the bottom of the rent roll page.

On the lower right side of the rent roll, there is a summary containing the totals for the most basic figures such as size, occupancy and anchor tenants.

Per Square Foot (PSF)

You will notice in commercial rent rolls as well as in many other real estate documents that many of the numbers are expressed in both absolute terms and **Per Square Foot** (psf.) (see above, columns 7b, 13). This facilitates

easy and clear comparisons between various property data. One example of a comparison made easier by the psf. follows:

Landlords need anchor tenants for the success of a property and are willing to give them much better terms and lower rents. Skimming through the absolute base rent numbers in the commercial rent roll above, this would not be immediately apparent since the overall rents of the anchors are more than those of the ancillary tenants. However, looking at the ‘psf. rent’ column (7b), you will see that the anchor tenants are indeed getting a much better deal. The absolute rents are only larger because the anchor tenants occupy more space.

It is very important for a buyer to be able to compare the rents being charged in a particular property in relation to comps in the neighborhood. Using the ‘psf. rent’ it is easy to determine how much more one tenant is paying for the same amount of space as another tenant - or how much square footage one tenant is getting for the same price as another. It is important to know if the tenants are paying above or below market rents to assess the risks of a tenant leaving. The comparable market rents are based on the amount of rent a tenant is paying on a psf. basis.

CHAPTER 9

Purchasing a Property

In the previous chapters, you have learned the basic concepts and terms associated with the real estate market. In this chapter, you will follow the actual steps an investor takes from the time he hears about a deal until the deal is closed.

This is only a basic overview of the process. An examination of the myriad technical and legal details that must be worked out before a deal can close is beyond the scope of this work. You must, however, have a working understanding of the major stops along the way from offering to closing.

Objectives

- To understand the initial review process of a potential purchase
- To become familiar with the various aspects of due diligence

9.1 Assessing a Deal

When an investor hears about a potential deal, he first gets acquainted with the property being offered. This includes both physically checking out the building and doing a basic financial overview.

Drive-by assessment

In the first stage of review, a drive-by physical inspection of the building to get a feel for the condition of the building and the character of the neighborhood is performed. An investor will get an initial sense if the property meets his investment needs and expectations. For example, if he is looking only for a steady source of rental income and is not interested in spending major capital on renovations, he will avoid a building that looks neglected. A poorly maintained building in a run-down neighborhood, even if presently fully occupied, will not stand the test of time. In a down market quality tenants will avoid such buildings and the property will empty of its income producing tenants. If he is willing to invest in renovations, it is important to see the quality of the building so that he can properly factor in the cost of the needed renovations into his offering price. (See 1.2, 1.3 for more on individual investment preferences.)

Checking out the Financials

The second thing a potential buyer does is look at the setup – the income and expense statement and itemized rent roll for the property. Many times these documents will come as part of the **sales offering**. The sales offering is a brief description of the property offered for sale and a summary of its basic information. The sales offering includes the asking price, location, square footage, cap rate, age of the building, income and expense sheet, rent roll, and photos of the property and its immediate surrounding area. The sales offering may also include other information such as a site plan and sales figures for the major tenants for the previous years. (See the sales offering for the fictional ‘Belk Shopping Center, at the end of this chapter.)

An investor must determine if the profits and rates of return are suitable for his investment needs. This is done by checking out the NOI and the price of the property and then calculating the expected ROI and cash-on-cash return (See 1.1, 1.2). If the numbers match his expectations, he can continue examining the financials of the property.

At this point, there are some quick calculations that he can do to ascertain if the asking price is fair. For example, he can check if the price matches the value indicated by the cap rate (see 2.1). Take the case of the Belk Shopping Center as an example. A quick review will show that the offering price of $9,200,000 is less than the cap rate indicates. The cap rate, listed on page 2 in the Offering Summary, is 8.82%. Applying this to the NOI of $812,027 for the present year, (the Financials, page 2), yields a value of $9,206,655. See chapter 2 for other methods of calculating value.

The basic observations described above by no means take the place of adequate investigation into all aspects of the property. These are merely an investor's way of becoming acquainted enough with the property to decide if it is a deal worth pursuing.

9.2 Due diligence

Due diligence next requires a reasonable effort to ascertain that all the information is accurate and to find any other information about the property which can affect the sale. Due diligence is the responsibility of the buyer. It is important to investigate the information in the setup by reviewing the numbers and checking them against the facts on the ground.

Asking Questions

When reviewing the income and expense sheet, it is imperative that an investor ask about any inconsistencies. There is no detail too small for an investor to investigate. Any unanticipated increase in a particular expense over the course of a few years must be understood. If the expenditure for a valid expense such as taxes is unexpectedly low, the buyer must find out the reason. It is important to make sure that there is no inappropriate activity going on that can put his future profits from the property at risk.

As an illustration, see the I/E for the Belk Shopping Center at the end of the chapter. (This is also the I/E used in chapter 7.) Under the 'miscellaneous income' entry (line [6]) for the year 2004 there is an unusually high number. The buyers should find out what is behind that 'miscellaneous' expense. This document may also cause a prospective investor to ask the following questions: What was the very large and non-recurring expense for utilities (line [8]) in the year 2002? If utility expenses usually rise, why do the utilities here generally decrease? Why was there seemingly very little paid for taxes (line [11]) for the year 2003? This may simply be due to the way the tax year and the financial year intersect, but it is still something that must be asked.

Sometimes there can be a mathematical inconsistency in the setup. For example, in the above I/E, the net income (line [13]) listed for the year 2003 does not equal the amount of the gross income (line [7]) minus the total operating expenses (line [12]) as it should. A buyer must find the mistake and then check with the seller to make sure that it was indeed only an mathematical mistake and not a reflection of an inherent inconsistency. In this case the mistake is in the addition of the column of expenses for that year. The correct number $107,414, does yield the net income displayed..

Checking the Facts

It must be ascertained that all of the numbers that are given reflect the actual income and expenses. Generally, the number initially given for the NOI will not stand the test of a thorough investigation by the buyer and will decrease. For example, many times there are expenses that are not included in the NOI such as vacancy and maintenance.

One of the steps in due diligence is securing **estoppels** from the each of the listed tenants. Estoppels are legal documents that the buyer receives from the tenants affirming that they actually occupy space in the stated building and that they pay the stated amount of rent to the landlord.

Another example of information that may be revised upon investigation is the cap rate. The given cap rate may be based on a certain market without taking the sub-market or recent growth of the industry into account. The buyer may ask an appraiser to re-appraise the cap rate for the property, which can in turn lower the price for the building.

Through due diligence, the buyer gains an accurate picture of the property and is in a position to make the decision to purchase or not to purchase.

9.3 The Actual purchase

With any serious offer to purchase, the buyer must submit **earnest money**. This money is given to indicate his seriousness and good faith and remains in escrow until the time of closing. At that point it becomes part of the down payment.

A buyer will now order title insurance. This is an insurance policy that protects the insured against loss arising from defects in title. It guarantees a buyer that nothing is wrong with the property and that no old claims will surface after closing. The title company runs title reports which reveal all previous owners of the property and confirms that the seller is the current owner. It also shows if there are any current liens on the property. Once the full reports are assessed, the title company will insure the title of the property. It typically takes about three to four weeks to get title insurance. A closing is impossible without a clean report and title insurance.

Financing

Part I covered the basics of real estate investing and purchasing. However, the main ingredient in any sale of real estate was left out - the money. The average commercial property is worth millions of dollars, money that most real estate investors do not have lying around. How does an investor obtain the money necessary to make a purchase? The answer, of course, is that he borrows it. Who does he borrow from and how much can he borrow? What is the cost of borrowing? How does the lender insure the return of the money?

To answer these questions it is important to have a thorough understanding of the financing process. Part II of this book, **The Bank**, traces the money and the security behind it from its source until its destination. This is the lifeblood of the real estate purchase.

PART II

THE BANK

Part I of *The Eastern Way* introduces the foundations of real estate investment. Part II introduces the foundations of real estate financing. You will learn the various types of lenders, how they work, and the differences between them - both in terms of financial goals and in methods of operation.

It is crucial for a broker to be able to see the same deal from all angles. Just as you must be familiar with what your client's needs are, you must also fully understand the needs of the lender. How do they make their money? What are their concerns with a deal? Only when you have the complete picture can you place the deal satisfactorily for both sides.

Most of part II does not focus on the day-to-day duties of brokering but rather the concepts behind financing. These are the foundations upon which the broker's job is based. As any real estate investor knows, you cannot build up without a solid foundation!

CHAPTER 10

Cash Flow Lenders

*Banks make money by charging the borrower a fee for the service of lending out their money. This fee is charged as a percentage of the **principle**, or original loan amount, for each year of the loan, and is called the **interest**.*

While the interest represents a potential profit for the bank, there is also considerable risk inherent in lending out large sums of money. What if the borrower cannot afford to make the mortgage payments and defaults (stops payments) on the loan? What stops a borrower from sinking the money into a bad investment which cannot produce enough to cover the cost of the loan in the first place? What measures can a bank take to protect itself from these risks?

Most banks approach lending with a two-pronged safety strategy. Before it lends out money a bank ensures that the property being borrowed against has the capacity to produce the revenue necessary to pay for the loan. The actual process of the bank's evaluation of a mortgaged property is the subject of this chapter.

*Secondly, the bank assures itself that should the loan default, the bank will be compensated for its loss with the sale of the property. This process is called **foreclosure**. The details of how a bank prepares for and executes a foreclosure are explained in chapter 11.*

Objectives

- To become familiar with a bank's approach to an investment; its similarities to, and differences with, the investor's approach
- To understand the concept of reserves
- To learn the meanings and concepts behind the terms DSCR, and LTC

10.1 Cash Flow Lenders

Cash flow lenders rely on profits from monthly interest payments on loans that they give out. Therefore, they are primarily focused on the cash flow that the mortgaged property can produce. Most banks are cash flow lenders. (See '**asset based lenders'**, 11.4.)

The bank performs much research into the property to ensure that it can produce enough cash flow to service the debt, as well as produce enough profit for the owner to take home after the mortgage is paid. If the projected cash flow covers only the **debt service**, the bank will not lend the money. Debt service is the amount necessary to service, or pay, the monthly bills for both the principle and the interest of the debt.

As long as there is enough income to cover the debt, why should the bank care about the owner's profit? First, if the property's cash flow just covers the debt, there is no room for the possibility of a drop in income. In order to keep some cushion, the bank requires more cash flow than is actually necessary to pay the debt service. Furthermore, the bank has an interest in the owner making a profit on his investment. An owner who is not making a profit on his building is not inclined to put in the effort to push the property through a potential difficult situation. In a crunch, he may decide to stop paying the mortgage and let the bank take it back instead of dealing with a non-profitable building. However, a cash flow lender is in the business of making money from monthly mortgage payments, not from selling foreclosed properties. Since the bank does not want to deal with foreclosures, it has a vested interest in ensuring that the owner makes a profit from the proposed property.

Due Diligence

Just as it is in the owner's best interest to perform due diligence to assure that the acquisition will not cause him a loss, it is also in the interest of the bank that lends the money for the sale. Generally, the conditions that indicate stability and profit for the investor are the same for the lender. A landlord who is making money on a building will pay the mortgage punctually and will put sufficient efforts into the continued success of the property. Therefore, all of the precautions that a prospective owner takes before buying a property are also taken by the bank. The bank makes its own assessment regarding the income and expenses of the property. It also reviews the tenancy to make sure that the property has a sufficient number of anchor and credit tenants and that the tenants have been in that location for some time. Long standing tenants indicate that the tenants are successful in this location and that they will likely renew their lease when it expires. This means less TI dollars, less LC costs and no down time between tenants.

Bankers' view

While both the bank and the buyer are looking at the same property, they may not always see eye to eye about what constitutes a good investment. In a typical acquisition, a bank puts much more money on the line than the buyer does. Therefore banks are more conservative in their investing outlook. They will not allow for any speculation when making calculations of future profits. A bank's calculations are always based on the worst case scenario.

For example, an investor may consider buying a property with a low NOI, with the plan that he would undertake improvements to increase the cash flow of the property. Based on these considerations, he decides that it makes sense to pay more for the property purchase than the current value of the building indicates. He figures that after his improvements, the profits will justify overpaying for the investment. However, a bank needs to justify the amount of money that they lend based on the *current* level of cash being produced by the property and will never lend based on such speculation.

An investor may also calculate his projected expenses differently than the bank conducts those calculations for the same building. For example, a building may presently be managed by the owner and have 100% occupancy, thus avoiding any vacancy losses and cutting out any management fees. The owner may also have a discount on fuel or insurance costs due to his overall portfolio which includes many other properties. These factors will influence the buyer to calculate a low amount for expenses, thus raising the NOI. However, the bank will always calculate a vacancy of 5% or average market vacancy, whichever is higher. It will also always include a management fee even if the owner is not presently paying this fee due to the chance that a management fee may be needed in the future. Fuel and insurance costs are calculated based on the rate for an average owner. The bank always takes the most cautious position on these expenses. A bank must take into account the possibility of having to take over and operate the property in case of foreclosure. This angle will be explained in more detail in chapter 11.2.

10.2 Debt Service Coverage Ratio

How much profit must the bank see above the debt service before they will lend? Banks have developed a formula to calculate this amount, called the **DSCR**, **Debt Service Coverage Ratio**. It is the ratio of the NOI to the amount of the debt service. The minimum DSCR required by most banks is between 1.2x and 1.3x.

For example, if the debt service coverage is $42,967 and the NOI is $72,967 then the DSCR is 1.7x. After servicing the debt, the owner is left with 70% of the amount of the debt service as profit; in this case $30,000.

Debt Service Constant

In the above example of debt service coverage, the amount given for the debt service did not change annually. In order to calculate the DSCR, you must have a debt service amount which is constant. To keep the debt service constant banks need to use a special calculation called the **debt service constant**.

Without the debt service constant, a different mortgage payment would be paid every year. This is because every year the amount of interest paid changes since the interest is being paid on less and less principle. For example, a loan of $750,000 is borrowed at 4% interest and scheduled to be paid up at the end of 30 years (**self-amortize** at the end of 30 years). At the end of the first year, the borrower has paid $30,000 interest ($750,000 x 4%), in addition to 1/30 of the principle ($25,000). Total payment for the first year is $55,000.

At the end of the first year, the principle has been reduced to $725,000. 4% interest on $725,000 is $29,000. Together with an additional 1/30 ($25,000) of the principle, the second year's payment would be $54,000, a $1,000 decrease from the previous year's payment.

This fluctuating system of payment is a highly inconvenient arrangement for the borrower and for the lender. The debt service constant percent is a calculation used to figure out a constant amount that a borrower can pay and have the loan paid up by the end of the term. Each loan amount, interest rate, and payment schedule has a percent number, which yields the debt service constant for that loan when applied to the loan amount.

The DSC for $750,000 at 4% for 30 years is 5.73x (the constant annual percent table is found on page 76). Multiplying $750,000 by 5.73% yields $42,967. By paying even annual payments of $42,967, the borrower's balance will be fully paid by the end of the 30 years.

The following chart illustrates the relationship between the constant and the DSCR for a 30 year amortization vs. a 25 year amortization. The DSC will be discussed more thoroughly in chapter 18.

	OPTION A	**OPTION B**
Loan Amount	$750,000	$750,000
Interest Rate	4%	4%
Amortization	30 YEARS	25 YEARS
Net Operating Income	$72,967	$72,967
Annual P&I Payment	$42,967 ($750,000x5.73%)	$47,505 ($750,000x6.33%)
Debt Service Coverage Ratio	1.7x ($72,967/$42,967)	1.54x ($72,967/$47,505)

10.3 Reserves

A prudent landlord regularly puts away money to cover large, non-recurring expenses that can arise. These expenses include structural repairs, such as a new roof or repair of the facade, or purchasing new appliances for his tenants in a multifamily property. Other common expenses are the TI's and LCs for tenants that do not renew their leases. If the owner has money put away for these occasions, he will be able to absorb the costs of paying for these expenses without having to neglect his other regular expenses.

Often landlords are not so prudent. When a bank lends money, it is concerned that the owner will not have money set aside for these expenses. When a large expense does come up, the owner has to pay out of pocket and may not be able to keep up with the mortgage payments. The bank does not wait for this to happen. As part of the arrangement of the loan, a bank collects a certain amount for **reserves** each month. This is money earmarked for various non-recurring expenses and put away in an escrow account. This money does not belong to the bank. The bank merely collects and holds the money so that it will be available to the landlord when he needs it. When the landlord wishes to withdraw this money for the expense it was designated for, he submits a bill to the bank and the bank releases the funds. For more details regarding the methods of collecting and calculating reserves, see chapter 6.2.

10.4 Equity

A bank will not lend out 100% of the money necessary for a purchase because banks want the borrower to be personally invested in the success of the property. An owner who does not invest any of his own money into a property may be inclined to walk away from it at the first difficulty. But an owner with a considerable amount of personal funds invested in the building will look after the success of the property because it his own money at stake.

Typically, a bank wants the owner to have 25% equity in a building at all times. In other words, the owner should have 25% ownership in the property after all debts. When buying a commercial property for $1,000,000, the buyer would need a down payment of 25% of the purchase price ($250,000) and would finance the remaining 75% ($750,000).

The percentage of the cost of the property that a bank is willing to lend on is called **Loan to Cost** (**LTC**). A bank that lends on a 75% LTC only lends up to 75% of the total purchase price. The buyer is forced to pay for the remaining 25% from his own resources, ensuring that he retain 25% equity in the building. LTV, and the difference between it and LTC, is explained in the next chapter.

A buyer that cannot pull together enough of his own money for the down payment may hire a **syndicator**. A syndicator is in charge of arranging different sources of income for the purchase of a property and consequently acquires part ownership of the property for his work. See also ‘second mortgage’ in chapter 14.3.

CHAPTER 11

Foreclosure and LTV

*A **mortgage** is a loan agreement secured by property. It is an agreement by which somebody borrows money from a money-lending organization such as a bank or savings-and-loan association and gives that organization the right to take possession of property given as security if the loan is not repaid.*[7]

*A lender's primary security that he will not take a loss on a loan is the mortgage itself. A mortgage is a loan which sets the purchased property as a lien in the case of default. If a borrower defaults on a loan, the bank puts the property into **foreclosure**. Through foreclosure, the bank sells the property and uses the money of the sale to pay back the loan.*

This chapter explains how a bank structures the loan so that the loan amount is fully covered in the case of foreclosure.

Objectives

- To understand the meaning behind LTV and how it differs from LTC
- To appreciate why cash-based lenders prefer to avoid foreclosure
- To understand how asset based lenders differ from cash-based lenders

11.1 LTV

Before lending on a property, a bank makes sure that the amount of the loan can be covered by the sale of the building. This does not mean that the bank can lend on a building's full value at the time that the loan is made. Although a building may be worth a certain amount at that time, there is no guarantee that the bank would be able to get that amount years down the line, since buildings can devalue over time. Furthermore, a bank may not be able to get the full market value for a building in the process of foreclosure (see 11.2).

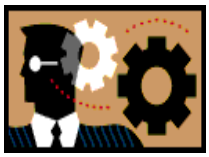
Therefore, a bank will only lend a percentage of the present value of the property. The percentage of the value that each bank lends on is referred to as **Loan to Value**, or **LTV**. A bank that lends on a 75% LTV will lend $750,000 on a building valued at $1,000,000. Even if the building devalued at the time of foreclosure by 25%, the bank can still recoup the full amount of the loan.

The LTV can vary between banks. The determining factor in this number is the level of risk that a lender is willing to take. A bank that lends at a high LTV risks a building devaluing more than the percentage of the LTV and not being able to recoup its money. For example, a bank that lends at 80% LTV would lend $800,000 on a building valued at $1,000,000. However to actually purchase this building, the buyer had closing costs of $50,000 making the total purchase price $1,050,000. Even though a loan of $750,000 is 75% of $1,000,000, it works out to 71.4% of the cost of the building - LTC. If this building would decreases in value by 25%, the bank will only be able to recoup $750,000 of the loan, thereby taking a loss of $50,000. Thus the lower the LTV, the safer the loan.

The common industry standard is 75% LTV. More conservative banks lend at 70% LTV and more aggressive banks are willing to lend up to 80% LTV.

[7]

Single Credit Tenant



Sometimes a lender will lend up to, and even beyond, the value of the property. This is in the case of a **single credit tenant**. A credit tenant, like Wal-Mart, often has a long-term lease (20 years or more) that is NNN. Under that arrangement, the landlord knows exactly how much he is going to get paid and is confident that he will indeed get paid. Since the tenant is a credit tenant such as Wal-Mart, the lender is very confident that the borrower will not default. When the only tenant for a property is such a tenant, a lender may structure extremely high loans, sometimes exceeding the value of the building. The lender does this since the loan is backed up by the credit of a strong tenant such as Wal-Mart.

LTV – LTC

LTV and the LTC are two measures that a bank uses to determine the loan amount. The LTV is concerned with the value of the building at the time that the loan is made, while the LTC is concerned with the amount that the owner is paying for the building (10.4). Usually, there is no significant difference between the bank using the LTV or the LTC. This is because the cost of the property (LTC) is usually the same as the present value (LTV) of the building. A bank therefore lends 75% of the value of the building which is also 75% of the cost.

However, there are times that the value of the building is not the same as the actual cost. An investor may overpay on a building with the belief that he can turn the building around and increase its profits over time. As explained above (10.1), a bank will only lend based on the actual current value of the building. In this case the LTC is higher than the LTV since the cost is higher than the value. Because both the percentage that a bank chooses for its LTC and that of the LTV are based on separate legitimate concerns, a bank will take both numbers into account and lend on whichever is *less*. In this case the bank will only lend on the LTV, which is less than the LTC.

In a reverse scenario, an investor may purchase a property for a bargain price that does not reflect the real value of the property. For example, an investor buys a property worth $1,000,000, but somehow gets a great deal and actually pays only $900,000. In this case 75% LTV, the percentage of the actual value of the building, is $750,000 since the building is actually worth $1,000,000. But the 75% LTC is only $675,000 - 75% of the *cost* of the building. Because the bank wants the owner to put in at least 25% of his own resources, it will insist on going with 75% LTC and will not lend more than $675,000 (75% of $900,000).[In this case, the owner may take a short term loan and then refinance; see ‘seasoning’, 18.1.

Appraisals

In order to ascertain the LTV in each particular case, banks order appraisals for a property to find out its value. See 2.1 for the various methods of appraising a property. Some banks prefer one of the methods of appraisals delineated there and some just use the method which yields the lowest amount in each case.

11.2 Foreclosure

Cash-based lenders are in the business of managing money, not buildings, and would prefer to avoid foreclosures. Foreclosure is not an assurance that they will get the full value for the building and they are additionally saddled with the responsibility of managing the property until it can be sold.

Foreclosure can be a lengthy process. When a building goes into foreclosure, the primary goal of the bank is to sell the property as fast as possible in order to recoup their loss. Banks are more interested in getting back their initial investment than profiting from the sale. The building is put up for sale on the courthouse steps. The lender opens the bidding at the lien amount (the balance left on the loan) and the highest bidder gets the property. If there are no

bidders, the bank will take over the property and sell it. It is through this process that investors are sometimes able to buy properties at below-market value.

Managing the Building

Once a bank starts foreclosure proceedings, it may still take a considerable amount of time before the property is sold. As the new owner, the bank must continue to manage the building so that the building can produce cash to pay for the mortgage. Since banks are not in the business of managing property, it can be more expensive for a bank to run a building than for a private landlord. For example, a private landlord may run the day-to-day aspects of the building himself, whereas the bank will have to hire a management company for the building. A landlord may have a deal worked out with an insurance company due to his many property holdings, whereas the bank will have to pay the prime rate. These potential costs are additional factors that cause a bank to calculate expenses at the highest possible rate when considering whether or not to lend on a building (see 10.1). While the owner may claim not to have so many expenses, the bank prepares for the possibility of repossessing the building. If that happens, it will have to run the building with its own resources.

11.3 Commercial Loan Analysis

After going through all of the research and calculations that affect the loan, the bank will create a commercial loan analysis. The commercial loan analysis is similar to an income and expense sheet, but the focus is on the viability and amount of the proposed loan. In addition, there is a section on the commercial loan analysis called 'underwriting'. In general financing usage, underwriting refers to the process by which lenders determine the profit of a building by using actual numbers and known formulas to calculate expenses (such as for vacancy). The underwriting column of the loan analysis contains projections of future expenses based on past performance and established formulas. The commercial loan analysis will be explained in further detail in chapter 16.

11.4 Asset-based Lenders

As explained in 10.1, a cash flow lender is primarily focused on the steady flow of cash that the building can produce. A cash flow lender will foreclose on a building if absolutely necessary.

Asset-based lenders look primarily at the value of a property (its assets) and make a risk decision based on how much the property can be sold for in the event of foreclosure. Asset-based lenders do not assign much importance to the potential cash flow. Most asset-based lenders are private lenders who lend on vacant buildings. They obtain their money from private funds. Asset-based lenders lend at higher interest rates than banks in order to compensate for their greater risk.

Asset-based lenders generally lend on a building that is worth much more than the amount of the loan. Should the borrower fail to make his payments, the lender can foreclose and sell the building, thereby making more than he initially lent. Someone looking to purchase a building for $1,000,000 and only needs to borrow $500,000 might go to an asset based lender for the loan. The asset based lender agrees since the building is worth double the amount of the loan. Should they foreclose, they make $500,000 profit on the deal. The inherent risk of ensuring the entire loan amount with foreclosure alone keeps most banks away from this type of lending.

CHAPTER 12

COST OF FUNDS

As explained in chapter 10, a lender's primary source of profit is the interest charged on its loans. These rates vary greatly from loan to loan, based on the type and structure of the loan and the time that the loan was closed. To understand how these factors affect interest rates, you must first become familiar with the fundamentals of financing - where do the lenders get the money that they lend, how much do they pay for it, what is their profit margin, and how is it set?

This chapter discusses the origin of the cost of funds in the general financing market and shows how these costs filter down to the individual mortgage loan.

Objectives

- To understand the relationship between the price and yields of bonds
- To appreciate how the security of government bonds serve as a foundation for all funds
- To become familiar with other indexes used in determining the rate of various types of loans

12.1 Bonds: Price and Yield

A company seeking to raise capital may offer (or 'float') **stocks** or **bonds** to the public for sale. Stocks are shares in the ownership of the company. A stockholder has an actual claim on a portion of the corporation's earnings and assets. On the other hand, bonds do not represent any ownership in the corporation. One who buys bonds is investing in the company by lending the value of the bond to the company in return for a '**yield**' that is paid by the corporation when the bond matures in addition to the value of the bond. 'Yield' is the return on investment of the bond and is similar to the interest rate on a loan. A bond priced at $100 which matures at $110, has a yield of 10%.

Price-yield relationship

The yield of a bond is measured as a percentage of its price. Therefore, the yield and the price of the bond have an inverse relationship. As the price of a bond rises, its yield falls; as the price falls, its yield rises.

For example, an investor purchases a $100 bond, set to mature and pay $110 in one year. His yield is 10% at maturity. Suppose that two months after purchasing the bond, the investor needs cash and decides to sell his bond prematurely. Since the date of maturity is closer than it was at the time that he originally bought it, he can charge more than the $100 that he paid two months earlier. He sells the bond for $102, walking away with a $2 profit. For the second buyer, collecting the bond at maturity for $110 provides an $8 profit, which is a yield of 7.84% on *his* purchase price of $102. Thus, as the price of the bond rose (from $100 to $102), its yield fell (from 10% to 7.84%).
If the price of the bond drops to $95 at the time that the first investor sells the bond, then he would be taking a $5 loss, whereas the second investor would be making a $15 profit when the bond is redeemed upon maturity. Because his purchase price was $95, his yield is 15.8% ($15 is 15.8% of $95). Thus, as the price fell (from $100 to $95), the yield rose (from 10% to 15.8%).

12.2 Government bonds and T-bills

The U.S. government sells bonds to raise money. These bonds are called **Treasury Bills**, or **T-bills**. All government bonds are backed by the "full faith and credit" of the U.S. government and are therefore considered the most secure bond in which one can invest. U.S. bonds are viewed by the market as having no credit risk; it is virtually certain that both the principle and the yield will be paid on time. The most commonly traded Treasury is the ten-year Treasury bill.

The price of Treasuries is in constant flux. Because of their security, people flock to Treasuries at any sign of instability in the market. As the market changes, so does the demand for, and therefore the price of, U.S. Treasuries. Because Treasuries are the most secure investment, all other investments are assessed in relation to Treasuries. All investments are considered to be higher risk than Treasuries and their yield must accordingly be higher (higher risk = higher reward). The credit rating of the investment company is compared with that of Treasuries and the yield is determined proportionately.

12.3 Setting the Rate

When a bank is approached for a $1,000,000 loan, it makes the following calculation: "If we had $1,000,000, we could buy $1,000,000 worth of Treasuries which will yield 3.5%. For us to lend on this property, which is a greater risk than Treasuries, we need to see a yield of at least 1.5% more than the Treasury yield." The rate for this loan is set at 5% (3.5% + 1.5%). The difference between the cost of funds (measured by a particular index rate, such as the T-bill; see 12.4) and the rate quoted by the lender is called the **spread**.

The spread that a lender will demand is also influenced by the individual lender and the type of loan. For example, safer investments such as loans on multifamily properties (see 3.2) will typically have a smaller spread (lower risk = lower reward).

Quotes

When a borrower requests financing from a lender, the lender will give a verbal statement, or a **quote**, which contains the main features of the loan: the amount, term and interest rate. Although all lenders base their rates on a common index, such as the ten year T-bill, some tie their rates to it more closely than others, depending on the source of the money that they are lending.

Commercial Banks and Wall Street Lenders

Some lenders, such as commercial banks and Wall Street Lenders (see chapter 13), lend from money that they themselves borrow from the government. These lenders run a risk by quoting a flat interest rate for their loans. If they quote a rate of 5% to a borrower and they intend to obtain funds from the government at a rate of 3.5%, they expect to make a 1.5% profit from the loan. However, if the government's interest rate rises to 4% by the time the loan is closed, the lender must still keep to its quote of 5% to the borrowers. The lender has now lost 50 basis points of their spread. A basis point is one hundredth of a percentage point (0.01%). 1% = 100 basis points. Basis points are often used to measure changes between yields, since these often change by very small amounts.

Because of the risk of fluctuating rates, these lenders do not quote a flat rate. Instead, they quote a spread above a given index. For example, the lender may give a quote on a loan as 1.5% above the T-bill. When the deal is closed, the rate is locked at 1.5% above the rate of the T-bill on that day. If the cost of the bank's funds rises or falls prior to locking the rate, the borrower's rate is affected accordingly. The potential risk to the lender is transferred to the borrower. When going into the loan, the borrower must keep in mind that the cost of funds may increase by the time the loan is closed, giving him a higher total interest rate.

Floor and Ceiling

It is important for lenders to ensure a certain minimum level of return on their loans, even when quoting a spread. In a down-market, when rates are falling, a lender may propose a **floor**. A floor is the minimum amount a lender will accept in interest, no matter how low the index falls at the time of the closing.

Conversely, in an up-market, a borrower may request a **ceiling** from the bank. This is the opposite of a floor and ensures that the overall interest rate of the proposed loan cannot rise above a certain point, regardless of the index rate at the time of closing. In these cases, a bank may actually have to make less than their preferred 1.5% spread.

Savings Banks

The source of funds for savings banks is usually money that they receive from their depositors. The rate of return that they provide their depositors is usually less than the rate that the government charges. Nevertheless, the rates that they charge for loans are based on a spread above the cost of funds. In today's market, a bank typically marks up its mortgages by 1.5% above the market's cost of funds. Because the spread is based on the cost of funds and they are actually paying less than the cost of funds for the money that they lend, savings banks make a larger profit.

The profits of savings banks are not directly tied to the cost of funds at the time of closing and so they can quote a flat rate without risk. Their profit margin is calculated in relation to the rate of interest that they pay their depositors, which stays the same regardless of the cost of funds. (See 18.3 regarding locking a rate.)

12.4 Other Indexes

Two other common indexes for setting rates are **Libor** and **Prime**. Libor stands for London Inter-Bank Offered Rate, and its interest rate is typically fixed for only 30 to 90 days. The prime rate corresponds to the rate of overnight funds. A benefit of Prime is that it doesn't fluctuate on a day-to-day or month-to-month basis - it is set by the chairman of the Federal Reserve. The rate stays stable until the Federal Reserve meets and resets the overnight rate, accordingly affecting Prime. Prime is most commonly used for home equity loans and credit card loans.

CHAPTER 13

Wall Street Lenders

Cash-based lenders base their earnings on the steady income of monthly mortgages (10.1), and asset-based lenders rely on profits from selling foreclosed property (11.4). This chapter deals with lenders who make their money from loans by selling off the loans as soon as they are lent. They profit from selling the loans at a higher rate than they loaned for and from closing costs. The process of buying and selling the loans is extremely complicated and most of it is beyond the scope of the responsibilities of a mortgage broker. It is important to acquire a basic understanding of the process so you can best service your clients.

Objectives

- To acquire a basic understanding of the process of conduit lenders

13.1 Wall Street Lenders - Conduits

Wall Street lenders have a limited amount of money and lend out that money to different borrowers for mortgage backed loans. Then, instead of keeping these loans and collecting interest over the term of the loans, they sell all of the loans to investors. Investors buy the ownership of the loans so that they can collect the interest or foreclose on the properties if necessary. The Wall Street lender turns a profit from the sale and from the closing costs. Lenders such as these are also called **conduit lenders** since they are the bridge between the borrower and the investor. The investments that Wall Street lenders sell are called CMBS, Commercial Mortgage Backed Securities.

The profit made by the Wall Street lender on these loans is less than that which could be made by keeping the loans and collecting the interest. The advantage to this method is that by selling the loans, they get back the money that they lent right away, along with the profit. Since they do not have to wait for the end of the loan terms to get back their money, they can then lend out the same money again to make another profit. In this way the same money is used many times over in the span of one loan term.

13.2 The Process

Pooling

It is not feasible nor profitable to sell each of the mortgage backed loans individually. To do this an investor would need to be found for each specific loan, with its own specific terms and level of risk. Instead, the conduit lender pools together a group of loans and sells them off in pieces. An investor who would rather not be involved in lending directly can choose the exact level of risk that he wants to invest in and buy into a general pool of loans.

- **Step 1**

  For example, the Wall Street lender lends out $100,000,000 in mortgaged loans. Usually this is borrowed money (see 12.3). The money is lent out for different types of loans at different levels of risk. For example, they may lend out $50,000,000 for multifamily properties, $35,000,000 for industrial properties, $10,000,000 for office buildings, and $5,000,000 for retail properties. All together, the entire $100,000,000 of loans is referred to as the pool.

- **Step 2**

The pool is then rated. This is done by rating each loan individually and then rating the pool as a whole as the average of all of the individual loans. Generally, 65% of the pool is made up of loans of AAA/Aaa (the highest rating). The remaining 35%, contains many layers of loans, ranging from an AA/aa rating to unrated (below the level of the lowest rating). A rating agency rates a real estate pool based on the mix of tenants, property types (multifamily, commercial etc.), and average loan-to-value.

- **Step 3**

  The pool is then separated into **tranches**, or parts. The first tranche is made up of the bottom 50% of the pool. After that, each tranche is much smaller, from 5% to 10%. Each tranche represents a different level of risk. (How the tranches represent risk will be explained shortly.) The first tranche is the least risky, and therefore has the lowest yield. As you go higher in the tranches, the level of risk rises, as does the yield.
  The investors can now choose the exact mix of tranches that they want to buy, based on the level of risk versus reward that they are comfortable with.

- **Step 4**

  Once the loans are sold off, the Wall Street lenders turn over the management of the loans to a servicing agency. They are now free to take their profits and start the process over again.

13.3 Order of Tranches

The first tranche investors are in the last loss position, while the last tranche investors are in the first loss position. To understand how the different levels of tranches represent different levels of risk you must first understand how the loans in a CMBS pool are paid.

Each month, as the mortgages are paid by the original borrowers, the money is pooled together. The money in this pool goes to the investors who bought the loans from the Wall Street lenders. However, the first tranche investors are the first in line to receive their money from the pool of payments. So, if the bottom tranche is made up of 50% of the pool, the first tranche investors receive 50% of the money. Next in line are the next tranche investors, who receive the amount of money corresponding to the percentage that their tranche takes up in the pool, and so on.

In this setup, the last tranche investors are in the position of the highest risk. If any of the payments default and the money cannot be recouped through foreclosure, it is the investors in the first loss position who take the loss. On the other hand, the first tranche investors are virtually assured of seeing their return. Even if the markets were to crash, in all probability the properties can be sold off for at least half of their value, so the 50% first tranche will recoup their total investment.

Following the formula of risk vs. reward, it follows that the first tranche investors, who are in the position of the least risk, also receive the lowest yield. The last tranche investors, who are in the position of first loss, and therefore highest risk, receive the highest yield on their investment should the loans come through.

First Tranche Investors

Who are first tranche investors? Often, they are conservative investors, such as pension funds or life insurance companies, who cannot afford to run any risk on their investments because they must guarantee a yield to their clients. Lending directly to individual borrowers is not a viable option for them for two reasons. Since these investors cannot afford to risk any of their investment, they must lend on an extremely low LTV. However, most borrowers want a loan with as high an LTV as they can get. Therefore, it may take time to find the right borrowers for their investment. Second, lending on any one mortgage, even a highly rated one, is inherently risky. There is always a possibility of something happening to that particular property or market.

The best option for these investors is to buy the bottom tranche of a diverse pool of mortgages. They do not have to wait for a specific type of borrower—the Wall Street lenders offer an investment in a pool consisting of all types of borrowers. Such a pool would contain a mix of multifamily, retail and commercial mortgages. In this way, even if one market falls, there is enough value in the properties of the other markets to pay up their loans in full. Thus, their investment is virtually assured.

Profits

To illustrate how the Wall Street lender profits from selling loans off at a higher rate, consider this example:

A Wall Street lender puts together a pool consisting of $100,000,000 of loans. The average interest rate for these loans is 10%. The lender then sells the first 50% of the loans at a 5% return to the investors. The 5% spread on the first 50% of the loans is the profit of the Wall Street lender.

As the Wall Street lender sells off more of the loan, a higher and higher rate must be offered. This is due to the higher risk taken by the later tranche investors. The Wall Street lender may not be making any profit at all from some these investors. Indeed, by the time they sell to the last tranche investors, the lender may have to offer more than the average 10% rate. However, when the entire pool is sold, due to the enormous spread that the Wall Street lender makes on the lower portions of the pool, the Wall Street lender walks away with a sizable profit. The lender's profit is usually equivalent to 1% to 3% of the pool's total loan amount. In the above example, the profit made from this maneuver, plus closing costs, range from $1,000,000 to $3,000,000.

Not all loans are suitable to be entered into a CMBS as explained at length in chapter 16.3.

PART III

THE MORTGAGE BROKER

There is a gap between the subject of the first part of this book, the borrower, and the subject of the second part, the bank. Each borrower has a unique set of needs and expectations, based on his financial status at the time and his particular personality. Each lender has a unique set of criteria and a limited variety of loans that it can offer. It is the job of the broker to bridge the gap from borrower to lender.

To do this, a broker must be familiar with the real estate market from the standpoint of the buyer. In this way the broker will recognize which deals are most profitable for him and will be able to customize a loan to the needs of the individual client and the particular deal. The broker must also know what it is that each bank and lender is looking for in a loan, and find the loans that best fit their unique preferences. Finally, the broker must know how to match an appropriate lender to each buyer and to negotiate the deal through to the end.

Often, due to the different ways that bankers and owners assess a property, a building will have three different values: the sellers, the banks and the buyers. It is your job as a broker to get all three to agree on one price and one value.

Part III of this book takes you through these steps. In chapter 14 you will become familiar with the various types of loans available to a buyer. In chapter 15 you will learn the differences between lenders and which loans are appropriate for each. Chapter 16 guides you through the document of the commercial loan analysis. And chapter 17 sketches out the process of structuring and obtaining a loan.

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This book primarily focuses on the field of commercial financing. For the broker, commercial financing provides the opportunity for larger financial gain than residential financing. As a rule, the size and frequency of commercial loans far outpace those of residential loans. This is due to the following reasons:

One commercial real estate deal brings another.

Most people only own one home. No matter how happy a residential client is with the service of his broker, he will not likely have him as a repeat customer. In the commercial real estate market, most investors own more than one property. Over the course of a few years, the same investor can bring you many deals. In addition, an investor likely has partners in this and other investments. If your client is happy with your service, you will likely pick up their business as well. Your client's attorneys and accountants can also be excellent sources of referral business.

In commercial real estate, your services may be used for the same loan multiple times.

The most common loan for a one-to-four-family home is a 30-year loan. The goal of a homeowner is not to refinance unless he needs to cash out or the interest rates drop considerably. (Refinancing is explained in detail in chapter 15.1-2.)

In contrast, the average commercial loan, while payable over 25-30 years, only has a term of five, seven or ten years. This means that the interest rates are only set for the length of the term. For this reason, the loan is usually refinanced at the end of each term (see 15.1). An owner of multiple commercial properties may have to refinance often, as his properties will be up for refinancing at different times.

A homeowner minimizes his loan amount; a commercial real estate investor maximizes it.

The goal of a homeowner is to have as little debt on his home as possible. When he buys the home he will pay for as much of it as he can, and subsequently he will use any surplus money towards paying off the loan. When he has no debt at all, and owns his home completely, his goal is reached.

The goal of many commercial property owners is to have the maximum debt that their property can carry. The less money that they put down out of pocket for a new property, the more money available to buy other properties, which eventually will mean a greater profit for them. After they own a property, they will look to take out money on the property by refinancing as soon as the value of the property rises. They will then use the proceeds to purchase new property.

The average commercial financing transaction is larger than the average residential transaction.

A recent study found that the average commercial loan in the country is $7,500,000. With an industry standard of a 1% brokerage fee, the broker's payment is $75,000. The average residential loan is $250,000. Even if the percentage of the residential broker's fee were 2% higher, the average fee is still only $7,500, significantly lower than the commercial fee.

CHAPTER 14

LOANS

When someone takes out a loan in order to buy a property, it is called a purchase money mortgage. The most common loan aside from the purchase money mortgage is the refinance loan. This is when someone takes out a new loan on property that he already owns. A person refinances for many reasons, and the risks involved in refinancing are different than those for a purchase money mortgage. This chapter discusses some of the unique aspects of the refinance loan. A brief description of other loan types is also included at the end of this chapter.

Objectives

- To understand the various incentives to refinance
- To learn the three methods in which prepayment penalties are charged
- To gain a basic familiarity with other types of loans

14.1 Refinancing

Refinancing means taking out a new loan to replace an existing loan on a property. In a sense, the process of refinancing renews the property to the owner. It can be understood as selling the building to the bank and then buying it back under a new loan arrangement. The balance of the old loan is absorbed by the new one.

Reasons to Refinance

There are three general reasons that a client may want to refinance:

1 – *The previous loan term expired*

The average term of a commercial real estate mortgage is five, seven, or ten years, payable on a 25-30 year amortization schedule. This means that the monthly payments are scheduled as if the loan would be paid off in 30 years. However, the interest rate is only locked for the life of the loan, which is five, seven or ten years. Most banks offer options to extend the loan at a predetermined rate when the term ends. Since this rate is usually higher than the market rate, most people choose to refinance their loan at the end of a term rather than accepting the bank's option.

2 – *To lower the monthly payments*

When interest rates go down significantly from the time that the loan was taken out, it may be possible to lower one's monthly payments by refinancing with the new rate. Any such calculation should include the costs of the refinance itself, i.e., closing costs, and related fees.

For example, someone took out a twenty-five year mortgage at 12%, and is paying $1200 per month. Ten years later, interest rates for 15-year loans stand at 6%. Refinancing will reduce his monthly payment from $1200 to $844.

3 – *To cash out*

As the rents in a property increase over time, so does the equity, or value, of the property. This added value can be borrowed against by the owner of the property.

Even if the property value did not rise, since he has been paying the mortgage for some time, an owner is able to cash out by renewing the loan. For example, someone who has a mortgage of $500,000, takes out a new mortgage for $800,000. Even after allowing for closing costs of $20,000, the owner cashes out $280,000. A real estate investor usually takes out this money to reinvest in other real estate (see Introduction to Part III).

See 18.2 for more on the advisability of refinancing in various situations.

14.2 Prepayment Penalty

Upon setting a loan, a bank relies on the monthly payments of the principle plus interest in a timely manner for the remainder of the term. If a borrower pays the loan before the term finishes, the bank cannot collect the interest on the loan for the time between the payment of the debt and the end of the term. The bank therefore charges the borrower a penalty, called a **prepayment penalty** (**PPP**), to address this loss.

There are three formulas commonly used to calculate the PPP. They are structured to accurately assess and balance out the loss that the bank takes on the prepayment. The bank decides which prepayment penalty method to use, not the borrower.

➢ Sliding Scale

Since the loss to the bank diminishes as the end of the term approaches, the bank, using the sliding scale formula, penalizes less for each passing year. In brokerage terminology this formula is also called the "**5,4,3,2,1**".

In a five-year term, a borrower will be charged 5% of the loan balance for prepaying in the first year, 4% for prepaying in the second year, 3% in the third, etc. During the last 60-90 days of a loan, the bank will usually allow a borrower to pay off the loan without incurring any penalty. When the term is longer than five years, the penalty is increased proportionately for the duration of the term.

When interest rates go down, the sliding scale schedule is not so prohibitive as to prevent a borrower from paying off the existing loan to take advantage of lower rates. As always, the appropriate calculations must be made to account for penalties and closing costs. For example: A client took out a loan with a 9% rate. Now, with three years left to the loan, rates fall to 6.5%, and the client wants to pay off his old loan and take out a new one at the present rate. His penalty of 3% will be recouped in approximately 14 months with the money that he saves due to the lower rate and he continues to enjoy the lower rate for the rest of the loan term.

➢ Yield Maintenance

Yield maintenance is the present value (**PV**) of future cash flows. This means that the bank charges the full amount of interest that it could have made on the balance of the loan. Since the bank can use the prepaid principle to buy Treasuries and thus make some profits on this money, the yield that Treasuries will give for the remainder of the term is deducted from the penalty.

To illustrate: For a loan of $3,000,000 at 7% for a ten year term, the annual payments are at least $210,000 ($3,000,000 x 7%). To keep the illustration simple, assume that the borrower only paid the interest, not the principle. If the borrower pays the balance with three years left on the loan, the bank loses $630,000 in interest ($210,000 x 3). However, with the repaid principle, the bank can buy three-year Treasury bills at 2.00%. On the

$3,000,000 balance, this amounts to a profit of $60,000 for three years, or, $180,000. Thus, the penalty in this case would be $450,000.

The yield maintenance formula usually makes refinancing prohibitively costly. However, if the value of the property has gone up significantly and the rates that the Treasury bills are trading is not too far from the actual current rate, a borrower can consider cashing out even with the yield maintenance PPP. There is a minimum 1% penalty with the yield maintenance formula.

An easier way to calculate the yield maintenance: Take the current interest rate (7%), minus the current T-bill representative of the remaining years (2%), and multiply that (5%) by the balance ($3,000,000), multiplied by the number of remaining years (3).

$3,000,000 x 5% = $150,000.

$150,000 x 3 = ***$450,000.***

Defeasance

With defeasance, the borrower exchanges the existing collateral with bonds. This means that the borrower buys bonds and sets the yield of the bonds as payment for the old debt. If the rates of the bonds are higher than the rate of the loan at the time of refinancing, the difference of the rates becomes the borrower's profit.

14.3 Other Loans

Construction loan

A construction loan is a short term loan to pay for the construction of commercial buildings or homes. These loans typically provide periodic disbursements to the builder as each stage of the building is completed. When construction is completed, a take-out or permanent loan is used to pay off the construction loan.

Before a bank will lend a construction loan, it looks at several factors related to the construction job and to the borrower. Regarding the job itself, the bank reviews the cost of the project, projected sellout (condominiums) or income (rentals), and the expertise and experience of the contractor.

Regarding the borrower, the bank reviews his financial statement, experience, and exit strategy. The bank needs to know how he plans to pay off the loan once construction is complete. In addition, a bank will not lend unless the borrower is making a significant profit on the construction and sale. If the borrower is not making a profit, there is a risk that the borrower will take a loss and walk if any issues arise (see 10.1).

Banks lend construction loans based on the value of the finished product, not the cost of the job. If a building is projected to be worth $900,000 at completion and the cost of the job is $1,000,000, the bank will only lend 75% of the projected value, or $675,000.

Bridge Loan

When someone buys a property, he often starts by taking out temporary financing for the property. After a short period of time, he arranges permanent financing. However, the permanent financing often does not take effect until after the original financing is due. In this case, the buyer will take out a bridge loan which covers him for the time between the loans. The second loan is used to pay the bridge loan.

Second Mortgage

A second mortgage is taken out to cover the down payment not covered by the first mortgage. Rates for a second mortgage are higher and terms are tougher since the second mortgage is not in the first position for the property and thus runs a higher risk.

CHAPTER 15

LENDERS

In part II of this book, you were introduced to different types of lenders. Cash-based and asset-based lenders, Wall Street lenders, commercial banks and savings banks each focus on a specific market. Loans that are suitable for one may be a terrible investment for another. Risk assessment and method of property evaluation can vary greatly depending on which lender is asked to review a loan. In addition, even the same type of lenders can have divergent needs when it comes to loans and different criteria for approving them.

As a broker, one of the most important skills to acquire is appreciating these differences and working with them. Just as a sales broker knows that there is a buyer for every property in America—the only question is who has the appetite for the property he is selling - so too, a mortgage broker operates with the principle that there is a lender for every loan. He simply must find the bank whose current needs and appetite fit his client's requirements.

Sometimes you can get lenders to stretch beyond their traditional parameters. As a rule, however, a lender will not change its criteria and lending appetites. Over time you will learn the strengths, weaknesses, appetites and limits of each lender. After reviewing a deal for a client, you should eventually be able to say, "This deal is just right for that bank." Remember, there are enough lenders out there and it is not advisable to try to stretch a lender too much.

In this chapter, the different areas of focus for various lender types are explained. This should be your starting point for directing loans to the appropriate lender. The endpoint is matching each loan with the bank best suited for it. This is the result of years of experience and is the hallmark of a great broker.

Objectives

- To learn which loans are appropriate for the following types of lenders:
  - residential and commercial mortgage lenders
  - cash flow and asset-based lenders
  - Wall Street lenders

15.1 Residential vs. Commercial

As a commercial broker, your main area of work is commercial mortgages. However, it is important to have a basic understanding of the ways that a residential lender differs from a commercial lender. Regarding the differences between investing in residential and commercial properties, see chapter 3.2.

The basic rule is that when lending on a commercial property, the primary focus of the bank is on the property itself. When lending on a residential property, the primary focus of the bank is on the borrower.

Most commercial loans are **non-recourse** loans. This means that there is no personal guarantee by the borrower on the loan and the bank cannot go after his other assets. If the borrower defaults on the loan, the only thing the bank can do is sell the mortgaged property through foreclosure. Any amount not raised by selling the property is the bank's loss.[8]

The banks risk this loss because the bank is mainly focused on the property itself when lending a commercial loan. As explained at length in chapter 10, the bank protects itself by assuring that the building can produce sufficient

[8] In a case of fraud, such as improper running of books or withdrawals by the company prior their default, there is usually a provision which dictates that the loan turn into a recourse loan, and the bank can then seize the borrower's assets. Local lenders outside of New York City usually have borrowers sign recourse even on commercial properties.

cash flow and by not lending more than a 75% LTV. Thus, its investment is protected by the property itself. The bank does do a credit check on the owner to make sure that he can be trusted to use the income of the property to pay the bank its monthly mortgage. However, the personal income level of the borrower is almost irrelevant. Although most lenders (except those in New York City) do require the borrower to present his tax returns and personal financial statements (PFSs), it does not compare to the personal assessment done on loans for residential property.

With residential mortgages, there is no cash flow produced by the property. The bank must focus on the ability of the borrower himself to pay back the loan. The bank does this by checking two factors: the credit rating of the borrower and his income level. His income level is checked to make sure that he can afford the monthly payments and his credit rating is checked to make sure that he does not have a history of late payments. Most residential loans are recourse loans. In the case of default, if the foreclosure process does not bring in the full amount owed to the bank, the bank will go after the assets of the borrower. The house is viewed only as collateral for the loan and is one way for the bank to recoup its loss in case of default.

15.2 Cash Flow vs. Asset Based Lenders.

The primary focus of a cash flow lender is the ability of a property to produce enough cash flow to provide steady, monthly payments. An asset-based lender is focused on the amount of money that can be made by taking over the property should the borrower default on the loan. (See 10.1 and 11.4 for a full explanation of the methods of both.) These different ways of approaching loans dictate the types of loans that you, as a broker, should or should not seek from each lender.

For example: A client is looking for a loan of $2,000,000 for a vacant building worth $8,000,000. From a risk standpoint, this is a great deal. In the worst case scenario, the bank will certainly be able to sell the building and recoup their $2,000,000. However, a cash flow lender does not want to be in the foreclosure and sale business. Their most important goal is to have steady income to pay their depositors or the source from which they borrowed the money. On the other hand, this is a perfect loan for an asset based lender. Since the value of the building could easily cover the loan, they are not taking a major risk. If the loan is paid on time, the lender has the benefits of charging higher interest rates.

15.3 Commercial Banks vs. Wall Street Lenders

The main characteristic of Wall Street Loans (explained at length in chapter 13) is that they are inflexible. Since the loans are sold to investors, Wall Street lenders must guarantee a certain steady return to their investors. This inflexibility can express itself in many ways, each of them a possible determining factor in choosing the appropriate lender for your client.

Prepayment Penalties – Wall Street Loans do not accommodate prepayment easily. They sell the loan assuming a steady income and therefore penalize prepayment heavily. For a smaller loan (under $5mm), prepayment is costly and inefficient. The best loans for a Wall Street lender are large and stable with no reason to suspect needing prepayment.

Personalized Treatment - With a standard loan, there is one entity or lender who has authority over the loan. If any issues arise with a loan, they can can be dealt with on an individual basis, taking various aspects of the loan into consideration. With a Wall Street loan, many different entities manage and have a share in the loan. It is much more difficult to make any needed adjustments within the course of the loan term.

Standardization – Wall Street loans are highly standardized. The process of applying for and obtaining the loans is familiar to brokers, making an easier and quicker procedure for certain loans.

In summary, loans suitable for securitization (Wall Street loans) are: large and long term loans mortgaged on conventional property types (e.g. retail, office, multifamily) with regular and stable cash flows.

CHAPTER 16

I/E or COMMERCIAL LOAN ANALYSIS

A commercial loan analysis is a document prepared either by the finance broker or by the bank. All pertinent information regarding the loan is charted out. Much of this information is included in the Income and Expense sheet and is explained in chapter 7. In this chapter, information unique to the loan analysis is explained.

Objectives

- To become familiar with the components of the commercial loan analysis

16.1 Sample Loan Analysis

It is important to note that the numbers that the owner provides to the bank may be modified by the bank due to the different ways that the same expenses are approached (see 10.1 and 11.2).

A sample loan analysis is found on the next page.

Commercial Loan Analysis

Property Name:	Eastern Center	Corporate New York, New York	New City	
		Term (Years):	3	
Net Rentable Square	107,568	Amortization (Years):	30	
Origination Date:	12-Jun-02	Interest Rate:	6.000%	
Original Loan Amount:	$12,375,000	Debt Service Constant:	7.195%	

		2000		2001		UNDERWRITING	
Date:	6/12/2002 8:49		$/SF		$/SF		$/SF
INCOME:							
GROSS POTENTIAL BASE RENT:		$1,592,585	$14.81	$1,763,611	$16.40	$2,483,892	$23.09
CAM and UTILITY REIMBURSEMENTS		$158,658	$1.47	$161,255	$1.50	$208,003	$1.93
Total Reimbursement Income		**$158,658**	$1.47	**$161,255**	$1.50	**$208,003**	$1.93
OTHER INCOME		$88,336	$0.82	162,166	$1.51	$149,040	$1.39
Total Gross Potential Income		**$1,839,579**	$17.10	**$2,087,033**	$19.40	**$2,840,935**	$26.41
Less: Physical Vacancy		$0	0.00%	$0	0.00%	($306,000)	-10.77%
Total Economic Vacancy		**$0**	**0.00%**	**$0**	0.00%	**($306,000)**	**-10.77%**
EFFECTIVE GROSS INCOME		**$1,839,579**	**$17.10**	**$2,087,033**	**$19.40**	**$2,534,935**	**$23.57**
EXPENSES:							
Management Fees		$99,847	5.43%	$99,857	4.78%	$126,747	5.00%
Fuel		$49,513	$0.46	$36,475	$0.34	$20,000	$0.19
Payroll		$35,262	$0.33	$28,452	$0.26	$32,000	$0.30
Cleaning		$54,881	$0.51	$34,340	$0.32	$36,000	$0.33
Elevator		$15,542	$0.14	$11,236	$0.10	$12,000	$0.11
Snow Removal		$23,298	$0.22	$20,424	$0.19	$22,500	$0.21
Utilities		$132,842	$1.23	$131,383	$1.22	$128,600	$1.20
Insurance		$17,884	$0.17	$22,609	$0.21	$27,000	$0.25
Repairs & Maintenance		$28,843	$0.27	$96,671	$0.90	$65,000	$0.60
Supplies		$9,321	$0.09	$16,552	$0.15	$12,000	$0.11
Telephone		$2,429	$0.02	$2,602	$0.02	$2,500	$0.02
Real Estate Taxes		$235,545	$2.19	$221,123	$2.06	$231,500	$2.15
Water/Sewer		$9,321	$0.09	$7,768	$0.07	$15,000	$0.14
TOTAL OPERATING EXPENSES		**$714,528**	$6.64	**$729,492**	$6.78	**$730,847**	$6.79
Replacement		$0	$0.00	$0	$0.00	$21,514	$0.20
TOTAL EXPENSES & REP. RESERVE		**$714,528**	**$6.64**	**$729,492**	**$6.78**	**$752,360**	**$6.99**
NOI AFTER REP. RESERVE		**$1,125,051**	**$10.46**	**$1,357,541**	**$12.62**	**$1,782,575**	**$16.57**
TENANT IMPROVEMENTS		$0	$0.00	$0	$0.00	$61,725	$0.57
LEASING COMMISSIONS		$0	$0.00	$0	$0.00	$44,132	$0.41
Total TI & LC		**$0**	**$0.00**	**$0**	**$0.00**	**$105,857**	**$0.98**
CASH FLOW BEFORE DEBT SERVICE		**$1,125,051**	**$10.46**	**$1,357,541**	**$12.62**	**$1,676,718**	**$15.59**
DEBT SERVICE		$890,381	$8.28	$890,381	$8.28	$890,381	$8.28
Net Cash Flow		$234,670	$2.18	$467,160	$4.34	$786,337	$7.31
DSCR BEFORE TI'S/LC'S		**1.26**		**1.52**		**2.00**	
DSCR AFTER TI'S/LC'S		**1.26**		**1.52**		**1.88**	
EXPENSE RATIO (net of R/Rsrvs)		38.8%		35%		28.8%	

In the above loan analysis, the box at the top provides basic information about the loan, such as property name and size. It also shows basic loan information - date, amount, term, amortization, rate and constant.

Term - The amount of time that the bank commits to a specific rate

Amortization - The amount of time allotted for the loan to be paid off. The average commercial real estate loan is for a five, seven, or ten-year term, payable on a 25 or 30-year amortization schedule. This means that even though the monthly payments are calculated as if the loan will be paid over 25 or 30 years, the bank only locks its interest rate for the life of the loan, which can be for five, seven, or ten years.

Rate – The interest rate may be either a **fixed rate** or a **floating rate**. A fixed rate remains constant throughout the term of the loan. A floating rate is based on a spread above a predetermined index which 'floats' or changes with that index throughout the term of the loan.

Debt service constant - See 10.3. Do not confuse the interest rate and the annual constant rate. A bank may issue a commitment with the constant payment as 8.48% and the interest rate at 7%. You must explain to your client that the difference in the constant and the interest rate is the amount that will go towards amortization - paying off the principal.

The above loan analysis was prepared in 2001 and contains information for both the year 2000 and 2001. The underwriting column refers to the bank's projections for the future for each of the items.

Many of the items in this list are explained in the chapter on the I/E sheet in chapter 7. Here, only items that are unique to the loan analysis or to the bank's underwriting are explained.

16.2 Loan Analysis - Line by Line

2 and 3 Reimbursements – see 6.2

5 Gross Potential Income – Total income level that could be obtained, assuming that all tenants are current with their rent plus the market rate for all vacant spaces

6 and 7 Vacancy – Each property type and each market determines the underwriting vacancy rate. Even though a particular building may have no vacancy at the time of the loan, a lender or buyer must underwrite the property as if it did. The bank must anticipate the possibility of a lag time between the time that the space comes up for renewal and a new tenant is found. Tenants can also fall behind on their rent, which is equivalent to a vacancy loss. A bank underwrites the loan with a vacancy and rent loss of 5% or the average market vacancy, whichever is higher.

When calculating the vacancy dollar amount, multiply the gross potential income by the market vacancy percent for that property. For example, if the average vacancy in a neighborhood is 5% and the gross potential income is $800,000, the vacancy is assigned as $40,000. [See 18.2 for more on calculating vacancy.]

10 Management Fee – See 6.1. An average property is usually underwritten with a 5% management fee and a larger property with 4%. This percentage is multiplied by the effective gross income. It is common for the owner not to take this expense into account, but it is underwritten by the bank; see 11.2.

11 Fuel - The bank underwrites the fuel expense with the estimated cost that the bank would have to pay should the bank take over the building. A multifamily property is typically underwritten at market cost. If the owner is paying above market, the bank will use the owner's number. The bank always takes the higher expense.

12 Payroll – The labor cost of a super and/or maintenance worker on or off the premises, full or part time (see line 10)

23 Total Operating Expenses - This figure reflects the total operating expenses, excluding the money put away for reserves. Total expenses, including reserves, are entered in line 25.

Both figures, the expenses with reserves and without, are important as they shed light on different angles of the value of the building. The value of a building is reflected by the amount of net profit that the building can produce, taking into account all income and expenses. The bank requires that some of that money be put away as reserves. However, that money essentially belongs to the owner and is put in an escrow account for him (see 10.2). When assessing the profits and value of a building, that money is counted as income since it is, in fact, part of the income of the building.

There are other factors, such as DSCR, which require an assessment of how much money the owner actually walks away with. These are accounted for in lines 33 and 34, which reflect all expenses including reserves.

24 **Replacement Reserves** – See 10.2. Replacement reserves are designated to cover structural and one-time expenses that arise, such as a new roof or repair of the facade. Replacement reserves for a high quality multifamily property in a decent neighborhood usually amount to about $250 per apartment per year. Commercial properties are calculated based on a price per square foot, usually $0.15 to $0.20 per square foot. Most major banks and financial institutions underwrite this expense and require the money to be put into an escrow account. Most local banks merely underwrite the expense but don't collect it.

25 **Total expenses** – This is a reflection of the actual expenses and the underwriting expenses added to the building to reflect the current market and comparable conditions.

27 and 29 **Tenant Improvements** - These are typically funded by reserve escrow accounts and often required by the bank. See lines 24 and 25. There is no fixed amount allocated for TI's. The bank assesses each loan for future TI's individually, based on tenant sizes, the going market for TI's, and assumptions of whether or not each tenant will renew their lease or choose to move. After estimating the amount that the owner will need in TI's for the life of the loan, the bank requires the owner to put a portion of that amount into reserves every month. This portion represents the total estimated amount, divided by the amount of months of the loan. Because the majority of tenant improvements are done early on, the bank may require the landlord to put away more at the time of closing to cover that extra expense.

When there are many tenant leases set to expire within the first 12 to 18 months, a lender might **holdback** an additional amount at closing since there is not enough time for the owner to build up an adequate TI reserve account. This means that the bank *holds back* some of the loan amount at the time of closing and sets it aside for TI's. All expenditures for tenant improvements are reimbursed by the lender after the work is done or expenses are paid.

28 **Leasing Commissions** - These are divided equally over the duration of the lease. For a ten-year lease, the bank calculates the cost of the LC and divides by ten, apportioning accordingly.

30 and 32 **Cash Flow** –NOI minus the amount taken off for TI's and LC's. This figure reflects the amount of cash available to pay the mortgage (see line 23).

CHAPTER 17

THE PROCESS OF OBTAINING A LOAN

This chapter focuses on various aspects of the process for obtaining a loan for your client. You will learn how to avoid any misunderstandings between your client and the bank in the presentation of the loan and how to present the numbers in the best possible light.

Objectives

- To understand the basic process of applying for and receiving a loan
- To become cognizant of possible discrepancies in the reading of the lease
- To learn how to present the borrower's numbers to a bank

17.1 Obtaining a Loan

The following is a basic outline of the process for applying for and receiving a loan:

1. The borrower submits a request to the lender for financing.

2. The lender provides a verbal quote which includes the main points of the loan – amount, term, and rate.

3. The borrower may request from the lender to lock the interest rate. This means that the lender commits that the rate quoted will be the final rate when the deal is closed. Most banks charge a refundable fee for locking a rate and the borrower is given a limited time in which to close. It is common to lock a rate within 30 days of the projected closing date.

4. If the quote is acceptable, the bank will put the quote in writing in a document called a **letter of intent** (**LOI**). The letter of intent, together with the term sheet, outlines the details and conditions of the loan, including projected closing costs (fees incurred by the borrower for transferring ownership).

5. A bank will not close without title insurance (See 9.3).

6. The lender and broker fees are charged in the form of a percentage of the loan and referred to as "points". The standard fee is one point. On a $2,500,000 loan, the fee would be $25,000.

7. Do not confuse the percentage of the fee with the rate of the loan. When a borrower takes a loan at 7% and is charged a 1% bank fee, the 7% interest is paid annually while the 1% is a one-time fee. It is not a rate of 8%. These fees are referred to as 'points' and not 'percents' so as not to confuse the two.

17.2 Reading the Lease

When preparing loan packages to present to the bank, it is extremely important to read through each individual lease on the property. Many times you will find discrepancies between the lease agreement and the information that had been provided to you by the landlord. Often, these discrepancies go unnoticed even by the landlord. Such discrepancies are common in the tenant's reimbursements. (See 6.2 for a full description of reimbursement methods.) Following are two examples of such discrepancies:

You may be told by the landlord that a tenant occupying 10% of the property reimburses all expenses above his base year on a pro-rata basis. Thus, if total base year expenses were $1,000,000 and year two's expenses were $1,200,000, the tenant would be responsible for reimbursements of $20,000 (10% of $200,000). Upon careful reading of the lease, however, you may discover an entirely different story.

It is common that a lease will stipulate a cap on the reimbursements. For example, the lease may state that the tenant is responsible to pay a pro-rata share of all expenses above the base year, *up until 5% above the prior year's expenses*. In the above illustration, expenses rose 20% ($200,000) during the second year. The tenant, however, is only responsible for a pro-rata (10%) of up to 5% above the previous year's expenses, which comes to only $5,000 (10% of 5% of $1,000,000). This is a difference of $15,000!

Should such a mistake remain unnoticed, the landlord would gain considerably. It would add $15,000 to his income and raise the value of his property, thus enabling him to obtain a bigger loan. Nevertheless, to submit the loan with such an error would be unethical and a clear misrepresentation of the lease. During the bank's underwriting process, the error will be caught and the bank will credit the overestimated amount back to the tenant and deduct it from the landlord's income. Your clients will appreciate and respect you more when such issues are dealt with upfront, rather than allowing them to go unnoticed and hurt them later.

Another example of base year discrepancies: A lease is signed with a tenant with the year 2004 serving as the base year for tax reimbursement. In 2004 the landlord paid $1,000,000 in taxes. Upon reviewing the taxes, the municipality concluded that the taxes were overpaid by $200,000 and refunds the landlord the difference in the year 2005. Thus, the actual taxes paid for the year 2004 are only $800,000.

In the year 2005, the taxes are $1,000,000. The landlord now demands from the tenant his share of the $200,000 raise in taxes since the actual taxes for the base year were only $800,000. The tenant will claim that at the time the lease was signed, the taxes were $1,000,000. Taxes have not exceeded the base year and the tenant should not be responsible for any reimbursement at all. This sort of discrepancy is common when taxes are prepaid based on a prior year's estimate, as it is in many municipalities, or when they are paid months after the period date for which the taxes were prepared.

This situation is usually resolved by referring to the lease. In most cases, the lease clearly states that the reimbursements are calculated based on the actual base year expenses, not the amount that the tenant had assumed based on the original payment.

17.3 Presenting the Numbers

A broker may never change numbers when presenting the setup of a property to the bank. However, it is important to know how to present the numbers in a way that accurately reflects the facts and also makes a good first impression on the bank.

Rents for vacant space

As you have seen, the bank underwrites vacancy for all properties. The number used for the vacancy is usually the average vacancy rate for the area of the property. This number is applied to the net rents of the property. It is therefore important to assign a rent for every available space, even those that are presently vacant. If you do not do this, you will be allowing for vacancy twice.

For example: An apartment building in an area with a 5% vacancy rate has a gross potential income of $800,000. The vacancy is assigned as $40,000. If there is an actual vacancy of 5% and the gross rent was entered as $760,000, the vacancy would be applied onto that amount, leaving the bank with a total income of $722,000 (5% of $760,000 = $38,000). The vacancy is, in effect, being taken off twice. However, if a rent is assigned to every space, then the gross income would be $800,000 and the vacancy of $40,000 would reflect the actual vacancy.

This is no small difference. In the above example, if the property is being assessed at ten times the value of the property, the loss for such a mistake amounts to $380,000! (See 'Variation to Cap Rate' in 2.1),

Super’s Apartment

A common example of marketing the numbers for the best first impression is the rent assigned for the super’s apartment. Often, the salary of the super is in the form of a rent-free apartment. The landlord may fill in a zero in the space for the rent of the super’s apartment on the income and expense statement. In the expenses section, instead of writing an amount for the super’s salary, he will write "free apartment."

Without changing the bottom line at all, these numbers can be presented in a much more appealing way to the bank. For the rent of the super’s apartment, enter the amount of rent that such an apartment is worth. In the ‘expenses’ column, deduct that amount as the super’s salary. Either way, the same thing is happening; the super is getting free rent for his services. But presented in this way, the numbers have a better effect. One of the first items that a lender looks at when assessing the numbers of a multifamily property is the gross rent amount. Based on this amount, a lender will decide if the loan amount being sought is commensurate with the value of the building. Using the above building as an example, if the super’s rent is applied, the gross rent is increased by $12,000 a year. If the building is being valued at six times gross rent, the setup yields an added $72,000 to the value of the building.

CHAPTER 18

THE BROKER'S ROLE

The most basic skill that a broker must possess is knowing how to structure a loan. Finding an interest rate that is two points lower may not sound like a big deal, but on a $1,000,000 loan it translates into a difference of $20,000 per year. A broker must also know that a lower rate does not automatically mean a better loan. Sometimes the borrower is stuck in a long term loan with a low interest rate but prohibitive prepayment penalties. For a client who may need to cash out down the line, the low rate is counterproductive.

In this chapter, you are introduced to some basic angles of loan structuring. The few examples included do not exhaustively cover the subject.. They are to be used merely as illustrations of the angles that must be kept in mind when looking for a loan for your client. Mastering the art of loan structuring results from a lifetime of working on loans and staying vigilant to keep learning from your experiences.

Other aspects of the broker's job include dealing with the client, the bank, and negotiating between the two. As a broker, you must ask yourself about each deal, "If I were asked to lend my own money, what questions and concerns would I have? Do I really understand this deal?" Finally, you must be able to answer the question, "If I had the money, would I buy or lend on this deal?" If you can answer with a confident "Yes", then you will be able to find a lender and work out a loan. If not, in all probability you will not be able to place the deal.

Objectives

- To appreciate some of the basic angles of loan structuring
- To acquire an understanding of a broker's role as guide and representative of his client

18.1 Structuring the Loan

The most basic measure of any loan is its interest rate. The first goal of the client is to lock in as low a rate as possible for the longest possible time. However, there are other aspects of the deal to keep in mind when arranging a loan. The term length must match the needs of the borrower. If the borrower is looking for a place to put away his money for a while, then you may take a long term loan with a low rate. If he is an investor who is in constant need of cash to invest in other real estate, you do not want to tie up his money for too long.

Another point to keep in mind is the type of lender that you approach for the loan. A Wall Street lender may offer a lower rate than a savings bank, but as explained at length in chapter 15, not all loans are suitable for all lenders.
Some examples of the different angles to keep in mind when appraising the individual situation of your client follows.

Loan Term

The term of a typical loan is five years. Rents increase on a yearly basis and as the rents increase, the value of the property increases. After about five years, there is enough equity built up in the property to make refinancing worthwhile.

The general rule is that the longer the loan term, the lower the interest rate. The disadvantage of a long term is that refinancing is costly due to prepayment penalties. These two aspects must be balanced according to the individual investor's situation.

One condition that can influence the length of the loan term is the current interest rates. If the rates are especially low and the investor feels that they will not stay this low for long, he may take a ten-year term to lock in a low interest rate for a substantial amount of time.

Improving the Property

A situation in which taking a short term loan is prudent is when an investor is looking to buy a low-valued property and then invest in improving it, thus increasing its cash flow. Because the building in its present state does not have a high value, the investor will not be able to get a large loan for the property or very desirable terms. In this case, you should arrange a shorter term loan. After the building has been improved and the cash flow has increased considerably, he can then take out a new loan on the now higher value of the building.

For example, an investor is considering a property currently valued at $8,500,000. By making some basic improvements, the investor calculates that the building can be brought to a $10,000,000 value within one year. To take out a long term loan would mean getting a loan of about $6,000,000 on a 75% LTV. After a year he is stuck with a $6,000,000 loan on a $10,000,000 property.

Instead, he should obtain a short term loan for the smaller amount, even if the rate is slightly higher. After 12 - 18 months, he can take out a $7,500,000 loan on the property now valued at $10,000,000. The slightly higher rate that he paid for the small amount of time of the first loan will now have been well worth it.

You must remember, however, that all of the above applies only to an investor who is looking to have as much cash on hand as possible. For a client who has more than enough cash for his investment needs, it may be better to take the longer term loan for the lower amount and enjoy the larger cash flow after his building rises in value.

Seasoning

Taking a shorter loan is prudent when the client gets a bargain on a property, meaning the purchase price is lower than the actual value. In that case, the bank will not lend 75% of the value of the property, but 75% of the cost (See 11.1). However, most banks engage in a practice called seasoning. This means that after a certain amount of time of ownership of the property (usually one to two years), the bank no longer considers the cost of the property. It only looks at its current value. By taking a short term loan initially and refinancing after the term is up, the borrower can get a larger loan without increasing the value of the property.

For example,, a client buys a $1,000,000 property for $900,000. The bank will only lend him 75% LTC ($675,000), not 75% LTV ($750,000). By taking a shorter term loan, he can refinance after the seasoning period and pull out an additional $75,000 on the property.

Refinancing

When a client wants to refinance, it is important to know the motives behind the refinance. You must ascertain his current loan balance, interest rate, and which prepayment penalties are in place for the loan. By comparing the current available loans, you can calculate if the new rate and cash out is worth the costs of the prepayment penalties and closing costs.

While there are times that a client may miscalculate the cost effectiveness of a refinance, sometimes a client has a pressing need for
cash and must refinance no matter what. It is therefore extremely important to always ask a client for his motivation for refinancing so that you may best structure his loan.

18.2 The Owner's Guide

A good broker is one who is able to place himself in the position of the buyer and then provide him with objective opinions, not only about which type of loan to get, but also about the deal itself.

A buyer may be affected by factors external to the deal itself and having an objective person to constructively criticize or concur with his decisions can be very valuable for him. Just as an investor will personally visit the site of a potential acquisition, so should the broker. Upon visiting the property, a broker may notice details that escaped the attention of the buyer. For example, he may notice that down the block from the property there is a strip of vacant stores. The broker should urge the client to consider how this can affect his deal. Or the broker may point out that a comparable building two blocks over has a doorman, whereas his client's building does not. A broker must survey every angle of the deal and lay all possible scenarios on the table in order to best serve his client.

Regarding the loan, a broker must guide his client through the various options available to him, both in the structure of the loan and in the choice of lender. You may have to explain to the owner why the bank underwrites many of the expenses differently than his own calculations (See 'Banker's View' 10.1 and 'Managing the Building' 11.2). The best way to explain this to him is to say, "You know how to buy and manage; a bank only knows how to lend. If the bank gets stuck with the property it will not be run at optimum efficiency and they will be stuck with more vacancies and expenses."

Finally, a broker is the borrower's representative in dealing with the bank. An investor wants to maintain his rapport with the bank and therefore minimizes his own personal dealings with the bank. It is your job to do the haggling for him and negotiate all aspects of the deal with the bank, from the interest rate to the amortization schedule.

CONCLUSION

The Eastern Way provides you with the skills and knowledge you need to become a good broker. It introduced you to the principles of real estate and the foundations of financing. As the concepts and scenarios in this book are likely new to you, it is important to read this book repeatedly until you gain a familiarity with all aspects of the field.

As you become involved with the details of different deals and the practical aspects of commercial real estate, the concepts described in this book will spring to life and become even clearer in your mind. Actual brokering will teach you the most about being a broker. Put yourself out there and get involved in as many deals as you can. Familiarize yourself with prior deals, keep an ear out for new deals, and extend your list of contacts. Look at every deal from all angles and judge the deal by the whether or not your client will come out on top. If you work hard to serve your clients to the best of your ability, your success will continue to grow.

With honesty, integrity and sincerity, you will gain respect, admiration, and a solid reputation as a broker. This is the surest route to success.

Glossary of Commonly Used Real Estate Terms

A

Adjustable rate mortgage (ARM) – a loan in which the interest rate is changed periodically based on a standard financial index. Most ARM's have caps on the amount that the rate may increase.

Amortization – the total amount of time allotted for paying off a loan; commonly set for 25-30 years.

Anchor tenant – a major department or chain store that is strategically located in a shopping center, giving maximum exposure to smaller satellite stores.

Annual constant payment – the actual amount (principal plus interest) a borrower pays on an annual basis.

Appraisal – an opinion or estimate of the current value of a property. The appraisal is the basis for the lender's determination of the loan amount or LTV. Gross income, underwriting, NOI, comparables, and a physical inspection are used to help determine this value.

Asset-based lenders – lenders whose primary focus is not the cash flow of a property (see cash flow lenders), but the present resale value of the property

B

Balloon payment – the full balance due at loan term expiration in the case of loan which is not fully amortized; see "Fully amortized loan." More common with second mortgages

Base year – the year a tenant's pro-rata for reimbursements is based on. A tenant agrees to reimburse a landlord certain or all expenses above and beyond "x" amount of dollars. The "x" amount of dollars is the total amount of a full calendar year's expenses for an agreed upon base year.

Basis point – one hundredth of a percentage point (0.01%). 1% equals 100 basis points. Basis points are often used to measure changes in or differences between yields since these often change by very small amounts.

Bonds – When a company or a government is looking to raise capital, they may "float bonds." Money is borrowed from the bond purchaser and he is promised a certain return. Return fluctuates based on the bond's risk and demand.

Bottom line – gross income minus incurred expenses. *See also* Net income.

Build-outs – developing raw tenant space; usually the landlord's responsibility

C

Cap rate – the rate of return used to derive the value of an income producing property

Cash flow – the amount of money left after all expenses are paid. This is calculated by taking the NOI minus the annual mortgage payments.

Cash flow lenders – lenders who analyze the income of the property and the bottom line (cash flow) to determine how much money they can lend on it

Cash-on-cash – the return on the cash put into the down payment and closing costs for purchasing a property

Cash out – the profit an owner can make on the equity of his property by refinancing the existing mortgage

Ceiling – a fixed predetermined point which a floating rate cannot exceed

Closing – (1) the act of transferring ownership of a property from seller to buyer in accordance with a sales contract; (2) the time when this transfer of ownership takes place. Closing also occurs at the time of a refinance because in a sense, the property is renewed to the owner.

Closing costs – fees and expenses, such as lawyer's fees and survey charges, incurred by the buyer and/or the seller during the property ownership transfer.

Commercial properties – all properties excluding one-to-four-family homes. A 5+ unit multifamily building requires a commercial loan even though there are no office or retail tenants. However, in the commercial real estate industry, a "commercial property," refers to a non-residential property like a shopping center, office building, or industrial building.

Common area maintenance (CAM) – the maintenance expenses to upkeep the common areas, such as hallways, lobbies, and parking lots

Conduits – the bridge between the borrower and the investor. They are usually Wall Street lenders; they make loans to property owners and then sell them off to investors.

Construction loan – a short-term loan to pay for the construction of buildings or homes

Credit rating – the rating that an agency such as Moody's gives a company. This rating lets investors know what level of risk they are incurring when they do business with that company.

Credit tenant – a tenant with a credit rating by a reputable rating company (see credit rating).

D

Dark tenant – a tenant who closed a store but is still liable to pay rent until expiration of their lease

Debt – the total amount of loan, mortgages, and liens placed on a property

Debt service – the cost of the annual payments of all the debt, including principle and interest

Debt service constant – the constant percentage that the total debt service is in relation to the debt

Debt service coverage ratio (DSCR) – the ratio of the NOI to the debt service; the bank requires an owner to earn a certain percentage, usually between 1.2% and 1.3%, above the debt service amount.

Deed – when recorded with the local government, the document that determines ownership of a property. It is transferred from seller to buyer at closing.

Defeasance – *See* Prepayment penalty.

Depreciation – For tax purposes, it is assumed that property wears out over time. The value of the property depreciates over its lifetime to eventually reach $0. This is not an actual out-of-pocket expense, but rather a theoretical expense. This allows the owner to reduce his "taxable income" even though the value or equity of the property may have increased over time. For example, if the actual profit on a building is $300,000 and the depreciation for that year is $250,000, the client only pays taxes on $50,000.

Down payment – the cash that the buyer puts toward the purchase price. The rest of the money will come from financing.

Downsize –a reduction of the amount space that a company occupies. Depending on the terms of the lease, the company may sublet some or all of their space to another tenant.

E

Earnest money – money that is submitted with an offer to purchase, indicating a buyer's seriousness and good faith. In virtually all cases, earnest money needs to be submitted at the time of offer and remains in escrow until the closing, at which time it becomes part of the down payment.

Effective gross income – the NOI from all generated income (rent, laundry, parking, etc.) minus the underwritten vacancy

Equity – the value the property owner has over any debt owed on the property. Equity = property value – loans and liens against the property. Typically expressed as a percentage of the property value

Escrow account – Money held by a third party until conditions of an agreement are met

Estoppels – a legal document from a tenant affirming various facts to be true: that they actually occupy space in the stated building and that they pay the stated amount of rent to the stated landlord, etc.

F

Floor – the minimum amount a lender will accept in interest, regardless of the index at that time

Foreclosure – a process in which the lender takes over the property as a result of the borrower failing to pay his monthly payments

Free and clear – a property on which there is no debt

Fully amortized loan – a loan in which the entire principal is paid out over the term of the loan. For a 15-year self-amortizing loan, the principal is paid out over 15 years with a zero balance remaining at the end. This is in contrast to a loan in which there is a balloon payment at the end of the term. For example, on a five-year term with a 20-year amortization, the borrower's principal payments are calculated as if it was paid out fully over 20 years, but since he is paying it out over only five years, there will be a lump sum payment due at the end of the term.

G

Gross potential income – the income the building would produce if fully rented out at market rents. This number is used to assess the value of the building when fully stabilized.

H

Holdback – the holding back of a portion of the loan when there are no reserves. The borrower pays out of pocket and gets reimbursed by the lender when funds are later needed.

I

Income and expense statement (setup) – a breakdown of the cash inflow and outflow for a specific property. This is the backbone of the deal and sets the value of the property.

Income-producing property – In commercial real estate, an income-producing property is defined as a property that incurs a profit or positive cash flow after applying all the expenses.

Interest rate – the rate of compensation lenders receive for their service of lending money, generally calculated by adding a certain percentage to their cost of funds.

Locking an interest rate – In the simplest form, this is a commitment from a lender to the borrower of the actual interest rate that he will be paying when the deal is closed.

L

Landlord – an owner of property who rents it to another party - the tenant

Lease – a written agreement in which a property owner allows a tenant to use his property for a specified period of time and rent

Lease end date – a date when a lease expires. At the end of the lease, there may be options for the tenant to renew their lease.

Lease start date – the date a lease actually goes into effect

Leasing commission (LC) – commission paid to a leasing agent for finding a tenant to fill a vacancy. The commission is based on the total rent to be paid throughout the life of the lease. The landlord usually pays this fee.

Letter of intent (LOI) – a letter from a lender outlining the general terms of a loan they are willing to give for a certain property

Loan origination fee – A charge imposed by the lender, payable at closing, for processing the loan

Loan-to-cost (LTC) – the percentage of the total purchase price that a lender is willing to lend on

Loan-to-value (LTV) – the percentage of the total value of a property that a lender is willing to lend on

M

Management fee – the fee that is paid to a company or person to take care of a property. The duty of the manager includes collecting rents, paying bills, and supervising the maintenance of the building.

Mixed-use properties – a property that contains more than one property type; e.g. a property that has stores on the ground level and apartments on the second

Mortgage – a loan used to finance the purchase of property, using the property as collateral for the loan

Mortgage-backed securities – a security created when a group of mortgages are gathered together and bonds are sold to other institutions or the public. Investors receive a portion of the interest payments on the mortgages as well as the principal payments.

Multifamily properties – a property that contains multiple residential units, such as an apartment building or garden apartment complex

N

Negative amortization – amortization in which the payment made is insufficient to fund complete repayment of the loan at its termination. This usually occurs when the rate increases, but the monthly payment is limited by a ceiling. Since the borrower does not have to pay above a certain amount each month, the portion of the payment that should be paid is added to the remaining balance owed. By doing this, the payments will not be completed at the end of the original loan term and will continue until the balance is paid off.

Net operating income (NOI) – This is the bottom line or profit after an owner calculates his gross effective income and subtracts all his expenses (See underwriting). It is the deciding factor for cash flow lenders to determine how much they are comfortable lending or for buyers to determine how much to pay for the property.

Net income – gross income minus incurred expenses. For a business, it is the same as net profit. *See also* Bottom line.

Non-recourse – no personal guarantee by the borrower. The security to the lender is the property itself.

O

Operating expenses – the expenses involved in the day-to-day running of a property

Options – an extension of the original loan term. If the original loan term is five years, then an option may be an additional five years. When a borrower takes a loan that has a term shorter than the amortization, he would want to have options to renew at the end of the term.

P

Points – interchangeable with "percent." Each point refers to one percent of the loan. Commonly used to refer to the lender or broker fees

Prepayment penalty (PPP) – the amount of money a borrower has to pay his existing lender as a penalty for paying off the loan early

Private mortgage insurance (PMI) – insurance that is required on virtually all conventional loans with less than 20% down payment. Although the payments for PMI are included in the mortgage payment, it protects the lender if the borrower defaults on the loan.

Pro-rata share – the proportion of the total space that a tenant leases in relation to the size of the building

Purchase money mortgage – a mortgage used to finance the purchase of a property

Q

Quote – a verbal statement by the lender following a borrower's request for financing. Includes the main points of the loan, such as the loan amount, term, and interest rate

R

Recording – The act of entering deed and/or mortgage information into public record with the local government jurisdiction

Recourse – a personal guarantee by the borrower to pay off the loan. Some banks will only lend with this personal guarantee.

Refinance – obtaining a new mortgage loan on a property that the borrower already owns. It is often used to replace existing loans on the property.

Reimbursements – when tenants agree to pay for certain expenses that the owner will incur, the owner pays the bills and the tenant "reimburses", or pays back, the owner for those bills.

Rent – monthly payment from tenant to landlord, for the use of space or property

Rent per square foot – the total square footage a tenant occupies divided by the *annual* rent

Rent roll – a listing of all tenants leasing space within a building or property, along with their square footage (and room count for apartments), lease start and end dates, option leases, and any reimbursement income

Replacement cost – the cost to rebuild a building from scratch at current prices

Replacement reserves – an account required by many lenders to ensure that money is available to perform infrequent repairs, such as roof replacement

Return on investment (ROI) – the return, or profit, that an owner sees from his investment in a property

S

Savings bank – a bank that pools the savings of individuals for investment in mortgages. Historically, savings bank earnings depended on the spread between what they paid depositors and what they received from borrowers.

Seasoning – the time period that a lender requires in which the buyer continues to maintain a certain minimum equity in a property. After this period, many lenders will allow the borrower to borrow as much as the value of the building allows, regardless of how little he paid for it.

Securitization – the process by which financial assets that generate a cash flow, such as real estate loans, are converted into securities for sale to investors in the capital markets. Potential investors include insurance companies, banks, pension funds, and real estate funds.

Self-liquidating loan – a loan that is entirely paid off at the end of the term; the term and the amortization run simultaneously.

Seller financing – *See* Vendor financing.

Setup – an income and expense statement and an itemized rent-roll

Sliding scale – *See* Prepayment penalty.

Spread – the difference between the cost of funds, typically measured by a certain index rate, and the rate quoted by the lender. The spread amounts to the lender's profit.

Sublet – to sub-lease some or all of a tenant's space to another tenant, commonly due to downsizing

Syndicator – the person in charge of putting together all the different aspects for the purchase of a property. For example, if a prospective buyer hears of a building for sale and thinks it is a good deal but does not have all the money needed to complete the transaction, he'll go to contract on the property and then hire a syndicator to find other people to be partners in the deal. The syndicator will get a part of the ownership for his work in putting the deal together.

T

Tenant – an individual or business that has possession and pays rent for real estate owned by another party (the landlord).

Tenant improvements (TI's) – improvements that a tenant can request from the landlord upon moving in to a new space or renewing a lease.

Term – the life of a loan that a bank is committing to at a specific rate. It can be a **fixed rate** loan, where the rate quoted remains stable throughout the entire term of the loan or a **floating rate**, where the rate quoted changes throughout the term of the loan based on a spread above a predetermined index.

Term sheet – *See* Letter of intent.

Title – evidence that the current owner of the property is in lawful possession; evidence of ownership without any hindrances to his title

Title insurance – an insurance policy that protects the insured against loss arising from defects in title. Defects include liens against the property or the improper recording of the deed

Title report – a report from the title insurance company that presents all previous owners of the property and confirms the current owner. It also shows if there are any current liens on the property.

Tranches – portions of an investment

Triple net lease (NNN) – a lease in which the tenant pays rent to the landlord, as well as all taxes, insurance, and maintenance expenses that arise from the use of the property.

U

Underwriting – the process by which lenders determine the profit of a building by using actual numbers and minimum criteria for expenses (e.g. vacancy and cap rates) to determine values.

U.S. Treasury bills – The U.S. Treasury issues securities to raise the money needed to operate the Federal Government and to pay off maturing obligations and the U.S. government's debt.

V

Vacancy – the total percentage of a space in a building that is unoccupied and therefore not producing income. If a 100-unit building has five vacancies, the vacancy of the building is 5%.

Vacancy factor – The lender will subtract a vacancy factor from the income, even if all units are occupied. This is done in order to determine what the income would be if several apartments became vacant.

Vendor financing – Also known as *seller financing,* this is when the seller provides the loan to the buyer. Occurs in cases when the property is difficult to finance through conventional sources

Y

Yield – the percent return

Yield maintenance – *See* Prepayment penalty.

Z

Zoning – laws that govern how a zoned area can be used. For example, an area may be zoned for single-family residential, condominiums, commercial, retail, or a mix of two or more uses.

INTEREST RATE		5 YEARS	7 YEARS	10 YEARS	15 YEARS	18 YEARS	20 YEARS	25 YEARS	30 YEARS	40 YEARS
3.000%	3	21.562%	15.856%	11.587%	8.287%	7.197%	6.655%	5.691%	5.059%	4.296%
3.125%	3 1/8	21.629%	15.924%	11.657%	8.359%	7.271%	6.731%	5.769%	5.141%	4.383%
3.250%	3 1/4	21.696%	15.992%	11.726%	8.432%	7.345%	6.806%	5.848%	5.222%	4.470%
3.375%	3 3/8	21.763%	16.060%	11.796%	8.505%	7.420%	6.883%	5.927%	5.305%	4.559%
3.500%	3 1/2	21.830%	16.128%	11.866%	8.579%	7.496%	6.960%	6.007%	5.389%	4.649%
3.625%	3 5/8	21.897%	16.196%	11.937%	8.652%	7.572%	7.037%	6.088%	5.473%	4.739%
3.750%	3 3/4	21.965%	16.265%	12.007%	8.727%	7.648%	7.115%	6.170%	5.557%	4.830%
3.875%	3 7/8	22.032%	16.334%	12.078%	8.801%	7.725%	7.193%	6.252%	5.643%	4.922%
4.000%	4	22.100%	16.403%	12.149%	8.876%	7.802%	7.272%	6.334%	5.729%	5.015%
4.125%	4 1/8	22.168%	16.472%	12.221%	8.952%	7.880%	7.351%	6.417%	5.816%	5.109%
4.250%	4 1/4	22.235%	16.541%	12.293%	9.027%	7.958%	7.431%	6.501%	5.903%	5.203%
4.375%	4 3/8	22.303%	16.611%	12.364%	9.103%	8.037%	7.511%	6.585%	5.991%	5.299%
4.500%	4 1/2	22.372%	16.680%	12.437%	9.180%	8.116%	7.592%	6.670%	6.080%	5.395%
4.625%	4 5/8	22.440%	16.750%	12.509%	9.257%	8.195%	7.673%	6.755%	6.170%	5.492%
4.750%	4 3/4	22.508%	16.820%	12.582%	9.334%	8.275%	7.755%	6.841%	6.260%	5.589%
4.875%	4 7/8	22.577%	16.890%	12.655%	9.412%	8.356%	7.837%	6.928%	6.350%	5.687%
5.000%	5	22.645%	16.961%	12.728%	9.490%	8.436%	7.919%	7.015%	6.442%	5.786%
5.125%	5 1/8	22.714%	17.031%	12.801%	9.568%	8.518%	8.003%	7.103%	6.534%	5.886%
5.250%	5 1/4	22.783%	17.102%	12.875%	9.647%	8.599%	8.086%	7.191%	6.626%	5.986%
5.375%	5 3/8	22.852%	17.173%	12.949%	9.726%	8.681%	8.170%	7.280%	6.720%	6.088%
5.500%	5 1/2	22.921%	17.244%	13.023%	9.805%	8.764%	8.255%	7.369%	6.813%	6.189%
5.625%	5 5/8	22.991%	17.315%	13.098%	9.885%	8.847%	8.340%	7.459%	6.908%	6.292%
5.750%	5 3/4	23.060%	17.387%	13.172%	9.965%	8.930%	8.425%	7.549%	7.003%	6.395%
5.875%	5 7/8	23.130%	17.458%	13.247%	10.045%	9.014%	8.511%	7.640%	7.098%	6.498%
6.000%	6	23.199%	17.530%	13.322%	10.126%	9.098%	8.597%	7.732%	7.195%	6.603%
6.250%	6 1/4	23.339%	17.674%	13.474%	10.289%	9.268%	8.771%	7.916%	7.389%	6.813%
6.500%	6 1/2	23.479%	17.819%	13.626%	10.453%	9.439%	8.947%	8.102%	7.585%	7.025%
6.750%	6 3/4	23.620%	17.965%	13.779%	10.619%	9.612%	9.124%	8.291%	7.783%	7.240%
7.000%	7	23.761%	18.111%	13.933%	10.786%	9.786%	9.304%	8.481%	7.984%	7.457%
7.250%	7 1/4	23.903%	18.258%	14.088%	10.954%	9.962%	9.485%	8.674%	8.186%	7.676%
7.500%	7 1/2	24.046%	18.406%	14.244%	11.124%	10.140%	9.667%	8.868%	8.391%	7.897%
7.750%	7 3/4	24.188%	18.554%	14.401%	11.295%	10.319%	9.851%	9.064%	8.597%	8.119%
8.000%	8	24.332%	18.703%	14.559%	11.468%	10.500%	10.037%	9.262%	8.805%	8.344%
8.500%	8 1/2	24.620%	19.004%	14.878%	11.817%	10.865%	10.414%	9.663%	9.227%	8.797%
9.000%	9	24.910%	19.307%	15.201%	12.171%	11.237%	10.797%	10.070%	9.655%	9.256%
10.000%	10	25.496%	19.921%	15.858%	12.895%	11.998%	11.580%	10.904%	10.531%	10.190%
12.000%	12	26.693%	21.183%	17.217%	14.402%	13.583%	13.213%	12.639%	12.343%	12.102%
14.000%	14	27.922%	22.488%	18.632%	15.981%	15.245%	14.922%	14.445%	14.218%	14.054%
16.000%	16	29.182%	23.834%	20.102%	17.624%	16.971%	16.695%	16.307%	16.137%	16.028%
18.000%	18	30.472%	25.221%	21.622%	19.325%	18.752%	18.520%	18.209%	18.085%	18.014%

To figure out the monthly P & I payment, multiply the loan amount by the constant%, and then divide by 12.

Example: The formula to figure out the monthly payment for a $1,500,000 loan at a rate of 4.75% on a 30-year amortization schedule is *$1,500,000* ***** *6.260***% / ***12*** which equals $7,825 a month of P & I payments.

Constant Annual Percent Table

Amortization Schedule			Yearly PMT	($42,967.38)							
Loan:	$ 750,000		Loan Constant	5.73%							
Rate:	4.00%										
Amort:	30										
PMT #	Beginning Balance	PMT	Interest	Principal	Ending Balance	PMT #	Beginning Balance	PMT	Interest	Principal	Ending Balance
1	$ 750,000	($3,580.61)	$ 2,500.00	$1,080.61	$ 748,919.39	31	$ 715,964.80	($3,580.61)	$2,386.55	$1,194.07	$ 714,770.74
2	$ 748,919.39	($3,580.61)	$ 2,496.40	$1,084.22	$ 747,835.17	32	$ 714,770.74	($3,580.61)	$2,382.57	$1,198.05	$ 713,572.69
3	$ 747,835.17	($3,580.61)	$ 2,492.78	$1,087.83	$ 746,747.34	33	$ 713,572.69	($3,580.61)	$2,378.58	$1,202.04	$ 712,370.65
4	$ 746,747.34	($3,580.61)	$ 2,489.16	$1,091.46	$ 745,655.88	34	$ 712,370.65	($3,580.61)	$2,374.57	$1,206.05	$ 711,164.61
5	$ 745,655.88	($3,580.61)	$ 2,485.52	$1,095.10	$ 744,560.79	35	$ 711,164.61	($3,580.61)	$2,370.55	$1,210.07	$ 709,954.54
6	$ 744,560.79	($3,580.61)	$ 2,481.87	$1,098.75	$ 743,462.04	**36**	$ 709,954.54	($3,580.61)	$2,366.52	$1,214.10	$ 708,740.44
7	$ 743,462.04	($3,580.61)	$ 2,478.21	$1,102.41	$ 742,359.63	37	$ 708,740.44	($3,580.61)	$2,362.47	$1,218.15	$ 707,522.30
8	$ 742,359.63	($3,580.61)	$ 2,474.53	$1,106.08	$ 741,253.55	38	$ 707,522.30	($3,580.61)	$2,358.41	$1,222.21	$ 706,300.09
9	$ 741,253.55	($3,580.61)	$ 2,470.85	$1,109.77	$ 740,143.78	39	$ 706,300.09	($3,580.61)	$2,354.33	$1,226.28	$ 705,073.81
10	$ 740,143.78	($3,580.61)	$ 2,467.15	$1,113.47	$ 739,030.31	40	$ 705,073.81	($3,580.61)	$2,350.25	$1,230.37	$ 703,843.44
11	$ 739,030.31	($3,580.61)	$ 2,463.43	$1,117.18	$ 737,913.13	41	$ 703,843.44	($3,580.61)	$2,346.14	$1,234.47	$ 702,608.97
12	$ 737,913.13	($3,580.61)	$ 2,459.71	$1,120.90	$ 736,792.23	42	$ 702,608.97	($3,580.61)	$2,342.03	$1,238.58	$ 701,370.38
13	$ 736,792.23	($3,580.61)	$ 2,455.97	$1,124.64	$ 735,667.59	43	$ 701,370.38	($3,580.61)	$2,337.90	$1,242.71	$ 700,127.67
14	$ 735,667.59	($3,580.61)	$ 2,452.23	$1,128.39	$ 734,539.20	44	$ 700,127.67	($3,580.61)	$2,333.76	$1,246.86	$ 698,880.81
15	$ 734,539.20	($3,580.61)	$ 2,448.46	$1,132.15	$ 733,407.05	45	$ 698,880.81	($3,580.61)	$2,329.60	$1,251.01	$ 697,629.80
16	$ 733,407.05	($3,580.61)	$ 2,444.69	$1,135.92	$ 732,271.12	46	$ 697,629.80	($3,580.61)	$2,325.43	$1,255.18	$ 696,374.62
17	$ 732,271.12	($3,580.61)	$ 2,440.90	$1,139.71	$ 731,131.41	47	$ 696,374.62	($3,580.61)	$2,321.25	$1,259.37	$ 695,115.25
18	$ 731,131.41	($3,580.61)	$ 2,437.10	$1,143.51	$ 729,987.90	**48**	$ 695,115.25	($3,580.61)	$2,317.05	$1,263.56	$ 693,851.69
19	$ 729,987.90	($3,580.61)	$ 2,433.29	$1,147.32	$ 728,840.58	49	$ 693,851.69	($3,580.61)	$2,312.84	$1,267.78	$ 692,583.91
20	$ 728,840.58	($3,580.61)	$ 2,429.47	$1,151.15	$ 727,689.43	50	$ 692,583.91	($3,580.61)	$2,308.61	$1,272.00	$ 691,311.91
21	$ 727,689.43	($3,580.61)	$ 2,425.63	$1,154.98	$ 726,534.45	51	$ 691,311.91	($3,580.61)	$2,304.37	$1,276.24	$ 690,035.67
22	$ 726,534.45	($3,580.61)	$ 2,421.78	$1,158.83	$ 725,375.62	52	$ 690,035.67	($3,580.61)	$2,300.12	$1,280.50	$ 688,755.18
23	$ 725,375.62	($3,580.61)	$ 2,417.92	$1,162.70	$ 724,212.92	53	$ 688,755.18	($3,580.61)	$2,295.85	$1,284.76	$ 687,470.41
24	$ 724,212.92	($3,580.61)	$ 2,414.04	$1,166.57	$ 723,046.35	54	$ 687,470.41	($3,580.61)	$2,291.57	$1,289.05	$ 686,181.36
25	$ 723,046.35	($3,580.61)	$ 2,410.15	$1,170.46	$ 721,875.89	55	$ 686,181.36	($3,580.61)	$2,287.27	$1,293.34	$ 684,888.02
26	$ 721,875.89	($3,580.61)	$ 2,406.25	$1,174.36	$ 720,701.53	56	$ 684,888.02	($3,580.61)	$2,282.96	$1,297.65	$ 683,590.37
27	$ 720,701.53	($3,580.61)	$ 2,402.34	$1,178.28	$ 719,523.25	57	$ 683,590.37	($3,580.61)	$2,278.63	$1,301.98	$ 682,288.39
28	$ 719,523.25	($3,580.61)	$ 2,398.41	$1,182.20	$ 718,341.05	58	$ 682,288.39	($3,580.61)	$2,274.29	$1,306.32	$ 680,982.07
29	$ 718,341.05	($3,580.61)	$ 2,394.47	$1,186.14	$ 717,154.90	59	$ 680,982.07	($3,580.61)	$2,269.94	$1,310.67	$ 679,671.39
30	$ 717,154.90	($3,580.61)	$ 2,390.52	$1,190.10	$ 715,964.80	**60**	$ 679,671.39	($3,580.61)	$2,265.57	$1,315.04	$ 678,356.35

About the Author

In the late 1990's, Ira Zlotowitz emerged from his role as a recruiting sales associate in a small, one-office funding business and proceeded to transform the firm into a national company. He trained several hundred brokers, opened satellite offices across the country, and helped boost annual financing volume to more than $2 billion.

When the firm's owners decided to change focus, Mr. Zlotowitz resigned in February 2001 and with his long-time friend, Abraham Bergman, launched Eastern Union Funding the following May. Fifteen years later, working closely with Mr. Bergman, Ira Zlotowitz has yet again transformed a small company into a nationally acclaimed firm: Eastern Union closed some $3 billion in financing in 2016 thanks to the outstanding efforts of a skilled staff that takes the client's interest to heart.

In January 2005, Ira Zlotowitz's past and present triumphs were acknowledged in the nationally celebrated Crain's New York Business magazine with his inclusion among New York City's top "40 Under 40" entrepreneurs.

In March 2013, Real Estate Forum, the commercial real estate sector's most prominent national trade publication, recognized Ira Zlotowitz in its prestigious "Tomorrow's Leaders" feature, citing him and other leaders on New York's dynamic real estate scene.

Mr. Zlotowitz's achievements also extend to his community. At the age of 19, he started an after-school youth program called Masmid Govoha. The program offers prizes and incentives to motivate junior high school students to take on extracurricular studies. Ira Zlotowitz is the sole benefactor of this highly successful educational initiative. Now in its 22nd year, the program serves more than 2,500 young students. Tens of thousands of students have benefited from Masmid Govoha and it has motivated participants to undertake hundreds of thousands of added hours in school studies.

Mr. Zlotowitz resides in Lakewood, New Jersey with his wife, Rochie, and their three children, ages eighteen, sixteen and thirteen. He is recognized in his community for his charity, generosity and involvement in community affairs. Mr. Zlotowitz attributes all of his success to a Higher Power and is thankful for the opportunity to engage in charitable acts and philanthropic events in his community.

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