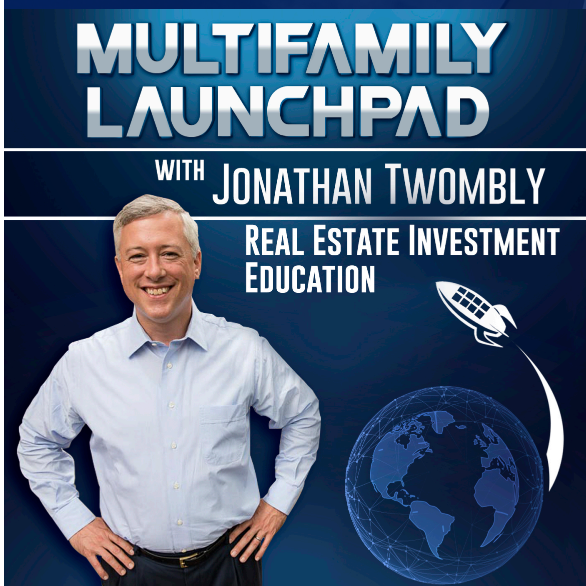

The Commercial Debt Landscape

Module 7 - Video 2

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VIDEO OVERVIEW

What's covered:

- The main differences between commercial and residential mortgages
- The main types of commercial debt, with advantages and disadvantages of each
- Prepayment penalties


What's Different About Commercial Mortgages?

RESIDENTIAL MORTGAGES

- Familiar to you, if you own a home
- Main features:
  - ✓Down payments as low as 3-5%
  - ✓Terms as long as 30 years
  - ✓Fully amortizing
  - ✓No prepayment penalties
  - ✓Eligibility based on your income and credit score
  - ✓Second mortgages, home equity lines, etc., possible
  - ✓Paying on time is enough to satisfy the lender

Commercial Mortgages

- Very different from residential mortgages
- Main features:
  - ✓Down payment almost never less than 20%; usually 25%
  - ✓Terms rarely exceed 10 years
  - ✓Only partial amortization, with balloon payment at end
  - ✓Stringent pre-payment penalties
  - ✓Eligibility: property income & borrower NW & liquidity
  - ✓Second mortgages usually not permitted
  - ✓Paying on time is not enough; reporting obligations, DSCR, etc.

When Do You Need a Commercial Loan?

- Any residential rental property with 4 or fewer units is considered "residential," and qualifies for a residential mortgage
  - ✓ Lender assumes that the borrower will occupy the property, and that lowers lender's risk of default
- Any residential rental property of 5 units or more is considered "commercial"
  - ✓ Assumption is the borrower won't occupy the property and it's purely for investment, so borrower may make business decision to walk away
  - ✓ Thus, higher risk for lender
- If your property is 5+ units, you must obtain a commercial mortgage


Different
Types of
Commercial
Mortgages

Two Main Types of Commercial Loans

Two main types of commercial debt:

- "Bridge" debt
- "Permanent" debt (sometimes called "perm")

Bridge Debt

- ”Bridges” the property from non-stabilized to stabilized condition
- Stabilized condition = required number of months at required level of occupancy, depending on lender
- You need bridge debt if you buy a <u>distressed</u> property <u>below</u> the required occupancy level (i.e., not for routine value-add)
- Usually interest-only
- Term 1-3 years only, though sometimes you can roll to perm with same lender
- Obtainable from specialized bridge lenders
- When you complete your rehab program, you refinance your bridge debt into permanent debt

Main Sources of Permanent Debt

- If you complete rehab, or you are buying a stabilized property, you need permanent debt
- Four main sources of permanent debt:
  - ✓Community (local) banks
  - ✓Government agency (Fannie Mae, Freddie Mac, etc.)
  - ✓Commercial mortgage-backed securities (CMBS)
  - ✓Life insurance companies

Community Banks

- Local banks in the area where the property is located
- Advantages:
  - ✓ May lend on smaller deals, under $1,000,000 in debt
  - ✓ More flexible on borrower net worth, experience requirements
  - ✓ Usually service own loans, so when you need flexibility, they are more likely to work with you
- Disadvantages:
  - ✓ Usually full recourse, so you are personally on the hook for default
  - ✓ Terms rarely exceed 5 years, so you take on more refinance risk
  - ✓ Sometimes refuse to work with borrowers who are not local
  - ✓ Don’t have ability to do very large deals

Government Agency Loans

- Advantages:
  - ✓ Up to 80% LTV
  - ✓ Very competitive interest rates
  - ✓ 10 year or longer terms are possible
  - ✓ Non-recourse, subject to “bad-boy” carve-outs
- Disadvantages:
  - ✓ Strict net worth and liquidity requirements
  - ✓ Strict experience requirements
  - ✓ High pre-payment penalties
  - ✓ Usually only for loans of $1,000,000 and up

CMBS Mortgages

- "CMBS" = Commercial Mortgage-Backed Securities
- Mortgages are packaged together and sold
- Advantages:
  - ✓ Excellent interest rates, locked in for up to 10 years
  - ✓ Often lend on deals government agencies won't
  - ✓ Non-recourse, subject to "bad-boy" carveouts
- Disadvantages:
  - ✓ Strict on net worth, liquidity, experience requirements
  - ✓ Servicing is inflexible, with no discretion to work with you
  - ✓ Prepayment penalties very expensive, only with defeasance and yield maintenance available (no step-down)
  - ✓ Usually only $1,000,000+

Life Insurance Companies

Life insurance companies ("lifeco")

- Advantages:
  - ✓Most competitive debt in terms of rates and terms
- Disadvantages:
  - ✓Only available for very large deals, on institutional investment-grade assets

What's the Best Debt to Get?

- The best debt to get, in this order is:

1. Agency
2. Community banks
3. CMBS

- Life insurance not really relevant here, because lifecos don't invest in the kind of multifamily deals you are likely doing


PREPAYMENT
PENALTIES

The Importance of Prepayment Penalties

- Unlike residential mortgages, you cannot freely pre-pay your mortgage
- Commercial lenders want a stream of payments locked in, so pre-paying affects them negatively – so they penalize you
- This penalty impacts your ability to sell, refinance, etc. and affects your profits
- Principal penalty structures are
  - ✓Step-down
  - ✓Yield maintenance
  - ✓Defeasance

Step-Down Prepayment Penalty

- Step-down is just how it sounds
- After a lock-out period (usually 2 years), you can pre-pay the loan if you also pay a penalty equal to a percentage of the loan
- This percentage goes down the longer you hold the loan
- For example, with a 10-year term, prepayment in year 3 equals 7% of the loan balance
  - ✓ Then a step-down each year, so that by year 10, the penalty is just 1% of the loan balance
  - ✓ Advantages are certainty and ease: you can easily calculate your penalty, and all you need to do is write a check at closing

Yield Maintenance Penalty

- Yield maintenance (YM) “maintains” the yield (return) the lender would have, if you did not pre-pay the loan
- Advantages:
  - ✓Ease: you just write a check at closing and you are done
  - ✓No extra fees
- Disadvantages:
  - ✓Very expensive, because you are paying the entire remaining interest stream at once
  - ✓Moving target: it’s affected by current interest rates

DEFEASANCE

- Like YM, defeasance is designed to replace lost yield
- Re-creates the stream of payments, rather than a lump-sum
- You must buy T-bills maturing on your payment dates for the rest of the loan and set up an entity to oversee them
- Disadvantages:
  - ✓ Moving target – don't know what you will pay until closing
  - ✓ Expense – the lower interest rates go, the more expensive T-Bills get
  - ✓ Fees – you must pay expensive fees to buy the T-bills and set up the administering entity
- Advantage: it's possible to make a profit if interest rates rise enough, because T-bill cost goes down

What's the Best Penalty?

Penalties ranked:

1. Step-down, because of certainty of payment and ease
2. Yield maintenance, because of ease and lack of fees
3. Defeasance – avoid if possible
   - Only take if you know you will not sell before maturity
   - Or if interest rates are very low, and you believe strongly that they will rise at the time you have to repay
     - When I bought, interest rates were at all-time low; but they are even lower now, and I got whacked when I sold

Q&A in The Facebook Group

Next up:

Module 7 - Video 3
Qualifying for Commercial Debt