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Manage Borrowers' Great Expectations

Brokers are well-positioned to prepare clients for coping with lending's new rules

IN THE CURRENT COMMERCIAL REAL ESTATE environment, property-owners and buyers face difficult conditions. In most parts of the country and across most asset classes, property values are falling, rents are declining and vacancies are increasing. To make matters worse, the availability of credit has continued to diminish, with the Mortgage Bankers Association recently reporting that commercial originations were 54-percent less in the second quarter of 2009 than during the same period in 2008.

There are few signs that these problems will abate soon. Default rates on existing debt are projected to continue increasing through 2011. Nevertheless, commercial property-owners and investors still require debt to stay in business, to refinance existing loans or to finance property purchases.

In light of these challenges, commercial mortgage brokers must proactively manage borrower expectations. From recognizing the availability of financing to lending standards and documentation, here are a few solutions to consider when preparing clients for the difficult lending environment awaiting them.

Limited financing

From the start, brokers should advise borrowers that debt sources are extremely limited compared to in years past. The market for commercial mortgage-backed-security-conduit loans and portfolio loans has effectively evaporated, removing a once-

substantial portion of funding sources. Also, large national financial institutions still are weathering the fallout from the credit crisis and appear to be more interested in moving commercial debt off their balance sheets than in issuing new debt.

Thus, borrowers should understand that the lender relationships they may have developed in the past are probably not available to them today. Brokers can help borrowers develop new lender relationships and also consider alternative funding sources, such as regional banks, hedge funds, thrifts and privately held financial institutions.

In addition, there may be one or more uncontrollable asset-based factors that affect borrowers' ability to obtain financing. For instance, certain asset types have generally fallen out of favor with lenders. Borrowers likely will have a more difficult time finding funding in the hospitality, retail and office sectors than in multifamily until those markets begin to show signs of recovery.

Additionally, the asset's location is critical. Some regions have experienced worse economic downturns than others. If a property is located in hard-hit areas such as California, Nevada, Arizona or Florida, for example, the borrower may encounter significant difficulty finding financing unless there are mitigating factors.

Finally, borrowers may also have a difficult time finding a lender if the asset in question is a Class B or Class C property, if it has a weak tenant roster, or if it needs significant maintenance or upgrades.

Tightened standards

Lending and underwriting standards have tightened, and lenders now expect and demand well-documented borrower and tenant financials. With so many borrowers competing for a limited amount of loans, only those with the most-organized and complete financial documents will get through a lender's front door.

Generally, lenders have become extremely cautious. A high-quality building, a roster of credit tenants and a low vacancy rate do not necessarily guarantee borrowers the financing they require or the terms they want.

With respect to debt and equity positions, 90-percent loan-to-value (LTV) ratios are gone. Many first-lien lenders require 60-percent to 70-percent LTVs or lower.

Borrowers often must be prepared to raise more equity than they anticipated at greater returns to their investors. When refinancing, they potentially must dilute existing equity to offer greater returns to additional equity investors or mezzanine lenders.

Although the prime rate and the federal funds rate remain at or near historic lows, cautious lenders require greater spreads to offset the perceived risks associated with commercial mortgage lending. The same is true for mezzanine lenders and preferred-equity providers, where interest rates can range from 10 percent to 15 percent, not including upfront points. Borrowers should be prepared to incorporate these increased spreads into their analysis when considering their projections.

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Lenders also are more likely to tighten their requirements with respect to leasing reserves, earn-outs and holdbacks, cash-management arrangements, guarantees, and amortization periods. Inform borrowers of these underwriting aspects as early as possible to give them enough time to recalculate projections or to analyze such requirements.

It is equally important to ensure that the loan commitment documents these requirements sufficiently. This will help avoid surprises when the loan documents first appear near closing — and after the borrower likely will have removed contingencies with respect to the underlying real estate transaction.

Documents and requirements

When borrowers have cleared the loan-application and commitment hurdles, prepare them to encounter loan documents that contain provisions that look different from what they may have seen before and may expect.

Borrowers first should review the loan's guarantee provisions carefully. Although many lenders previously only required non-recourse carve-out guarantees, many now require full-recourse guarantees from one

or more principals. Guarantors will be on the hook for the loan's full amount in the event it is not repaid for whatever reason. Although the potential to negotiate some lesser degree of recourse exists — perhaps partial recourse to a certain limit — borrowers should nevertheless be prepared to provide full-recourse guarantees in the current market.

Additionally, borrowers should carefully review any cash-management provisions the lender requires. Although the loan commitment may reference basic terms of the cash-management requirements, the loan documents will describe these arrangements in detail. Such provisions may also contain additional legal, reporting or administrative requirements that may be subject to negotiation depending on the practical circumstances of the asset in question.

If full-time cash management is not required from the start of the loan term, borrowers should be aware of the triggers for instituting cash management. They should know how these triggers may affect their day-to-day property management and operation, as well as their ability to make distributions to investors or subordinate lenders.

Finally, prepare borrowers for more-stringent leasing parameters and lender-oversight requirements. Lenders also are likely to have tougher administrative hurdles regarding how they handle and distribute reserves and holdbacks for future repairs or improvements.

Lenders are now more sensitive to the possibility of borrower defaults and the potential of having to take control of the property. Thus, they are insisting on a greater degree of leasing oversight and also a greater deal of control over the release of leasing and improvement reserves because they view these funds as additional security for the loan.

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Although the commercial lending environment is in a period of contraction and uncertainty, mortgage borrowers still need financing to make their deals happen. In addition, willing lenders still exist, albeit under much-different circumstances.

If mortgage brokers can manage their clients' expectations effectively, not only will all parties to the transaction be in a better position to negotiate, but a positive outcome also will be more likely. ●