

Borrowing in the New Reality

We are seeing a slow thaw in the frozen mortgage-lending landscape of the past couple of years. Borrowers today still face a lengthy and difficult process, spending more time, effort and money than needed in the past to obtain loans. Being prepared with realistic expectations can make the difference between experiencing costly disappointment and getting needed funds.

A Plan of Attack

- **Know Yourself**

A strategic approach can avoid wasted effort. Evaluate your strengths and weaknesses as a borrower. Available financial terms vary widely depending on the borrower's financial strength. Lenders will also look closely at the borrower's reputation, management experience and history. With an honest assessment, you will know if you need to be prepared to pay more.

- **Analyze Your Property**

Take a critical look at your property. Realize that a low loan-to-value ratio could be even tougher to meet when the lender's appraiser values the property. In the recent environment of declining values and uncertain market conditions, lower than expected appraised values often create problems. Carefully assess the property's income and expenses. When determining whether your property meets their debt service coverage requirements, lenders require realistic numbers.

- **Identify Lenders**

Success is more likely with lenders seeking to make loans that match your loan size and property type. Mortgage bankers and brokers may help identify a potential fit. Possible types of lenders include local or regional banks in the area where the borrower or project is located, and life insurance companies or even credit unions that are expanding into commercial mortgage lending. In addition, some lenders face regulatory scrutiny that limits their ability to make real estate loans. Pressures on lenders have increased the risk that a lender may pull out of making a loan at the last-minute through no fault of the borrower. To protect against this risk, borrowers must plan an extended time frame for the loan process and be ready with alternate lenders.

- **Practical Preparations**

While assembling a war chest to cover lender's fees, expenses and closing costs is critical, do not overlook other practical details. Streamline the due diligence process by assembling old surveys, plans, copies of leases, entity documents and other materials that the lender will request. Confer with an accountant to be ready with current financial statements and operating statements. Make sure that any borrowing entity is in good standing, with all of its franchise taxes paid. If a new entity will be formed, engage legal counsel and work through business issues to avoid delays due to protracted negotiation of entity documents. If possible,

determine additional provisions that the lender will require in the entity documents, such as single purpose entity requirements.

Common "New Reality" Terms

- **Financial Terms**

As mentioned above, terms vary widely. Stronger borrowers and loans secured by the best properties can obtain very attractive rates of interest on loans for longer periods of time. Extremely favorable terms have also been obtained for multifamily property loans that fit HUD parameters. Except during construction periods, even blue chip loans will generally require payments of both principal and interest. Amortization periods for loans with a final balloon payment tend to be shorter. Floating interest rates will certainly include a floor rate, but will not necessarily include a ceiling rate. For extensions of existing loans, by providing additional collateral or guaranties as discussed below, borrowers are now more likely to get more than the one or two year extension terms of the recent past.

- **Guaranties**

A small percentage of non-recourse loans are being made, but full guaranties are most typical. Construction loans may require additional completion guaranties. When lenders consider limits to guaranties, rather than a percentage limit or a limit to a certain principal amount, the limit may be the "burn off" type of future limit tied to benchmarks and performance.

- **Additional Collateral**

Lenders are likely to be checking financial statements for sources of additional collateral. They may seek pledges of liquid assets, including securities accounts. The proposed additional collateral may be liens on other real estate assets or security interests covering ownership interests in those assets. If the real estate proposed as additional collateral is subject to a first mortgage, any additional lien without the first mortgagee's consent will generally be a default under the first mortgage. Governing entity documents are also likely to limit pledges of ownership interests. Borrowers should protect themselves from triggering problems with co-owners or prior lenders by seeking legal help with these types of requests for additional collateral.

- **Escrows and Reserves**

Lenders are less likely to waive requirements for tax and insurance escrows. They may also require a growing number of other types of reserve accounts. These could include reserves for capital improvements, for immediate repairs, for leasing costs such as tenant improvements and broker commissions, or even for reserves based on certain tenant risks or concessions.

- **Lockboxes and other Continuing Requirements**

To ensure funding of escrows and multiple reserves in addition to debt service payments, lenders are more likely to require lockbox arrangements to capture rent payments. The lockbox agreement will typically include "waterfall" provisions that prioritize the distribution of the rents, with the borrower being last in line. Debt service coverage requirements may be monitored throughout the life of the loan, not just at its inception. A failure to meet these requirements may result in shutting down the borrower's access to funds in the lockbox. The loan-to-value ratio requirement may likewise be periodically reassessed. If these features must be accepted to obtain the loan, borrower's counsel may temper some aspects. For example, adjustments applicable in casualty situations can be made.

Negotiating Early

Today's starting point for a loan is likely to be a non-binding term sheet or letter of intent rather than a loan commitment letter. Because the lender is not obligated to carry through on the loan, borrowers may not expect such letters of intent to be complete, and may intend to push for more favorable terms after signing off on an acceptance of the letter. Instead, in the non-binding term sheet, the borrower must insist on including any term that will be a "must have" and must affirmatively eliminate any term that would be a "deal-killer". A very detailed and careful review, including review by legal counsel, can protect the borrower and prevent later unpleasant surprises. Include rights for the borrower to retain due diligence items such as appraisals and environmental studies for use with a different lender.

In an environment where borrowers receive few accommodations, this early stage is more important than ever. A well-prepared borrower who knows what to expect prepares for a successful loan closing with a strong beginning.

Submitted by Cynthia S. Olsen
Wilson, Cribbs & Goren, P.C.