

**Discussion Topic: “How to Be Prepared When the Banks Start Lending” - #202**

**Sub-topic: “Financier, and Not Uncle: The Imperative of Adequate Capital”**

**Presenter: Kenneth S. Dreifus – Principal, Dreifus Realty-Funding, LLC and Deputy Chair, Department of Business and Accounting, Touro College – New York, NY**

- A. Initial Bank lending for new real estate credits will be cautious and conservative
- B. Many loans written off during the current cycle looked great during underwriting, but became non-performing assets when borrowers burned through reserves. Stronger borrowers might have been able to shift cash from other projects in order to keep the loan current, as banks would have tried to roll the loan pending the advent of better times, as “a rolling loan gathers no loss.” With the institutional nightmare still seared in the collective memories of senior bank managers, the (over)emphasis on borrowers having more than adequate cash will be paramount. Lenders will also insist on multiple exit strategies, and full financial disclosure, including details of contingent liability on other transactions.
- C. The fragile state of the secondary markets has turned previously liquefiable assets into the equivalent of frozen heads of cabbage, and the fact that the primary capital markets are basically on life support precludes most institutions from raising much additional cash or capital. Accordingly, banks will have to fund new deals out of current cash flow.
- D. As practically every bank on the planet had to write down or write off assets, the remaining bank capital allocated for lending will be rationed in order to try to have enough for all new worthy borrowers. Until bank ratios and capital improve, loan-to-value ratios will tend to be lower than in previous years.
- E. The impaired amount of capital will also see banks unwilling to do JV’s with developers, and will press for personal guarantees on deals that were doable without them two years ago.
- F. The evolution of the economy from one that emphasized manufacturing to one that emphasizes services means that the gap between rich and poor is likely to grow in the years to come. Fewer higher-paid manufacturing jobs will force more non-college educated buyers into lower paid service positions. Coupled with the death of the limited- and no-documentation mortgage, fewer families will qualify for home mortgages unless cheaper homes are built.
- G. It is crucial for developers to understand that banks are in the money business, not the real estate business. A bank profits when it is able to take principal and interest received on an old deal and re-cycle it into a new deal. If a bank is deprived of the timely receipt of these funds, their ability to lend has been reduced, even if the underlying collateral is more than adequate to assure a 100% recovery in the event of foreclosure. The argument that the collateral is more than adequate for a deal, especially a land loan which has no cash flow of its own, will therefore not be readily accepted, understood, or approved.

**RECOMMENDATIONS**

- 1. If a proposed development has a finite amount of cash allocated thereto, plan on building smaller, more energy- efficient homes with a lower cost per square foot that will be easier to sell. If a potential buyer wants more features, the base price goes up. Get a few genuine pre-sales. Make sure that the pre-development costs and the costs of doing the sub-division are paid before you request the loan, even if it means that there will have to be a smaller number of units being built at any given time.

2. The rapid change in technologies has permanently affected the way that institutions will look at loans on shopping centers and office buildings. With practically everyone over the age of 12 now armed with a laptop and Wi-Fi hot spots all over the world, the need to have a traditional office has been materially changed. The growth of retail sales over the past five years has been overwhelmingly in the area of on-line purchases. The demise of many hoary regional retailers has also permanently changed the definition of a credit tenant. Bottom line, lenders will be highly circumspect about funding of new office buildings and shopping centers. The whole concept of building these types must be re-evaluated.

3. The growth of the Latino and Arab populations, which have traditionally lived in extended family, multi-generational settings, creates opportunities for different kinds of housing. Rather than concentrating on the construction of detached single-family dwellings on tracts, thoughts should be given to the erection of units to which additional modules can be added as children marry. It will surely require changes in local zoning laws. The best places to start might be in severely-economically depressed areas such as Lackawanna, NY, Detroit, MI, or Camden, NJ – which fit the demographics, have lots of vacant land, and have no downside to changing the zoning to permit this experiment in housing.

**Sub-Topic: “A Bird in Hand....Occupied is (Beaucoup) Better”**

**Presenter: Jeffrey S. Chiger – Managing Director, Lacrosse Partners, Inc.**

### New rules

- ✓ Relationship Lending
  - Banks to focus attention on core customers
- ✓ Loan to Cost (LTC) to become more widely used [instead of Loan to Value (LTV)]
  - As we have seen in the past few years, values may fluctuate greatly, but cost should never change
- ✓ Debt Service Coverage Ratios (DSCR) will be adhered to more stringently
- ✓ More equity in deals
- ✓ Personal guarantees
- ✓ Better due diligence by the lenders will require that borrowers have substantial collateral, and proof that they are credit worthy with a low degree of risk as a prerequisite for a loan
- ✓ Existing Property Loans - Additional items to be reviewed during due diligence
  - How well is property leased
  - Lease expirations
  - Creditworthiness of tenants
  - Creditworthiness of borrower
  - Any new properties coming on board in the market that may affect our loan
  - How had developer fared during the "recession" of the past few years
  - Property sensitivity to changes in occupancy levels and rental rates
- ✓ Construction Loans - Additional items to be reviewed during due diligence
  - Market analysis - is it complete, logical and realistic
  - What space is available in the market, and how does your property stand up against them
  - Pre-leasing - how much...strength of tenant
  - Can construction timeline be met
  - Strength of general contractor
  - Creditworthiness of borrower - careful review of financial statements
  - How had developer fared during the "recession" of the past few years
  - Property sensitivity to changes in interest rate, occupancy levels and rental rates

## New guidelines

- ✓ New real estate lending “playbook”
  - May take the banks 12 to 18 months to develop the playbook (new rules / guidelines) for lending
  - In some cases, the money the bank is working with is no longer just their own – it could be government infused capital (which comes with another layer of security and restrictions)
  - The capital committed to new deals is likely coming from the bank’s internal cash flow as long as the capital markets are on life support. Accordingly, bank capital will be even be allocated to the best deals and customers, resulting in a need for borrowers to be prepared to come up with more cash due to lower LTC/LTV and higher DSCR guidelines.
- ✓ Overall cash flows of borrower / guarantor
- ✓ Borrowers will be required to meet higher standards and adhere to stricter guidelines for real estate financing
- ✓ Loan documentation will be more on the side of the Lender, and will be monitored more closely
  - Loans will have more covenants especially at conversion / renewal time. These will include, but not be limited to Loan to Value minimums, DSCR minimums, leasing minimums (both occupancy percentage and dollars generated) and Material Adverse Change (MAC) clauses which may give the lender broader control of the future, including but not limited to posting additional collateral or the possible curtailment of the loan amount (to bring its numbers in line to meet the aforementioned ratios)
- ✓ Loans will be underwritten for the “what if” situations (example...an industrial condo and its possible conversion to rental property). This may have an effect on the dollars borrowed (smaller loan amounts to support the “doomsday option”)

## What to do until lending has been stabilized (or How to be Prepared When the Banks Start Lending)

- ✓ Learn to adhere to the new rules and new guidelines
- ✓ Become familiar with a bank or two (or three)
  - Open depository accounts with the bank
  - Try to seek out real estate lender(s) and get to know them

**Sub-topic:**        *“Simplicity is Elegance...When Vanilla Is the Only Flavor”*

**Presenter:**     **Daniel P. Fowler, CEO – Connaught Real Estate Finance**

Overall basics – KISS Concept (Keep It Simple Stupid):

- Simple, organized, clear ownership and capital structure:
  - Sponsorship group JVs should be set up prior to contacting lenders
  - Minimal number of players: optimally one sponsor/one guarantor. If multiple parties – clearly defined roles and hierarchy of decision-making.
- No mezzanine or preferred equity position – difficult to workout with 2<sup>nd</sup> mortgage or pledge of borrower membership interest in place
- DSCR no lower than 1.25X
- Equity levels 30% or greater – **cash is king, amass it now!**

Example of a past deal that won’t work today:

- Luxury condominium development on three separate projects/parcels of land
- Three senior lenders (two A&E, one Construction), one mezzanine lender collateralized across all one projects (cross-default potential)

- Only partial construction financing obtained for one project
- Back end lump sum payments and for each sold unit contracted to land seller
- Multiple guarantors, multiple borrowers
- Developer inexperienced with large projects
- Sales pitch enhancement includes future projected revenue streams based on rentals of sold condos and unit sales dependant on high-end spa/amenity center

From 2003-2006, just about anyone could obtain financing. For the foreseeable future, only a select few projects will be financeable, often based on the following factors:

Old Way	New Way (For Now)
▪ High leverage (Sr.: 70%-80%, Mezz.: 85%-95%)	▪ Low leverage (Sr.: 50%-60%, No Mezz.)
▪ Non-recourse - playing with house money from past profitable deals, so risk to sponsor is minimal	▪ Full recourse
▪ Lenders fight to be selected to finance project	▪ Sponsor fights to find a suitable lender and needs to shop project to alternative financing sources (high net worth, family office, hedge fund, seller financing, government tax credits, etc.)
▪ Lowest cost lender (fees, interest, etc.) used	▪ Past lending relationships leveraged for optimal success
▪ Guarantor strength irrelevant	▪ Guarantor's liquid assets and overall balance sheet is primary factor driving decision to lend
▪ Projected cash flow to determine project feasibility	▪ Historical cash flow to determine project feasibility
▪ Track record inconsequential	▪ Proven track record with asset class and geography a must
▪ Secondary accounts at financial source unimportant	▪ Feed lender deposit needs – park excess cash at lender of choice to sweeten opportunity
▪ Any deal size	▪ Small deals only
▪ Any deal type (value-add, core, development)	▪ Stabilized, cash-flowing properties
▪ Any project type (including alternative asset classes such as condo-hotel, timeshare, resorts, anything spec, anything mixed-use)	▪ Basic asset classes (office, industrial, apartment, etc.)
▪ Long-term investment horizon with continued pro forma cash flow growth	▪ Short-term investment horizon (cannot assume consistent tenant renewals)
▪ Undetermined/not contemplated downside scenario	▪ Clearly outlined downside/exit strategy (i.e. for-sale housing able to cash flow as rental)

**Sub-Topic: “Walking Precedes Running: How to Get your First Deals Approved”**

**Presenter: Marjorie Knitter, The Moote Group**

### **Banks getting ready to lend?**

Hundreds of partially completed projects are becoming available. From blue topped pads to finished lots; some with standing inventory, some with incomplete infrastructure some with completed condominiums with no certificate of occupancy.

Many of these partially completed projects are great deals if you can clarify and confirm the completed and uncompleted improvements to the banks. The more you understand about the project in real-time

dollars and cents and all related issues, the better you can negotiate a good price from the bank or qualify for a construction loan

### **What kind of borrower are they willing to lend to today?**

- Cash rich borrower
  - Must have liquidity – more equity partners
  - They will give you money as long as you don't need it
- First source of repayment
- Second source of repayment (personal guarantee – yet there is no net worth now)
- Complete and comprehensive package
- A borrower that can produce information quickly
- They want to know if you have contingent liability on other deals.

### **What are they requiring of the borrower?**

- Fully Entitled Projects
- Risk Assessment
- Due Diligence – Complete Comprehensive Package
- Third Party Verification – Fourth Party Verification
- Valuation – Secondary Backup
- Ability to phase the project – smaller draw requests – smaller exposure
- Third Party Construction Verification and Reimbursement Recommendation  
(the past cycle – many banks (all of them) seemed not to require a third party cost verification or construction verification - guess we did not learn enough from the 1984 and 1991 cycle – we are working out 2 projects where the construction funds for Project A & B went to the builders salary and to Project C.

With this kind of backup you may be able to achieve a higher loan to value.

### **Handouts**

- A. Master Diligence Checklist – Existing Project
- B. Project Feasibility Checklist – Land
- C. Comprehensive Checklist - Land

### **OPENING COMMENTS -**

- Moot Group's core service - due diligence and risk assessment support – cost estimating/verification and construction management/verification.
- 35 years – over 4800 projects – 15 states – 5 countries.
- Moot due diligence work for builders/developers/investors during this past up cycle peaked in 2005 – stopped July 2007. Today our clients are banks and receivers who need to know the cost to complete.
- It will be 2011 / 2013 before banks are lack again – before this current down cycle the last time Moot worked for a lender verifying costs and or construction was 2001.
- Private builders/developers are still working out their problems with the banks.
- Public builders/developers have an edge – they have money and bank lines. We are seeing a real surge in the public builders picking up finished lots throughout the western states.
- We are just starting to hear (October 2009) from large investment firms looking for large portfolios.

### **WORKING WITH YOUR LENDER –**

- Banks are practicing “Responsible Lending”.
- Look at the process through the eyes of your lender.
  - They are scared to death of the regulators.
  - “If they don't make a loan, they won't have to provide capital against it.”

- They do not know what the regulators will be asking for as far as underwriting.
- You can not afford to make a mistake and neither can the banks.
- If you do not have experience in a particular type of project or location, you need to buy it – what Ken in Brooklyn calls “rebbe gelt”. You would be well advised to partner up with someone who does have the expertise and reputation (and deep pockets) in order to acquire the necessary reputation for yourself. 50% of a deal that gets done is better than 100% of a deal that never happens.
- Due Diligence – Complete and Comprehensive
- Be proactive – find the weakness – address them
  - Disclose all issues you are aware of.
  - Alert them when a new issue arises.
  - Let them know how you will remedy them.
- Be sure the lender does not discover an issue you either overlooked, missed or just flat out did not disclose.
  - It is a very small industry and you will lose your credibility quickly throughout this tight small lending community.
- Fully entitled – Banks are more likely to lend on a fully entitled project this next cycle.
- Expose past bankruptcies.

#### RISK ASSESSMENT:

- Typically done long before you are going to the bank for a loan.
  - Risk Assessment is the discovery period of areas that can be remedied.

#### DUE DILIGENCE:

- Goal is to get more loan to value ratio and a solid complete package can add value.
- Cross the “t’s” and dot the “i’s”
- Know all the issues
- Enlighten bank on all issues and your remedies
- Cost to Complete in real time dollars – today’s dollars.
- Third Party Verification / Audit
- Work with a trusted broker.
- Meet with the City/Public Agencies (they are proactive).
- Meet with the consultants and subcontractors who were on the job (if they are still in business).
- Entitlements – status – are they all in place – expiration dates.
- Bonds that are in place or not.
- Fees – paid and unpaid.
- Special Finance Districts.
- Code compliance – age of the plans.
- Conditions of Approval / Development Agreements – status of obligations.
- Goal is to get more loan to value ratio.

DUE DILIGENCE CHECK-LIST: \*\* These can be found on the conference website, [www.CrittendenRealEstateFinance.com/SessionHandouts.html](http://www.CrittendenRealEstateFinance.com/SessionHandouts.html)

- A. Master Diligence Checklist – Existing Project
- B. Project Feasibility Checklist – Land
- C. Comprehensive Checklist - Land

