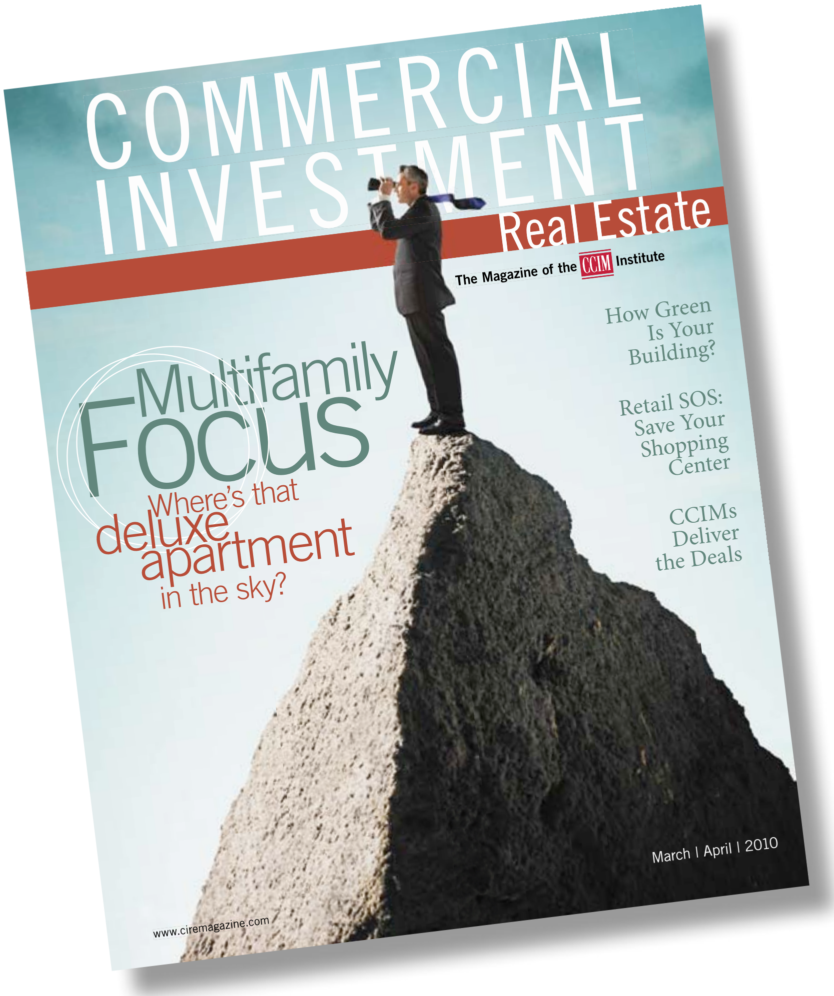

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Bridging the Gap

A new breed of lenders is providing capital in today's market.

by Jerry Dunn

The credit crisis has had a significant impact on commercial real estate and the availability of financing. Most lenders have reduced maximum loan-to-value thresholds to 65 percent and increased debt service coverage ratio minimums. Life insurance lenders are cherry picking only the highest quality properties, and banks are retaining only their best relationships. In addition, many institutions are deleveraging their balance sheets. As a result, a precipitous reduction in commercial real estate originations has occurred. According to data from the Mortgage Bankers Association, origination volumes for banks, life companies, and conduits have declined 86 percent, 62 percent, and 90 percent respectively from the market's peak to trough.

Colin Anderson/Veer

New-Breed Financing

Conventional lenders presently are using very conservative criteria, which is putting many deals outside of the reach of traditional banks. Criteria such as cash out for any reason, less that 90 percent occupancy, an unstabilized property, or a borrower that is a little tight financially yet has a great property — individually these items may add only a slight credit risk but they sour the mouths of most bankers today.

Historically, such dynamics take these deals out of the bankable world and put them into the hard money bucket. While some investors have made a lot of money using hard money lenders, for many the numbers just do not work. These lenders may charge four to more than eight points or interest rates of 14 percent to 20 percent, which does not pencil out for many projects.

A new breed of alternative lenders is slowly emerging to fill this gap. They are able to take on a bit of risk and can fund deals that are just outside of bankable structures. Some investors categorize them as bridge lenders, but they actually fill a broader gap. Lenders in this new category lend for terms up to two to three years and fill the gap for nearly bankable-type transactions.

These firms specialize in first mortgage loans on transactions that conventional lenders would have financed in the past. But conventional lenders are not shying away because of the transactions. They're reticent because they are deleveraging their balance sheets or they are hampered by legacy loans. Since alternative lenders are not regulated and do not have red tape, they can complete the same level of due diligence as conventional lenders in a fraction of the time to ensure that they can meet the tight deadlines of opportunistic purchases. Many alternative lenders are capitalized with significant equity and have access to senior funding facilities from large institutions.

This new breed of alternative lenders, such as A10 Capital, makes loans in the $1 million to $10 million range, charges only a couple of points, and offers interest-only terms so payments are close to amortized bank loan payments. Because of the credit crisis, very few of these alternative lenders exist today. Some of the newly formed mortgage real estate investment trusts have entered this niche, but they tend to focus on larger loan sizes, typically more than $10 million.

Alternative lenders that have the backing of major financial institutions have the ability to make commercial mortgage loans in today's market. They have significant dry powder and no legacy issues from loans made at the peak of the market.

An alternative lender should have a more-sophisticated underwriting and credit culture. Those that do likely will structure loans that will be positioned to succeed, thus enabling the property to eventually qualify for conventional take-out financing. Most alternative lenders do not have a loan-to-own philosophy like hard money lenders.

Alternative lenders make loans in the $1 million to $10 million range.

Money for Opportunities

Most alternative lenders look to finance properties that either are income-producing or have the ability to produce income in a very short time. They prefer collateral in the four primary groups — retail, office, industrial, and multifamily — and consider sponsorship with local knowledge critical.

Yet even for the new-breed alternative lenders, straight refinancing is difficult today — especially on properties that were purchased at the peak of the market with loans that are now coming due. Many borrowers have very little, if any, "true equity" remaining in the property. To be viable in today's market, refinances often require the previous lender to accept a discounted payoff and the sponsor to bring in fresh equity.

Loan Volume Declines

3Q07 to 3Q09

Conduits 90%

Banks 86%

Life cos. 62%

Most experts believe that commercial real estate will face significant challenges over the next three to five years. For those with access to capital, the very same stress will create one of the most advantageous buyers' markets in history. Most buyers today require 18 percent to 25 percent unleveraged returns. Nearly bankable loans provided by the new-breed alternative lenders carry interest rates in the high single digits and provide significant positive leverage to those transactions.

A current multifamily transaction best describes how A10 Capital's nearly bankable loan program is helping savvy real estate investors. The current lender is owed $12.2 million and has agreed to sell the asset to the borrower for $4.9 million. Since the property is only 42 percent occupied, the borrower cannot qualify for conventional financing. Rather than tying up all of its precious equity in the project, the borrower has turned to A10 Capital for $2.7 million of acquisition financing and an additional $600,000 of future financing for lease-up costs. This will enable the borrower to acquire the property and stabilize the asset over the next two years. Ultimately, the borrower should create significant value and have its high returns magnified by financing a portion of the project with an affordable senior loan.

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