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Find Lending Amid Economic Uncertainty

Private lenders offer a viable option in a still-tight credit market

With looming Congressional disagreements over government spending, this year is likely to start just like this past year — with continued economic uncertainty. Conventional lenders may remain cautious in extending loans that are necessary to fund certain real estate acquisitions and projects despite the recent signs of economic recovery. In this respect, private lenders can step up to fill the void left by traditional lenders.

Although real estate values remain depressed compared to their prerecession peaks, transactional activity has increased, boosting the demand for capital. The ability to secure funding from conventional sources remains difficult at best, however. That tight-credit scenario creates an opportunity for private lenders and commercial mortgage brokers who are ready to capitalize on private-money deals.

Opportunities

The correlation between the availability of credit from traditional sources (including government agencies) and the demand for private funding was clear in this past October's federal-government shutdown. In a way, private-money lenders benefited from being a viable option when uncertainty hit borrowers' confidence.

By some estimates, the 16-day government shutdown cost the economy about $24 billion, and the debt-ceiling crisis unfortunately is likely to flare up again this February. This ongoing economic uncertainty is a concern for everyone involved in the mortgage industry, including investors and lenders. When people are worried, conventional lenders continue to tighten even further.

For several years, real estate investors and entrepreneurs have been sitting on the sidelines as a result of the recession, and now they are increasingly eager to build up their investment and real estate portfolios. Because the true entrepreneurs in this economy will be looking at nonconventional funding sources, private-money lenders can see the opportunity and need for capital.

In addition to the reticence of conventional lenders to provide funding, it is important to note that the private-lending world also has changed dramatically since the financial crash of 2007 and the subsequent recession. Private-money lenders have been performing meticulous underwriting and due diligence on each deal that is being considered for funding. Each and every deal must make sense on its own.

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Indeed, there are strong real estate deals out in the marketplace right now for those who know how to underwrite. Private lenders spot these viable deals and typically are able and willing to underwrite and extend the necessary credit to these entrepreneurial borrowers for the deals to close. That's a strong opportunity available in today's market.

Questions

Conventional lenders in particular don't want to extend credit in any situation that they deem risky. In the wake of the heavy regulations that were imposed in the past few years, many conventional lenders try to avoid having bad loans on their books, and they are more conservative in their underwriting criteria.

As a result, many conventional lenders won't look at deals that otherwise make sense in a prerecession context, and that's where the opportunities exist for private lenders. There are businesses that have been operating successfully for more than 25 years but can't get credit today. They're coming to private-money lenders and borrowing against the values of their real estate properties, and the situation is working out for everyone involved.

How does it work? To prepare for the underwriting of private-loan transactions, commercial mortgage brokers first should be able to answer a number of questions, including:

- **Do you understand your borrowers' exit strategy?** They must have realistic

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plans to repay their lenders within the terms of their loans.

- **Will your borrowers sell out the properties** in the case of construction projects, or will they be able to bulk-sale multiple properties in collateralized packages?
- **Are your borrowers hoping to get refinancing from conventional lenders?** In that case, there must be some assurance from the given lender that the refinance will take place in a timely manner.

Commercial mortgage brokers must be aware that private lenders typically view themselves as lenders first and foremost, as opposed to real estate owners — aka loan-to-own lenders. That is important because the intention of private-money lenders is to be repaid with interest, points and fees. The alternative, which includes going through a costly foreclosure, is undesirable.

Skin in the game

The next threshold question that has to be answered is related to having "skin in the game," which refers to the equity contribution of the borrower toward the deal. Private-money loans are secured by either a deed of trust or mortgage and should be in the first-priority lien position with equity behind it. The more equity that the borrowers contribute to the project, the safer the real estate loan will be for the lender. In a properly structured and secured private-money loan transaction, 100 percent of the equity will be lost before any debt is lost. This is reflected in the loan-to-value (LTV) ratio of the property or the loan-to-cost (LTC) ratio in a development project.

For example, a loan of $2 million at a 50 percent LTV would have the borrower contributing $1 million in equity. The borrower's equity contribution not only protects the debt, but also indicates the level of the commitment that the borrower has to the particular project or investment. It is important to note that when private-money real estate deals are underwritten, lenders typically want to see real dollars put into a deal. That will increase the value of the real estate as opposed to soft costs, which typically are paid to professionals but don't increase the value of the real estate materially. The bottom line is that commercial mortgage brokers should be wary of borrowers who don't want to contribute equity to their own projects, as this will raise a red flag with lenders.

Understanding risk

In dealing with private-money lenders, commercial mortgage brokers should be aware that lenders' ability to lend against real estate depends on their permissible LTV and LTC. The various types of real estate (residential, commercial, industrial, etc.) carry risks that should be fully understood.

As a general rule, private-money lenders never take uninsurable risk related to the collateral (i.e., the property itself). They therefore require a full review of the title and a survey of any environmental issues on the property. The purchase of a title policy to ensure that the lender has a first-priority lien is a must.

To make your deals go more smoothly through private lenders' underwriting, try to eliminate lenders' concerns over any environmental issues related to the property. With that in mind, it's recommended to have an environmental review of the real estate done. Lenders worry that a contaminated property that requires a costly remediation can impact the value of the property substantially. As a result, the yield and return to investors who make a loan against the property will be impacted.

It is important to stress that one must not only do desk underwriting, but also must visit every property that is the subject of a loan. Almost everyone in the private-lending community has stories to tell about potential borrowers who have misrepresented property conditions. Actual conditions can be discovered only by an actual visit and thorough study.

Careful pricing is another aspect of private lending that should be fully understood before proceeding with a deal. Pricing usually consists of a combination of the interest rate, points and fees paid at the closing. The pricing matrix for private loans is impacted directly by the LTV and any other circumstance that, in the analysis of the underwriter, would make the loan riskier.

Property-level risks should be fully understood in the underwriting and evaluation process. These could include the risk of approvals not being in place, a lack of infrastructure or other similar issues that may impact the viability of the project. In certain circumstances, the borrower's background and past experience could be interpreted as a risk, as well. Pricing on private loans generally ranges between 8 percent and 14 percent interest, and 10 points or more. As demonstrated by this range, the private-lending business can be lucrative, particularly if these steps are followed properly.

With all of that said, which deals work? For private lenders, all types of commercial transactions are considered. Deals have to make sense in terms of business model and underwriting criteria, however. Private lenders typically are careful in their due diligence because they must protect their investors. Commercial mortgage brokers must ensure that they work with private lenders that are willing to work closely with borrowers and require minimal upfront fees to do their due diligence and research the properties involved.

Purposes

Commercial mortgage brokers who have been following recent private-money transactions in the mortgage market can see how private lending meets various funding purposes, including:

- **Acquisition:** Borrowers can use private loans to acquire real estate.
- **Preparation for refinancing:** Borrowers can use private loans to purchase the remaining interests in commercial buildings and cover the cost of improvements to be able to secure conventional refinancing eventually.
- **Quick closing:** Borrowers can use private loans as a short-term solution to close on properties before they arrange

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for conventional financing.

- **Turnaround:** Borrowers can use private loans as a first lien that allows them to complete renovations on a property and increase its value to attract new tenants and eventually seek refinancing.

Because many deals that fall within such funding purposes may not be considered by conventional lenders, private-money lenders are poised to meet this market need, if they're convinced of the feasibility of these deals. Here comes the role of commercial mortgage brokers, who must establish why the deals make sense and how they satisfy the given underwriting requirements.

There are some caveats in defining which deals make sense, however. For one, private lenders might be advised to avoid businesses that are in heavily regulated industries, such as casinos, commercial properties serving liquor and nuclear-power plants. The reasoning is that anything that's heavily regulated requires a two-prong analysis:

1. **What is the property worth?**
2. **Will the operator maintain its licensing requirements to retain tenants of the property?**

In short, lenders may have concerns over whether or not the operator of the property will continue to maintain regulatory compliance. If the regulatory authority revokes the license for a restaurant with a bar, for example, that will affect the ability of the borrower to pay off the loan. Those are the type of deals that must be considered carefully because private lenders might be advised to avoid them.

That said, opportunities abound in the current commercial real estate market. Economic uncertainties aside, the marketplace is fostering a spirit of entrepreneurship, and those entrepreneurs require funding. Private-money lenders with sound business models will continue to go where conventional lenders fear to tread, creating new opportunities for commercial mortgage brokers in the process. ●