COMMERCIAL REAL ESTATE LOAN PROGRAMS

SIMPLIFIED by PRC

Owners and investors of commercial real estate properties depend on commercial real estate finance professionals like Pioneer Realty Capital to help identify the most appropriate loan programs and structures to finance their property. This guide will introduce you to the various loan programs used to finance commercial real estate. You will also learn the typical situations in which each loan program is used to solve problems sometimes experienced by CRE owners and investors.

In this guide, we will identify the best loan programs for:

- **Stabilized properties**
- **Non-stabilized properties**
- **Properties that owners intend to own for a longtime**
- **Properties that owners intend to sell**

When PRC engages a CRE client, the first question is usually, "what is your capital acquisition strategy?" In other words, what do you intend to accomplish with this loan? The answer to that question will help determine which loan program will allow the client to execute the strategy for the property.

What are the possible loan programs available?

1. CONVENTIONAL FINANCING

Conventional commercial real estate loans are mortgages that are typically provided by a bank, credit union, savings institution, or other traditional financial institution and are secured by a first lien position on the subject properties being financed. New bank regulations have caused banks to decrease the amount of risk they are willing to take on commercial real estate assets. This has opened the door for private debt funds to enter into the conventional lending space. The collateral may be any type of commercial real estate and do not always require previous experience. These loans will all most always require full-recourse financing, or financing requiring a full personal guarantee.

Conventional loans are best suited for stabilized commercial real estate properties. For a property to be considered stabilized, it must have the following characteristics:

- The property is fully leased or leased to the market occupancy
- Property rents are at market rates
- Tenant turnover is minimal in the short term and is staggered over the long term
- The property requires minimal capital improvements to maintain present operating standards

Typical Conventional Underwriting Guidelines

Conventional Lenders typically have maximum LTVs of 65-80%, while some lenders can stretch up to 85% in limited circumstances for especially strong borrowers. Leverage for construction loans can be as low as 50-55% LTV.

Borrowers should expect to have "hard cash" equity invested in purchase transactions, while being able to maintain a post-closing liquidity sufficient to service their debt for at least six months and an overall net worth equal to or greater than the loan amount (although there may be some flexibility). Properties will need to be able meet a DSCR of at least 1.25x (depending on the LTV and property type) at the underwriting rate.

Term/Amortization

The length of term and amortization depends heavily on the institution providing the funding as well as the property type. Terms can vary from 3-15 years with amortizations ranging from 10-30 years. Depending on the way the loan is structured, it may "balloon" at the end of the term, meaning at the loan balance will need to either be refinanced or paid off; otherwise the loan is self-amortizing, meaning that the loan will be fully paid off when the loan matures, so there is no loan balance to pay off (unless the loan is prepaid before it matures). A loan can also have a variable fixed rate period that resets every 1, 3, 5, 7, or 10 years. These loans are priced according to a corresponding index. The Wall Street prime rate or the LIBOR rate are the indexes generally used for pricing commercial real estate loans. If the investor intends to sell the property, a shorter loan term consistent with the investors disposition strategy is chosen.

Recourse

Conventional loans may be non-recourse, limited recourse, or full recourse loans. If it is non-recourse, the Borrowers are not personally liable for the repayment of the loan and that the collateralized property and its cash flows would be the sole source of repayment of the debt in the event of a default or foreclosure.

However, in the event the Borrower actively participates in an activity that could cause harm to the property, there could be springing recourse in some limited circumstances; this may include loan fraud, property transfer or subordinate financing without consent of the Lender, and voluntary or collusive activity leading to a bankruptcy filing, among other such actions. These actions are referred to as "bad-boy" carveout clauses in the loan documents.

Limited recourse loans make the sponsors guarantying the loan responsible for a percentage of any shortfall between the loan balance and sales price in the event of default and foreclosure, where the property must be auctioned off as well as any applicable legal and ancillary fees. The carve outs for the non-recourse loans would also apply.

Full recourse loans make the sponsors guarantying the loan responsible for any and all shortfalls between the loan balance and sales price in the event of default and foreclosure as well as any applicable legal and ancillary fees.

Loan Assumption

A conventional loan may or may not be assumable. Typically, assumption occurs when the Borrower wants to sell the commercial real estate that secures the loan, and the Purchaser of the property wants to take the loan over. Once the property sale and assumption are completed, the Purchaser becomes the owner of the property and is bound by the original terms of the assumed loan and the original Borrower/Seller is released from its obligation to the property and the existing loan.

The benefit of this structure is that the assumption of the loan allows the Borrower/Seller to avoid pre-payment costs and give the buyer the opportunity to assume a loan that may have favorable terms than what is market. Sometimes the lender will charge an assumption fee of 1%.

Loan assumption is an especially attractive option in high interest rate environments or tight credit environments. However, loan assumption may require a large down payment which may make the transaction less attractive.

For instance, suppose and investor purchases an office building for $3MM and want to sell it 5 years later. A buyer wants to assume the loan to take advantage of an attractive rate and terms. However, now the value of the property has increased to $5MM. Additionally, the loan balance is now $2MM. In order to assume the loan, the buyer will need a down payment of $3MM verses simply obtaining a new loan with a down payment of just $1.5MM.

Prepayment Penalty Structures

Prepayment penal structures vary greatly depending on the institution funding the transaction. It may be structured as Yield Maintenance, Break-funding, Declining (or step-down) prepayment penalty, or may be specially structured to suit a construction or mini-perm loan.

Yield Maintenance: The goal of Yield Maintenance is to allow the bond investors to maintain the same yield as if the borrower made all scheduled mortgage payments until maturity. The penalty is typically calculated by a formula contained in the Note of the Loan Documents. The language will vary between different institutions, but will typically have the same two amounts to be repaid, namely: 1) The loan's unpaid principal balance and 2) a prepayment penalty, which is typically determined by calculating the difference between the loan's interest rate and the replacement rate (based on the US Treasury or other index that most closely corresponds to the maturity date), with the remaining loan payments discounted back for the time value of money. One thing to keep in mind is that yield maintenance provisions usually contain a prepayment penalty "floor" of at least 1% and allow for prepayment without penalty in the last 3-6 months of the loan.

Fixed Prepayment Penalty: A fixed prepayment penalty will require a fixed amount to be paid if the loan is paid prior to its maturity date. For instance, if a $20MM loan with a five-year term and a 3% fixed prepayment penalty is paid in year four, the loan will be subject to the full 3% prepayment penalty.

Declining (Step-Down) Prepayment Penalty: A declining prepayment penalty may be structured in a variety of ways, but always has the same feature of the prepayment penalty decreases by 1% per step with the last 3-12 (or more) months open to prepay or refinance without penalty. These are usually offered on shorter-term loans (i.e. 5-10 years) but could potentially be offered on longer terms as well. An example of a 5- and 10-year declining prepayment penalty would be the following:

5 Year Declining: 5% of loan amount if prepaid in the first year, 4% if prepaid in the second year, 3% if prepaid in the third year, 2% if prepaid in the fourth year, and 1% if prepaid in the fifth year, also represented as 5-4-3-2-1% or 5% declining.

10 Year Declining: 5% of loan amount if prepaid in the first or second year, 4% if prepaid in the third or fourth year, 3% if prepaid in the fifth or sixth year, 2% if prepaid in the seventh or eighth year, and 1% if prepaid in the ninth or final year, also represented as 5-5-4-4-3-3-2-2-1-1% or 5% declining.

2. COMMERCIAL MORTGAGE BACKED SECURITIES (CMBS)

A CMBS Loan, also known as Conduit Loan, is a type of commercial real estate loan that is secured by a first-position mortgage on a commercial property. These loans are packaged and sold by Conduit Lenders, commercial banks, investment banks, or syndicates of banks.

A CMBS Loan has a fixed interest rate (which may or may not include an interest-only period) and is typically amortized over 25-30 years, with a balloon payment due at the end of the term. Because the loans are not held on the Conduit Lender's balance sheet, CMBS Loans are a great way for these lenders to provide an additional loan product to Borrowers while at the same time maintaining their liquidity position. Because of the more flexible underwriting guidelines, CMBS Loans also allow CRE investors that cannot usually meet stringent conventional liquidity and net worth guidelines to be able to invest in commercial real estate. For investor who intend to own the property for a long-time, a CMBS loan is an excellent choice. However, the penalty is very expensive if the loan balance is paid early. In order to finance a property with a CMBS loan, the property must be stabilized.

Term Length/Amortization

CMBS (Conduit) Loans typically have terms of 5, 7, or 10 years (with 15 years as a rare exception) and 25-30-year amortizations. Part or all of the term may be interest-only depending on market conditions. Because the term doesn't match the amortization schedule, the loan will "balloon" at the end of the term, meaning that the remaining loan balance will need to either be paid off or refinanced.

Recourse

CMBS (Conduit) Loans are always Non-Recourse, except for what is colloquially termed the "bad-boy carve outs." What this means is that the Borrowers are not personally liable for the repayment of the loan and that the collateralized property and its cash flows would be the sole source of repayment of the debt in the event of a default or foreclosure. However, in the event the Borrower actively participates in an activity that could cause harm to the property, Conduit Lender, or investors, there could be springing recourse in some limited circumstances; this may include loan fraud, property transfer or subordinate financing without consent of the Lender, voluntary or collusive activity leading to a bankruptcy filing or failure to maintain SPE status, among other such actions.

Prepayment Penalty Structures

There are two prepayment penalty structures for CMBS Loans – Yield Maintenance and Defeasance. With a Yield Maintenance prepayment penalty, the loan is actually paid off and the mortgage note is cancelled, whereas a Defeasance is a substitution of one source of collateral (the property) with another (typically treasury bonds) which is then transferred to a special purpose entity (SPE) called a "Successor Borrower." Both of the structures can cause the Borrower to incur significant monetary penalties if the loan is prepaid well before the maturity date or the US Treasury bonds fall substantially, so anticipated hold time and consideration of future markets should be taken into consideration when contemplating the term for this type of loan structure.

3. LIFE INSURANCE COMPANIES

An Insurance Commercial Real Estate Loan is a mortgage that is provided by a life insurance company or conglomerate of life insurance companies and is secured by a first lien position on the subject property being financed. Most life insurance companies favor the "four food groups," for their collateral (apartment, office, retail, and industrial properties), but may finance other property types (i.e. hotel or mixed used) on a case-by-case basis. These loans are typically best suited for transactions that have strong borrowers with good credit, newer, well-maintained properties, low leverage, and where the collateral is situated in or around a major MSA. Metropolitan Statistical Areas (MSAs) are configured to represent contiguous geographic areas with a relatively high density of human population.

Underwriting Parameters

For life insurance loans, Lenders have continued and even strengthened their conservative approach toward underwriting the cash flow of the collateral as well as the borrowers and sponsors. As part of the underwriting process, Insurance Companies are simultaneously assessing the risks of default while trying to minimize such risks, so they require detailed borrower and property information. Underwritten cash flows are based on "in place" income and rents rather than anticipated income or further rent escalations and leases are analyzed with closer scrutiny to ensure market rates. Insurance Loans require a more conservative loan to value (LTV) with maximums for most lenders between 60-75%, and debt service coverage ratios (DSCRs) of at least 1.25-1.35x, Lenders are also calculating the anticipated debt yield (net operating income/loan amount) of at least 8-10%. Additionally, Borrowers should expect to have "hard cash" equity invested in their projects, while being able to maintain a reasonable post-closing liquidity. Prior commercial real estate ownership experience is highly desirable. Most insurance companies will only finance stabilized assets.

Term Length and Amortization

The length of term and amortization depends heavily on the institution providing the funding as well as the property type. Terms can vary from 5-30 years with amortizations ranging from 15-30 years. Depending on the way the loan is structured, it may "balloon" at the end of the term, meaning at the loan balance will need to either be refinanced or paid off; otherwise the loan is self-amortizing, meaning that the loan will be fully paid off when the loan matures, so there is no loan balance to pay off (unless the loan is prepaid before it matures). Loans from insurance companies are suitable for short and long-term holding strategies. If the borrower does not plan to sell the property in the near future, then a longer-term loan is chosen. However, if the borrower plans on selling the property, it is most likely that the borrower will choose a shorter loan term.

Recourse

Life insurance loans may be non-recourse, limited recourse, or full recourse loans. If it is non-recourse, the Borrowers are not personally liable for the repayment of the loan and that the collateralized property and its cash flows would be the sole source of repayment of the debt in the event of a default or foreclosure. However, in the event the Borrower actively participates in an activity that could cause harm to the property, Lender, or investors, there could be springing recourse in some limited circumstances; this may include loan fraud, property transfer or subordinate financing without consent of the Lender, voluntary or collusive activity leading to a bankruptcy filing or failure to maintain SPE status, among other such actions. Limited recourse loans make the sponsors guarantying the loan responsible for a percentage of any shortfall between the loan balance and sales price in the event of default and foreclosure, where the property must be auctioned off as well as any applicable legal and ancillary fees. The carve-outs for the non-recourse loans would also apply. Full recourse loans make the sponsors guarantying the loan responsible for any and all shortfalls between the loan balance and sales price in the event of default and foreclosure as well as any applicable legal and ancillary fees.

Loan Assumption

The vast majority of life insurance loans are assumable, typically for a fee. This can occur when the Borrower wants to sell the commercial real estate that secures the loan, and the Purchaser of the property wants to take the loan over. Once the property sale and assumption are completed, the Purchaser becomes the owner of the property and is bound by the original terms of the assumed loan and the original Borrower/Seller is released from its obligation to the property and the existing loan. The benefit of this structure is that the assumption of the loan allows the Borrower/Seller to avoid pre-payment costs and give the buyer the opportunity to assume a loan that may have more favorable terms than what is at market. Loan assumption is an especially attractive option in high interest rate environments or tight credit environments.

Prepayment Penalty Structures
Prepayment penalty structures vary greatly depending on the insurance company funding the transaction. It may be structured as Yield Maintenance, Breakfunding, Declining (or step-down) prepayment penalty, or may be specially structured to suit a construction or mini-perm loan.

Yield Maintenance: The goal of Yield Maintenance is to allow the bond investors to maintain the same yield as if the borrower made all scheduled mortgage payments until maturity. The penalty is typically calculated by a formula contained in the Note of the Loan Documents. The language will vary between different institutions, but will typically have the same two amounts to be repaid, namely: 1) The loan's unpaid principal balance and 2) a prepayment penalty, which is typically determined by calculating the difference between the loan's interest rate and the replacement rate (based on the US Treasury or other index that most closely corresponds to the maturity date), with the remaining loan payments discounted back for the time value of money. One thing to keep in mind is that yield maintenance provisions usually contain a prepayment penalty "floor" of at least 1% and allow for prepayment without penalty in the latter 3-6 months of the loan. See the following example for a more mathematical representation of this calculation: (Loan balance at time of payoff) * (note rate - new cost of funds) * (# years left in loan) * (365/360)

Declining (Step-Down) Prepayment Penalty: A declining prepayment penalty may be structured in a variety of ways, but always has the same feature of the prepayment penalty lessening by 1% per step with the last 3-12 (or more) months open to prepay or refinance without penalty. These are usually offered on shorter-term loans (i.e. 5-10 years) but could potentially be offered on longer terms as well. An example of a 5- and 10-year declining prepayment penalty would be the following:

5 Year Declining: 5% of loan amount if prepaid in the first year, 4% if prepaid in the second year, 3% if prepaid in the third year, 2% if prepaid in the fourth year, and 1% if prepaid in the fifth year, also represented as 5-4-3-2-1% or 5% declining.

10 Year Declining: 5% of loan amount if prepaid in the first or second year, 4% if prepaid in the third or fourth year, 3% if prepaid in the fifth or sixth year, 2% if prepaid in the seventh or eighth year, and 1% if prepaid in the ninth or final year, also represented as 5-5-4-4-3-3-2-2-1-1% or 5% declining.

4. FANNIE MAE (FNMA) MULTIFAMILY MORTGAGES NATIONWIDE

The Federal National Mortgage Association (FNMA), commonly known as "Fannie Mae" offers federally guaranteed mortgages and is one of the largest multifamily loan programs in the country. Most FNMA apartment mortgages are non-recourse (except standard carve outs) and properties are underwritten using its Delegated Underwriting Services (DUS) program to make sure that lending parameters are met. Loan collateral may be traditional apartments, affordable housing, senior housing, student housing, and manufactured housing communities. Loan amounts start at $750,000 and go up with terms between 5-30 years and amortizations up to 30 years.

Fannie offers both fixed and variable products for all property types and can go nationwide, although primary and large secondary markets are preferred (i.e. MSA populations of at least 200,000). There are 2 major FNMA programs under which the majority of the products fall:

Standard DUS Mortgage: The Standard DUS product is for the purchase or refinance of existing, stabilized properties including traditional, affordable housing, senior housing, student housing, and manufactured housing communities. Properties must have a minimum of five units (50 pad sites for manufactured housing) and the Borrower must be a single-asset U.S. entity with all U.S. principals. Borrowers may also have foreign ownership interests, subject to proper structuring of the borrowing entity. Minimum loan amount is $750,000. Maximum LTV is 80% for purchases and 75% for refinances with a minimum 1.25x DSCR requirement, but this will depend on the collateral.*

"Pre-Review" markets have a maximum LTV of 65% without a waiver granted by Fannie Mae.

Small Loan Program: The Small Loans product is for the purchase or refinance of existing, stabilized properties including traditional, affordable housing, seniors housing, student housing, and manufactured housing communities. Properties must have a minimum of five units (50 pad sites for manufactured housing) and the Borrower must be a single-asset U.S. entity with all U.S. principals. Borrowers may also have foreign ownership interests, subject to proper structuring of the borrowing entity. Loan amount must be between $750,000 - $3 million ($5 million in eligible MSAs*). Maximum LTV is 80% for purchases and 75% for refinances with a minimum 1.25x DSCR requirement, but this will depend on the collateral.**

Term Length/Amortization

Fannie Mae loan terms range from 5-30 years with amortizations up to 30 years, depending on the type, location, and condition of the collateral. Depending on the way the loan is structured, it may "balloon" at the end of the term, meaning at the loan balance will need to either be refinanced or paid off; otherwise the loan is self-amortizing, meaning that the loan will be fully paid off when the loan matures, so there is no loan balance to pay off (unless the loan is prepaid before it matures).

Underwriting Parameters

Recourse

Most FNMA mortgages are non-recourse, except for standard carve-out provisions. Full recourse mortgages make the sponsors guarantying the loan responsible for any and all shortfalls between the loan balance and sales price in the event of default and foreclosure as well as any applicable legal and ancillary fees. Non-recourse means is that the Borrowers are not personally liable for the repayment of the loan and that the collateralized property and its cash flows would be the sole source of repayment of the debt in the event of a foreclosure. However, in the event the Borrower actively participates in an activity that could cause harm to the property, Lender, or investors, there could be springing recourse in some limited circumstances; this may include loan fraud, property transfer or subordinate financing without consent of the Lender, voluntary or collusive activity leading to a bankruptcy filing or failure to maintain SPE status, among other such actions.

Rate Lock

Fannie Mae has an early rate lock feature which is available with a good faith deposit, allowing the borrower to lock a rate 45 to 180 days in advance of closing. Otherwise the rate will lock 1-2 days before closing.

Loan Assumption

Fannie Mae mortgages are assumable for a 1% fee, but the new assuming borrower (i.e. Purchaser) must qualified by meeting the original underwriting standards. Typically, this occurs when the Borrower wants to sell the commercial real estate that secures the loan, and the Purchaser of the property wants to take the loan over. Once the property sale and assumption are completed, the Purchaser becomes the owner of the property and is bound by the original terms of the assumed loan and the original Borrower/Seller is released from its obligation to the property and the existing loan. The benefit of this structure is that the assumption of the loan allows the Borrower/Seller to avoid defeasance or other pre-payment costs and give the buyer the opportunity to assume a loan that may have favorable terms than what is market. Loan assumption is an especially attractive option in high interest rate environments or tight credit environments.

Prepayment Penalty Structures

Yield Maintenance: The goal of Yield Maintenance is to allow the bond investors to maintain the same yield as if the borrower made all scheduled mortgage payments until maturity. The penalty is typically calculated by a formula contained in the Note of the Loan Documents. The language will vary between different institutions, but will typically have the same two amounts to be repaid, namely: 1) The loan's unpaid principal balance and 2) a prepayment penalty, which is typically determined by calculating the difference between the loan's interest rate and the replacement rate (based on the US Treasury rate that most closely corresponds to the maturity date), with the remaining loan payments discounted back for the time value of money. One thing to keep in mind is that yield maintenance provisions contain a prepayment penalty "floor" of at least 1%.

Declining (Step-Down) Prepayment Penalty: A declining prepayment penalty may be structured in a variety of ways, but always has the same feature of the prepayment penalty lessening by 1% per step with the last 3-12 (or more) months open to prepay or refinance without penalty. These are usually offered on shorter-term mortgages (i.e. 5-10 years) but could potentially be offered on longer terms as well. An example of a 5- and 10-year declining prepayment penalty would be the following:

5 Year Declining: 5% of loan amount if prepaid in the first year, 4% if prepaid in the second year, 3% if prepaid in the third year, 2% if prepaid in the fourth year, and 1% if prepaid in the fifth year, also represented as 5-4-3-2-1% or 5% declining.

10 Year Declining: 5% of loan amount if prepaid in the first or second year, 4% if prepaid in the third or fourth year, 3% if prepaid in the fifth or sixth year, 2% if prepaid in the seventh or eighth year, and 1% if prepaid in the ninth or final year, also represented as 5-5-4-4-3-3-2-2-1-1% or 5% declining.

5. FREDDIE MAC (FHLMC) MULTIFAMILY MORTGAGES

A FHLMC mortgage is a type of multifamily loan that is secured by a first-position mortgage on a traditional, student housing, senior housing, or affordable housing property. These mortgages may be held in the FHLMC portfolio (10% of mortgages) or sold to bond investors (90% of mortgages).

The loan may be fixed or floating (which may or may not include an interest-only period) and is typically amortized over 25-30 years, with a balloon payment due at the end of the term unless it is a self-amortizing portfolio loan.

Loan Features

Term Length/Amortization

FHLMC loan terms are typically 5-10 years unless the mortgages are held in the Freddie Mac portfolio, in which case the terms may go up to 30 years. Amortizations may also go up to 30 years, but amortization depends heavily on the product selected as well as the condition and type of the property.

Recourse

Mortgages are always Non-Recourse, except for standard carve-out provisions. What this means is that the Borrowers are not personally liable for the repayment of the loan and that the collateralized property and its cash flows would be the sole source of repayment of the debt in the event of a foreclosure. However, in the event the Borrower actively participates in an activity that could cause harm to the property, Lender, or investors, there could be springing recourse in some limited circumstances; this may include loan fraud, property transfer or subordinate financing without consent of the Lender, voluntary or collusive activity leading to a bankruptcy filing or failure to maintain SPE status, among other such actions.

Rate Lock: Borrowers will lock the interest rate in advance of the loan closing, but the type of rate lock selected will depend on how far the Borrower will need it completed before closing. FHLMC offers four types of rate lock options in order to meet whatever the Borrower's needs are.

Loan Assumption: FHLMC mortgages are assumable, but the new assuming borrower (i.e. Purchaser) must qualified by meeting the original underwriting standards. Typically, this occurs when the Borrower wants to sell the commercial real estate that secures the loan, and the Purchaser of the property wants to take the loan over. Once the property sale and assumption are completed, the Purchaser becomes the owner of the property and is bound by the original terms of the assumed loan and the original Borrower/Seller is released from its obligation to the property and the existing loan. The benefit of this structure is that the assumption of the loan allows the Borrower/Seller to avoid defeasance or other pre-payment costs and give the buyer the opportunity to assume a loan that may have favorable terms than what is market. Loan assumption is an especially attractive option in high interest rate environments or tight credit environments. In an attempt to expedite FHLMC loan assumption, processes have been streamlined for Buyers and Sellers.

Prepayment Penalties

There are two prepayment penalty structures for fixed FHLMC mortgages – Yield Maintenance and Defeasance, and both include a 2-year lockout period. With a Yield Maintenance prepayment penalty, the loan is actually paid off and the mortgage note is cancelled, whereas a Defeasance is a substitution of one source of collateral (the property) with another (typically treasury bonds) which is then transferred to a special purpose entity (SPE) called a "Successor Borrower." Both of the structures can cause the Borrower to incur significant monetary penalties if the loan is prepaid well before the maturity date or the US Treasury bonds fall substantially, so anticipated hold time and consideration of future markets should be taken into consideration when contemplating the term for this type of loan structure.

There are 4 prepayment penalty structures for floating FHLMC mortgages which include a flat 1% fee as well as 3 declining structures.

Yield Maintenance: Yield Maintenance. The goal of Yield Maintenance is to allow the bond investors to maintain the same yield as if the borrower made all scheduled mortgage payments until maturity. The penalty is typically calculated by a formula contained in the Note of the Loan Documents. The language will vary between different institutions, but will typically have the same two amounts to be repaid, namely: 1) The loan's unpaid principal balance and 2) a prepayment penalty, which is typically determined by calculating the difference between the loan's interest rate and the replacement rate (based on the US Treasury rate that most closely corresponds to the maturity date), with the remaining loan payments discounted back for the time value of money. One thing to keep in mind is that yield maintenance provisions usually contain a prepayment penalty "floor" of at least 1%.

Defeasance: With defeasance, the loan is not repaid, and the note remains in place, but substitute collateral (typically in the form of bonds or other securities) is arranged by the defeasing firm and replaces the commercial real estate securing the loan so the property can be sold or refinanced. The cash flows generated from these new securities are in the form of coupons and maturing securities which will cover all future loan payments. When the average yield on the substitute collateral is higher than the loan, it is cheaper to purchase securities to cover the loan's remaining principal and interested (P&I) payments. Unlike yield maintenance, defeasance provisions do not contain a floor. However, the third-party administrative fees in order to defease typically range from $50,000 to $100,000, depending on the loan's size and complexity. For more specific detail, you may also review the Defeasance Rider to the loan documents.

Securitization/Loan Pools (K Deals)

After a loan is funded, it is put into a security pool of at least $1 billion which is sold to a bond issuer/depositor that puts the pool into a third-party trust. This trust packages the pools into bonds, or "securitizes" the loans. FHLMC then purchases the senior, guaranteed bonds issued by the trust and securitizes them via the Freddie Mac Trust into K Certificates, which are guaranteed by Freddie Mac. These certificates are then sold on the open market to investors, which typically include life insurance companies, pension funds, money managers, mutual funds, and commercial banks for the investment grade pools. The subordinate and mezzanine bonds (which are not guaranteed by Freddie Mac) are sold to private investors by the third-party trust. Investors choose which bonds or certificates to purchase based on the level of credit risk, yield, and duration that they seek.

Rating Agencies

FHLMC's mortgage securities are not rated separately by any of the main rating agencies (i.e. Moody's, Standard & Poors, etc.). This is because they carry the implied AAA rating of Freddie Mac's Credit Rating and its reputation for default rates far below the rest of the industry.

6. FEDERAL HOUSING ADMINISTRATION (FHA)

FHA is a federally guaranteed program under the government's Department of Housing and Urban Development (HUD). FHA Loans can be used for the purchase/refinance as well as the construction/ substantial rehabilitation of multifamily or healthcare properties. Loans are non-recourse (except standard carve-outs) and rates are very competitive with 35-40-year fixed terms and amortizations. FHA are available nationwide and are available for any market (primary, secondary, tertiary). Because of the longer diligence/underwriting period and closing time of FHA mortgages, borrowers may need a short-term bridge loan to finance the property until closing their FHA loan.

Multifamily Programs:

FHA's multifamily program is for the purchase/refinance or construction/rehabilitation of traditional, affordable, senior, cooperative or manufactured housing communities. Properties must be in good condition (for purchase/refinance) and not more than 30-40 years old unless substantially rehabilitated. Borrowers must have previous FHA ownership/management experience if they are managing the property themselves or hire an FHA property manager unless an FHA waiver is attained.

Healthcare Programs:

The Office of Healthcare Programs (OHP) oversees Section 232 for Residential Care Facilities and Section 242 for Hospitals programs. Both insurance products enable the affordable financing and refinancing of healthcare facility projects nationwide. These programs reduce the cost of capital needed by hospitals and residential care facilities and improve access to quality healthcare while decreasing overall healthcare costs.

The Office of Hospital Facilities (OHF) manages the Section 242 program, which provides mortgage insurance for acute care hospital facilities ranging from large teaching institutions to small rural critical access hospitals. The Office of Residential Care Facilities (ORCF) manages the Section 232 program, which provides mortgage insurance for residential care facilities such as assisted living facilities, nursing homes, intermediate care facilities, and board and care homes.

Underwriting Parameters

Multifamily Accelerated Processing (MAP): MAP underwriting is intended to cut the HUD approval time and to assure consistent application of credit standards across all processing offices. This delegates more underwriting responsibility to approved "MAP lenders."

Loan Features

Recourse
Loans are always Non-Recourse except for standard carve-out provisions. What this means is that the Borrowers are not personally liable for the repayment of the loan and that the collateralized property and its cash flows would be the sole source of repayment of the debt in the event of a foreclosure. However, in the event the Borrower actively participates in an activity that could cause harm to the property, Lender, or investors, there could be springing recourse in some limited circumstances; this may include loan fraud, property transfer or subordinate financing without consent of the Lender, voluntary or collusive activity leading to a bankruptcy filing or failure to maintain SPE status, among other such actions.

Loan Assumptions
FHA Loans are assumable for a 1% fee. Typically, this occurs when the Borrower wants to sell the commercial real estate that secures the loan, and the Purchaser of the property wants to take the loan over. Once the property sale and assumption are completed, the Purchaser becomes the owner of the property and is bound by the original terms of the assumed loan and the original Borrower/Seller is released from its obligation to the property and the existing loan. The benefit of this structure is that the assumption of the loan allows the Borrower/Seller to avoid pre-payment costs and give the buyer the opportunity to assume a loan that may have favorable terms than what is market. Loan assumption is an especially attractive option in high interest rate environments or tight credit environments.

Prepayment Penalty
FHA Loans generally have a declining prepayment penalty with a two-year lock-out but may be restructured for a fee or increase in rate. This structure makes the loan unable to be paid for the first 2 years, then declining thereafter (i.e. 8% the third year, 7% the fourth year, and so on). This may be shorted to: 8-7-6-5-4-3-2-1%.

7. BRIDGE LOANS

A **bridge loan** is defined as a short-term real estate loan that gives the property owner time to complete some task - such as improving the property, finding a new tenant and/or selling the property. The typical commercial property bridge loan has a term of one to two years, although many commercial bridge loan lenders will grant the owner the option to extend his loan for six months to one year for a fee of between a half-point point to two points.

Bridge loans are best suited for non-stabilized commercial real estate properties. Non-stabilized properties are usually real estate assets that require major renovations, have high expense ratios, below market rents, and/have higher than market vacancy rates. Non-stabilized properties are attractive to investors because the real estate asset is usually listed and able to be purchased well below stabilized market value. The investor is also confident the property can be transformed through a value-add play into a stabilized property by fixing the aforementioned issues thereby increasing net operating income (NOI). NOI can be increased most commonly through renovations, which in term attracts better quality tenants with higher market rents and longer-term leases.

Loan Features
Bridge loans are more expensive than permanent loans. In a market where a commercial property borrower might be able to obtain a 6% permanent loan, he might have to pay LIBOR plus 3.5% to 7% (6-month

LIBOR is 2.61% as of 10/18/18), plus a point or two, for a bridge loan from a commercial real estate opportunity fund.

Most large bridge loans ($3 million to well above $100 million) are written on a floating rate basis, tied to one-month LIBOR or 6-month LIBOR.

LIBOR stands for the London Inter-Bank Offer Rate, which is the rate that European banks lend funds to each other. It is similar to the U.S. federal funds rate.

Commercial property bridge loans are typically paid off when the owner places permanent financing on the property, after the improvements are completed and the new tenant(s) move into the property. Because of their short-term nature, most bridge loans have no prepayment penalty.

8. MEZZANINE LOANS

Mezzanine debt is subordinate to the senior debt, and in virtually all cases, the mezzanine instrument is not secured by the property, but rather by the equity in the entity that owns the equity in the property. As such, the mezzanine position is a riskier one to be in, and for this reason, the cost of mezzanine capital is higher than that of senior mortgage debt.

Mezzanine loans are similar to second mortgages, except a mezzanine loan is secured by the stock of the entity that owns the property, as opposed to the real estate. If the mezzanine lender forecloses on the stock, it owns the entity that owns the building. Lenders can foreclose on a mezzanine loan in just 5 weeks, as opposed to 18 months it would usually take to foreclose on the property in event of a default.

Mezzanine loans are frequently used to increase the leverage of a construction loan. In this case, the mezzanine will fund before the senior debt in a construction loan and will be repaid only after the senior loan is repaid in full.

Mezzanine loans can also be used for acquisitions if the borrower needs a little more equity to close the transaction.

Loan Features

As with other forms of subordinate financing, mezzanine loans tend to have higher interest rates than mortgage loans. The increase in interest rate is due to the higher risk profile of a mezzanine loan as compared to the mortgage financing. One factor contributing to the higher rate of interest is that mezzanine loans are not secured by the real property. Any liens recorded against the related property, whether voluntary or involuntary, will have priority over the mezzanine loan.

The mezzanine loan will have a higher loan to value ratio than the mortgage loan. Generally, mortgage lenders will loan up to a certain percentage of the appraised value of the property. Mezzanine loans are used by borrowers to bridge the gap between the amount of proceeds advanced by the mortgage lender and borrower's equity in the property.

The mezzanine loan will typically mature on the same date as the related mortgage loan and will typically have the same payment date as the related mortgage loan. Mezzanine loan interest rates can be either fixed or floating and rates are generally higher than senior debt ranging from 14-18%. However, in almost all cases, mezzanine debt is less expensive than equity and provide the investor complete control over the property as long as the debt payments are made on the mezzanine and senior debt as agreed.

Mezzanine borrowers will typically be structured as single-purpose, bankruptcy remote entities, in the same manner and subject to the same requirements as required by the senior debt holder.

There are three primary documents related to mezzanine financing:

- Loan Agreement – the central agreement between the mezzanine borrower and the mezzanine lender setting forth the basic terms of the loan.
- Pledge Agreement – the security agreement pursuant to which the mezzanine borrower pledges its 100% direct equity interest in the mortgage borrower as collateral security for the mezzanine loan.
- Inter-creditor Agreement – the governing agreement between the mortgage lender and the mezzanine lender, setting forth their respective rights and limitations. This agreement is not usually shared with the mortgage borrower or the mezzanine borrower as neither borrower is a party.

9. PREFERRED EQUITY

Preferred equity is a general term used to describe any class of securities (stock, limited liability units, limited partnership interests) that has higher priority for distributions of a company's cash flow or profits than common equity. Typically, all cash flow/profits remaining after required payments to a company's lenders are distributed to the preferred equity investors until they receive the full amount of a previously agreed upon return, commonly stated as a fixed percentage annual rate.

Preferred equity can also be thought of as form of equity measurement that takes into account the company's preferred shareholder equity and disregards common shareholder equity. Another way to put it is that preferred equity equals total shareholder equity less common shareholder equity.

As with common equity, preferred equity represents an ownership interest in the company. That interest, however, is unsecured and does not provide its holders with direct recourse to company assets, as is the case with secure debt holders.

Preferred Equity Features

Preferred equity is widely used to describe a specific type of investment in commercial real estate projects. Investors buy a direct ownership interest ("equity") in a limited partnership (LP) or limited liability company (LLC) that owns real property. In return, the investors get the right to receive a fixed rate of return on their investment (typically 12-16% per year) that is paid before other ownership interests in the LP or LLC. Preferred equity investors are repaid the original amount of their investments either at a set date (the "maturity date") or when the property is sold.

The company owning the subject real property will usually have different classes of investors and tiers of lenders. Preferred equity holders rank senior to investors who own common equity, but rank junior to the holders of the loans (or bonds) used to finance the real estate project. In other words, when the property generates income from rent-paying tenants, or profits when the property is sold, preferred equity holders are paid after the lenders (or bond holders), but before common equity holders.

The four common reasons for including preferred equity in the capital stack are:

- Conventional senior and mezzanine financing are unavailable or insufficient for the project.
- The project's sponsors want to leverage the property by more than 80% of the property's value, that is, beyond typical mortgage investment amounts.
- The sponsors wish to avoid investing more of their own money if lenders refuse to fund the project in the desired amount.
- Preferred equity investors are often not required to sign an intercreditor or subordination agreement with the project's lenders. This can simplify the transaction and permit an earlier closing date.

10. United States Department of Agriculture (USDA) Loans

The **USDA** helps create jobs and stimulates rural economies by providing financial backing for rural businesses and properties. Its primary purpose is to create and maintain employment and improve the economic climate in rural communities. USDA Loan proceeds may be used for working capital, machinery and equipment, real estate, and certain types of debt refinancing. This is achieved by expanding the lending capability of private lenders in rural areas and helping them service quality loans that provide lasting community benefits.

Business Loans and Grants: The Business Program (BP) works in partnership with the private sector and community-based organizations to provide financial assistance and business planning. Its primary purpose is to fund projects that create or preserve quality jobs and/or promote a clean environment with a rural area (under 50,000 population). This program is often leveraged with public and private lenders to meet business and credit needs in under-served areas. Recipients of these programs may include individuals, corporate entities, public agencies, not-for-profit organizations (NPOs), Indian tribes, and private companies.

Business and Industry Guaranteed Loan (B&I) Program: The purpose is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities.

Rural Business Investment Program: The purpose is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities.

Loan Features

Term Length and Amortization: USDA term length and amortization depends on the product as well as the underwriting guidelines of the conventional partner. Terms and amortizations can go up to 40 years in some limited circumstances but are typically between 5 and 30 years.

Recourse
USDA Loans are almost always recourse, which means that a personal guaranty for the repayment of the loan is required. Full recourse loans make the sponsors guarantying the loan responsible for any and all shortfalls between the loan balance and sales price in the event of default and foreclosure as well as any applicable legal and ancillary fees.

Prepayment Penalty
Prepayment structures can vary greatly, depending on the how the conventional partner structures the loan and what USDA program is guarantying the loan.

Lending Areas
USDA guaranties are only available in rural areas (Less than 50,000 population).

11. SBA LOAN PROGRAM

The **Small Business Administration (SBA)** does not offer grants or direct loans, with the exception of disaster relief loans, but instead guarantees against default pieces of business loans extended by banks and other official lenders that meet the agency's guidelines. The number one function of these loan programs is to make loans with longer repayment periods available to small businesses.

Therefore, SBA loans are bank or debt fund loans that are insured by the SBA. There are two types of loan insurance programs offered by the SBA for commercial real estate.

7(a) Guaranteed Loan Program: The SBA's primary business loan program is the 7(a) General Business Loan Guaranty Program. It's generally used for business start-ups and to meet various short- and long-term needs of existing businesses, such as equipment purchase, working capital, leasehold improvements, inventory, or real estate purchase. These loans are generally guaranteed up to $750,000. The guaranty rate is 80 percent on loans of $100,000 or less and 75 percent on loans more than $100,000.

The guidelines for SBA guaranteed loans are similar to those for standard bank loans. In addition, your company must qualify as a small business according to SBA standards, which vary from industry to industry.

The interest rate charged on SBA guaranteed loans is based on the prime rate. While the SBA does not set interest rates, since they are not the lender, it does regulate the amount of interest that a lender may charge an SBA borrower. If the loan has a term of seven years or more, the SBA allows the lender to charge as much as 2.75 percent above the prevailing prime rate. If the loan has a term of less than seven years, the surcharge can be as much as 2.25 percent.

You can use the following assets as collateral for an SBA guaranteed loan:

- Land and/or buildings
- Machinery and/or equipment
- Real estate and/or chattel mortgages
- Warehouse receipts for marketable merchandise
- Personal endorsement of a guarantor (a friend who is able and willing to pay off the loan if you are unable to)
- Accounts receivable
- Savings accounts

- Life insurance policies
- Stocks and bonds

504 Local Development Company Program: The 504 Loan Program provides long-term, fixed-rate financing to small businesses to acquire real estate, machinery, or equipment. The loans are administered by Certified Development Companies (CDCs) through commercial lending institutions. 504 loans are typically financed 50 percent by the bank, 40 percent by the CDC, and 10 percent by the business.

In exchange for this below-market, fixed-rate financing, the SBA expects the small business to create or retain jobs or to meet certain public policy goals. Businesses that meet these policy goals are those whose expansion will benefit a business district revitalization (such as an Enterprise Zone), a minority-owned business, or rural development.

Conclusion

This guide discusses the most frequently used loan programs for financing commercial real estate properties. You've learned that Conventional loans are usually low leverage loans that can be combined with Mezzanine loans and Preferred Equity to leverage up a deal. Conventional loans can be used to finance virtually any commercial real estate asset. Conventional loans can be made by banks, life insurance companies, and private debt funds.

Agency loans made by Fannie Mae, Freddie Mac and the FHA where discussed. We discussed how these loan programs are mainly for multifamily, assisted living, hospitals, and for portfolios of residential properties.

This guide also introduced bridge loans which are designed to financing transitioning properties that have not reached stabilization. We hope that together with PRC, we can create some very exciting synergies with you and your portfolio. What is the best financing solution for your commercial real estate? Call PRC at 682-518-9416 today and find out.

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