

Real Estate Lending Has Rules of Its Own

When They Are Violated by Bedazzled Investors, Troubles Follow

Real estate lending is not commercial lending, partly because of its unpredictability, and those who violate some basic rules are in for difficulties, says Mr. Haddow, vice president in the Atlanta office of Landauer Associates Inc., real estate consultants and appraisers.

By DAVID FORBES HADDOW

Real estate lending is governed by underwriting techniques and standards that differ from commercial lending. Some of these variations are necessitated by the type of security, while others result from basic differences in approach. Problems arise when underwriting fundamentals are violated in the rush to produce loan volume or the allure of a glamorous real estate deal.

Two basic rules always apply: align yourself with good people, and make sure they have something at risk. For real estate lenders, it is also imperative to thoroughly know the market in which the property is located.

Real estate developers share many qualities. They are highly entrepreneurial, aggressive, creative, and not averse to risk. Yet no two developers are alike, each having a unique personality and business style. It is impossible to construct a list of necessary qualifications or systematic method of evaluating developer capabilities. The ultimate test is performance.

Lenders should take more than a cursory look at the physical and financial aspects of a borrower's existing devel-

opments because they offer tangible evidence of his ability to perform. Other factors to consider are staff background, previous lender relationships, financial history, and qualifications of associated companies.

Several questions are raised: has the developer assembled the necessary talent to take a project from conception to completion? Do members of the developer's team have a proven track record and reputation for quality? Has the developer shown a strong level of commitment to projects that have encountered problems? What previous experience does the developer have with the type of project planned and marketplace? Does the developer exhibit personality traits that suggest pride, stability, imagination, and purpose?

To think of real estate as only bricks, mortar, and a plot of ground is to overlook its most essential ingredient. People develop real estate projects. Marketing and management determine ultimate profitability, and these are not assembly line operations. The process begins with an idea, and if that idea is flawed, even a great property can yield unsatisfactory results.

Banks often assume the full risk of real estate projects by funding total development costs. The safety valve is

usually a permanent lender who has committed to retire the construction loan upon project completion. However, if cost overruns exhaust construction funds or lease-up requirements delay permanent loan funding, the interim lender may have to go it alone. Besides, open-ended construction loans (no permanent takeout) are increasingly common, transferring market risk to the construction lender.

The question is, why are lenders willing to bear all the risk while developers reap all the benefits if the project is successful? More importantly, what level of commitment can one expect from a borrower who has nothing at stake but his reputation, particularly in a business that is forgiving of mistakes?

The answers to these questions are obvious. When lenders finance total development costs and bear all the construction risk and at least some portion of the market risk, they are essentially a joint venture partner without the benefit of an equity interest. They also set themselves up for a fast goodbye if problems arise.

Think of it from the developer's point of view. When total project financing is available, there is a natural tendency to experiment and accept greater risk. Developers may also prove less cautious and thorough in their analysis of critical market factors. If problems develop, commitment to a project may wane a bit sooner with no equity at stake.

The traditional method of satisfying lender equity requirements has been to consider the increased value of the land as the developer's contribution. The problem is that this equity measure is usually derived from a land residual method of analysis. This value estimate assumes the project is built according to the construction budget and leases up as projected, which may or may not reflect probable resale value. To rely on a land appraisal to determine equity contribution is foolhardy.

Cash equity is preferred, but often unattainable. In lieu of cash, one might demand secondary liens on existing income-producing properties or require that the borrower forgo his developer's fee until certain performance criteria are met. Letters of credit and escrow accounts are other methods of insuring that the borrower has equity at risk.

Construction lending is a competitive business. If equity requirements become too severe, preferred borrowers will go elsewhere for financing. Therefore, it is important to remain flexible in structuring loan agreements. However, the construction lender should not be the only one who loses if a project fails.

Market Factors

Real estate forecasting is like predicting the weather; quite often the outcome is unexpected. This is because real estate frequently defies logic and precedent, much as the weather does.

While there are no absolute answers when projecting the future, it is possible to identify market factors that will contribute to a project's success or failure. Cash flow projections based on alternative outcomes can prove very helpful in attempting to quantify risk and evaluate the prospect of loan repayment.

Real estate should be analyzed on three levels: market, site, and project. The first step is to consider overall economic and demographic trends shaping the community in which the property is located. Next, an analysis of supply/demand conditions in that particular segment of the real estate market must be undertaken.

For instance, if one is reviewing a construction loan request for an office building, one would want a thorough inventory of existing supply, including rental rates, occupancy, and building characteristics, as well as a listing of proposed developments. On the demand side, one would like to know historical absorption trends, sources of demand, and factors influencing future demand.

The site and project are examined in the context of the overall market. The site analysis should consider physical elements as well as area population and employment characteristics, local image, environmental factors, and other issues. The project analysis addresses the fit between the proposed development, site, and market served.

The object is to learn enough so that one can critically examine the borrower's projections of operating results.



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Since each market is different, the application of industry standards or "rules of thumb" is inadequate. An informed judgment based on knowledge of the market is obviously preferable to blind acceptance of the developer's pro forma.

Sometimes these market factors are self-evident or the loan is structured in such a way as to eliminate market risk. However, it is usually beneficial to

seek outside counsel to obtain an independent analysis. Market studies prepared by the borrower or his counsel provide valuable information, but tend to highlight the good and downplay the bad. The lender's real estate adviser should at least review these studies, focusing on potential trouble spots.

Summary

The underwriting process should begin with an investigation of the prospective borrower's entrepreneurial talent and ability to perform. The best evidence is found in previous developments, which requires more than a passing glance or casual inquiry to gain meaningful insight. The loan should be structured so that the borrower is at risk. And lastly, careful scrutiny of the market, site, and development plan is needed to properly evaluate the borrower's cash flow projections and measure the degree of uncertainty. By following these basic rules, interim loans will remain just that. ■