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Commercial Real Estate Debt & Equity

White Paper: How Apartments Get Financed

In this White Paper, You'll Learn About:

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How Apartments Get Financed

Real estate investors get excited about potential, but lenders are much more concerned with current reality.

When it comes to financing apartments, there are two basic categories of properties:

Stabilized Properties

Stabilized properties are easier to get financed. A stabilized property can typically be described as one with 90%+ of physical occupancy for greater than 90 days. Lenders (the investors funding the loan) are usually looking for a specific rate of return or a yield on their investment. They like to see the past two year's cash flow to determine possible future cash flow available to repay the mortgage. Imagine that the lender is looking at the operating statement in a rear view mirror. They want to analyze what has happened in the past year or two to give them a good idea on how the property will be operated in the future. Higher leverage from the lender can be the reward for a stabilized property.

Non-Stabilized Properties

As the name would imply, these are properties which don't meet the aforementioned criteria of income stability.

Distressed assets are usually non-stabilized. These properties have functional and physical items that need to be corrected. Does the property need updating to compete? Does the property need to change managers or install a better quality of tenant? Many distressed properties suffer from low occupancy, lower net operating income, and physical ailments that need to be corrected. Buyers of non-stabilized properties are putting "humpty dumpty" back together again with corrective action.

Where Does the Money Come From?

When you purchase an apartment complex choosing the correct lender is critical. In a typical apartment purchase the bank puts in 70-75% of the total cost so in many respect "the bank is your partner" in the deal. They will make or break your ability to purchase the property.

There are two primary channels through which apartments are financed: traditional banks and or government sponsored agency (Fannie Mae or Freddie Mac).

Traditional Bank Lending

Traditional banks are just what they sound like- private institutions that take in deposits (from Grandma) and make loans. They might be large national banks or local community banks.

Traditional banks are generally preferred over Fannie Mae in the following circumstances:

- You are new to multifamily investing. Fannie Mae will only loan to individuals that have previous multifamily ownership experience. They do not want you learning on their dime. Fannie Mae will not put you in the apartment business unless you team up with additional partners that have past or current Fannie Mae apartment experience. That partner must sign on your loan documents.

- The property itself has some level of distress typically due to some physical issues that need to be cured and poor historic financial performance of the property. Fannie Mae typically only lends on stabilized properties in good physical condition. Fannie Mae hangs its hat on stabilized cash flow streams.

Loans to Newbies

When you are initially getting into ownership of apartments, lenders will typically take a more conservative stance. They generally want owners to have more skin in the game for their first deal. They'll also want a larger margin for error if something goes wrong.

Bank is your Partner

In commercial lending, the Bank is your greatest partner. You are putting in 25-30% of the equity needed in the transaction; but the Bank is putting in 70-75% in debt. You are the operating partner with measured upside and operational daily control of the asset and your Bank is the silent partner with hope on getting their principal balance returned with nominal interest.

Personal Guarantees ("Recourse" Loans)

Loan to newbies typically require personal guarantees from all guarantors (signers). From the bank's perspective, the more balance sheets backing the deal up, the better. The bank is not only taking a collateral interest in your property, but also in your personal balance sheet in case of a possible future deficiency balance. A deficiency balance is created if the bank has to foreclose on the property and sells the asset to a third party for an economic loss. That loss has to be cured (paid off) with your personal assets.

Cash Reserves

"Post-closing liquidity" (lots of cash in the bank after the deal is done) is critical for loan approval. The lender doesn't want you to put ALL your money into the deal. They want you to have cash in reserves in case there is an unexpected expense. For newbies, the lender may require reserves between 20-30% of the loan amount to be held. The reserves cannot be equity in other real estate investments or IRA's or 401k's. Lenders want to see cash, stocks or bonds in your name. If there is an unexpected loss, the lender wants you to be in a position to pay for that expense.

Professional Management

Lenders will also want a third party professional property management company hired for larger properties. From the lender's perspective, handing an inexperienced operator a large property to manage is akin to giving a child the keys to a very expensive car.

Due Diligence

Quality third party due diligence is required. A new apartment buyer is sometimes surprised at the number and expense of all the reports the lender will require. But in a big property, there are lots of things to look at and what might be an inexpensive problem in a single family home can be a significant expense in a large building.

In short, the lender wants to make sure they understand the quality and condition of the collateral. As a newbie, this is actually a great benefit to you. Often, the bank underwriter will find things you might miss, and this is where your "partnership" with the bank can be very helpful.

Create an Entity

Almost all lenders will require you to create a Single Asset Entity to be the borrower. Your asset is typically held in a Limited Liability Corporation. Typically, you will not create the new LLC until your offer for purchase is accepted. The LLC is the borrower; the managing member and the other guarantors of the LLC will sign for loan documents on behalf of the borrower.

Value Added Lending "Humpty Dumpty Loans"

These programs are specifically designed for properties which are either non-stabilized or are in need of minor to moderate renovation or some other value added strategy. Moderate renovations can be funded at acquisition so the property can be positioned to secure permanent financing in the future.

Here are some guidelines for this type of financing from a traditional bank:

Traditional Bank Lending (Bridge)

- Loan Amounts: $400,000 to $10,000,000+
- Loan to Value / Loan to Cost: 65% to 75%
- Term (maturity): Up to 7 years
- Amortization: 15, 20, or 25 years (largely dependent on the age and condition of property)
- Rates: Fixed & Adjustable
- Interest Only Payments Possible: Up to 1 year during rehab
- Rehab budget: Needed before appraisal
- 24-month monthly pro-forma operating statement: Needed before appraisal
- Occupancy: Typically Not lower than 70%
- Debt Service Coverage (DSC)[1]: Not lower than 1.0X
- Recourse: Yes, personal guarantees are required by the banks
- Origination fee: 1% + Appraisal/ Phase 1 environmental study

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[1] DSC is a ratio of Net Operating Income versus Principal & Interest. So of a property brings in $12,000 per month of NOI and the lender require a minimum 1.0x ratio, the largest the Principal & Interest payment could be would be $12,000 per month. If the lender required a 1.2x ratio, the PITI payment could only be $10,000 per month ($12,000 /1.2 = $10,000)

- Escrows: Not typically required, you will be responsible for paying your own taxes, insurance and capital projects

As previously stated, the lender is looking for the guarantors (sponsors) that have strong personal balance sheets to provide the lender with additional security. A lender will typically look for Post-Close Liquidity from the guarantor(s) of 20-30% of the loan amount or more. The lender wants to know that if something financially happens to the property (insurance claim not paid, lower than expected operating income, etc.) that the guarantors can still be able to operate the property without a capital call from the bank.

Most Banks will require a depository relationship. (Personal and Operating accounts)

One great benefit to getting a traditional bank loan is that it earns you ownership / management experience with Fannie Mae for future loans.

Rules of Thumb for Bank Financing

Not all Lenders are the same; some Banks are not real estate lenders

Not all Lenders like Apartment loans

Not all Lenders like older properties that need to rehabbed and repositioned Not all

Lenders like non-recourse loans; most will not even offer non-recourse loans Not all

Lenders will not like the part of town that you want to invest in.

Not all lenders will give you maximum leverage to acquire and rehab into your loan.

Not all lenders will amortize apartment loans greater than 15 years.

Your large bank loan officer is not the decision maker; help him/her build a case for their credit committee to approve the loan. Loan officers are sales people and problem solvers, but they don't have signing (approval) authority.

Help mitigate the lenders risk. Examples: You may need to add another guarantor or have the lender temporarily hold additional collateral in the form of a CD pledge. If you are new to apartment ownership hire a very qualified property management that manages similar properties. Lenders trust you, but they really trust a qualified property management company that already manages properties in the same submarket. The lender wants to see two things: 1)

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How Apartments Get Financed in its Entirety

Including remaining topics where you will learn about:

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- ✓ Simple Underwriting
- ✓ Things to Watch Out For
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- ✓ Typical Fannie Mae Guidelines

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- ✓ The Value of an Experienced Loan Broker
- ✓ Helping Your Commercial Mortgage Broker Help You

Thanks for taking the time to read this whitepaper. My name is Carlos Flores. I am a Commercial Mortgage Banker, Real Estate Investor, Syndicator, and Management Professional. I am a principal in a 100+ unit apartment complex and have ownership interest in an aggregate of 429 units. My mortgage clients really like the fact that I'm a real estate investor myself because I truly understand your needs and your point of view, not just the lender's side of the deal.

Remember to engage me early in the process, especially if you're just getting started in the business.

Best Regards,

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