Bridge Loans: Financial Alternatives in a Transitioning Economy Bridge

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There is a point in every economic recovery where business must be the driving force that pushes the credit markets to extend resources. In manufacturing, it may take the form of a growing backlog and the need to purchase materials or hire a work staff to complete it. In many industries, the cycle of credit (its extension and its subsequent payback) can generally be fairly compressed and can be quickly seen by increased sales and subsequent higher profit margins. However, in real estate, the time it takes for a property to "proof" or stabilize can be a period of time that is much greater.

Providing the appropriate financing for a property in transition or under renovation is critical for the success of a project. Depending upon the point in the economic cycle, traditional sources of credit, such as banks, are not always ready to accept the risk of riding through the process of a piece of real estate being renovated or repositioned from one use to another. In fact, changing a vacant industrial building into offices or apartments can be a tall order for a local bank early in an economic recovery. However, that is often where investors/developers/entrepreneurs can get their best acquisitions. The owner of an underperforming building in a recession may see the first signs of an early economic recovery as a selling opportunity to unload an underperforming asset. It's here where "deals" can be made.

However, if your credit source is not up to the task of having the patience to permit the property to properly transition and ultimately stabilize, the end result can be disastrous. It's not uncommon for a bank to make a development loan to the owner of a property and then call the loan prior to the property being stabilized. A lending institution may call a loan for many reasons, ranging from insufficient funds to complete the project to underperforming cash-flow that does not meet minimum debt reserve requirements to changes in prevailing lending appetites (or management) at the bank. The trick is not just getting financing but getting the right financing. You should find a lender with the appetite, commitment and history of working with borrowers if (and when) problems occur.

A Bridge Loan is often the product of choice for a property in transition, whether it is changing its use or being renovated. Since each sector of the credit markets tends to have its own nomenclature for describing different products, for our purposes, a bridge loan is a credit facility that improves the income-producing ability of a property by repositioning the property within its existing market/use via renovation or by changing the market/use of the property by implementing a structure of financing that commits monies over time, with the expectation of stabilizing the property.

A Bridge Loan is sometimes confused with a Hard Money Loan. A Hard Money Loan is generally shorter in duration, may provide for only one phase of development (either acquisition, tenant improvements, repositioning, etc.), typically provides "as-is" leverage up to 65%, generally is at a higher cost (in both rate and points) and can often close more quickly than a Bridge Loan. Additionally, a Hard Money Loan can generally be more "property-focused," which means that a Hard Money underwriter can focus more heavily on the property, offsetting any specific borrower shortfalls. Now that you have an understanding of what kind of property merits a Bridge Loan, it will be helpful to see what the structure of the loan may look like.

A good Bridge Loan should be flexible enough to accommodate a variety of application types, regardless of whether the facility is being transitioned into a different use or is being improved for new tenants. Since most bridge lenders are looking for a good story to sell to their credit committee, be prepared to document the property and surrounding market historically. Ownership's credentials and experiences with development will be a selling feature for the deal. Appraisals and feasibility study reports that show the market can absorb new space are critical. A plausible exit strategy that moves the property from a loan-in-process to permanent financing will help move the project through

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underwriting. Bridge lenders can offer preferred pricing and higher leverage to deals with signed contracts from strong credited tenants waiting to move into the property upon completion. Deals without tenants-in-waiting will have to be supported by very strong market conditions that show space is in short supply. Stronger transactions can retain financing up to 90% loan-to-cost.

Most national bridge programs will offer non-recourse terms. This allows the borrower the luxury of not signing the deal personally, which many developers seek. This gives them the ability to reserve the strength of their own personal balance sheets for deals that are less financially strong. To offset some of the risk associated with a transitioning property, expect interest rates 100 to 200 bps above typical bank rates. Interest-only terms during renovation are typical, with a potential reduction in the interest rate when the financing rolls into the end-loan. It's important to keep in mind that the end-loan is a big carrot to bridge lenders. Certainly they'll make a profit on the loan-in-process, but servicing and selling the permanent loan will be a second income source for the lender in the transaction. Most lenders will ask for one point to finance the transaction, yet with some negotiating, three-quarters to one-half point is not uncommon.

Many bridge lenders have specific appetites for offices, industrial properties, apartments, etc. More complicated product types, such as regional malls, hotels or entertainment parks will command higher pricing and generally more equity on behalf of the developer or owner. Most bridge lenders start at $5 million and go up; however, there are a few that will accept deals down to $1 million for certain product types. Every deal is a story. Don't be afraid to ask your borrower questions. Learn as much about the deal as possible. If it sounds unreasonable, it likely is! A good starting point might be to talk to your local bank to get their spin on the market for a deal you are reviewing; they may likely have seen it and can tell you all the "hair" up-front. When talking to your client, non-recourse can be a huge selling point. It's important to know your programs; a seasoned developer can be a very unique borrower, having some skill in finance and risk. Additionally, most national bridge lenders are more comfortable providing longer amortization schedules. Amortization schedules of 20 to 25 years can have a tremendous positive impact on the cash-flow of the project. When in doubt, ask questions. Good Luck!

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