Are You a Candidate for a Wall Street Deal?

by Gregory Malanos

Have you taken your local banker to lunch lately? If you do, check the menu first. After last years' Collateralized-Mortgage-Backed Security (CMBS) market took a dive, most of your traditional lenders for commercial paper have pulled tight the purse strings for all but the most risk adverse deals. However, the Capital Markets can be a smart solution for cost-effective, long-term financing without the downside of using your personal guarantee to secure the transaction.

What are the Capital Markets?

Until recently, only a very limited class of borrower, investor or entrepreneur had the opportunity or understanding needed to retain financing outside the traditional avenues most borrowers commonly use, your local bank. Large corporations, institutions, credit unions, entities typically cash-rich, looking for longer-term yields spread over treasury rates with moderate amounts of risk, are some of the biggest holders of commercial mortgages. This market provides the most competitive rates and costs, but the loan amounts would often start at $50 million and quickly escalate. But as more and more institutions began to tap into the market for investing idle capital, breadth of product began to expand as well. Loan amounts began to fall, opening up capital market sources to more borrowers. Still though, $5 to $10 million extensions of capital seemed to be the bottom. But as the 1990's opened up and the real estate market expanded, more sources of capital expanded their criteria making a "Capital Markets Transaction" part of our market genre. Currently a savvy borrower looking in the right places can assemble a financing package that is likely to have his local banker losing sleep at nights. With a loan request as low as $500,000, all the Capital Markets bells and whistles including superior pricing and non-recourse terms can be had. More and more, small loan programs (slp's) are becoming available and competing for a greater share of the commercial properties that seek money for refinance, acquisition, expansion or rehabilitation.

Use Capital Markets for cost-effective, long-term financing without the downside.

How Did We Get Here?

With the explosion of the real-estate market at the beginning of the 1990's, a lot of small fish were swimming in the "big pond." If a local lender really wanted a deal, and after the obligatory nod from the lending committee, the deal was done. Spreads had shrunk to historically low levels (90 to 140 basis points over the 10-year treasury note for class A multi-family), and with the market in high gear, and no end in sight, commercial originators everywhere were pushing their underwriters for lower rates and more competitive terms. With a little haggling and holding out, you might even see an amortization in the 20-year range from your local lender. However, after the erosion of last year's market, many of the really huge Wall Street players (Lehman, AMMERSO, etc.) were actually paying previously committed deals a point to go away. For many back offices, the process of pooling (the process of securitizing product for delivery to investors) had become so burdened, that deliveries had logistically been pared down to a quarterly exercise at best. This left many Wall Street lenders sources with swollen portfolios of unsecuritized product, promoted by the insatiable demand of investors, and gobs of interest spread risk. Typically, the fee income from the deal was enough hedge to compensate the extended delivery window. However, even an improving bond market was not compensation enough to offset spreads as they slashed skyward. The movement was enough to drive local lenders to safer havens; suddenly 10-year amortization's became the rule, choking cash flows and approvals for all but the richest deals.

If you were considering SBA/SBIC financing, last year's debacle was equally devastating. Even though a bank will use the guarantee provided by the SBA to enhance their security position, the terms and conditions of the note will still be subject to the appetites and tolerances inherent in traditional local lending. If a bank's appetite for commercial and business financing is underwritten subject to a 10-year cash-flow/amortization schedule, the additional guarantee from the SBA won't provide the impetus to elongate term or schedule of the note.

Nearly a year later, a leaner, more aggressive Wall Street is cranking up the volume to satisfy their investors' need for Commercial Real Estate once again. Gone are the casual players. If commercial real estate is not your bread and butter, then you just can't be competitive. While the underwriting is a bit more in check, Non-Recourse Commitments still remain (no borrower personal guarantees), 25 to 30-year amortization's, 15 and 20-year self-liquidating schedules, assumability and a generally far less restrictive covenant structure than typically offered by most bank SBA providers.

What You Need to Know

In the commercial lending world cash is king, and generally the lender has it and you don't. Consequently, "He who has the gold, makes the rules." However, that axiom can work both ways. If your project is capable of generating cash flows, then no doubt, it can be valued. What then remains is the commercial loan application and which source can provide the best terms and conditions which may translate into several investors competing deals with strong cash flows.

Today's market contains a plethora of lenders who are available to commercial property owners. However, just because you are able to get a loan won't mean you've got the right loan for you. A host of concerns ranging from cost, term, rate, covenants, and the expertise of your lender or finance provider will affect your end product. Most individuals who seek financing, regardless of their use, will generally be limited to their immediate region. Your local banker will be more than happy to make you a loan to fund the expansion of a new wing for your nursing care facility, but likely has no idea about your specific business needs. The loan he made you, was the same loan he made to the last business that walked in the bank. By not matching lending sources with lending uses, how can you be sure you'll retain the lowest rate and best terms possible for your project.

How the Industry Works

While most of us have gone through applying for a mortgage for your home, commercial lending is a completely different process. While a residential underwriter evaluates the four "C's," Collateral, Credit, Character and Capacity in fairly equal amounts, a capital markets commercial underwriter will generally focus his evaluation on collateral. Certainly the credit will be looked at, as will capacity and character, however, the property, and its ability to provide cash flow is of principle concern. Cash flows are evaluated in terms of Debt-Service-Coverage-Ratio (DSCR) after appropriate adjustments in vacancy, reserves, escrows, tenant improvements and replacement costs (if applicable), etc., are made. The product is then pooled along with other similar product types and delivered to investors who desire a piece of the cash flow with the anticipated yield over a certain number of years. And with some exceptions, most capital markets deals will range in the 75 to 80 percent LTV. This insures that even in the worst situation, default, the lender has the protection of a collateral value. In some situations credit can be an underwriters focus. Certain product types that have credit enhancement are eligible for higher loan-to-values. As an example, newer retail properties with credit-rated tenants that sign long-term leases can often qualify for more loan dollars and better terms.

What is a Non-Recourse Loan?

Let's stick with our previous comparison of applying for a loan for your home. When you sign a note with the bank, you personally sign for the loan. If you should default on your loan and the sale of the home does not provide enough proceeds to satisfy your payoff, the bank has the right to continue to pursue you personally for the remaining debt. With a conforming product and a capital markets lender, many loan commitments include non-recourse terms. This means that with the exception of standard loan carve-outs, you are not personally signing for the loan. If you should not be able to satisfy your monthly debt-service, and the lender calls your note, and if the sale of the property is not sufficient to pay off the existing note on the property, you bear no additional liability. Your worst case is liquidation of the property, the lender may not pursue you individually for any shortfall. Most banks will usually insist on your personal guarantee to secure the loan. This is standard operating procedure for gaining a foothold on additional business. If a lender has the ability to "lock-up" the borrower with a personal guarantee, the bank knows the chances are good the borrower will give "first shot" at additional business to the bank. Most borrowers will avoid the frustration of moving a business if they have a history with a lending institution. However, what many borrowers miss is the long-term cost of not pursuing superior financing. The additional monies paid in higher interest rates plus the burden of loading up your personal balance sheet with large dollar guarantees can cripple and severely restrict the ability to gain monies for future projects on both a personal and corporate level.

More lenders are pushing for Single-Purpose-Entities (SPE). Many borrowers own multiple properties, yet under one company. A SPE protects the lender and the borrower. If a liability issue should occur on a property that is one of several holdings in a company a claim can be filed that may encumber all the holdings of the company. Since this could impair the lender of first position, a SPE insures that no outside claim can obstruct ownership and ultimately the cash flows of the property.

When is an SBA Guarantee Appropriate?

Many Capital Market lenders will combine SBA/SBIC assurances or guarantees along with their underwriting and subsequent funding. SBA monies can be a great financial tool. The ability to lend money for real estate, working capital and inventory in one package can be an exceptionally cost effect way to provide "cradle-to-grave" financing from businesses starting up to older ones that may need a jump start. The additional security of an SBA guarantee can provide a lender with additional security to allow "borderline" cases to be funded, or possibly improve existing terms and conditions. An SBA guarantee generally provides that the collateral is owner-operated. Investment properties are not eligible.

The SBA allows for a variety of lenders to utilize SBA guarantees. It's generally in your best interest to select an SBA preferred provider that has the ability to specialize in your project type. There are three levels of lender that may utilize SBA guarantees; 1.) General, 2.) Accredited, 3.) Preferred. A preferred provider originates, processes, underwrites, approves and closes your transaction. A preferred provider has the authority to make the final decision on the loan. Many SBA approved lenders only assemble or process the package then submit the deal to the SBA for their final approval. Many bankers are happy to accept your SBA application, yet don't fully understand the SBA product. This prevents your deal from having an advocate who understands your business and why SBA should approve your loan. Most deals end up being unique enough that the originator is an essential partner to pilot your deal along successfully. Generally, SBA Preferred Providers are the most experienced providers and have the discretion to make the tough deals work. Additionally, an SBA preferred provider has the ability to offer extended terms and conditions that are

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Export *(continued from page 5)*

If you think you are all knowing about the world of exports, please answer the following: *Do You Think Exports Are ...*

A) Only for large multinational companies with international operations;
B) Only for large, big-ticket items or large quantities of small items;
C) Shipments to Wyoming;
D) For anyone who has a marketable product that a
foreign company wants to purchase.

Answers to the above questions:

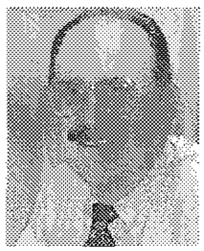
A) Wrong.
B) Wrong - again.
C) Forget about exporting - get a geography lesson.
D) Move to the head of the line - you are now class Valedictorian.

There is a considerable misconception regarding exports. To borrow a phrase from a popular national radio announcer... "And now the rest of the story"...

SMC Business Councils (SMC), wants to be a progressive force in advancing the exports of small businesses. To this end, I was asked to attend the Export-Import Bank of the United States (Ex-Im Bank) Annual Conference in Washington D.C. SMC's goal is to establish a leadership position in another area of interest for its membership.

I have to admit my initial skepticism. What would a trade association like SMC, that represents the interests of small businesses, want with exporting? Then again, I never saw the gasoline shortage, sport utility vehicle or cabbage patc doll craze coming! I was very wrong then and I was wrong now.

The Ex-Im Bank really does want YOU — the small businessperson — to become an active participant in their programs. As the primary U.S. government agency responsible for assisting in export financing, Ex-Im Bank has a variety of loan and/or insurance guarantee programs and some direct loan programs to help companies sell to foreign buyers and to protect U.S. exporters against foreign credit risks.



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consistent with capital markets financing. That means longer terms to help cash flow and a less restrictive commitment.

If You Think You Need help, Consider an Expert

With the proliferation of lenders and the emergence of a more diverse capital market, the marketplace can provide an infinite source of rate and terms to the seasoned borrower. Since the capital markets are heavily driven by supply and demand pressures, each lender develops its own appetite for product that is often a moving target. Navigating these new waters can be a task not for the faint-hearted. Today, firms exist that specialize in delivering financing for commercial properties. Sources may include, life insurance companies, REITS, pension funds, conduits, private investors, credit unions, investment banks, bridge lenders, international funds, finance companies, SBA/SBIC and government subsidized funds to name only a few. Many of these sources retain relationships with companies for a steady stream of product. The full service commercial property specialist can help prepare financials, business plans, package your deal and provide options for financing your property with a wide variety of lenders. These commercial specialists keep abreast of market changes to best direct your project to the most cost-effective source of funds. This minimizes time searching for funds and gains your widest exposure.

Remember, always do your homework, firms may often specialize in certain financing types. Expertise will range from a variety of areas; real estate, venture capital, bond issues, REITS, factoring, lines of credit and leasing are just some of the areas available.

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