Is Alternative Financing the Preferred Option?

In today's financial landscape, non-traditional private lenders are stepping up to fill a void.

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The 2008 crisis was a game-changer for everyone interested in commercial real estate lending. At the time, there was a much smaller pool of private lenders operating in the industry, but when the recession hit, it meant being welcomed at the game unlike ever before.

Banks were forced to retrench their operations and focus on their larger, blue-chip clients, while more nimble, private lenders saw an opportunity to step in and capitalize on the lack of liquidity in the marketplace. Today, both institutional and non-institutional investors are off the sidelines and actively competing to fill the capital needs of borrowers in the market. All this capital, however, can be distracting.

When looking for the right lender in today's environment, four critical factors are worthy of close consideration: ***pricing***, ***speed***, ***leverage*** and ***structure***. While these may seem obvious, it's essential to cut through the noise and look beyond face value to ensure securing the best option.

How low will pricing go?

With so much capital flowing through the system and competing for business, private lenders have become highly aggressive in their pricing. This is particularly true with debt funds that need to deploy idle capital that is depressing investor yields. Whereas between 2008 and 2013, a private lender could charge 10-15% on a variable, interest-only loan without the borrower blinking, private lenders today are lucky to win deals if they are in the 8% range.

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Assuming the loan does not include construction, raw land, or specialty properties, such as resorts, gas stations, or golf courses, today's prices are more in the 7% range. Premium real estate markets like California are offering fixed rates within that range, which is a coup for borrowers whose mortgage advisors secure a lower cost of debt for their investments.

The downside is that with all the new capital saturating the market, mortgage brokers and real estate investment bankers are having a harder time distinguishing between loan programs. This has prompted many to use price as the deciding factor. While price is always important, it is only part of the equation. As most mortgage advisors know, the real question is, what is the ***total cost*** of the loan? And more importantly, not only at closing, but what can it cost in the future? A trusted private lender will openly discuss this question. This kind of transparency can go a long way in building trust.

The need for speed

One of the differentiators between private lending and traditional bank lending is the speed of execution from inception to closing. Privately-funded loans close much more quickly than traditional ones because of five fundamental factors:

1) A more direct decision-making process that eliminates layers of bureaucracy;
2) Reliance on internal valuations that combine in-house market knowledge with market research from established, local commercial real estate brokers, rather than third party appraisals that take two to four weeks to complete;
3) A focus on asset-based lending that only requires underwriting the creditworthiness of the property and not the borrower, as is typically the case with bank lending;
4) The rapid evolution of the FinTech industry and generally quicker adoption by private lenders, which has automated and hastened the origination process; and
5) Local credit approval authority that is closer to the market and able to respond quickly to requests.

How high will leverage go?

Another trend in the market today is the ever-increasing leverage game that private lenders are playing to secure loan opportunities. We see the prevalence of this in the residential fix-and-flip and triple-net retail construction markets where leverage goes as high as 90 to 100% of cost. The multi-family bridge space isn't far behind, with LTVs pushing the 80-85% ceiling.

Although sponsors reap the benefits of highly leveraging their investments to juice returns by substituting cheaper debt for more expensive equity in a real estate investment, the lurking shadow of an economic shift in the market will always portend the risk that another house of cards will fall. And highly leveraged properties will be hit hardest in a falling market, as rents decline and cause cash flow to drop, while debt payments remain constant. In this situation, real estate lenders may have to lean on other sources of cashflow to service the debt, or risk losing the property. An important consideration for advisors in the capital market space is understanding the motivation of these lenders in going so high on leverage, as well as the alignment of interests between the capital source and sponsor. It's essential to look at a lender's history, know the players, and rule out potential loan-to-own scenarios, regardless of how attractive an LTV on an offer may seem.

Structure, structure and more structure

The last bastion for the private lending market to differentiate itself from the widespread availability of other capital blurring the "who offers the best debt" scoreboard is structure. To date, the most entrepreneurial lenders who have secured a place near the top are those who finance ground-up construction projects. With interest rate increases, higher construction costs, and federal regulations placing limits on banks providing HVCRE loans and requiring higher equity requirements for sponsors, private money has taken a leap of faith in filling the capital gap, structuring loans for projects that don't have many options. This is serving developers well in an environment where value-creation in the real estate market exists in the entitlement process and building a property that is at its highest and best use, and not on a purchase where the yield return is less than the cost of debt in today's overvalued environment. On the other hand, many such lenders may not have the background or the back-office resources to work out these loans in the event of major economic shifts in the market, when finding creative ways to partner with their borrowers to complete projects may be required.

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Financing of commercial properties continues to remain strong, with lenders loosening the structure of the loan in order to win the deal. Besides being apparent in the higher LTV's now being offered, loosening of structure also occurs in guarantees with many private lenders offering non-recourse loans as a standard product, whereas the bank lenders more often require a full or limited guaranty. Bank lenders may also have financial and reporting covenants that are omitted or much lighter than the loans offered by private lenders. Lastly, bank lenders often underwrite the financial wherewithal of the borrower, while the private lender will underwrite just the property. All of these allow the private lender to be more competitive in the commercial real estate financing market.

What's on the horizon?

Private money has transcended all expectations in the market as a flexible and expedient source of funding for real estate investors and developers. Pricing, leverage, speed and structure have all played into the private money equation to provide mortgage professionals with unique financing solutions to very complex property and borrower requirements and circumstances.

The question remains as to how much more creative and flexible private lenders can be to get the job done. While that remains to be seen, mortgage advisors who are thorough will consider not only the price, speed, leverage and structure, but also how the ***whole*** package, and the lender behind it, can affect the client in the future.

By taking that extra step, astute advisors not only are doing all they can to help their clients, but are doing all they can to assure and preserve integrity and reputation, which is all we have at the end of the business day.