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Alternative Lenders Differentiate for Success

Non-traditional lenders might not historically be known for innovation, but there are still some who are finding ways to succeed by stepping out of the box.

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The real estate banking, lending and opportunity landscapes are changing rapidly, as new alternatives for investment success become available.

Once the dominant providers of property loans, traditional banks have lost market share as a result of tightened federal regulations, stricter internal criteria and the emergence of alternative lenders. As well, tighter qualifications have eliminated opportunities for some and have stalled others in a world of bureaucracy and red tape.

Enter the non-bank lender...today providing commercial property investors with conservative alternatives, along with faster approval processes, limited bureaucracy, fewer restrictions and more options when it comes to structure.

Proof of the appeal of these lenders is in the numbers. While total private non-residential construction spending has reached historic highs—approximately $714.3 billion in 2017, according to the U.S. Census Bureau and Associated Builders and Contractors—the percent of total loans being offered by traditional banks has decreased.

Traditional loans have fairly straightforward structures. They are typically either variable or fixed rate, with regular payments required until the loan is paid off. In a stable economic environment, traditional banks offer relatively low rates because they have access to large pools of low cost capital, as well as extensive regulations and criteria in place to reduce their risk and exposure.

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As a result of the Great Recession, both the federal government and the banking industry implemented even stricter lending guidelines, including in 2015, the High-Volatility Commercial Real Estate proposal from the Basel Committee on Banking Supervision that was approved in the U.S. by the bank regulatory agencies. The regulation made qualifying for a commercial real estate loan more challenging for commercial property investors, prompting banks to further tighten their lending criteria and portfolios. While the extensive measures taken by banks to mitigate risk provide benefits to banks in the form of reduced exposure—and to the investor through lower rates—it can also manifest as an opportunity cost for the investor.

Alternative lenders have evolved to fill the gap and return broader financing opportunities to the market.

Since non-traditional lenders are not subject to the same regulatory constraints as banks, they are able to provide greater flexibility in their structure choices, while qualifying borrowers and closing loans more efficiently. Borrowers turning to non-traditional loans, however, will find that many private lenders compete with similar offerings, making it a challenge to distinguish between loan programs or see a clear benefit from one loan product to the next.

To stand out, some alternative lenders are finding new ways to market and structure specific products, often adopting technology and operational efficiencies that dramatically decrease the time needed to close a loan. It is important for mortgage brokers to compare the terms and benefits of the loan, pay attention to fees and select the lender that brings the best combination of value-add innovation, certainty of execution and trusted experience.

A pay rate structured bridge loan, or “Pay Rate Protection” loan, is just that kind of innovative approach to private lending, providing a differentiating opportunity to the experienced and sophisticated sponsor who prefers to optimize cash flow.

What is a pay rate structured bridge loan and how is it unique to the real estate industry?

The pay rate structured bridge loan defers a portion of the interest until loan maturity or payoff—whichever occurs first. The structure is advantageous to borrowers in that it allows for a lower payment during the term of the loan. In addition, at loan pay-off or maturity, the borrower pays deferred and accrued interest that has not been compounded. The interest rate is uniquely priced similarly to a bank loan during the loan term, but borrowers can close more quickly and easily given the execution capabilities of a private lender.

The structure of this loan is optimal for borrowers with an eye toward preserving liquidity, as well as spreading capital over multiple, attractive investment opportunities. For a borrower in a pay rate structure, the monthly debt service obligations are lower. Given the lower mortgage payments, the structure provides greater cash flow for other investment purposes, reinvestment in the underlying collateral, and/or increased liquidity to improve financial condition for future bank refinancing. The pay rate structure also helps borrowers avoid additional loan costs by not compounding interest on the deferred interest of a pay rate protected loan. This type of loan further reduces or eliminates the need for an interest reserve should there ever be a shortfall in property income.

While traditional loans haven't changed much, the lending and opportunity landscape has. Waiting for bank approvals can be costly in terms of opportunities and potential profits. When time is of the essence and when other factors may affect a borrower's eligibility to secure a compelling financing solution through traditional means, a pay rate structured bridge loan is worth considering. It will embolden borrowers to move quickly when presented with an attractive opportunity, as well as optimize cash flow during the loan term—a valuable combination for differentiating success.