JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

6. Real Estate Finance/Mortgage Banking/Mortgage Guaranty Insurance

aa. "Income Property Mortgage Lending", August 21 - 22, 1985

Index

Outline of Lecture

INCOME PROPERTY MORTGAGE LENDING

By

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on

August 21 & 22, 1985

Principles of Income Property Mortgage Lending

I. Organization of an Analytical Viewpoint

A. Basic strategy - pleasure, pain, and bailout

1. Continuous monetary profit for the borrower
2. Contingent opportunities to apply pain in the form of money and pride
3. Consider the loan the sale of the put and price for the bailout

B. The Harvard view

1. The property
2. The people
3. The package

C. The Wisconsin view of income property analysis

1. Political exposure
2. Market control
3. Management intensiveness
4. Sensitivity of financial plan
5. Sensitivity of tax plan
6. Thoroughness of risk management plan
7. Realism of estate plan of principal borrower

D. Major misconceptions of bankers in real estate lending

1. Mortgage loans are a two party contract

a. See Exhibit 1 for party clusters
b. See Exhibit 2 for minimum list of documents

2. A real estate loan is a credit loan

a. It's a small business loan
b. It's a commodity straddle

3. Capitalization rates indicate value, and loan to value ratios indicate security of principal

4. Real estate marketing is shot gun rather than rifle

a. High degree of segmentation
b. High sensitivity to price, product, pace, and promotion

5. Foreclosure losses are minimal relative to income

a. Mismatching of losses to income
b. Opportunity costs of concealing mistakes of auditors in terms of management time
c. Opportunity costs of money tied down in non-earning assets
d. Opportunity costs of loss reserves which diminish loanable funds, reported income per share and increased cost of new capital

6. Appraisals and market studies are worthless

    a. Regulatory CYA documents
    b. No input to basic lending decision
    c. No letter of engagement to specify product

7. Real estate is generic so that site planning, architecture and engineering professionals make little difference

II. A Risk Management Approach to Underwriting

A. Risk is variance between budget and realization

B. Risk management is control of variance by means of:

1. Information (to reduce frequency and severity of loss
2. Incentive (positive and negative) to reduce frequency and severity of loss
3. Insurance to share loss
4. Guarantees to shift loss
5. Shift of reliance by contract
6. Limit of liability for losses
7. Limit losses by hedging

C. Mortgage closing as risk management

1. Title insurance as guarantee
2. Bonded surveyor to shift by contract
3. Property and casualty insurance
4. Default guaranty (FHA, PMI, SBA)
5. Letters of credit or escrows

D. Mortgage underwriting

1. Control of capital cost
2. Capacity to absorb excess capital cost variance
3. Limit of liability on total capital cost
4. Quality and duration of income
5. Control and limit on operating expenses
6. Capacity to cover negative cash flows
7. Capacity to cover variable interest rate charges

III. Basic Cash Flow Formats

A. Front door approach, Exhibit 3

B. Back door - debt cover approach, Exhibit 4

C. Back door - breakeven approach, Exhibit 5

D. Timing and amount of operating receipts

1. Base rents
2. Index adjustment to base
3. Collection of escalators and passthroughs

4. Collection of special assessments for common areas or refurbishing
5. Collection of tenant improvement amortization
6. Collection of percentage clause rents
7. Collection of parking revenues
8. Collection of service charges

E. Timing and amount of operating outlays

1. Operating expenses
2. Real estate taxes and insurance
3. Utilities
4. Energy costs
5. Management fees
6. Leasing fees
7. Replacement and refurbishing
8. Sinking fund disbursements

F. Timing and amount of interest and principal payments

1. Fixed rate loans, Exhibit 6
2. Variable rate loans, Exhibit 7
3. Standby loans, Exhibit 8
4. Accrual loans, Exhibit 9

IV. Critiquing a Leasing Program

A. Computer spread sheet powers

B. Leasing abstracts and rollover assumptions

C. Key questions for the analyst, Exhibit 10

1. Definition of space
2. Definition of finish
3. Definition of services
4. Definition of parties
5. Conditions of commencement
6. Conditions of termination
7. Recognition of changing conditions
8. Formula for rental adjustments

V. Adequacy of Expense Budget Planning

A. Always regard large loans as sale of a put

B. Evaluate operating efficiency and material quality as though the lender would own the building

C. Use the banks own mechanical engineer for structural and energy analysis

D. Anticipate where trends are leading in ten years to protect collateral value

1. Office trends toward smaller tenants spaces, less partitioning, more window wall
2. Retail trends toward smaller stores, domestic materials, low cost store cabinetry and display
3. Less finish by landlord

VI. Adequacy of Investment Capital

A. Strength of contract detail and bidding winners

B. Payment and performance bonds

C. Letters of credit for specific variables such as contingencies, latent defects, operating losses, rental abatement

D. Gap financing

E. Assessment of partners

F. Standby credit from general partner or parent corporation

G. Inadvertent credit from building subcontractors

VII. Traditional Appraisal Process--Normalized Assumptions

A. Date of appraisal--hold harmless clause

B. Definition of value--hold harmless clause

1. Five basic conditions--cash equivalency
2. "Financing typical of the market"
3. "As financed"
4. Limiting conditions

C. Highest and best use (most probable use)

1. Technically feasible
2. Legal and political feasibility
3. Effective demand
4. Financing viable

D. Legal property description

1. Land
2. Building and improvement
3. Tangible personal property
4. Intangible personal property
5. Public entitlement and their transferability

E. Essence of collateral

1. Salvage value (exit value vs. finished value)
2. Going concern value
3. Profit centers for services
4. Commodity value
5. Franchise value
6. A set of assumptions about the future
7. Credibility of expertise

F. Three approaches to value

1. Market comparison (suspect due to engineered prices)
2. Cost approach (invalid since collateral is a customer which determines liquidity price of space-time inventory--just like self-liquidating retail loans)
3. Income approach (NOI/OAR is infantile for commercial loans)

G. Appraisal reconciliation

1. Three approaches should not produce same number
2. Go with method with best data

H. Problems with traditional appraisal for commercial properties

1. Methods have no predictive power
2. Fair market value is normalized economies rather than behavioral
3. Lenders have corrupted process by using appraisal to vindicate a decision rather than make a decision
4. Lenders have corrupted process by requiring borrower to pay appraiser directly
5. Lawyers have corrupted process by confusing their advocacy with appraisal objectivity
6. Appraisal organizations have been unable to improve process because of laws of defammation, American tradition of reciprocity, economic weakness, inertia of courtroom precedence

VIII. Contemporary Process of Appraisal

A. What is the issue for which the appraisal is required?

B. What is the definition of property to be appraised?

C. What is the definition of value?

1. Fair market value
2. Most probable price
3. Liquidation value
4. Insurable value

D. What is most probable use?

1. Physical attributes
2. Legal/political attributes
3. Linkage attributes
4. Dynamic attributes
5. Environmental attributes
6. Matrix of alternatives

Exhibit 1

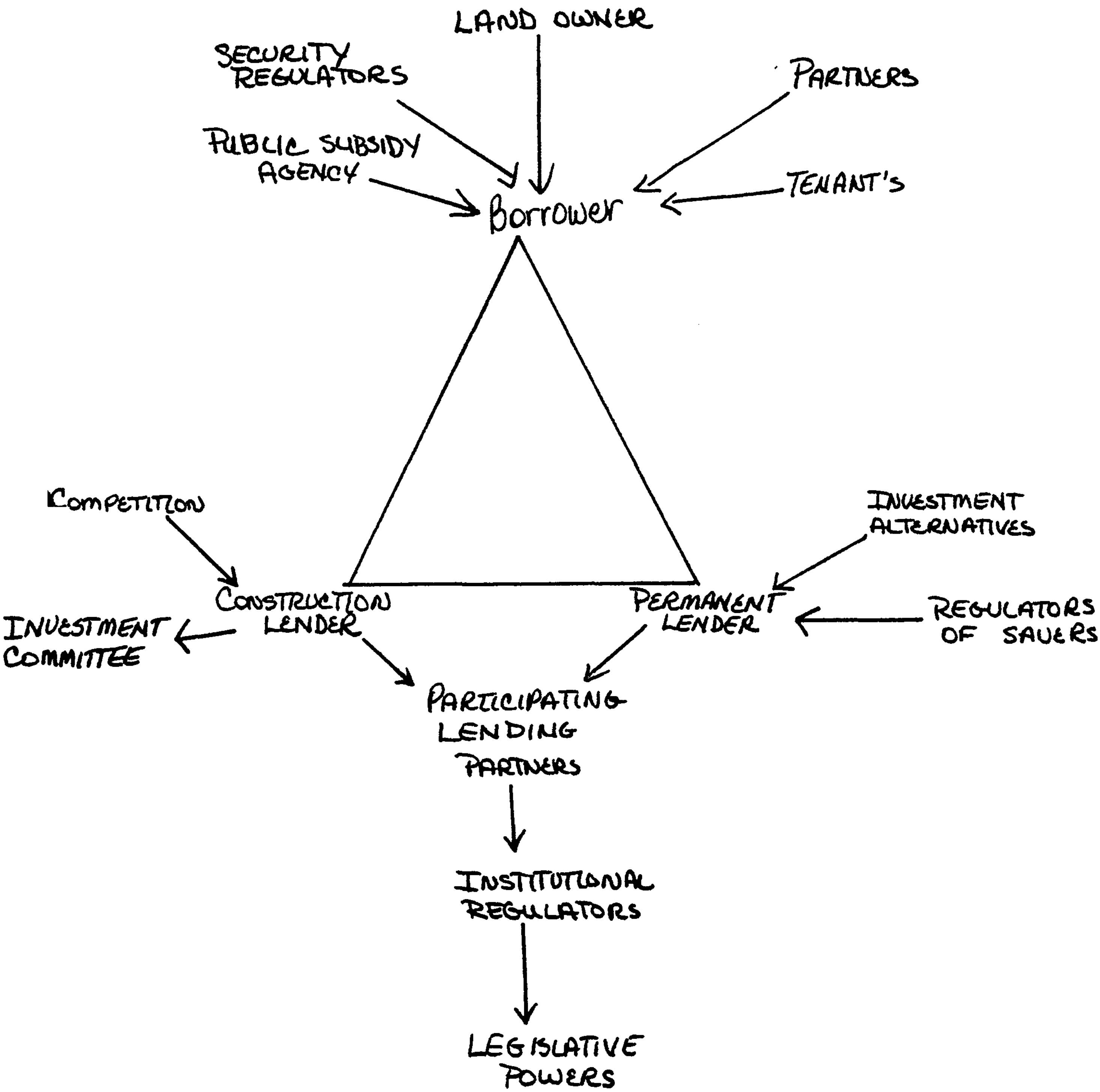

LAND OWNER
SECURITY REGULATORS
PARTNERS
PUBLIC SUBSIDY AGENCY
TENANT'S
Borrower
COMPETITION
INVESTMENT ALTERNATIVES
CONSTRUCTION LENDER
PERMANENT LENDER
INVESTMENT COMMITTEE
REGULATORS OF SAVERS
PARTICIPATING LENDING PARTNERS
INSTITUTIONAL REGULATORS
LEGISLATIVE POWERS

Exhibit 2

APPLICATION AND CLOSING CHECKLISTS

CONSTRUCTION LOAN

FROM BORROWER FOR APPLICATION

1. Permanent or standby commitment.
2. Financial statement of principal (balance sheet and cash flow).
3. Background, experience and current projects of principal.
4. Bank references of principal.
5. Income-expense pro forma or sales schedule (include outline of all leases indicating name of tenant, area, initial term of lease, renewal options, base rent, rent escalation during initial term, rent during renewals, tenant contributions for common area, parking lot or mall, details of tax stop, percentage rent, status of signing of lease, etc.).
6. Plans and specifications.
7. Detailed projected cost breakdown (include direct building costs by trade, land, site preparation, paving, interest, taxes, architect, engineer, legal, closing, promotion, leasing, operating deficit, brokerage, loan fees, tenant improvements, contingency, overhead, etc.).
8. *Survey and legal description.*
9. Appraisal and/or feasibility study.
10. Name of architect and general contractor.

FROM BORROWER FOR CLOSING

11. Principal's statement as to no adverse change of financial condition since application.
12. Permanent lender approval of site, leases, lease amendments, plans, specifications, appraisal, survey, title, etc.
13. List of general contractor and major subcontractors over $10,000.
14. Copies of general contract and major subcontracts.
15. Contractor's performance and/or payment bond.
16. General contractor's letter agreeing to perform for construction lender.
17. Architect's contract.
18. Architect's letter agreeing to perform for construction lender.
19. Builder's risk insurance policies and other casualty policies with endorsement naming lender as loss payee.
20. Public liability and workmen's compensation policies.
21. Title insurance binder or commitment with copies of all easements, *restrictions, covenants, etc.*
22. Inventory of personal property.
23. Executed leases.
24. Required executed lease amendments.
25. Executed ground lease.
26. Ground owner's estoppel certificate.
27. Evidence that real estate taxes and assessments are current.
28. Required legal opinions (borrower's counsel and outside counsel).
29. Cross easement, common wall, ingress and egress, and other similar agreements.
30. Subordination of existing mortgage or letter from existing mortgagee indicating amount required for satisfaction.
31. Corporate, partnership or beneficiary documents and consents.
32. Copy of building permit and other permits or variances.
33. Required governmental consents (including health, water, sewer, air, ecology, etc.).
34. Utility availability letters (including electric, gas, water, sewer, storm drainage, etc.).
35. Compute closing costs and legal fees (loan settlement statement).
36. *Set closing date, time and location.*

FROM LENDER FOR CLOSING

37. Construction loan commitment.
38. Buy/sell agreement.
39. Promissory note.
40. Mortgage or deed of trust.
41. Construction loan agreement.
42. Collateral assignment of tenant leases, rents and profits.
43. U.C.C. security agreement and financing statement.
44. Principal's guaranty of payment and/or completion.
45. Conditional assignment of construction contract.
46. Loan requisition form.
47. Procedure for loan advances and billing of interest.

PERMANENT LOAN

FROM BORROWER FOR APPLICATION

1. See "Permanent Loan Submission Checklist" on reverse side.

FROM BORROWER FOR CLOSING

2. Principal's statement as to no adverse change in financial condition since application.
3. Final rental schedule (certified by principal).
4. Final as built survey.
5. Appraisal.
6. Architect's certificate of completion.
7. *Final site inspection and approval from lender.*
8. Required insurance policies with endorsement naming lender as loss payee.
9. Up-dated title insurance binder or commitment with copies of all easements, restrictions, covenants, etc.
10. Inventory of personal property.
11. Mortgage insurance policy issued to lender.
12. Executed leases.
13. Required executed lease amendments.
14. Executed ground lease.
15. Ground owner's estoppel letter.
16. Subordination and non-disturbance agreements.
17. Tenant estoppel letters.
18. Evidence that real estate taxes and assessments are current.
19. Required legal opinions (borrower's counsel and outside counsel).
20. Cross easement, common wall, ingress and egress, and other similar agreements.
21. Letter of construction lender and other mortgagees indicating amount required for satisfaction (or subordination agreements).
22. Corporate, partnership or beneficiary documents and consents.
23. Certificate of occupancy (original) and other permits or variances.
24. Required governmental consents (including health, water, sewer, air, ecology, etc.).
25. Compute closing costs and legal fees (loan settlement statement).
26. Set closing date, time and location.

FROM LENDER FOR CLOSING

27. *Buy/sell agreement.*
28. Mortgage note (or endorsement from construction lender without recourse).
29. Mortgage or deed of trust.
30. Loan agreement for continued disbursements.
31. Collateral assignment of tenant leases, rents and profits.
32. U.C.C. security agreement and financing statement.
33. Agreement relieving principal from personal liability.
34. Interest and amortization schedule.
35. Date first payment is due.

NOTE: These checklists are representative of the general application and closing requirements of many lenders. In dealing with a lending institution or broker it is suggested that these lists be used as guides and that the borrower contact the lender or the lender's attorney for a list of those specific items required by the lender for a commitment or for closing.

(over)

PERMANENT LOAN SUBMISSION CHECKLIST

FUTURE CONSTRUCTION

1. Description of specific project and overall development plans.
2. Loan requested (amount, interest rate and payout).
3. Name of interim lender and availability of participation by permanent lender in construction loan.
4. Financial statement of principal (balance sheet and cash flow).
5. Background, experience and current projects of principal.
6. Bank references of principal.
7. Name of architect and general contractor.
8. Income-expense pro forma or sales schedule (include outline of all leases indicating name of tenant, area, initial term of lease, renewal options, base rent, rent escalation during initial term, rent during renewals, tenant contributions for common area, parking lot or mall, details of tax stop, percentage rent, status of signing of lease, etc.).
9. Copies of major tenant leases and/or letters of intent.
10. Appraisal and/or feasibility study.
11. Rental and operating comparables (market survey).
12. Plot plan outlining site in red (indicating area in square feet).
13. Street map outlining site and competing projects.
14. Survey and legal description.
15. Aerial photograph of site.
16. Rendering.
17. Present use of site or status of construction.
18. Cost of land and date of acquisition.
19. Present value of land.
20. Present zoning of land.
21. Preliminary building plans and construction specifications.
22. Typical floor plans, layouts and elevations.
23. Projected cost breakdown (include direct building costs, land, site preparation, paving, interest, taxes, architect, engineer, legal, closing, promotion, leasing, operating deficit, brokerage, loan fees, tenant improvements, contingencies, overhead, profit, etc.).
24. Economic and general information on the area.
25. Leasing brochure.
26. List of project features (parking, type of fuel, heating, air conditioning, elevators, guards, pool, laundry facilities, basements, storage, club house and recreational facilities, appliances, patios, etc.).
27. Method of real estate tax computation (basis of valuation, equalization rate and millage rate).
28. Month of construction start and projected completion.
29. Projected month of loan closing.
30. Unusual development obstacles or problems.

EXISTING BUILDINGS

31. Year project was completed.
32. Copy of certificate of occupancy.
33. Operating statements for prior three years.
34. Detailed rent roll (include items from number (8) above).
35. Copy of real estate tax bills for prior three years.
36. Photographs of property.
37. Name and address of managing agent.
38. Renovation or remodeling plans and specifications.
39. New income-expense pro forma if income is expected to change.
40. Cost and terms of purchase (if property is to be acquired).
41. Name of existing lender, original loan amount, interest rate, term, annual payment, present loan balance, earliest prepayment date, prepayment penalty, and maturity date.

Exhibit 3

LOAN TO COST RATIO APPROACH

SITE ACQUISITION COST $60,000 (30,000' @ $2.00)

\+

CONSTRUCTION BUDGET $450,000 (7,500 x 2 x 30)

\+

INDIRECT COST AND DEVELOPMENT FEES $50,000 / $40,000

=

TOTAL CAPITAL BUDGET $600,000

x	
1- LOAN TO COST RATIO .25	LOAN TO COST RATIO .75
=	=
CASH EQUITY REQUIRED 150,000	* MORTGAGE LOAN 450,000
x	x
REQUIRED PRE-TAX CASH DISTRIBUTION RATE .05%	DEBT SERVICE CONSTANT .1154
=	=
CASH THROW OFF REQUIRED FOR EQUITY $7,500	CASH REQUIRED FOR MORTGAGE LENDER $51,930

$59,430

NET OPERATING INCOME

\+

OPERATING EXPENSES $15,000

\+

REAL ESTATE TAXES $10,000

\+

CASH REPLACEMENTS $ 1,000

=

EFFECTIVE GROSS REVENUE REQUIRED $85,430 → $85,430

\+

VACANCY LOSS .05% = ÷ .95

=

GROSS POTENTIAL REVENUE = $89,926

\+

NET LEASABLE UNITS = 13,500 sq. ft.

=

RENT REQUIRED PER UNIT = $6.66/sq. ft.

Default ratio:

$$\frac{51{,}930 + 15{,}000 + 10{,}000 \pm 1000}{\$89.926} = .87$$

Debt cover ratio:

$$\frac{59{,}430}{51{,}930} = 1.14$$

Conclusion:

Smaller mortgage required
loan-to-value is misleading

* 10 3/4 25 yr mo pay is .009621 x 12 = .1154

Exhibit 4

DEBT COVER RATIO APPROACH

GROSS RENT POTENTIAL $10,000

\-

VACANCY LOSS ___% $,500

=

EFFECTIVE GROSS REVENUE $9,500

\-

OPERATING EXPENSES $2,500

\-

REAL ESTATE TAXES $1,500

\-

CASH REPLACEMENTS $ 500

=

NET OPERATING INCOME AVAILABLE $5,000 FOR DEBT PAYMENT, INCOME TAX, CASH DIVIDENDS

\-	÷
$4,000 DEBT SERVICE CASH	DEBT COVER RATIO REQUIRED BY LENDERS 1.25
=	=
* CASH AVAILABLE FOR INCOME TAX AND INVESTORS $1,000	CASH AVAILABLE FOR DEBT SERVICE $4,000
÷	÷
REQUIRED PRE-TAX CASH .04 % DISTRIBUTION RATE	DEBT SERVICE CONSTANT .1154
=	=
$25,000 JUSTIFIED CASH EQUITY INVESTMENT	JUSTIFIED MORTGAGE LOAN $34,662

$59,662

TOTAL JUSTIFIED INVESTMENT

\-

EXISTING CLAIMS OR PLANNED ________ IMPROVEMENT BUDGET

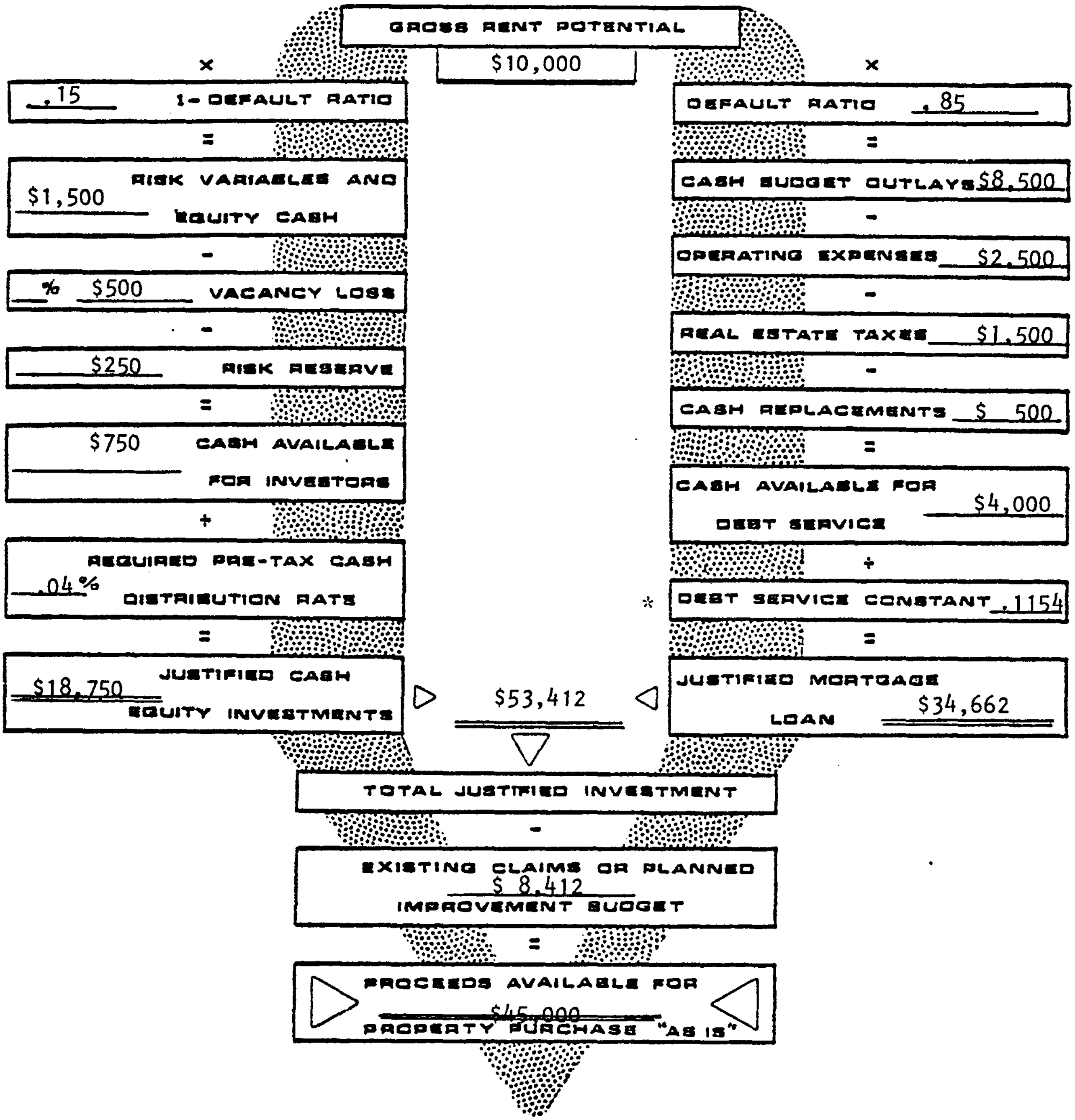
=

PROCEEDS AVAILABLE FOR ________ PROPERTY PURCHASE AS IS

* Note that a full $1,000 is distributed to investors rather than the $750 in Case 1.

Exhibit 5

DEFAULT RATIO APPROACH



* 10 3/4% 25 yr. monthly pay is .009620 x 12 = .1154
9% 25 yr. mo. pay is .008391 x 12 = .1006
or a $40,000 justified loan

Exhibit 6

FIXED-RATE MORTGAGES

Parameters

Rate/Yield

. Coupon rates of 100 to 250 basis points above prime or other similar index.
. Approximately comparable to similar-term corporate bonds of BAA rating.
. Long-term rates of 175 to 250 basis points above prime.
. Medium-term rates of 150 to 225 basis points above prime.
. Short-term rates of 100 to 200 basis points above prime.
. Forward commitment coupon rates of 100 to 200 basis points above regular rates.

Term

. Flexible: two to fifteen years.
. Most popular demand for five years or more.

Payment Format

. Flexible: fifteen- to thirty-five-year amortization for longer terms. Older properties use lower amortization.
. Typically interest-only for shorter terms (five years or less).
. Interest-only converted to amortization. Available for medium- and long-term loans.

Debt Coverage Ratio

. Higher coverages with longer terms (e.g., 120 percent, ten-year term).
. Flexible: 105 to 130 percent of annual debt service payments.
. 120 to 130 percent for multitenant and/or management-intensive projects.
. 105 to 120 percent for limited-tenant and/or credit-backed projects.

Loan-to-Value

. Lower ratios with longer terms (e.g., 65 percent, ten-year term).
. Flexible: 60 to 80 percent or less of appraised value.
. 65 to 75 percent most common range.

Dollar Size

. Various sizes.
. $350,000 or more as practical minimum.
. $2 million or more as a competitive and preferable range.

Prepayment Penalties

. Frequently negotiable for longer-term loans.
. Shorter-term loans typically locked in.
. Declining penalties available (e.g., 6 percent in year 5, reduced one percent annually).
. Yield recapture formula based on the spread between the current rate (or index) and the stated rate along with the remaining term of the loan.

Exhibit 6 (Continued)

Funding Period

- Immediate funding preferred, usually thirty to 120 days.
- Forward funding available, extremely limited supply; six to twenty-four months.

Financing Fees

- Flexible: lower fees for larger projects.
- 2 to 5 percent for smaller and unique deals (approximately $2 million or less).
- Zero to 2 percent for larger deals.
- Partially or fully refundable standby deposit fees of 5 percent or more for forward commitments.

Property Types

- Traditional: commercial, industrial, office, and residential.
- New and existing property preferred.
- To-be-built projects: scarce lending demand.

Special Features

- Personal guarantees required for smaller loans.
- Fully amortized term available with call options or rate review.
- Significant preleasing required for forward commitments, typically 30 to 50 percent minimum. Upon physical completion and minimum leasing achievements, floor funding of 65 to 80 percent of loan amount. Ceiling funding offered if approximately full debt coverage payments are achieved within six months or more. Extensions available at lender's option.

Exhibit 7

VARIABLE-RATE MORTGAGES

Benefits and Risks

Borrower - Benefits

- Lower initial coupon (interest) rate results in larger loan amount.
- Longer loan term available than other floating-rate debt vehicles such as accrual, construction, and standby loans.
- Lower initial coupon rates often fixed in earlier years.
- Attractively low payments during favorable interest rate cycles.
- Prepayment penalties often waived.
- Interest rate fluctuation protection. Upper and lower interest rate payment limits are frequently included.

Borrower - Risks

- Index formulas may not reflect mortgage market conditions.
- Increased default probabilities. Cash flows must be responsive enough to absorb increased rates paid to lenders.
- Increased payments and negative amortization reduce yields and equity.
- Higher financing fees than most other forms of permanent mortgages. As a result, early prepayment is discouraged.
- Difficult to refinance or encumber with secondary financing. Rate payment uncertainty and negative amortization are major obstacles.

Lender - Benefits

- Inflation and yield protection. Yields are indexed to cost of funds or other similar index.
- Attractive income generated from financing fees.
- During rapidly increasing interest rate cycles, borrowers are encouraged to prepay loan as soon as possible. Should unfavorable market conditions continue, lender's risk exposure is eliminated during the early part of the cycle.

Lender - Risks

- Index formula may not correspond to actual cost of funds.
- Negative amortization increases risk exposure.
- Interest rate adjustment ceilings effectively eliminate maximum yields during tight credit market conditions.
- Maturities could be extended beyond statutory and regulatory limits if payments were to remain the same and maturities were extended to accommodate increased interest rates.

Parameters

Rate/Yield

- Up to 100 basis points below comparable fixed-rate mortgages.
- 300-500 basis points above 180-day Treasury bills.
- 100-400 basis points above bank prime rates.

Exhibit 7 (Continued)

Rate Adjustment Periods

- Flexible: monthly, quarterly, semiannual, annual, or more rate adjustments.
- One- to three-year fixed rates available during early years. Subsequent years convert to more frequent adjustment periods.

Rate Adjustment Limits

- Flexible: 0-15 percent maximum fluctuation over previous period payment.
- Overall cap on rate of 0-5 percent.
- Deferred interest payments similar to accrual loans (negative amortization).
- Floor is set typically 100 basis points below initially funded interest rates.
- Floor and ceiling limits may be equidistant (e.g., ± 4 percent).
- Ceiling is set as high as 600 basis points or more above initially funded interest rates.

Term

- Flexible: one to fifteen years.

Amortization

- Flexible; interest-only for shorter-term loans.
- Amortized and/or interest-only combinations for longer-term loans.

Debt Coverage Ratio

- Lower than comparable fixed-rate mortgages.
- 100 to 120 percent of debt service.
- Lower coverage traded for higher rates and/or less restrictive adjustment limitations.

Loan-to-Value

- Higher than comparable fixed-rate mortgages.
- 65 to 90 percent of appraised value.
- Higher ratios traded for higher rates and/or less restrictive adjustment limitations.

Dollar Size

- Various sizes; $1 million or more preferable.

Prepayment Penalties

- Flexible; typically prepayable without charge.
- Early years may have smaller penalties of one to 3 percent.

Funding Period

- Immediate funding desired, usually thirty to 120 days.
- Forward commitments available. Rates based on future delivery quotes.

Exhibit 7 (Continued)

Financing Fees

- Flexible: zero to 5 percent.
- 1.5 to 3 percent range most common.

Property Types

- Properties with readily adjustable cash flows preferred.
- Residential, hotel/motel, and health-care preferred.

Special Features

- Lenders may joint-venture or participate in loan if project cash flows are attractive and refinancing unattractive.
- Option available to change index used in the loan term (e.g., change from bank prime rate to LIBOR).
- Interest-rate hedging with futures contracts may be used to reduce borrower's exposure to dramatic interest rate fluctuations.

Exhibit 8

STANDBY LOANS

Benefits and Risks

Borrower-Benefits

- A construction loan may be obtained for speculative development.
- With regular and suicide standbys, short-term permanent mortgage funds are available upon project completion.
- With regular and suicide standbys, 100 percent ownership rights and full control of the project are retained.
- Upon project completion, with regular and suicide standbys, a favorable permanent mortgage market may exist and the standby loan can be ignored.
- Regular and suicide standbys are practical alternatives to a forward commitment, a permanent mortgage that requires stricter leasing and funding provisions and is less available.
- With presale standbys, development profits are earned for successful projects.
- Standby commitments are available for a wide variety of to-be-built projects, including higher-risk projects such as hotels/motels, mini-warehouses, mobile home parks, and nursing homes.

Borrower Risks

- Standby fees create additional financing costs. Forward commitments, participating loans, and other direct permanent loan formats eliminate the need for interim financing.
- The construction lender may reject the standby commitment.
- Personal liability is involved. Funded regular and suicide standbys are typically structured as recourse loans.
- A successfully completed project in an unfavorable permanent mortgage market may have to be funded with a suicide standby loan.
- Construction and leasing delays can cause higher financing costs because commitment will continue to be extended or be canceled.
- With presale standbys, the buyer purchases project at a below-market price.
- Onerous suicide standby loan terms combined with poor market conditions and expensive alternative financing sources could force the project into failure and bankruptcy.

Lender-Benefits

- With regular and suicide standbys, fees are earned without advancing funds.
- Highly attractive yields for funded regular and suicide standby loans.
- Funded regular and suicide standby loans are usually protected by the personal liability of the borrower.
- If the project is unsuccessful and regular or suicide standby funding provisions are not met, the loan does not have to be funded.
- With presale standbys, property is purchased at an attractive price based on economic and leasing conditions.

Exhibit 8 (Continued)

Lender-Risks

- The construction lender may reject the standby commitment.
- Under difficult market conditions, borrower may be forced to accept an arduous suicide loan and subsequently declare default and bankruptcy.
- Under favorable market conditions, borrower may accept more attractive permanent financing from other lending sources over a regular standby loan.

Observations

A standby commitment should be marketable. The construction lender must be willing to accept the standby commitment, otherwise the borrower is wasting time obtaining that commitment. Many construction lenders refuse to accept standby commitments issued by lenders with unacceptable credit ratings and lower financial strength. The borrower should consult with the construction lender during the negotiation process with the standby lender.

Funding

For speculative projects, the releasing requirements play a key role in triggering a standby commitment. Requirements vary among lenders, although 25 to 50 percent preleasing is the most often quoted range. Many lenders will normally arrange floor funding without a leasing provision. In addition to floor funding, the lenders also establish holdback provisions for leasing and tenant improvements.

Parameters

Commitment Fees

- Flexible: 2 points or less for the initial one-year period; one point or less for every six-month renewal exercised.
- One-year minimum typically required.

Leasing Requirements for Funding

- Less stringent than forward commitments and traditional loans.
- Flexible: 25-50 percent preleasing for regular and suicide standbys.

Funded Standby Rates

- 150 to 300 basis points above bank prime rates for regular standbys.
- 300 to 500 basis points or more above bank prime rates for suicide standbys.

Funded Standby Term

- Flexible: two to seven years for regular standbys; extensions are available.
- Shorter terms for suicide standbys
- Six to twenty-four months or more, depending upon construction time, for presale standbys.

Funded Standby Payment Schedule

- Zero to 250 basis points over prime; fixed-rate payments with excess interest payments accruing to principal with an open accrual or up to a 10 percent maximum accrual permitted in regular and suicide standbys. (See "Accrual Loans.")
- 300 to 500 basis points over prime, floating rate, interest payments with no accruing permitted for suicide standbys.

Funded Standby Debt Coverage Ratios

- Lower than conventional, fixed-rate mortgages for regular standbys.
- Flexible: 100 to 125 percent of annual debt service payments.
- Most common range is 110 to 120 percent for regular and suicide standbys.

Funded Standby Loan-to-Value Ratio

- Higher than conventioanl fixed-rate mortgages.
- 75 to 90 percent or more of development costs for regular and suicide standbys.
- 100 percent of development costs (including developer profit), plus additional funds depending upon leasing achievements for presale standbys.

Dollar Size

- $1 million or more.
- Medium-sized deals preferred--$3 million to $25 million.

Funded Standby Prepayment Penalties

- Flexible: more attractive than permanent financing alternatives.
- None or minimal for regular standbys.
- Arduous penalties and restrictions for suicide standbys.

Funding Period

- Borrower's option; typically eighteen months or more.
- Commitment usually available thirty to 120 days.

Property Types

- All types for regular and suicide standbys.
- Traditional: institutional-grade office, industrial, residential, and retail for presale standbys.
- Limited demand for specialty properties, including hotels and medical facilities.

Exhibit 9

ACCRUAL LOANS

Benefits and Risks

Borrower-Benefits

- Full ownership is retained.
- Predictable payment schedule stabilizes project income stream.
- Construction loans can readily roll over to interim financing.
- Aggressive underwriting; lower debt coverages and initial rates provide higher loan amounts and a broad range of property types are acceptable.
- The actual value of future-paid accruals is reduced because of the time value of money.
- Attractive tax benefits--accrual basis taxpayers have larger soft-dollar losses.
- No or minimum prepayment penalties permit inexpensive conversion to more favorable permanent financing if available.

Borrower-Risks

- Unless project cash flow and/or value increases correspond to interest accrual increase amounts, refinancing and default risks arise.
- During higher interest rate cycles, negative amortization occurs and loan balance is increased.
- Interim financing only. Permanent financing will eventually be required in most cases.
- Negative amortization places additional pressure for property values to proportionally increase. Otherwise, refinancing and salability are hampered.
- Total interest paid--including fixed base rate and accrued rate--is typically above permanent mortgage rates.
- Additional financing is difficult to encumber over an accrual loan.
- Significantly higher up-front fees than with most other forms of debt.
- Personal guarantees are frequently required.

Lender-Benefits

- Attractive financing and commitment fees available.
- Inflation protection: during high interest rate cycles, attractive interim-term interest rate yields are available that are similar to short-term construction loans.
- Competitive yields: higher yields offered in comparison with similar-term permanent loans.
- Flexibility: accruals can be adjusted, capped, and restructured with changing market conditions.
- Project and risk control: optionally, a construction loan can be converted to an accrual loan followed by a permanent loan.
- Additional security--personal guarantees are often available.

Exhibit 9 (Continued)

Lender-Risks

- Accrued interest repaid with discounted future moneys.
- Loan risk exposure increases proportionally with rising accruals.
- Strong project performance required for timely repayment of loan principal and accrual. Cash flow should be expected to increase proportionally with respect to interest rates.
- Limited prepayment control--loan may be prematurely repaid during lower interest rate cycles.
- Illiquid investment--less salable debt instrument in secondary mortgage market.

Observations

Since additional interest is accrued adding to the total indebtedness, original coverage ratios and the loan-to-value relationships are changed. Where interest accrual is based on floating rates, initial underwriting parameters are difficult to establish. However, if the spread between the actual and accrual rate is initially fixed, the lender can readily identify the expected yeilds and the borrower can identify expected costs using discounted cash flow analysis. Investment analysis is often for structuring these loans to measure the effects of the various accrual formulas and predicted cash flow requirements needed to justify the initial loan amount along with deferred accruals due at the end of the loan term.

Because of higher interest rate costs and uncertainty, accrual loans are suitable interim loans for entrepreneurial properties such as hotels/motels nursing homes, rehab properties, and other projects that offer higher cash flows to support regular payments plus accurals. Eventually, more favorable permanent financing can be arranged with the same lender (or another lender) once the property demonstrates a strong, stabilized cash flow.

Parameters

Actual Rate/Yield

- 300 to 500 basis points over six-month Treasury bill rates.
- 100 basis points above comparable medium-term fixed-rate mortgages.
- 200 to 400 basis points above bank prime rates.

Payout Rate (Coupon Rate)

- Relatively equivalent to traditional permanent rates.
- Initially set lower than actual rate.
- Adjustable or step-up rates occasionally used.

Loan Accrual Limits

- Flexible: 5 to 15 percent of outstanding loan amount set as maximum accrual allowed; additional balance must be paid out.
- Interest costs may be charged on accrued amounts.

Exhibit 9 (Continued)

Term

- Flexible: two to ten years; three to seven years most common.
- Extensions negotiable.

Payment Schedules

- None or light amortization during early years.
- Typically interest-only payments.

Debt Coverage Ratio

- 100 to 120 percent or more of annual debt service.
- Comparable to variable-rate mortgages and lower than traditional permanent mortgages.
- Higher coverages are exchanged for higher accrual limits.

Loan-to-Value

- Increases during the accrual of additional interest.
- Higher than traditional permanent mortgages.
- 65 to 80 percent loan-to-value common.

Dollar Size

- $1 million or more.
- Medium-sized deals preferred: $3 million to $20 million.

Prepayment Penalties

- Flexible: no or small penalties.
- Zero to 5 percent penalties. One to 2 percent common.

Funding Period

- Immediate funding; usually thirty to 180 days.
- Forward delivery available to twenty-four months or more.
- Upon project completion, if tied to a construction loan.

Financing Fees

- One to 5 percent.
- Smaller deals require higher fees.

Property Types

- All Types
- Most suitable for management-intensive properties with substantial cash flows--hotels/motels, nursing homes, miniwarehouses, rehab properties, etc.

Exhibit 9 (Continued)

Special Features

- Accrual lenders may convert property to permanent, joint venture, or participating loan when cash flows are stabilized and seasoned.
- Rate ceiling and floor limits are sometimes available.
- Personal guarantees often required.

Exhibit 10

Leases - Their Various Clauses and Their Importance

I. Definitions

   A. Specific space and location to be leased

   B. Specific business entity as lessor

   C. Specific business entity as lessee

   D. Specific description of real estate elements to be leased (Definition of shell provided by landlord and finishes provided by tenant)

   E. Specific exemptions of tenant improvements to remain tenant property

II. Conditions for Commencement of Lease

   A. Conditions permitting cancellation by landlord (lessor)

      1. Failure to obtain specified financing prior to construction
      2. Death or disability prior to a certain date
      3. Impossibility of performance due to acts of God, government, regulation, labor conditions, etc.

   B. Conditions permitting cancellation by tenant (lessee)

      1. Completion according to specification
      2. Compeltion according to scheduled time
      3. Conditions relative to other occupancies

   C. Remedies of landlord

      1. Forfeiture of tenant deposits or escrow funds
      2. Liquidated damage provisions
      3. Guarantees by others
      4. Penalty rents, assessments, etc.

   D. Remedies of tenant

      1. Postponement of commencement date
      2. Rental abatement
      3. Cancellation of lease at option of tenant
      4. Penalty payments in contract assessed to the landlord
      5. No penalties other than suit for damages

III. Conditions for termination of lease

   A. Death or disability at option of lessee estate

   B. Scope of "change in conditions" clause

(over)

C. Guaranteed occupancy and operations clause

D. Cancellation liquidated damages formula

E. Bankruptcy receivership of business termination clause

F. Assignability clause

G. Implied good faith effort of percentage lease

H. Permitted uses clause

I. Casualty loss event

J. Condemnation events

K. Specific conditions subsequent explicitly identified as grounds for termination

L. Subordination position

IV. Rental Formula

A. Basic minimum rent

B. Formula for rental adjustment over time

C. Renewal options, if any, and base rent

D. Calculation of prominent area charges and tenant participation in same

E. Real estate tax escalator clause

F. Insurance premium stop loss clause

G. Utility expense stop loss clause

H. General maintenance and replacement assessments for HVAC, parking, lighting, etc.

I. Audit of sales and overage rents

J. Conditions for rental abatement due to casualty loss, remodeling, road construction, or business interruption due to riot, strike, civil commotion, or disruption of public services