



By Cheryl Higley,
national director, RBC Streamline

NAVIGATING ROUGHER WATERS

Small-balance plugs forward
amid new market realities

UNTIL RECENTLY, FINANCING FOR SMALL-BALANCE COMMERCIAL PROPERTIES — generally, loans of \$500,000 to \$5 million — was so competitive that brokers and borrowers could readily obtain many desirable loan terms.

No longer.

The easy terms, relaxed underwriting, low pricing, high proceeds and interest-only features that characterized small-balance commercial lending have dissipated, victim to the residential nonprime mortgage implosion and subsequent credit crunch.

Brokers and borrowers seeking financing today can still find it, but they are operating in a volatile new lending environment that includes tighter liquidity, skittish investors and wider spreads. Fewer lenders are offering fewer loan types and making fewer loans. Lower leverage and strict underwriting are now the norm.

There are new market realities around which borrowers and brokers must navigate. Those who anticipate and are prepared for today's new environment will have an advantage in obtaining the capital that is still available.

Continued ...

REPRINTED FROM *SCOTSMAN GUIDE* COMMERCIAL EDITION AND SCOTSMANGUIDE.COM, DECEMBER 2007

All rights reserved. Third-party reproduction for redistribution is prohibited without contractual consent from Scotsman Publishing Inc.

Navigating Rougher Waters

...Continued

How'd we get here?

The widespread impact of the residential nonprime mortgage market's collapse took many industry insiders by surprise. Although nonprime and small-balance commercial lending are not directly correlated, they are indirectly related in two ways.

First, many lenders that financed smaller commercial properties also financed residential nonprime mortgages. Having so much liquidity tied up in failing nonprime loans prevented these lenders from making new loans on commercial properties. This reduced the amount of capital available.

Second, many of the investors who bought bonds based on commercial real estate also bought bonds based on residential nonprime mortgages. When that market collapsed, numerous investors either stopped buying bonds entirely or ran for cover, only buying bonds based on collateral that reflected conservative lending practices.

A number of small-balance commercial lenders had no choice but to meet investors' preferences by adopting more-conservative standards.

Researching the funding source

When you are faced with funding a small-balance loan in this tighter market, it is especially important to choose a lender that can close *and* that will still be in business come closing. This means doing your research upfront.

Spending merely 20 or 30 minutes reading online about potential lenders should reveal plenty of information about their financial stability and could identify areas for further exploration.

Do not be swayed by the lowest spread or highest proceeds, however. They are meaningless if you cannot rely on the lender to close.

Ask potential lenders about their average time to close deals and obtain the names of other brokers with whom the lenders have worked recently. Call those individuals to discuss whether the lender's promised closing time was accurate and whether it was responsive throughout the process.

Don't rely entirely on lender-provided references, though. Contact brokers you know to discuss similar issues. The relatively modest size of the small-balance community means word-of-mouth should provide an accurate picture of a lender's reliability or lack thereof.

In addition, look for a lender that offers a team of originators, underwriters and closers who are dedicated to serving small-balance

borrowers. This may help ensure that your loan is not competing with larger loans for the attention it deserves.

In a volatile financing market, a funding source's reliability and predictability are extremely important. Inconsistent timelines, lack of communication and surprises just before closing are the last thing you or your clients can afford.

Getting the right loan

Selecting a loan that meets borrowers' needs always can be challenging. By understanding your borrowers and their deal, you can be equipped to sort available options and match their requirements to the right lender. At a minimum, you should know the following about your clients and the deal:

- **Desired loan flexibility:** Determine how much flexibility the loan should have, because most small-balance loans either cannot be prepaid or include a hefty prepayment penalty. Loans without these restrictions or penalties are available but usually at higher spreads.

- **Property details:** In a refinance, know when the borrowers acquired the property and at what price. Also determine how much equity will remain in the property and whether the property has any significant completed or planned improvements.

- **History:** What is the borrowers' credit score? Have they declared bankruptcy, been subject to legal judgments or consistently made loan payments late? Although you may be reluctant to ask these questions, you can't avoid them. If you do, the lender's due-diligence process will reveal the answers anyway.

Providing this information upfront will help a lender determine how to structure a loan to mitigate any borrower-related risks. Or it may help the lender decide it cannot lend to your borrowers.

New realities

Smart brokers will anticipate the market's new realities and make every effort to prepare borrowers for them. These realities include:

- **Lower proceeds:** Most lenders are capping proceeds at 75 percent to 80 percent, and mezzanine financing is difficult to find. Borrowers must provide more equity than in the past.

- **Higher debt-service coverage:** The days of 1.15 debt-service-coverage ratios appear to be over for now. Most lenders today are requiring coverage of 1.2 or higher.

Continued ...



Cheryl Higley

is national director of RBC Streamline, RBC Capital Markets' small-balance commercial loan program. RBC Capital Markets is the corporate and investment-banking arm of RBC Financial Group, the sixth-largest bank in North America with an AAA rating from Moody's Investors Service. RBC Streamline continues to offer small-loan borrowers a wide range of flexible options, commercial real estate expertise, responsive service and speed. Reach Higley at (972) 581-2811 or cheryl.higley@rbccm.com.

Navigating Rougher Waters

...Continued

■ **Increased due diligence:** Lenders are evaluating potential borrowers more carefully than before, analyzing their net worth, liquidity and previous commercial property experience before committing to a loan. They are also placing greater emphasis on the property's condition, repairs that might be required and the borrowers' ability to complete them.

■ **Lower property values:** The recent market adjustment has pushed some property values down. Property-owners looking to sell or refinance a property should recognize that cap rates are increasing and that lenders and buyers are using today's more-realistic prices. Some owners may wait to see if values climb; others may need to refinance, regardless.

■ **Unpredictable spreads:** Although stable lenders that remain committed to financing smaller commercial properties are making every effort to hold spreads stable, volatility in the broader financial markets limits their options. Be prepared for the possibility that a lender might need to resize a loan before closing.

■ ■ ■

Today's new financing market is undeniably more challenging than in recent years. Yet many financially strong, reliable lenders are still financing small-balance commercial properties. They continue to structure flexible loans to meet borrowers' specific needs. Although spreads are wider, all-in pricing is still reasonable by historical standards.

With your guidance in navigating the market's new realities, qualified buyers who want to acquire or refinance a property will find the financing they need with the right lender. 