CELEBRATING 55 YEARS
nerej

Protecting project value in a rising interest rate environment - by Kyle Jean

October 05, 2018 - Northern New England

Kyle Jean,
Bedford Lending Corp.

With additional Federal Reserve interest rate hikes looming over the next year, the commercial real estate industry is trying to adjust to normalized rates after a decade of historic lows. As rates increase, developers and investors must mitigate the impact that increased debt service will have on current projects, and find a way to preserve the long-term viability of portfolio assets as their loans come due in the future. For developers who are unsure if they want to sell or hold a property, there is no better way to insulate the long term value of an asset than HUD financing.

HUD is an often overlooked lending source which can benefit developers and investors throughout New England with multifamily or senior living assets. For ground-up construction, conventional financing is usually considered the only source of funding, with agency financing used for longer term permanent requests. If HUD is considered at all it is usually in the context of affordable housing projects with rental subsidies such as Section 8. In reality, HUD is used to finance hundreds of market rate projects each year, including luxury developments, projects with first floor commercial space, underground parking, and more. In 2015 alone, HUD was used to construct over 30,000 apartment units totaling $2.9 billion, and provided permanent financing for over 70,000 units totaling $4.5 billion. On the healthcare side, HUD can finance nursing homes, assisted living, and memory care facilities.

HUD financing imposes no income restrictions or limitations on project design, and can be used for new construction, substantial rehabilitation, acquisitions or refinances. Unlike conventional financing, for construction or rehabilitation projects, HUD seamlessly converts to a 40 year permanent loan term at construction completion and is non-recourse from day one. Plus, the interest rate for the 40 year term is locked prior to construction commencement, which mitigates all interest rate volatility during the building phase. In some instances, borrowers are eligible for a mortgage based on 90% of replacement cost which significantly reduces the equity needed to finance the project, and as-is land value can be used as a source of funds at closing.

Because of HUD’s cash flow protection, we have seen some developers receive offers from REITs and other institutional investors that effectuate a huge windfall before their construction project even reaches stabilization. For assets that are stabilized or with little to no repairs or renovations required, HUD can be used as a permanent only non-recourse financing option, with a fixed rate of 35 years and high leverage that does not vary based on geographic location. Many developers will secure cash-out first from HUD and then sell the asset to an investor, effectuating an exponential return.

If the holding time of an asset is unknown, HUD offers flexibility for shorter term investment strategies, as there are no onerous prepayment penalties like yield maintenance or defeasance, and all HUD loans are assumable. In an assumption, a buyer can inherit the original fixed rate and remaining term at any point of a HUD loan's maturation. Second mortgages can also be secured as needed for expansions or improvements.

HUD also provides flexibility in terms of individuals or types of entities that can secure ownership in a project, which can be especially beneficial for assets placed in a trust or with syndicated equity. For partners without decision making authority or control over the ownership entity, there is no formal credit review or analysis of financial statements required, and there is no restriction on the amount of partners that can maintain an ownership interest. LLCs, LPs, and similar vehicles are eligible to be included in a HUD mortgagor entity in any configuration, and foreign nationals are also eligible partners.

Historically HUD has required longer processing timelines and higher soft costs during underwriting than other options, which has been difficult to justify for time sensitive transactions or smaller requests, however new processing procedures on the federal level have streamlined many of the difficulties faced in the past. Plus the entirety of the soft costs required as part of HUD financing can be mortgaged and credited as a source of equity at closing. With one closing over the life of the loan, HUD also becomes more cost effective compared to the compounding costs of bank loans which reset every 5 to 10 years, and HUD interest rates are generally 50 basis points below other financing options regardless of market conditions.

As rates trend upwards, all owners and developers with existing assets or projects in need of funding would be prudent to run the numbers with HUD, as the leverage and terms can protect an asset's value longer than any other financing option available.

Kyle Jean is managing director for Bedford Lending Corp., Bedford, N.H.