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Where has the flexible development financing gone? The lenders are back in the drivers' seat!

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Ah, the good old days of 2007. It felt just like yesterday when you walked into your local lender and obtained an aggressive development loan with no real heavy lifting. Developers were churning out condo units, converting old mill buildings and creating mixed-use "smart" developments. Those days are long gone! A combination of the decreasing real estate market, a glut of condo units available in the greater Boston market, the economy in general and the subprime lending fiasco have all combined to scare lenders back into hibernation for the foreseeable future.

Borrowers and projects that were welcomed by banks last summer have almost no chance of obtaining similar financing in the current market. Today, lenders want borrowers to demonstrate superior credit and experience, greater liquidity and net worth. The projects in question should present a lower risk to the lender, i.e. loan to values are lower than in the recent past and borrowers have more cash equity into the projects. The new, tighter lending regulations posed by many local, regional and national lending sources have had a tremendous effect on the borrowing cycle. The lenders are now back in the driver's seat!

Roles Reversed

Flexible financing is still available, though the party demonstrating the flexibility has changed. Flexibility today refers more to the borrower, the project and the collateral. The days of flexible financing from a lender perspective are long gone. Lenders are entertaining lower risk opportunities only. It is the borrower that must now demonstrate the flexibility when trying to obtain construction and rehab funding.

Lenders today only consider borrowers that have the usual qualifications: good credit, experience, liquidity and net worth. Borrowers looking for financing in a limited pool of funds must differentiate themselves from the competition. Offering additional collateral, funding an interest reserve, purchasing a CD at the bank or bringing more cash to the deal are a few examples of how lenders are mitigating perceived risk.

A blanket lien is a good example of the type of flexibility required by borrowers in order to obtain needed financing. Recently, a borrower was purchasing a building that needed to be rehabbed and converted to apartment units. The lender was pleased with the idea of a perm loan on apartment rental units. They were not too excited about the eight month rehab and reposition aspect of the project. Based on current property values and market rental rates, the bank was convinced the project request was a bit too risky. The borrower added an existing apartment building to the mix to get the deal done. The lender used the equity and cash flow from the additional collateral to underwrite the rehab project.

Alternative Solutions

Bridge loans afford the borrower the ability to close on a loan very quickly. They are typically used to prevent foreclosure. They are also used when a borrower must close on a property within a limited time frame that would not allow for typical bank underwriting. Recently, many commercial banks have called their construction loans. Borrowers that were delayed on their construction projects due to permitting or environmental issues now find themselves trying to refinance in an environment where commercial banks are shedding construction loans from their balance sheets. Construction borrowers can utilize a bridge to payoff the current lender, complete construction and lease up the new space. Upon lease up they are better positioned to come back to a commercial bank for a permanent loan.

Another common use of a bridge loan is for repositioning a property. If the current property cash flow will not provide enough NOI to meet the minimum bank debt service coverage ratios, the best a bank can offer is a low LTV loan that leaves the borrower coming to closing with much more cash down than expected. A bridge loan can offer higher leverage because the debt service coverage requirements are much less stringent. A borrower can acquire the property with less overall cash out of pocket, implement the business strategy and lease up the property. Once the increased cash flow is seasoned for a few months, the borrower can go back to the bank with the repositioned property and obtain permanent financing.

While commercial lenders are being very conservative and lending to only the very best borrowers and projects, bridge lenders are finding that borrowers that are just shy of being bankable are much less risky that the typical borrowers of earlier this year. Borrowers must still present business plans and construction plans that make solid business sense and are presented in a professional manner.

Summary

The current conservative banking environment does not mean construction and rehab projects cannot be financed. It just means that borrowers need to be open to different options in order to accomplish their long-term goals. Of course, well capitalized projects with substantial backing from experienced borrowers will always find financing. Borrowers that may be lacking in one or two of the core underwriting criteria still have options.

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