Beyond traditional financing: How equity loans fill the gap in non-traditional real estate financing - by Jeff Jeff Munoz

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Not all good real estate investments, building projects, and commercial real estate (CRE) developments qualify for traditional financing. Certainly, not in their initial stages. Many banks and government lending programs specifically exclude unimproved (land with no buildings), non-income producing property (rehab or conversion projects), or underperforming buildings (properties that don't generate enough rent to adequately cover mortgage and expenses).

When traditional financing is not available, the borrower does not qualify for traditional financing, or when a deal's success depends on speed of execution that banks and government agencies can't provide, a different approach is necessary. That's where equity loans come in.

Traditional CRE Mortgages

Standard CRE mortgage loans are underwritten based on three main criteria. The first is the size of the loan in relation to the value of the building. This is called by bankers and finance professionals the loan-to-value (LTV) ratio. The next thing that's considered is the income the building generates. The final aspect lenders look at is the credibility and creditworthiness of the borrower.

Strict Underwriting Standards

National and regional banks, life insurance companies, and CRE finance firms have strict standards when it comes to traditional CRE mortgages. Funding sources are generally not able to violate underwriting standards even if they want to. These underwriting standards apply to both the investment and the borrower. Whether the finalized mortgages will be sold to government agencies or third-party investors, or held on the lender's balance sheet, these standards must be upheld. If the investment's numbers don't work, the lender can't sell the loan, which means the borrower isn't getting a mortgage. Also, if the borrower does not meet the criteria on minimum liquidity or net worth requirements, the profile of the loan may become too risky for traditional lenders.

Equity Loans

Equity loans are an altogether different animal. Equity loans are a unique and often creative way to provide preliminary or supplemental funding for viable deals that, for one of a thousand reasons, can't rely on traditional CRE mortgages.

Equity loans are primarily based on the amount of realizable equity a building will have left after the loan is made. They do not necessarily depend on a building's in-place rental income and are much less concerned with the credit score of the borrower. For these reasons, equity loans can be a useful tool for borrowers with a weaker credit profile or for short-term construction projects. If equity (value after debt is subtracted) exists in a good CRE investment and the borrower has a credible exit strategy – meaning a legitimate plan to pay the loan back – an equity loan can usually be made.

More Flexible Underwriting

Equity lenders are often private lenders backed by private investors, such as hedge funds, venture capital firms, private equity, or wealthy individuals. As such, equity lenders are not dependent on banks, Wall Street, or the government for their funds. They set their own lending standards and can be as creative as they need to be to get a deal done. Loan metrics, such as maximum loan-to-cost ratios, are not required, which allow equity lenders to focus on the expected value of the property upon the exit or completion of the project. This benefits both the borrowers who would not need to bring in as much cash into the deal, and the lenders who can focus on the performance of the borrower as an operator rather than their personal financial strength.

Worth the Cost

Equity loans are a somewhat more expensive source of capital compared to standard borrowing, but since they often make the difference between the success or failure of a deal, CRE professionals are very willing to pay the extra costs rather than lose out on an opportunity. Many years ago, equity lending was called “hard money” and was not looked at as altogether credible. Today, equity finance is universally considered mainstream and an alternate method of providing debt for the capital stack.

Proceed with Caution

While equity loans may be suitable for some investments, when taking out an equity loan on a property with existing debt (senior lender), borrowers should carefully read through their existing loan documents. Most, if not all, traditional CRE mortgages prohibit borrowers from taking out an additional loan on the same property without their prior approval.

Equity loans will create a secondary lien on the property. Without prior approval, the senior lender can force a technical default on the borrower and cause legal headaches for all parties involved.

Uses of Equity Loans

As mentioned, equity lending is a legitimate and widely used financing method. There are almost as many uses for equity loans as there are CRE deals that need funding. Equity funding should be looked at as just one of many possible ways to fund the capital stack.

In particular, equity lending is well suited for investments requiring bridge and construction financing, which tend to have a relatively short-term horizon. The time gap that exists between applying for a bank CRE mortgage and closing one can often be significant. It’s also very helpful in situations where the target real estate will soon qualify for a traditional mortgage but doesn’t quite qualify yet. Equity loans can be closed quickly, fund necessary improvements, and be paid off in short order when a deal measures up to bank standards. For these short-term investment strategies, the cost of capital is less impactful on the overall project costs since the loan is not outstanding for an extensive period.

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