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Lease financing and subsidized energy-saving equipment loans help improve property's cash flow

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To forecast a direction for the commercial financing market in 2008 it is important to understand where we are now. Simply put, the real estate bubble has burst and lenders as well as investors in asset backed securities have written off billions of dollars in loans that have soured. While most of the losses are in the residential mortgage market, shock waves are being felt in the commercial lending area as well, and lenders are anticipating a further deterioration in 2008 regardless of whether or not the country slides into a recession.

The Federal Reserve's rate cuts in the last few months have lowered Treasury yields. However, lenders have been reluctant to reduce interest rates for commercial loans in lock step with the drop in Treasury yields. In fact, banks have more often been quoting rates tied to Libor (London Interbank Borrowing Rate) as the Libor rate, as expected, has not dropped as much as U.S. Treasury rates. Furthermore, the day of easy loans is over as credit requirements have been tightened.

Driving these changes is the fact that banks are now forced to hold more loans on their books rather than sell them off through securitization vehicles to investors. With a reduced securitization market, banks will receive less fee income in 2008 while having to assume more risk by holding slower earning assets. This will immediately lower bank earnings. Bank stocks have already dropped in recognition of this by investors. The banks will be very diligent in protecting their earnings and will try to reduce bad loan write-offs by being more selective in the loans that they make. Therefore, 2008 will be the year when banks return to their old habit of lending to only the borrowers who need loans the least, i.e. the financially strongest.

The commercial loan market includes equipment financing and business loans as well as real estate mortgages. It is a large market consisting of non-bank as well as bank lenders. It is also an inefficient market, meaning that not every lender prices a financing the same and has different lending requirements even though there are common lending guidelines that credit officers follow to varying degrees. These differences between lenders will be more pronounced in 2008 without the efficiencies created by the securitization market. Furthermore, credit decisions will become more subjective as banks hold more loans for their own accounts. The more sophisticated, knowledgeable mortgage brokers who know how to "package a deal," and where to take it, will thrive in this new environment.

So what does all of this mean to a buyer or owner of commercial property in 2008? More cash equity will be required to buy a property and a higher level of cash flow will be necessary to provide lenders with a comfort level for repayment. In other words, loan to value ratios will decrease and coverage ratios will increase. The market for secondary financing will shrink as only aggressive non-bank lenders will offer this type of financing at interest rates that many will find to be too high to be attractive. Bottom line, property owners will need to invest as well as generate more cash.

Despite the gloomy forecast on a macro level, there are a few bright spots for commercial financing in 2008 when, in times like these, building owners look to reduce operating costs. One big area is to reign in the soaring cost of energy and the good news is that many states and utilities are now offering grants, rebates and low-cost loans to shorten the payback of installing energy efficiency measures as well as the greening of buildings. According to a spokesperson for the mayor's office, the average lighting upgrade for a commercial building in Manhattan is $340,000 with a payback of three years. However, I have seen paybacks as fast as 1.25 years for lighting upgrades when taking full advantage of subsidies including an energy equipment loan subsidized by the New York State Energy Research and Development Authority (NYSERDA).

Equipment financing for energy saving equipment and other building improvements provides 100% financing of project costs. This is not expected to change in 2008. As I recently wrote, savvy building owners have found equipment leasing to be a fast, easy, cost-effective way to finance a variety of building renovations where the items being financed are not strictly equipment.

Today, we are financing building renovations on 5-year (sometimes longer) equipment leases with a $1 purchase option at the end. The cost of labor as well as material such as paint, wallpaper, ceiling tiles, flooring and window treatments are being leased as well as HVAC upgrades and elevator modernizations. Rather than spend cash when picking up the tab for tenant improvements, a building owner conserves cash by leasing the improvements and offsetting equipment lease payments with incoming tenant rents.

Lease financing and subsidized energy-saving equipment loans provide an opportunity for property owners to conserve cash when implementing these projects and thereafter improve a property's cash flow. If cash is king, and I think it will be in 2008, knowing how to find it is the way to capture the crown!

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