Tips from a bridge lender: What to look for in a lease and what resources to utilize

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As a lender I see all types of leases in the properties I take as collateral. The careful analysis of these loans is a critical part of the due diligence process. The obvious issue to consider is the impact on the debt coverage ratio but this is only one of the direct effects on the security of the loan. There are more lease issues than can be considered in this article, but I'd like to address a few of the ones that I deal with on a day to day basis as a bridge lender. Lenders offering longer terms may have greatly different priorities.

As a caveat to this discussion, I can't stress the need for good legal review of more complicated leases. The first thing relayed by my real estate law professor at the NYU Masters Program was not to think for a second that this class made us legal experts. To me, the need for a good attorney is paramount. Also important is the use of estoppel certificates that definitively confirm the facts and status of the leases. Lastly, a personal inspection of a property offers great insight into the status of tenancy. It doesn't take that much experience to notice when a tenant appears to be on their way out or there for the long haul.

The expiration date compared to maturity-The expiration date of leases in the collateral property can affect the ability to cover debt service during the loan term, the possibility of obtaining take-out financing and the willingness of the lender to ultimately own the property in the event of a foreclosure. The focus on leases is primarily for commercial properties including retail, office and industrial. The short term nature of residential leases makes it a known entity going in.

The size of the loan and property dictate what type of leases will be given greater weight in the review. Single-tenant properties and larger tenants such as anchor stores in shopping centers are the most obvious requiring review. Short term leases are more of a concern if a large number expire in a short time period. For the large leases, a maturity during the loan term most obviously raises the risk of dramatic loss of income from a period of vacancy and costly tenant improvements. An understanding of the rental market may answer some of these risks. The ability to gauge the likelihood of a tenant extending their lease or exercising a renewal option is a definite plus.

Leases that expire shortly before the maturity of the loan may delay a refinance until the space is retenanted. Of course this could be a benefit to the lender if they will collect an extension fee without feeling their risk is greatly increased. Not as obvious is the effect of leases with expiration dates soon after loan maturity. A less experienced bridge lender may think this is the next lender's problem. They should hope that this next lender is as inexperienced as they. Long-term take out lenders are more cautious then bridge lenders and are less likely to take on the risk of a large vacancy occurring soon after closing. The short time period also hampers the ability to fund a leasing reserve. A reserve could be funded at closing but this doesn't necessarily address all of the risk a conservative lender would consider.

Non-arms-length leases - Careful attention needs to be paid to leases to related entities whether they are corporate or familial. Of course you must first determine that a lease is not arms-length. Not that I've ever been approached by a borrower trying to slip one through but you never know. Once this status is known, the specific terms of the lease should be studied and compared to the area rental market including, but not limited to, other leases in the collateral property. The lease could be above-market for the purpose of inflating income which may lead to a larger loan or a false sense of security from a higher dscr. It could be below market for a longer term than expected, possibly even excluding subordination language. In this case the lender who completes a foreclosure could be saddled with lower income then it should be. My solution to these issues is to require an entirely new lease to be signed at or before closing with terms acceptable to me.

Master leases with borrower-I only mention this because it is frequently offered to me by brokers/borrowers for a deal on a property with high vacancy. The idea being that the borrower will lease all of the vacant space under a single lease which, in their opinion, lessens income risk until the space is leased to a third party. This is worthless to me given that all of my loans are full recourse. I've already got a personal guarantee from the borrower to ensure payment of interest. A guarantee of rent payments is very nearly the same thing. It's not even "belts and suspenders" since there is no way they would continue paying one without the other. Unfortunately, my explanation often doesn't register with the broker who more often deals with non-recourse loans. Even in those cases, I don't feel such a lease enhances the security much. But that is up to those lenders to decide.

The above are only three of the many lease issues a lender should consider prior to closing. The ability to identify and address them provides a much better understanding of inherent risk.

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