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Small loans: Hidden gem of new commercial mtge. market

April 04, 2008 - Upstate New York

"Something happened on the way to the market," has turned into "something happened to the market itself," for many real estate professionals involved in commercial mortgage backed securities (CMBS). As a result, commercial mortgages that have traditionally flown under the radar screen of CMBS investors are now seeing their day in the sun, smaller loans that have always featured conservative underwriting.

In markets like the Hudson Valley, where smaller projects like apartments and small retail centers are germane, real estate sales activity is thriving, particularly bread and butter properties in the $500,000 to $5 million price range. Since KeyCorp's recent acquisition of the former Union State Bank (USB), it now offers private banking services through those Hudson Valley area branches, including access to this type of commercial mortgage, and to specialized professionals in this field.

If you are considering participation in the $500,000 - $5 million mortgage sector, there are nuances of the small loan market that are important to understand before you rush in.

Both Structure and Size Do Matter

During the past few years, an increasing number of large-scale CMBS loans allowed for low debt service coverage, proceeds based on projected rents and other aggressive terms, all on a non-recourse basis. This contrasts to the small loan arena. Small loan borrowers are not professional real estate developers or investors. As such, loans are usually written as full-recourse mortgages and the borrowers are incented to pay down their principal. While interest-only terms may appear compelling, they don't appeal to most small property owners seeking ongoing cash flow and long-term equity.

Term-inology

Interest rates are always a critical factor in achieving the desired financial returns from any commercial mortgage investment. Some small loan lenders may offer below-market rates, but require the borrower to move its other banking activities such as business banking accounts, personal checking or consumer loans to that institution. If this is the case, a low rate for the borrower may be deceiving to the potential investor. Remember that the entire package must make sense to the lender, investor and the borrower to create a win-win-win situation.

Many borrowers find themselves dealing with smaller financial institutions whose core business is residential mortgages, not commercial. This makes understanding the process from application to closing even more important during today's credit crunch, when rates and terms can be rapidly moving targets. If the lender is not experienced with commercial mortgage aggregation, each loan should be carefully examined to make sure the terms make sense, and will deliver the expected returns over time.

Check, Please!

Debt service coverage ratios can make or break a borrower's ability to obtain the funds they need.

Due to fallout from the sub-prime crisis, investors are demanding more conservative lending practices. To ensure a surprise-free closing, everyone involved in the equation needs to be upfront about their expectations. Closing day can bring a nasty surprise if the check for the loan amount is a lower number, due to a change in DSC requirements from a lender that is just learning the commercial side of the business. By dealing with a lending team that understands the small loan marketplace, everyone involved can avoid such scenarios, and play the small loan game to win.

Small commercial mortgages represent an area of opportunity for borrowers, lenders and investors alike. Taking a look at this naturally conservative sector makes a world of sense in today's marketplace, particularly in regions like the Hudson Valley that are home to a high concentration of eligible investment properties.

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