



Without traditional restrictions, private lenders can be creative in their financing

October 27, 2008 - Spotlights

With every decision in life there are pros and cons. The decision of what the best avenue to take when financing a commercial real estate transaction cannot be taken lightly. Exploring different options are crucial to reap the benefits of your asset. There are few options to finance commercial real estate, today. The traditional way of financing is to obtain a mortgage through a bank, a life insurance company or a government backed agency.

In the current state of the real estate market, financing through this means has been increasingly difficult to obtain. The traditional lenders that make loans are the balance sheet lenders, who hold their loans in their portfolio and have a limited amount of liquidity to put out each year. The secondary market has been non-existent since the sub prime fallout, which has sent investors looking for other means of financing. Several private lenders such as hedge funds and private investors have come into the market with fresh capital. There are many advantages and disadvantages to obtaining financing through private and traditional financing.

An advantage to obtaining private financing is the ability to close quickly. Financing through traditional means may require a committee approval as well as appraisals and environmental reports which may take several weeks to produce. Most private lenders order appraisals through the same parties that the banks order through, but pay a higher premium at the borrower's expense for turnaround time of approximately 3 days. Furthermore, to speed up the process, the private lender may do an Environmental Transaction Screen rather than a full Phase 1 report. Once, the borrower and lender have agreed to terms, and third party reports are in, the lender's council and the borrower's attorney would start on the legal work. The entire loan process can be completed within a few days.

Another advantage of private financing is the ability of the private lender to think "outside the box." Traditional lenders are cash-flow lenders and base their loans on the Debt Service Coverage Ratios which is typically around 1.20 - 1.35 depending the property type. In many cases, seasoned investors purchase properties that have a below market rental income average, and are buying the property for the upside potential to add value. These properties are usually mismanaged and more often than not need capital improvements and rehab work. A traditional lender would not be able to give the investor enough financing because the building could only support so much in annual debt service. As a result of the building being previously mismanaged, some work would need to be done so the lender may do some type of holdback or escrow thus holding back even more funds. Private lenders can creatively work through these issues and see the true value of the building and its potential and possibly offer more financing. Private lenders can be as creative as they want because they don't have the regulations or limits of what a typical bank may have.

The disadvantage of private financing is the cost. Private financing is usually a last resort to a

borrower, because of its costs. It is the investor's last chance of getting financed. The appraisal costs are usually double what it normally costs because of the time issue, and the same with the environmental. The lender charges a higher interest rate of about 12 - 17% and also charges loan fees, which typically range from 2 - 6% of the total loan amount. The legal fees are typically more expensive, because the documents may change from deal to deal and the time frame may be very short.

Based on the information presented it is clear that in certain situations private financing is the best way to go if your transaction needs to be closed quickly and if your building does not fit in the box for a traditional mortgage. Choosing the right private lender that understands what it will take to get your asset into conventional financing at the end of the day is another important decision to make and should not be taken lightly. At JG Capital LLC, we provide short term bridge financing for all commercial property types.

Jason Au is a managing member at JG Capital, LLC, New York, N.Y.

New York Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540