NC SCHOOL OF BANKING
A PROGRAM OF THE NORTH CAROLINA BANKERS ASSOCIATION

Key Commercial Lending Concepts– C&I and CRE

July 23, 2024

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David H. Ruffin | *Principal*

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Today's Presenters



David Ruffin

- Principal, IntelliCredit™
- 50 Years in Banking
- 16 years as Chief Credit Officer / Commercial Lender
- 3,000+ Loan Reviews
- ~350 Capital Raise or M&A Due Diligences
- Former Co-Founder of Credit Risk Management
- Prolific author and speaker on credit risk topics

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Credit is eternal

The fundamentals of credit and the need to risk manage it remain eternal; what changes of course are the products, technology, venues, and user profiles. There are challenges – but astute bankers will also see opportunities – in the immediate future.

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Most impactful to portfolio credit quality…

The market value of the commodity (products, goods, & services) produced by our borrowers is the single most impactful factor in determining the credit quality of our portfolios.

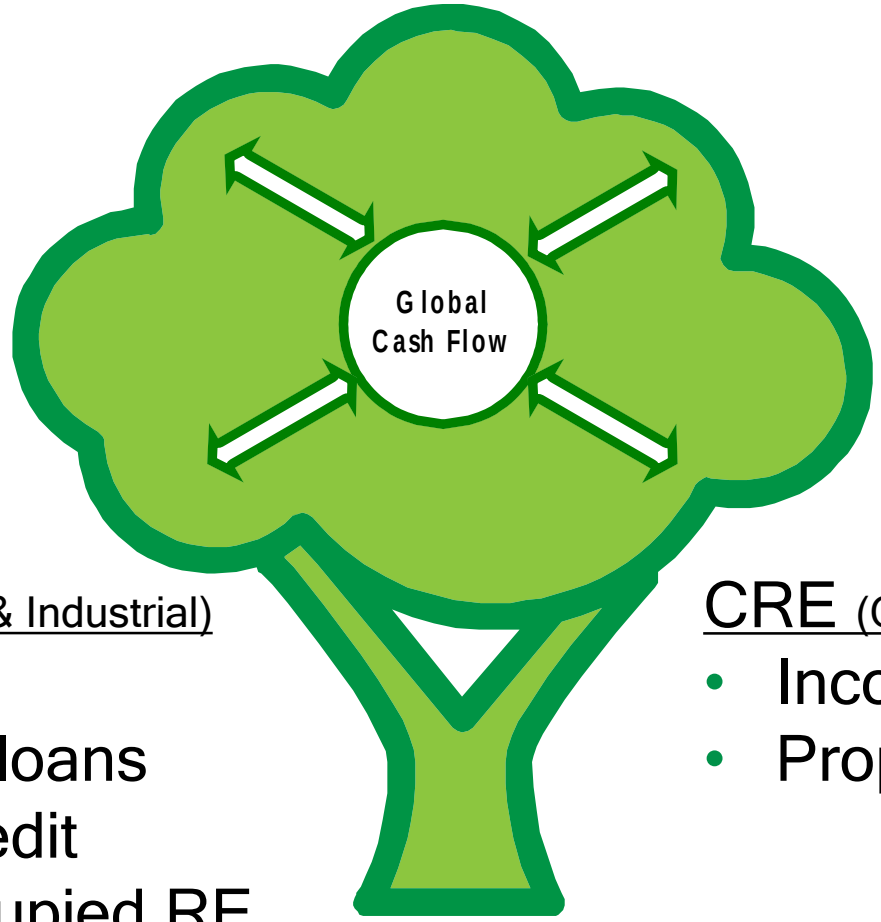
It determines:

- *Supply / Demand*
- *Revenue*
- *Margins*
- *Repayment capacity*
- *Collateral value*

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The *Commercial Lending* tree has two branches- underwritten very differently



C&I (Commercial & Industrial)

- Term loans
- Short term loans
- Lines of credit
- Owner-occupied RE

CRE (Commercial Real Estate)

- Income property
- Property for sale

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Keys to Analyzing C&I Commercial Loans

?

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Benefits to C&I Lending

- More relational than transactional
- More cross selling of other services
- Offers diversity away from RE
- More stable deposit-oriented
- Knowing the borrower is often a risk mitigant
- Less interest rate sensitive
- Re-claims bankers' heritage

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Challenges to C&I Lending

- Tough love about RE addiction / abdication of underwriting
- Debunking C&I Lending Perceptions:
  - *Consumerized Product*
  - *Unsecured lending*
  - *Asset Based Lending*
- Competition, especially from non-banks have degraded underwriting standards
- *Relational* aspect makes it “harder to move”
- Credit Talent
- Staffing
- Servicing
- Training

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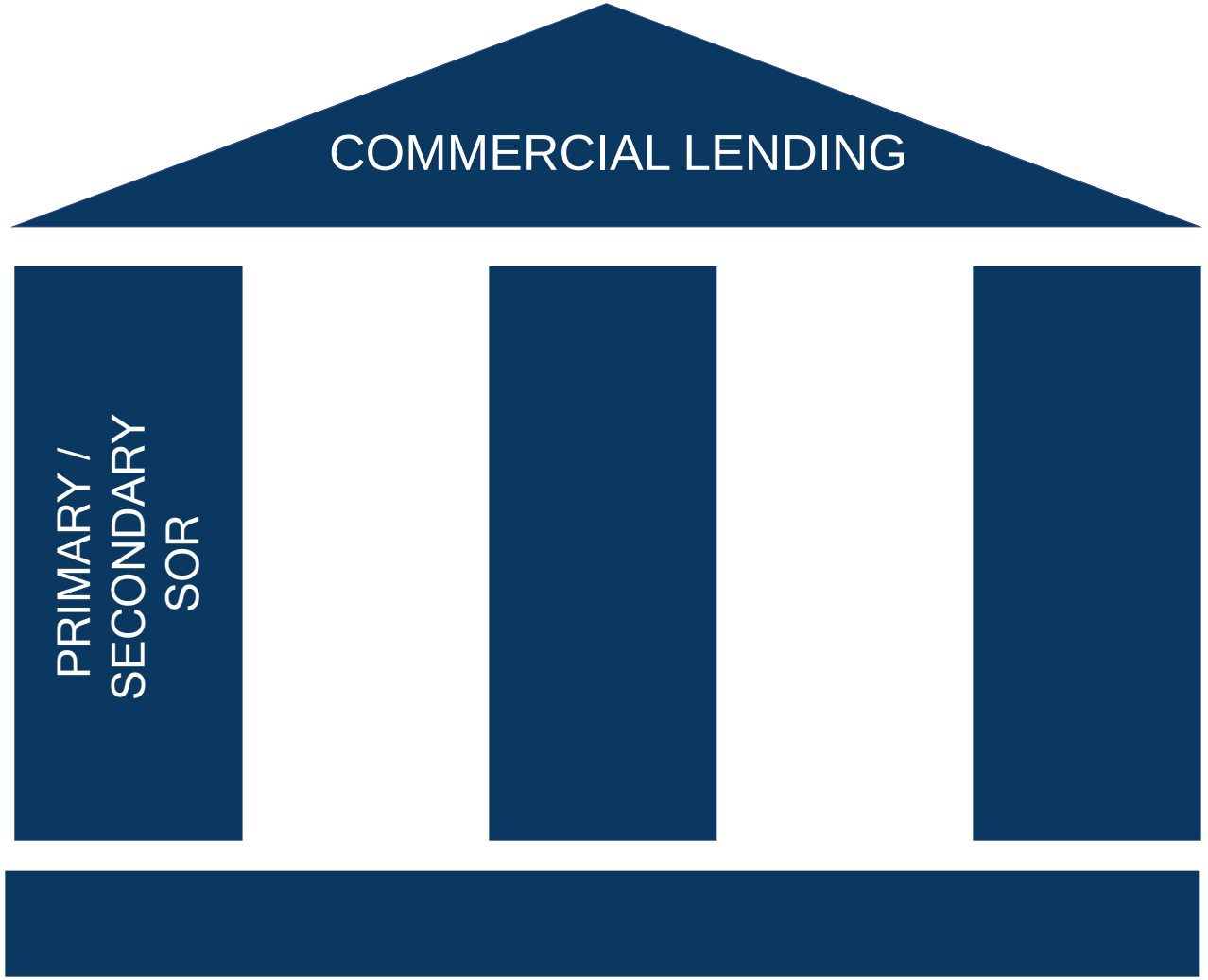
Key Pillars of Commercial Lending



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Key Pillars of Commercial Lending



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Primary Sources of Repayment

Legitimate Sources:

- Cash flow from profits
- Turn of trade assets
- Rents / Leases
- Sale of real estate
- True bridge loan

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Primary Sources of Repayment

Illegitimate Sources:

- Miss-matches of balance sheet financing
- Capitalization of interest
- Single pay loans / renewals / modifications with no defined SOR
- Riding trade payables
- Incurring more debt *(i.e.“robbing Peter to pay Paul”)*
- Dependence on “blue sky” projections.

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Secondary Repayment Sources

You should explain reliance on:

- Collateral liquidation
- Guarantor support

You should also explain the source's:

- Independence from the primary venture
- Verification and quantification

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Cash Flow

You should explain the *historical* and *projected* impact on cash by:

- Profitability of the business operations
- Buying or selling assets
- Borrowing or paying liabilities
- Injecting or withdrawing equity

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What is “Operating Cash Flow?”

Profit	$100,000
Depreciation & Amortization	+ $45,000
Interest Expense	+ $25,000
Distributions to Owner	($10,000)
Operating or “Gross” Cash Flow	= $160,000

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When is “Operating Cash Flow” the driving force?

- Operating companies – *Not* RE Developers
- Investment RE – Net Operating Income is similar to Operating Cash Flow
- Stable, sustainable operations – Seen in sales, margins, customer base, etc.
- Low growth rate – Operating Cash available to service debt; not needed to build balance sheet

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Operating Cash Flow is NOT the Primary Source of Repayment for:

- **Loans/Lines to acquire assets for sale**
  - Floorplan lines of credit
  - Speculative “flip” investments – RE, stocks, etc
- **Loans/Lines to improve RE for sale**
  - A&D activity
  - Construction
- **Lines to support Current Asset Conversion**
  - Accounts Receivable or Inventory

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Avoid Common Mistakes in Calculating Debt Service Coverage

- Owner distributions should not be considered discretionary. Do not assume that the owner can or will cut these back.
- For Single Pay loans, either ID a lump sum repayment source or presume that they must be amortized and include the payments in coverage calculations.
- Short term interest only loans (other than typical lines of credit) need to be amortized at some point. Include amortizing payments here, too.

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Other Common Mistakes to Avoid

- One time sources of income may not be recurring, but are included in Gross CF
  - Capital gains
  - “Other income”
- One time expenses are “added back” to Gross CF even though they may not really be one-time items.
- “Stress Test” for interest rate changes.

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Income Statement Trends

You should explain the *historical* and *projected* trends of:

- Sales
- Costs of sales
- Overhead
- Profitability (all aspects of cash flow)

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Income Statement Trends

Income Statement Ratio Calculations

Calculate the following ratios to analyze the income statement:

Ratio	Calculation	2002	2003
Sales Growth	Sales *present* – Sales *prior* X 100 / Sales *prior*		**(706.8 – 546.2) X 100 / 546.2 = 29.4%**
Gross Margin	Gross profit X 100 / Sales	**193.3 X 100 / 546.2 = 35.4%**	**42.6%**
Operating expenses	Operating Expenses X 100 / Sales	**186.2 X 100 / 546.2 = 34%**	**37.6%**
NPAT	NPAT X 100 / Sales	**7.6 X 100 / 546.2 = 1.4%**	**4.3%**

Income Statement Ratio Possible Explanations

Sales Growth	Gross Margin	Operating Expenses
▪*New products* ▪*Increased competition* ▪*Lower or higher prices for goods or services* ▪*Credit sales* ▪*Larger sales area* ▪*More employees*	▪*Major suppliers* ▪*Discounts* ▪*Inventory valuation methods* ▪*Cost of materials higher or lower* ▪*Sales price higher or lower*	▪*Large increases or decreases in expense items* ▪*Depreciation as a wash* ▪*Owner's compensation* ▪*Rent* ▪*Discretionary expenses*

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Balance Sheet Trends

You should explain the *historical* and *projected* trends of:

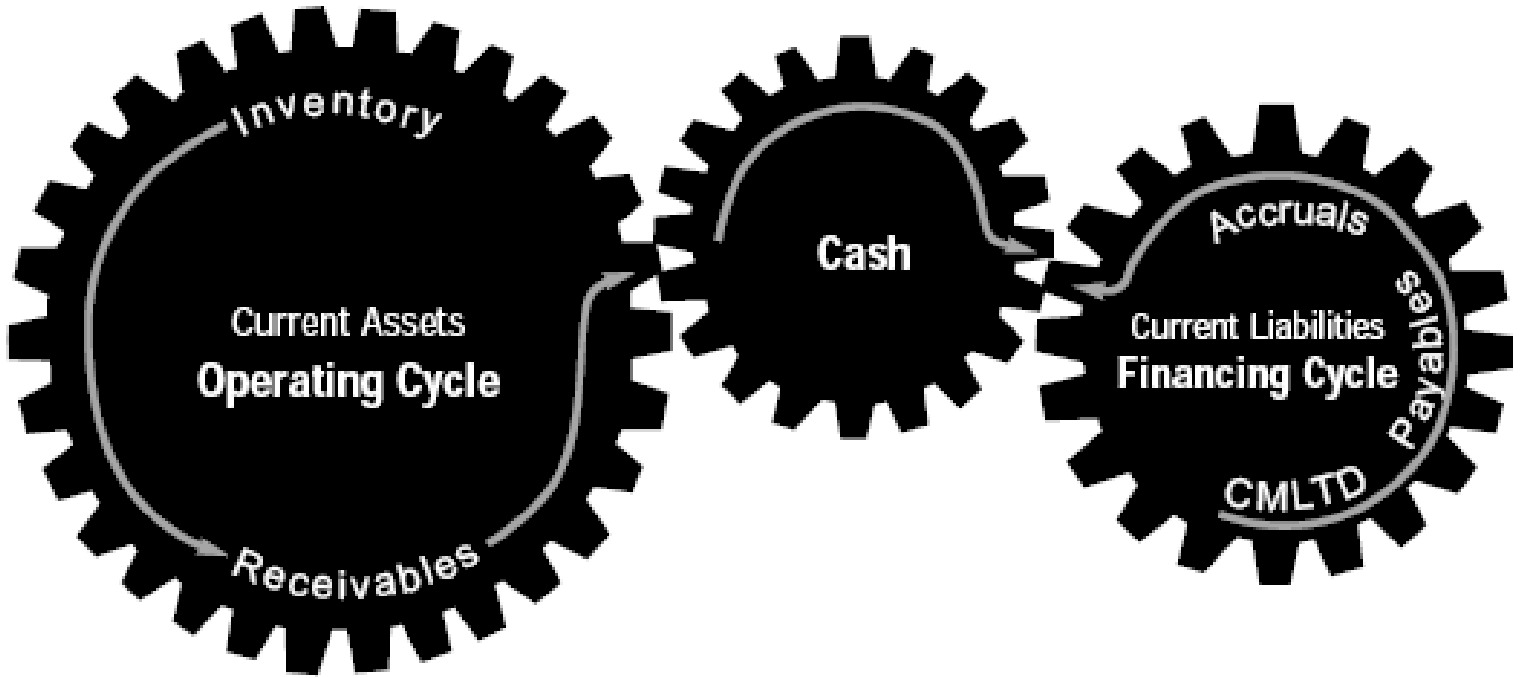
- Liquidity
- Collectability of accounts receivable
- Stability of inventory
- Use of trade credit
- Insider borrowing / debt
- Capital expenditures (maintenance/growth)
- Long term debt
- Equity management

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Working Capital (Positive) *–Source: RMA*

Schematic View of Positive Working Capital
Current Ratio in Excess of 1:1

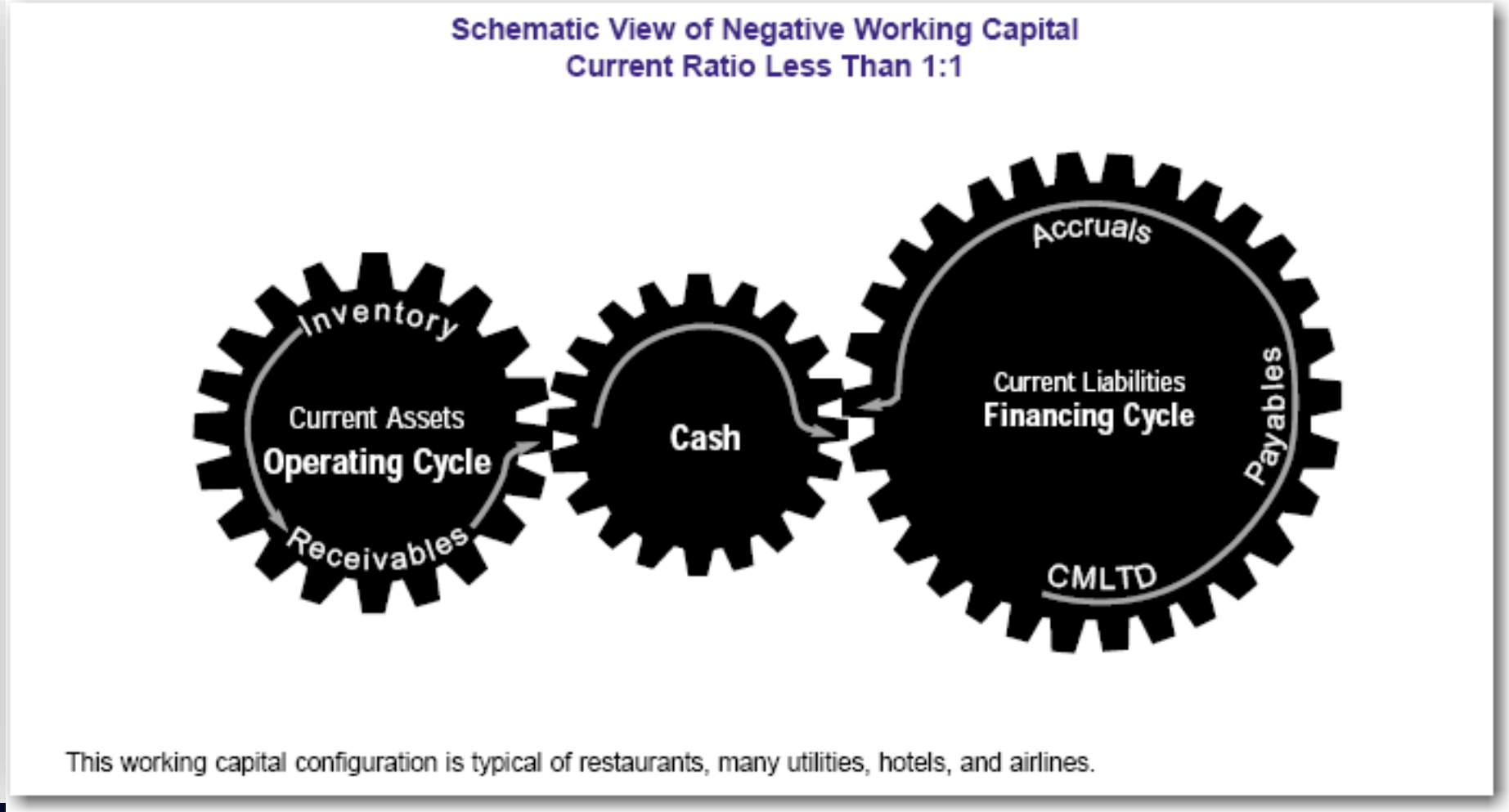


This working capital configuration is typical of light manufacturing, heavy manufacturing, wholesalers, and most retailers.

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Working Capital (Negative) *–Source: RMA*



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Balance Sheet Trends

Balance Sheet Ratio Calculations

Ratio	Calculation	2002	2003
A/R Days	A/R X 365 days / Sales	**31.9 X 365 / 546.2 = 21.3**	**30.6**
INV Days	INV X 365 days / CoGS	**19.7 X 365 / 352.9 = 20.4**	**15.4**
A/P Days	A/P X 365 days / CoGS	**27.4 X 365 / 352.9 = 28.3**	**43.8**
Working Capital	CA – CL	**52.2 – 78.4 = (26.2)**	**(43.7)**
DTW	TL / Equity	**302.8 / 74.9 = 4.04**	**2.31**

Balance Sheet Ratio Tips

A/R Days	INV Days	A/P Days	DTW
▪*Trend in days* ▪*Terms given to customers* ▪*An aging of accounts receivable* ▪*Bad debt expense and reserve trends* ▪*Company's credit policies* ▪*Concentrations* ▪*Timing of balance sheet*	▪*Obsolete inventory levels* ▪*Spoilage issues* ▪*Days turn trend* ▪*Inventory valuation methods* ▪*Raw materials* ▪*Work-in-progress* ▪*Timing of balance sheet* ▪*Inventory listing*	▪*Supplier terms* ▪*D&B reports* ▪*Payables aging* ▪*Days turn trend* ▪*Balance sheet timing*	▪*Insider debt* ▪*Intangible assets* ▪*Historical value (GAAP) of assets*

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Line of Credit Borrowing Base

Line of Credit Borrowing Base

Date:

Asset/ Liability	Book Amount $	Qualified Description	Qualified $	Advance/ Deduction %	Available Borrowing Base $
A/R	59.2	< 45 days Past Due	57.2	70%	40.0
INV	17.1	All gas inventory	17.1	70%	11.9
			(A/P)	100%	(48.7)
			(Other A/R or INV Debt*)	100%	0
			Total borrowing base amount		3.2

Actual LOC = 20.0

* Other A/R or INV Debt: is for other short term debt that is lent by any other creditor to support A/R or INV.

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How to Justify a Line of Credit

Often called a ***borrowing base calculation***

Asset / Liability	Total Book Amount ($) (A)	Disqualified Amounts $ (B)	Qualified $ (C) = (A) - (B)	Qualified Description	Advance / Deduction % (D)	Available Borrowing Base $ (E) = (C) * (D)
Accounts Receivable	$145,000	$8,100	$136,900	< 45 days Past Due	*70.0%*	$95,830
Inventory	$50,000	$4,900	$45,100	All Gas Inventory	*70.0%*	$31,570
Other Short Term Assets	$0	$0	$0	N/A		$0
Totals	**$195,000**	**$13,000**	**$182,000**			**$127,400**
		Accounts Payable	$85,000	N/A	*100.0%*	($85,000)
		Short Term Notes	$10,000	N/A	*0.0%*	$0
				Total Borrowing Base Avability *(Total Qualified Assets less A/P and S/T notes)*		***$42,400***

Actual LOC Outstanding	**$75,000**
Availability / (Collateral Shortfall)	**($32,600)**

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How to Justify a Line of Credit *(continued)*

Your borrower currently has a Line of Credit of $500,000 with $397,600 o/s balance.

Calculate a borrowing base (defense of a line of credit) for the following borrower:

- **Accounts Receivable: $550,000**
  - $86,350 is >45 days past due
- **Inventory: $390,000**
  - Consists of sand, rock, asphalt for a paving company
- **Accounts Payable: $342,750**
- **Short-term single pay note: $80,000**

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Industry Variances –*Source: RMA*

Leverage Comparisons

Assets	Auto Dealer	Wholesale Groceries	Grain Merchant	Manufacturer Plastic Foam	Hotel
Cash	9.0%	4.6%	10.9%	3.8%	9.0%
Receivables	8.3	30.5	24.7	24.1	5.9
Inventory	60.3	31.3	23.4	20.2	2.8
Other current	4.1	1.8	4.8	3.0	1.7
Total current	81.8	68.1	63.8	51.1	19.4
Fixed assets	10.2	19.6	28.0	38.3	67.4
Intangibles	2.3	6.0	1.2	7.3	3.2
Other noncurrent	5.7	6.3	7.0	3.3	10.1
Total assets	100.0	100.0	100.0	100.0	100.0
Liabilities					
Notes payable	52.6	16.0	12.2	8.0	4.0
CMLTD	1.5	2.8	2.0	4.2	5.4
Trade payables	4.6	23.3	22.5	15.9	3.9
Income taxes	.2	.2	.5	.4	.8
Other current	9.5	8.2	12.3	6.7	8.1
Total current	68.4	50.5	49.5	35.2	22.1
Long-term debt	6.3	10.9	10.6	23.4	41.9
Deferred taxes	.7	.3	1.5	.9	1.4
Other noncurrent	2.0	3.1	1.2	1.1	5.3
Net worth	22.6	35.3	37.1	39.4	29.2
Total	100.0	100.0	100.0	100.00	100.0
Pretax profit/sales	1.8	2.9	1.6	4.9	8.9
Sales/working capital	38.7	20.6	35.9	8.4	neg.
Pretax profit/total assets	7.1	6.2	4.5	8.4	6.3
Fixed assets/net worth	.4	.6	.7	1.2	2.3
Debt/worth	4.2	2.8	1.9	2.1	2.0
Current ratio	1.2	1.3	1.2	1.5	.9
Days' receivables	5	33	14	49	8
Days' inventory	52	39	16	45	n/a
Days' payables	3	26	16	29	n/a

Source: RMA's *Annual Statement Studies*

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What is “Global” Cash Flow?

- A comparison for a specific group such as:
  - Related businesses
  - Individuals in partnership
  - Multiple investments owned by one individual
- A comparison of collective cash available to pay debt service v. collective debt service of the group.

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Why do a Global Cash Flow?

You Want to Know:

Will operations and investments “outside” of the borrower provide excess cash to help repay your loan?

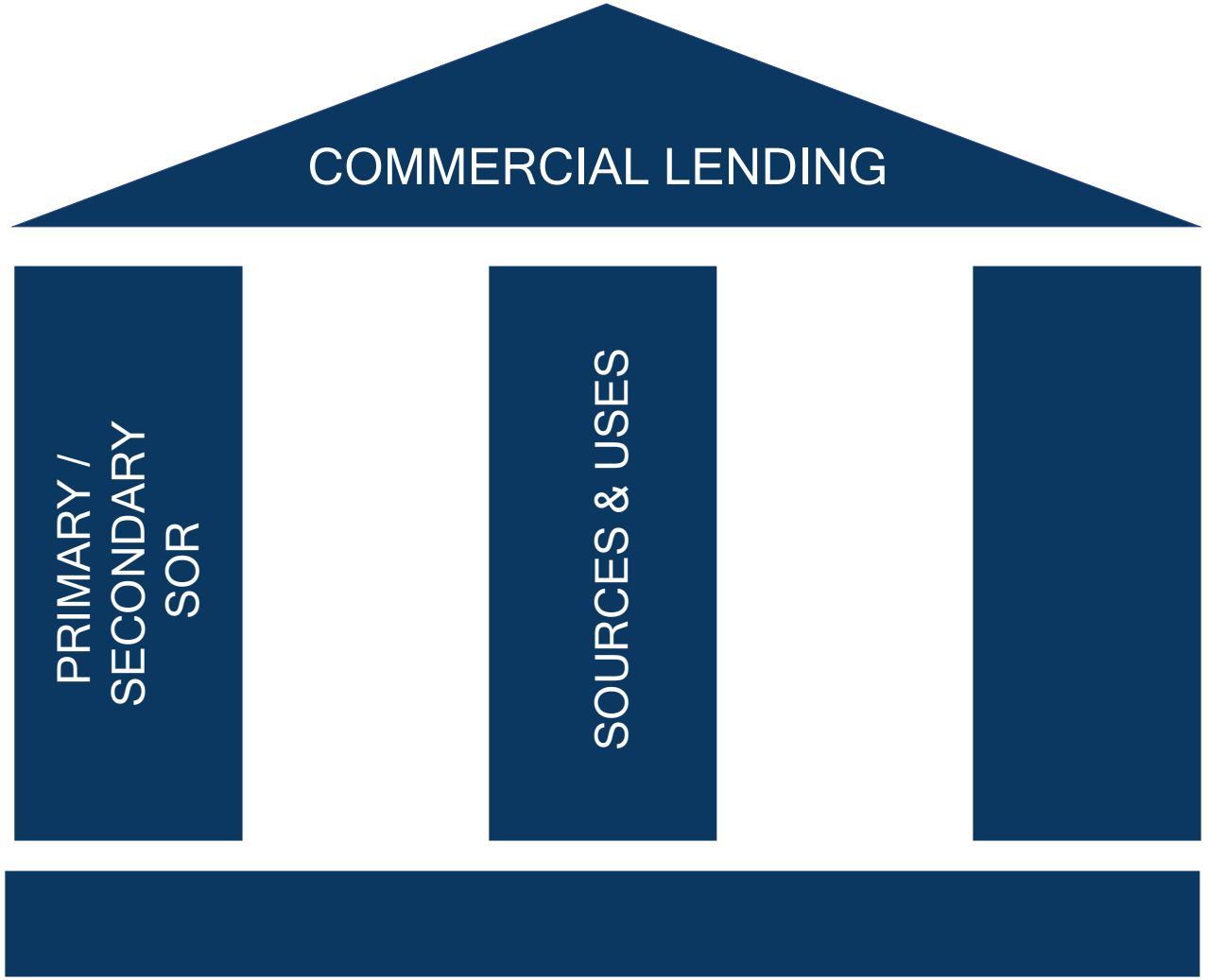
Or

Will these outside “activities” cash away from your borrower, thus straining repayment ability?

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Key Pillars of Commercial Lending



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Sources & Uses of Cash for a Business *(Only 4 Each!)*

Sources	Uses
Operating Cash Flow	*Operating Cash Loss*
Decrease Assets	Increase Assets
Inject Equity	Withdraw equity
Increase Liabilities	Reduce Liabilities

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Sources & Uses of Cash

Sources and Uses Calculation

Factor	How to Calculate	2003
Net Income	*From I/S* $NPAT_{2003}$	30.5
+ Depreciation exp.	*From Income Statement* $_{2003}$	41.4
+ Interest exp.	*From Income Statement* $_{2003}$	29.4
	Total Gross Cash Flow	101.4
- Current Maturities of LTD	*From* $CMLTD_{2002}$	(46.3)
- Interest exp.	*From Income Statement* $_{2003}$	(29.4)
	Total Net Cash Flow	25.7
- Dividends	*From the dividend adjustments to I/S Retained Earnings* $_{2003}$	(3.7)
Total Net Cash Flow After Dividends		22.0
Capital Expenditures	$NFA_{2002} - NFA_{2003} - DEP_{2003}$	(72.2)
Long Term Debt	$LTD_{2003} + CMLTD_{2003} - LTD_{2002}$	(9.9)
Accounts Receivables	$A/R_{2002} - A/R_{2003}$	(27.3)
Inventory	$INV_{2002} - INV_{2003}$	2.6
Accounts Payable	$A/P_{2003} - A/P_{2002}$	21.3
Bank Line	$Line_{2003} - Line_{2002}$	20.0
Other Current Assets	$OCA_{2002} - OCA_{2003}$	0
Other Non-Current Assets	$ONCA_{2002} - ONCA_{2003}$	0
Other Current Liabilities	$OCL_{2003} - OCL_{2002}$	16.1
Other Non-Current Liabilities	$ONCL_{2003} - ONCL_{2002}$	0
Equity (not including retained earnings	$EQ_{2003} - EQ_{2002}$	30.0
	Total Change in Cash	2.6
Actual Change in Cash	$Cash_{2003} - Cash_{2002}$	2.6

Page Break

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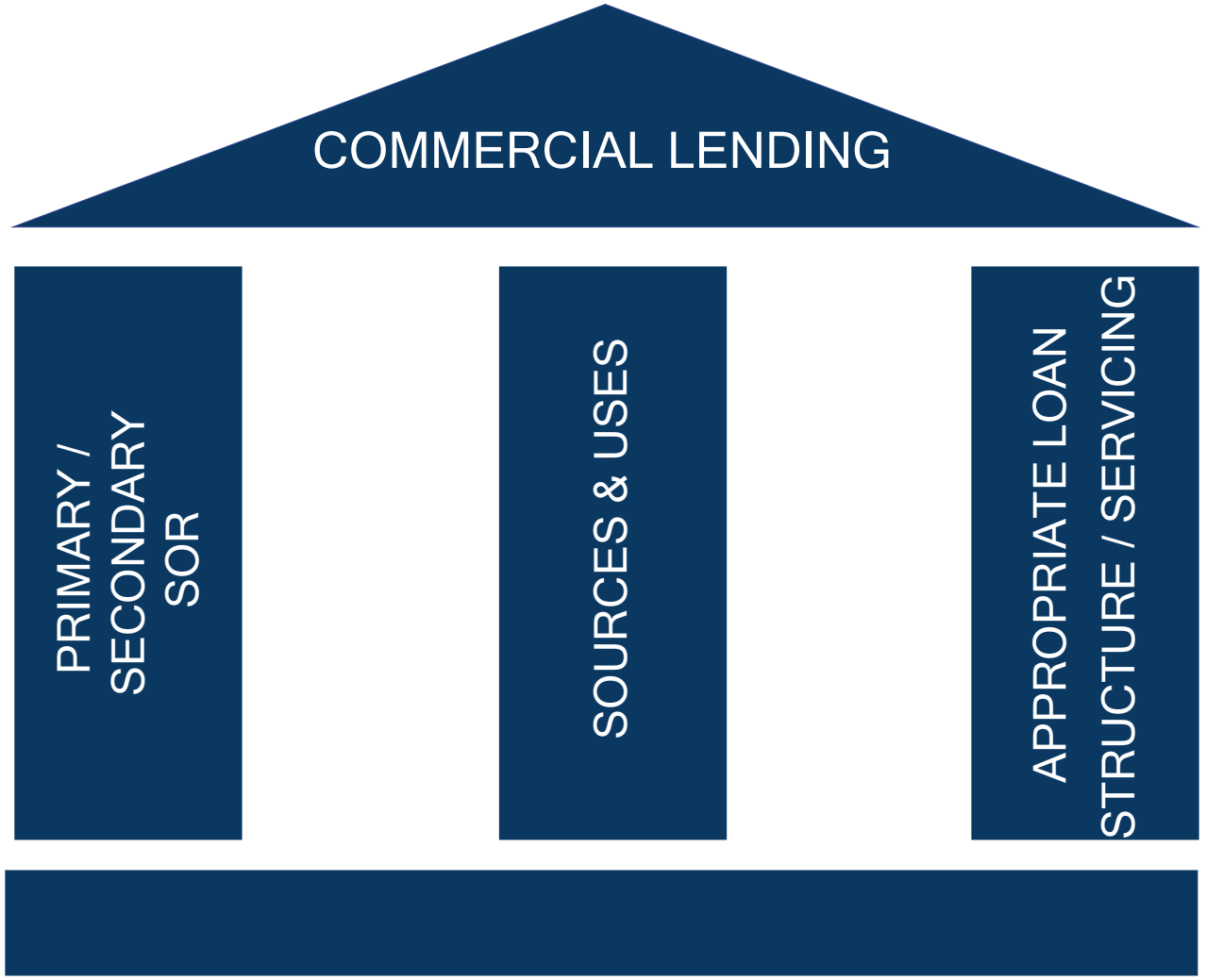
Sources & Uses Polling

The previous page depicts *Cash Sources & Uses* for a small propane gas distributor. The primary use of capital expenditures is for the purchase of large and small gas canisters. Other than cash generated through profits, what was the largest source of cash used for these purchases?

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Appropriate Loan Structure

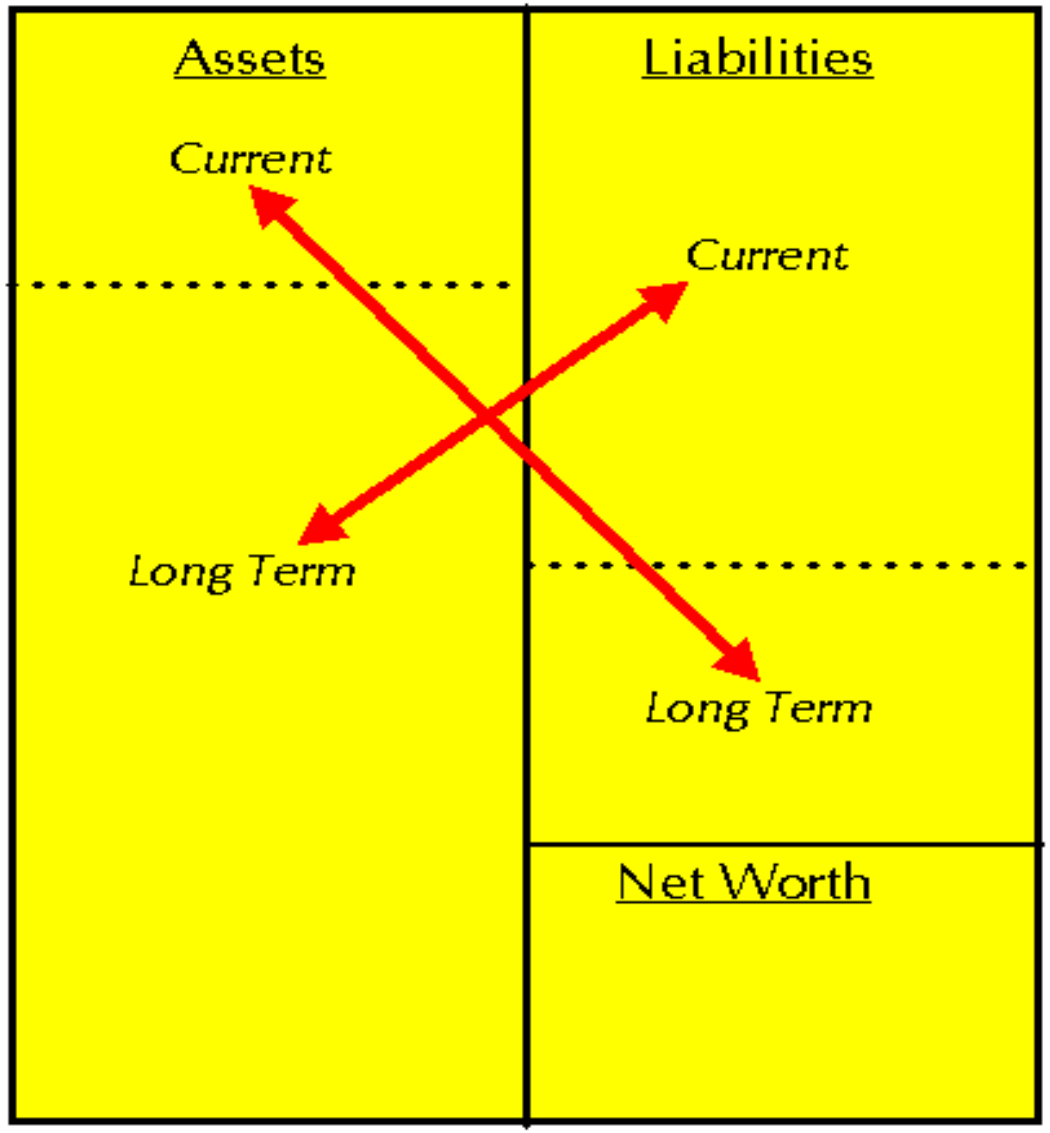
Appropriate loan structure is:

- Matching repayment terms to repayment sources
- Using appropriate balance sheet financing strategies
- From the bank's perspective, being paid in interest and fees for the risk taken and servicing required
- From the bank's perspective, establishing, monitoring, and enforcing appropriate covenants and agreements

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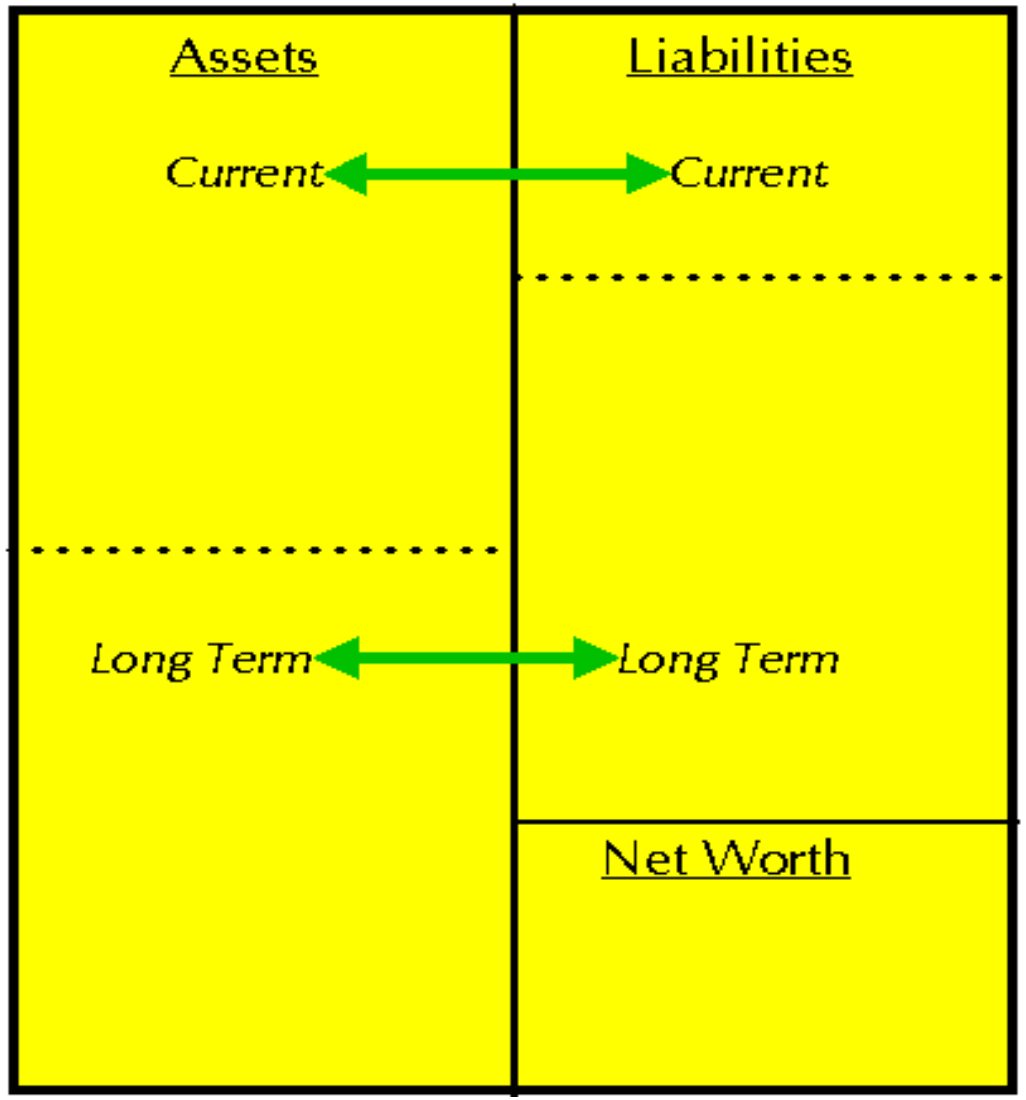
Improper Balance Sheet Financing



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Proper Balance Sheet Financing



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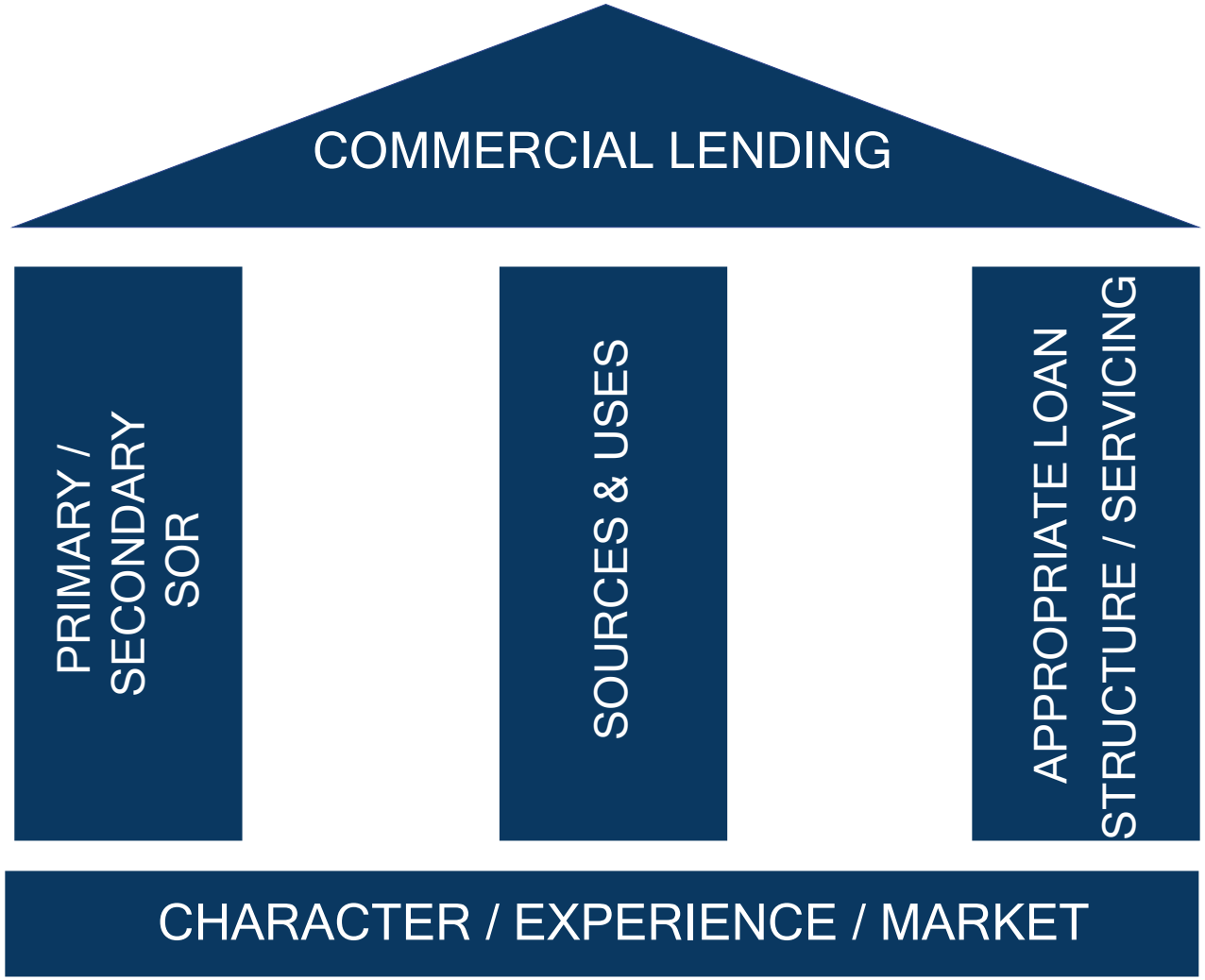
Administering the Loan

- Obtaining & analyzing current financials
- Monitoring Inv / AR / AP / Borrowing Bases
- Covenants
- Conducting inspections (RE / ABL)
- Monitoring loan draws

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Key Pillars of Commercial Lending



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Benefits of Quality Underwriting

Understanding your borrower financially is more than an investment in quality control– it's your Bank's ticket to profitable growth.

Thorough underwriting shouldn't be confused with an unwillingness to lend.

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How to understand commercial real estate lending

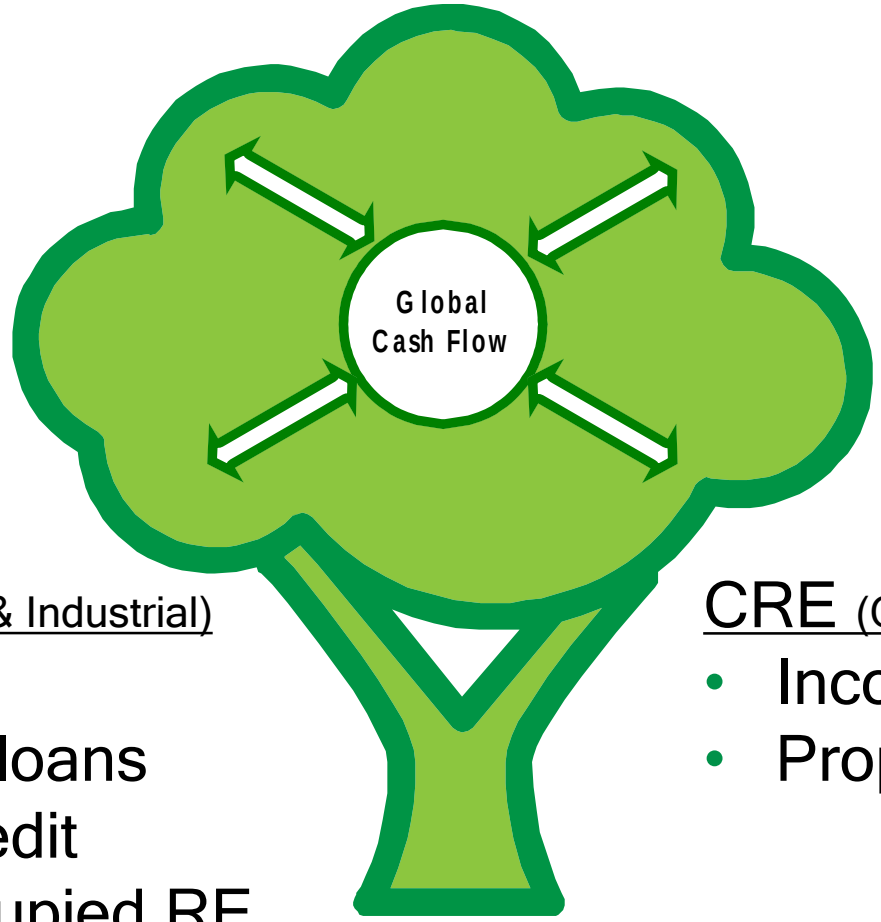
Keys to Analyzing Commercial Real Estate (CRE Loans)

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The *Commercial Lending* tree has two branches- underwritten very differently



C&I (Commercial & Industrial)

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- Lines of credit
- Owner-occupied RE

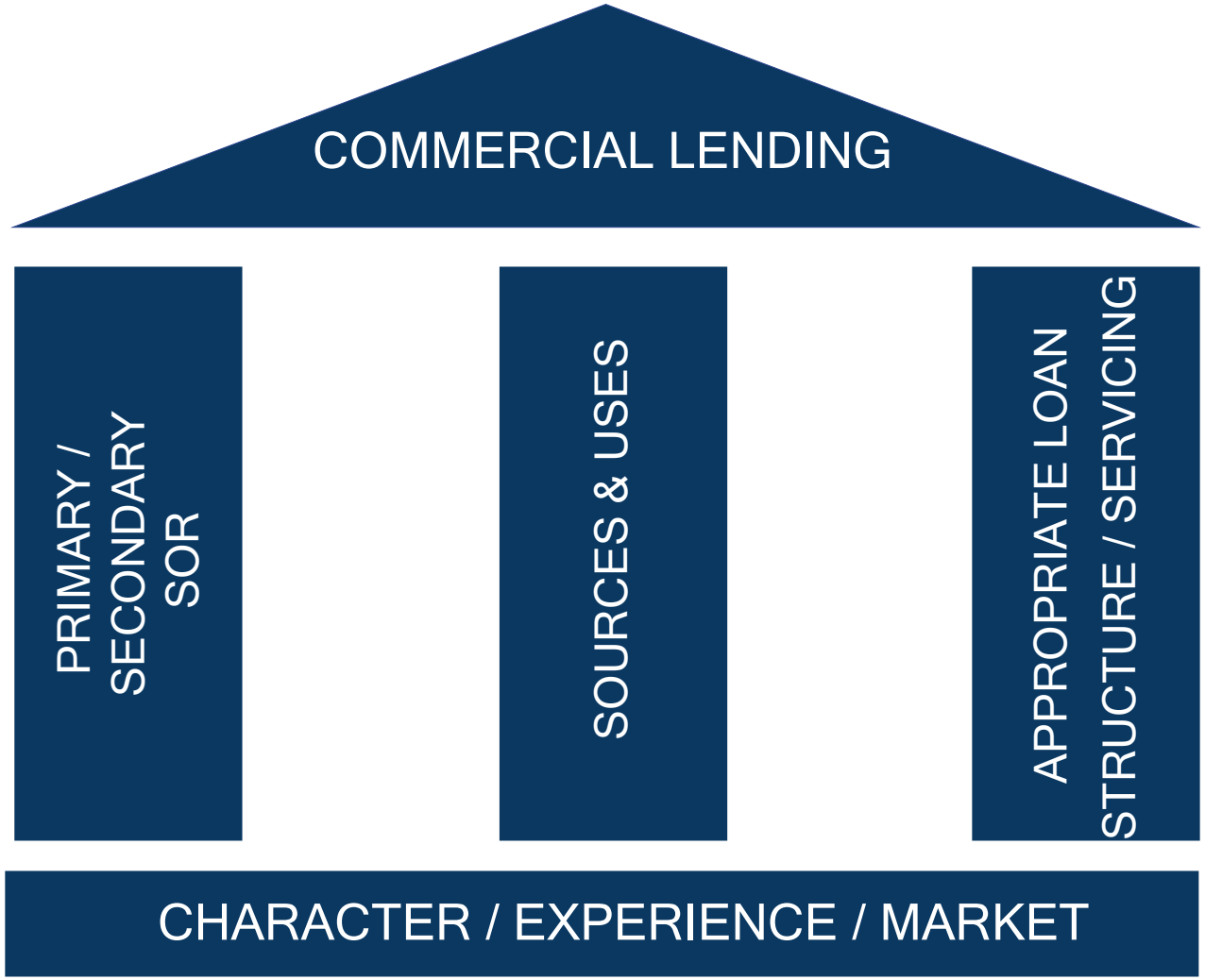
CRE (Commercial Real Estate)

- Income property
- Property for sale

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Key Pillars of Commercial Lending



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Real Estate Underwriting Rules of Thumb—*for Bankers*

- The project and builder/developer should be analyzed separately for primary, then secondary support
- ALL components of the borrower's credit relationships must be analyzed
- The loan's complexity and size must be matched by the bank's expertise and time commitment.

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Commercial Real Estate Loan Types

Permanent

- Investment Real Estate – aka “Income Properties”
- Owner Occupied Commercial Real Estate – aka “OOCRE”

Short-term/Phased

- Construction
- Acquisition and Development (A&D)

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Real Estate: *The Jekyll and Hyde* of Banking

- **Jekyll**
  - RE is the #1 Bank portfolio driver.
  - Historically popular. Considered secure.
- **Hyde**
  - Culprit in every major crisis in modern banking.



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Why do banks love RE lending?

- Better historic spreads
- Less perceived risk of loss
- Community development
- Big balances; on books for a long time
- Visible, tangible, durable
- Can be *one-and-done* vs relational aspect of C&I.

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Why does RE trouble banks?

- Incubation period between concept and stabilization
- Essentially a long-term asset funded by short and intermediate term lenders.
- Temptation for corner cutting due to size and complexity
- But, perhaps, most frustratingly…

  RE Lending involves present expectations of a commodity's future value



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How do we decide to make a CRE loan?

The answer is as in two halves of the same walnut:

1. One of which we're instinctively familiar: *underwriting the project / borrower for repayment capacity*

2. The other, emerging as equally important: *determining the market's supply & demand dynamic.*



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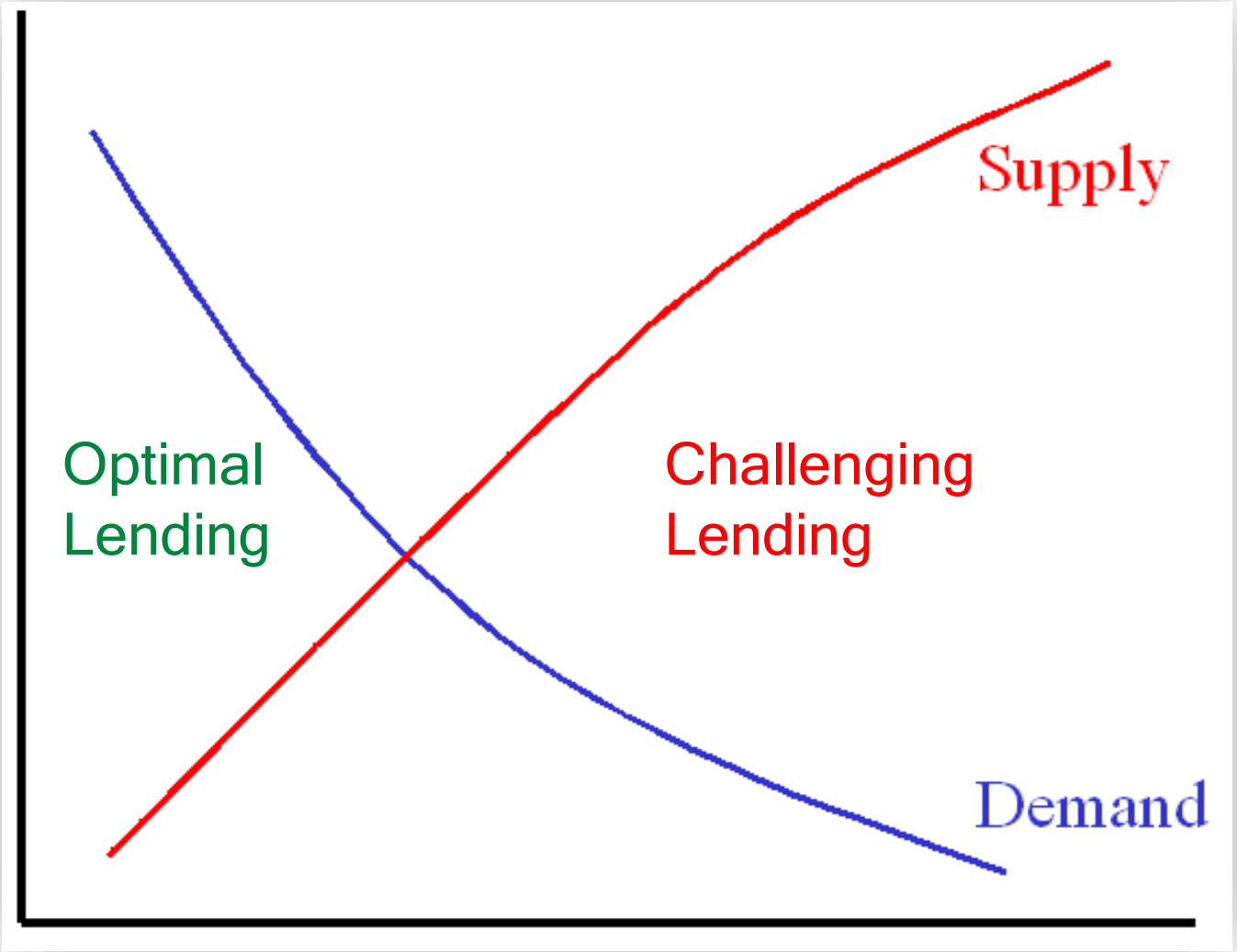
Keys to Analyzing the CRE Marketplace's Supply & Demand

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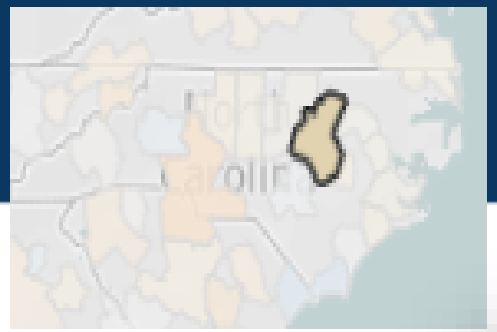
The most fundamental metric in CRE—*whatever the type*



Which side of the intersecting lines is better for bankers?

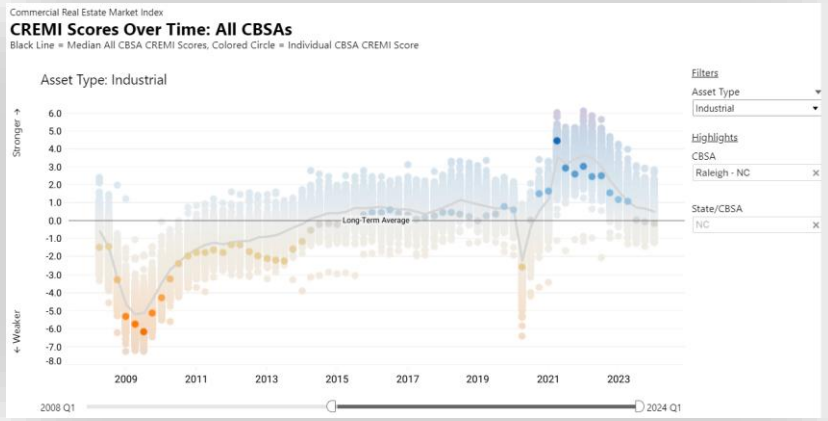
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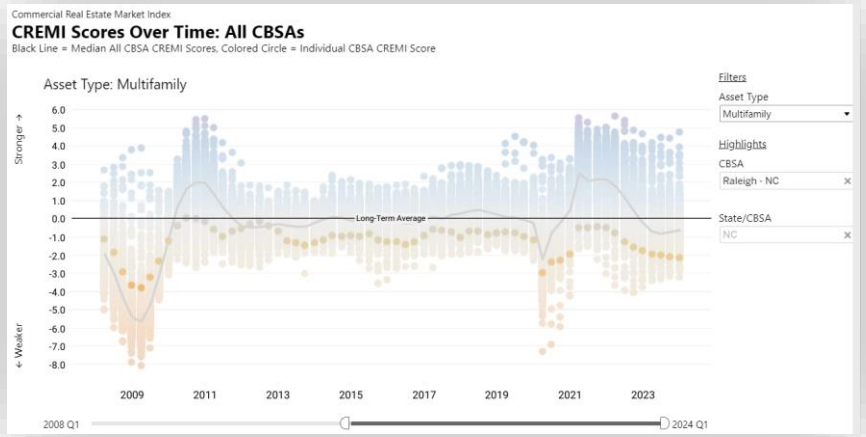


Raleigh *(Trends since Q1 '08 / CREMI as of Q1 '24)*

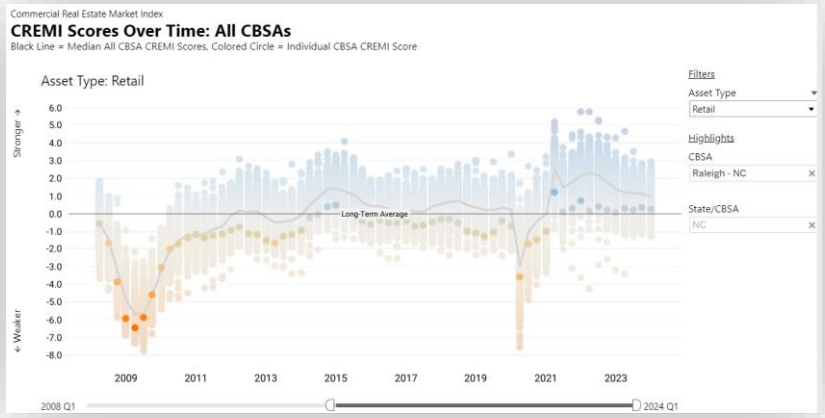
Industrial: **-0.20**



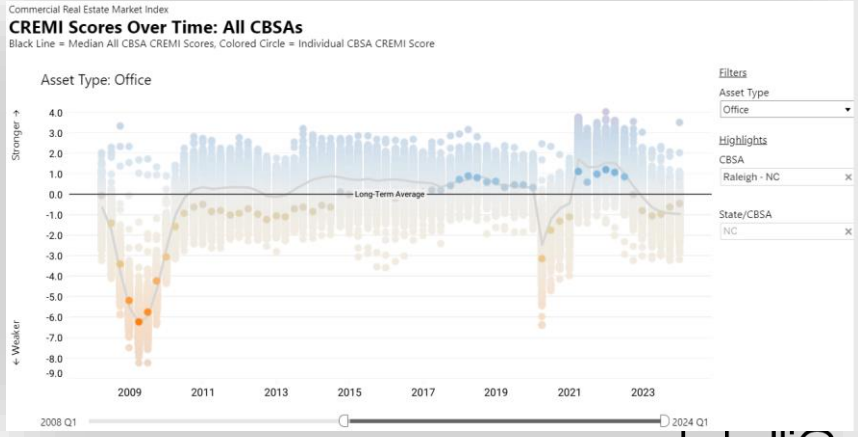
Multifamily: **-2.10**



Retail: **+0.20**



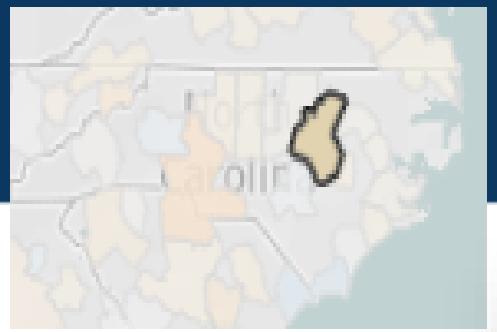
Office: **-0.50**



Source:
ATL Fed
CRE Market Index

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Raleigh *(Trends since Q1 '08 / CREMI as of Q1 '24)*

Commercial Real Estate Market Index

CREMI Scores Over Time: CBSA Level

CBSA: Raleigh - NC

Stronger →

← Weaker

5.0
4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
-6.0
-7.0

Long-Term Average

2009 2011 2013 2015 2017 2019 2021 2023

2008 Q1 2024 Q1

Filters

CBSA

Raleigh - NC

Asset Type

(All)

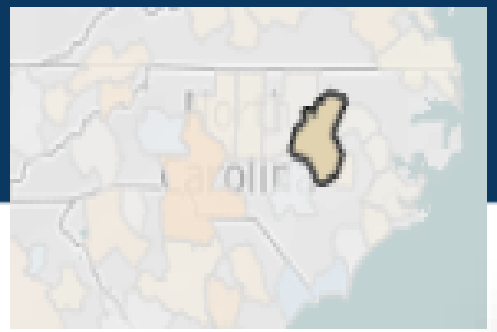
Industrial
Multifamily
Office
Retail

View on Tableau Public Share

Source:
ATL Fed
CRE Market Index

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Raleigh *(Trends since Q1 '08 / CREMI as of Q1 '24)*

Commercial Real Estate Market Index

CREMI Contributions Over Time: CBSA Level

CBSA: Raleigh - NC

Filters

CBSA: Raleigh - NC

Asset Type: Multifamily

Stronger →

← Weaker

0.00

-1.00

-2.00

-3.00

-4.00

Long-Term Average

2009 2011 2013 2015 2017 2019 2021 2023 2025

2008 Q1 — 2024 Q1

CREMI

CRE

Economic

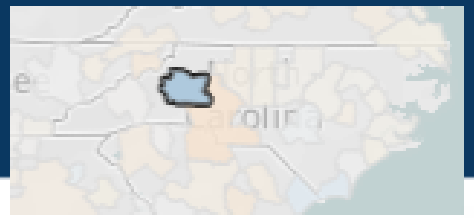
View on Tableau Public

Share

Source:
ATL Fed
CRE Market Index

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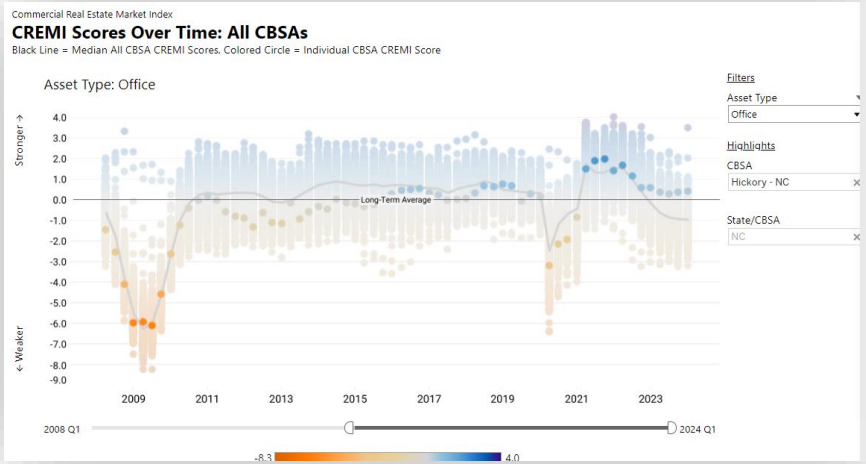
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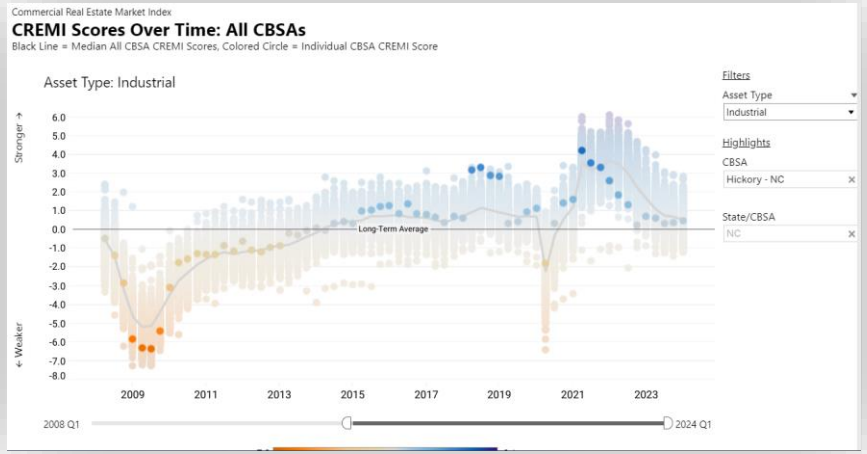
Hickory *(Trends since Q1 '08 / CREMI as of Q1 '24)*

Source:
ATL Fed
CRE Market Index

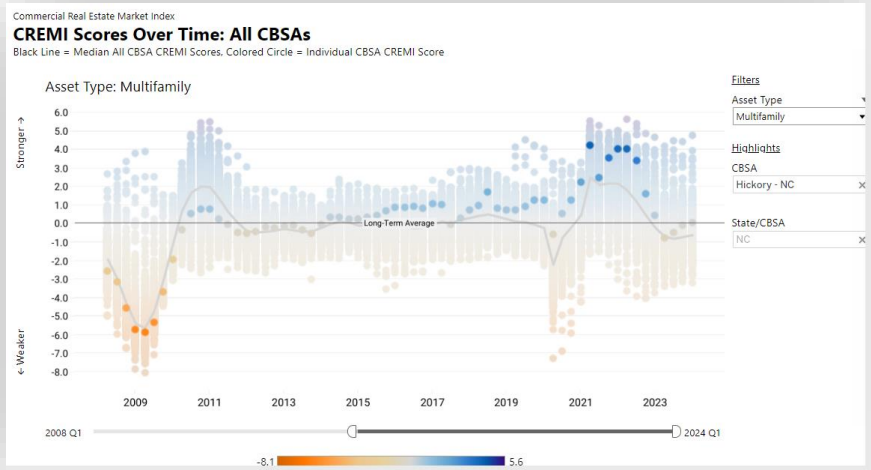
Office: -0.40



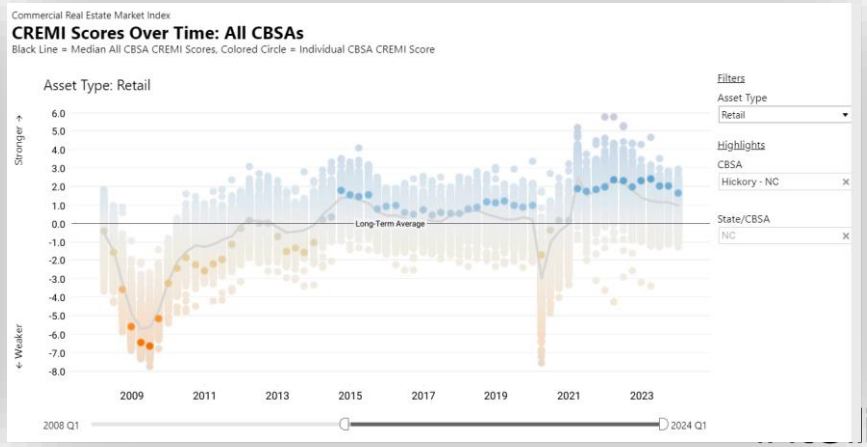
Industrial: +0.50



Multifamily: +0.00

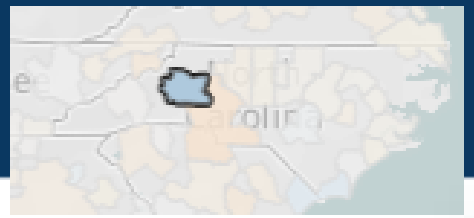


Retail: +1.60



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Hickory *(Trends since Q1 '08 / CREMI as of Q1 '24)*

Source:
ATL Fed
CRE Market Index

Commercial Real Estate Market Index

CREMI Scores Over Time: CBSA Level

CBSA: Hickory - NC

Stronger →

← Weaker

4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
-6.0
-7.0

Long-Term Average

2009 2011 2013 2015 2017 2019 2021 2023

2008 Q1 2024 Q1

Filters

CBSA
Hickory - NC

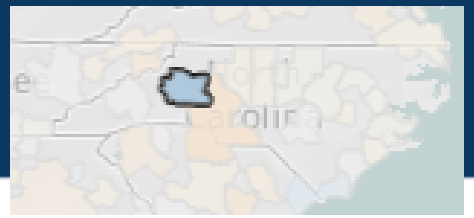
Asset Type
(All)

Industrial
Multifamily
Office
Retail

View on Tableau Public

Share

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Hickory *(Trends since Q1 '08 / CREMI as of Q1 '24)*

Source:
ATL Fed
CRE Market Index

Commercial Real Estate Market Index

CREMI Contributions Over Time: CBSA Level

CBSA: Hickory - NC

Filters

CBSA: Hickory - NC

Asset Type: Multifamily

Stronger →

← Weaker

4.00
2.00
0.00
-2.00
-4.00
-6.00

Long-Term Average

2009 2011 2013 2015 2017 2019 2021 2023 2025

2008 Q1 — 2024 Q1

CREMI
CRE
Economic

View on Tableau Public

Share

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Improving CRE Portfolio Management

- Deepen CRE concentration assessments (to include all material subsets)
- Improve econometric/market data on lending footprint
- Enhance portfolio analytics / MIS data
- Adapt policies / underwriting to sync with conditions
- Embrace multiple stress test modes
- Expand loan review
- Integrate with strategic and capital plans
- Communicate effectively with both *Boards* and *Management*

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Keys to Analyzing the Project / Borrower's Repayment Capacity

?

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Regulatory Loan-to-Value (LTV) Limits

Raw land	65%
Land development	75%
Construction:	
- *Commercial, multifamily, other nonresidential*	80%
- *1- to 4-family residential*	85%
Improved commercial property	85%

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Regulatory Loan-to-Cost Limits (%)

Type	Purchase LTV/LTC	Build LTV/LTC	Refinance LTV/LTC
Raw Land	65/65	N/A	65/X
Improved Land	75/75	75/100	75/X
Commercial Construction	N/A	80/100	80/X
Commercial Permanent	85/85	N/A	85/X
1-4 Family Construction	N/A	85/100	85/X
1-4 Family Permanent	<90/<90	N/A	<90/X

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Regulatory LTV limits / regs / guidance

- **Do not apply for:**
  - Loans with government guaranty
  - Loans to be sold promptly w/o recourse to Bank
- **All loans exceeding LTV limits must be formally reported to Board of Directors**
- **Other CRE Hot buttons:**
  - 300% (CRE) /100% (CA&D) 2005 guidance

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Types of RE valuations

- **Appraisal**
  - performed by State Certified Appraiser or higher
  - strict federal content guidelines
- **Evaluation**
  - usually performed by Bank
  - bank decides criteria -- “satisfy principles of safe and sound banking.”
  - tax value, broker’s opinion, etc.

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Appraisal “approach” options

- ***Sales*** – Based on recent sales of comparable or “comp” properties.
- ***Cost*** – Current cost to construct/duplicate less any existing depreciation.
- ***Income*** – Current value of future income
  - Recurring Income: capitalization
  - Development: Discounted Cash Flow

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When *Appraisal* is required

>$250M for "real estate related transactions" except

- **Abundance of caution**

- **Business purpose (not RE dependent) secured by RE (up to $1MM)**
  - OOCRE, Farmland, Timber

- **Renewal**
  - no cash out
  - no change in property or market

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General RE Valuation Issues

Property Type	Valuation Driver
Existing SF Residence	Comp Sales
Proposed SF Residence	a) Comp Sales b) Cost
Investment RE	a) NOI - Lease Rates, b) Cap Rate
Hotel	a) NOI - ADR, Exp mgmt b) Cap rate
Residential S/D	Absorption rate
Religious Org-Sanctuary	Cost

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Existing vs *Proposed* Improvements

- **For Existing**

  Valuation = “As Is”

- **For Proposed**

  Valuation =

  “As Is” and

  “As Built,” or “As Improved”

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Loan-to-Value Ratio (Developments)

$$\frac{\text{Loan Amount}}{\text{Appraised Value of Project}} = ?\,\%$$

Retail:

$$\frac{\$450{,}000}{\$800{,}000} = 56^{*}\%$$

Wholesale:

$$\frac{\$450{,}000}{\$600{,}000} = 75^{**}\%$$

*With imputed value of improvements and profits

**As is (in bulk)

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Loan-to-Value Ratio (With Junior Liens)

$$\frac{\text{Loan Amount}}{\text{Appraised Value of Project}} = ?\ \%$$

Combined LTV:

$$\frac{\$540{,}000\ (1^{st}\ \text{Lien}) + \$100{,}000^*}{\$800{,}000} = 80^*\%$$

More Liberal:

$$\frac{\$540{,}000\ (1^{st}\ \text{Lien})}{\$800{,}000} = 67.5\%$$ $260,000 (Equity) X 80% = $208,000*

*Proposed 2nd Lien Loan

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Income Property

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Income Producing Properties Considerations

- **General**
  - Leases and Tenant Quality
  - Market Considerations
  - Appraisals/Valuations
  - Collateral Eligibility
  - Environmental Assessment
  - Commercial Construction Lending
- **Property Specific**
  - Cash Flow Analysis
  - Property Type Idiosyncrasies

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Leases

Leases represent the market acceptance of the project. Determine:

- Term of the lease(s)
- Market vs. stated rents
- Obligations of the lessor / lessee
  - Inducements to sign up
  - “Triple Net” Leases
- Assignability of the lease
- If the lessee is a *credit tenant*.

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Types of CRE Leases *(Gross or Full-Service Lease)*

- Typically means the rental rate of the property includes all operating expenses associated with the property such as janitorial services, property maintenance, utilities, and property taxes. This is the simplest form of a commercial lease and is most common in multi-tenant office properties catering to smaller businesses (1-15 person businesses).

- While a Gross Lease has the vast majority of operating expenses included in monthly rent, the language within the lease typically states the landlord has the right to pass down to the tenants any future increases in those expenses on a pro rata basis. For example, if during the summer months a building incurs more air conditioning/electrical expense than was estimated, the tenants will receive a bill.

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Types of CRE Leases *(Net Lease)*

- The landlord charges a lower base rent for the commercial space, plus some or all of "usual costs," which are expenses associated with the operation, maintenance, and use of the property that the landlord pays. These can include real estate taxes; property insurance; and common area maintenance items (CAMS). CAMS include janitorial services, property management fees, sewer, water, trash collection, landscaping, parking lots, fire sprinklers, and expenses associated with commonly shared areas or services.

- <u>There are several types of Net Leases</u>:

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Types of CRE Leases *(Net Leases–Single Net)*

- The tenant pays base rent plus a pro-rata share of the building's property tax (meaning a portion of the total bill based on the proportion of total building space leased by the tenant). The tenant also pays utilities and janitorial services. The landlord covers all other building expenses.

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Types of CRE Leases *(Net Leases–Double Net)*

- The tenant is responsible for base rent plus a pro-rata share of property taxes and property insurance. The landlord covers expenses for structural repairs and common area maintenance. The tenant once again is responsible for their own janitorial and utility expenses.

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Types of CRE Leases *(Net Leases–Triple Net)*

- (NNN Lease) - This is the most popular type of Net Lease for commercial freestanding buildings and retail space. In this lease, the tenant pays all or part of the three "nets"--property taxes, insurance, and CAMS--on top of a base monthly rent. Common area utilities and operating expenses are usually lumped in as well; for example, the cost for staffing a lobby attendant would be part of the NNN fees. The tenants also pay the costs of their own occupancy, including janitorial services, utilities, and their own insurance and taxes. Typically, landlords estimate the amount of the expenses to be covered and charge tenants a portion of the expenses based on the proportion of total building space they lease.

- When reviewing a NNN Lease, bankers should maintain an awareness that such leases tend to be more landlord-friendly. The fees included and the caps on the amounts those fees can be increased by annually should be carefully reviewed. Additionally, an awareness should be maintained that NNN Leases can fluctuate from month to month and year to year as operating expenses increase or decrease, making a tenant's expense forecasting tricky.

- While NNN Leases are more landlord-friendly, there are tenant benefits. Transparency is one as tenants can see business operating expenses in relation to what they are charged. Cost savings in operating expenses are passed on to the tenant rather to the landlord. In addition, the monthly rent in a NNN Lease is potentially lower than in a Gross Lease, as tenants have a higher level of responsibility for the building.

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Types of CRE Leases *(Net Leases–Absolute Triple Net)*

- This is a less common option that is more rigid and binding than the NNN Lease, where tenants carry every imaginable real estate risk, for example, being responsible for construction expenses to rebuild after a catastrophe, or for continuing to pay rent even after the building has been condemned. Aptly called the "hell-or-high-water lease," tenants have ultimate responsibility for the building no matter what.

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Types of CRE Leases *(Modified Gross or Net, Industrial Gross)*

- As the Gross Lease tends to be more tenant-friendly and the Net Lease tends to be more landlord-friendly, there exists a compromise lease for the convenience of both parties. The Modified Gross Lease is similar to a Gross Lease in that the rent is paid in one lump sum, which can include any or all of the "nets"--property taxes, insurance, and CAMS. Utilities and janitorial services are typically excluded from the rent and are covered by the tenant. Tenants and landlords negotiate which "nets" are included in the base rental rate.

- The Modified Gross Lease is more popular with tenants, because its flexibility translates into an easier agreement between tenant and landlord. Unlike the NNN Lease, if insurance, taxes or CAM charges increase, the lease rate does not change. Of course, if those expenses decrease, the cost savings is passed on to the landlord. As janitorial service and utilities are typically not covered, tenants can better control how much they spend compared to a Gross Lease.

- This type of lease is most common with industrial or warehouse space. In most cases, tenants of industrial properties will have a Gross Lease that has been modified so some of the expense categories (usually electrical) will be charged in addition to monthly rent. All other property expenses are included in the regular monthly rent.

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Types of CRE Leases *(Percentage)*

- This is technically not a separate type of lease because the manner in which expenses are paid fall within one of the preceding categories. However, this type of lease is included here as the manner in which the amount of lease payments is determined is unique. In this type of lease, the tenant is responsible for paying base rent on the property, as well as a monthly percentage of revenue earned from the business occupying the rented space. These leases are most often used in retail spaces, specifically malls.

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Cash Flow Analysis - General

Operating Company Cash Flow	CRE Cash Flow
Sales	PGI (Potential Gross Income)
- COGS	- Vacancy & Collection Loss
= Gross Profit	= EGI (Effective Gross Income)
- Operating Expenses	- Operating Expenses
= Operating Profit	**= NOI (Net Operating Income)**
- Other Expenses (Interest)	- Leasing Commissions & T.I.'s
	- Replacement Reserves
= Net Income	**= Cash Flow Avail. for Debt Service**
For Debt Service Coverage:	**For Debt Service Coverage:**
Net Income + (Dep., Int., Amort., Etc.)	Cash Flow Available for Debt Service
Annual Debt Service	Annual Debt Service

Major determinant of value

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Income Property Valuation: Net Operating Income (NOI)

Gross Rents	$128,000
5% vacancy	- 6,400
Effective Gross Income	121,600
30% Operating expenses	- 36,600
Net Operating Income (NOI)	**85,000**
Annual debt service	- 68,200
Net Cash Flow	$ 16,800

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Income Property: Debt Service Coverage (DSC)

Amount of debt–agnostic to Cap Rate value!

Net Operating Income (NOI)	$85,000
	÷
Annual Debt Service	$68,200
Debt Service Coverage	1.25X

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Value by Capitalization Rate (Cap Rate)

A short-cut of the *income approach* used in appraisals is valuation by cap rate:

$$\text{Value / selling price of property} = \frac{\text{Net Operating Income}}{\text{Capitalization Rate (\%)}}$$

Examples:

1. $\$850{,}000 = \frac{\$85{,}000}{10\%}$

2. $\$653{,}846 = \frac{\$85{,}000}{13\%}$

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Income Property Value: *Capitalization Rate*

- Applies to any income generating asset
- A theoretical figure defined as:

> ***"A rate of return that a 'reasonable' investor would expect/demand if they were buying an asset of similar size, type, etc."***

- The number one item you pay an appraiser to determine for you!

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Direct Capitalization vs. *Discounted Cash Flow*

- **Direct Capitalization:**

  A single year's income is divided by an income rate to reach an indication of value and yield capitalization; it reflects the return *on* and the return *of* investment. It's a simpler, more one-dimensional approach– a short-hand version of DCS below.

- **Discounted Cash Flow:**

  Future benefits are converted into a value by discounting them at an appropriate yield rate that reflects projected changes in income, value and yield; the distinction between return *on* and return *of* capital is explicit.

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Discounted Cash Flow Analysis

	2012	2013	2014
Gross Rents	$72,500	$74,800	$79,650
Oper. Expenses	12,350	13,500	16,800
NOI	*60,150*	*61,300*	*62,850*

Present Value of Income @13% Discount Rate

60,150 X 0.884956 = $ 53,230

61,300 X 0.783147 = $ 48,007

62,850 X 0.693050 = $ 43,558

= $144,795

Present Value of Net Resale @ 13% (in 2014)

$485,000 (Projected Resale $) X 0.693050 = $336,129

Total Present Value $480,924

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Which method is best?

- *Direct capitalization* assumes everything about one year is frozen in time.
- *DCF* requires that various assumptions be made about the future when the future is unknown

What are examples of where one or the other should best be used?

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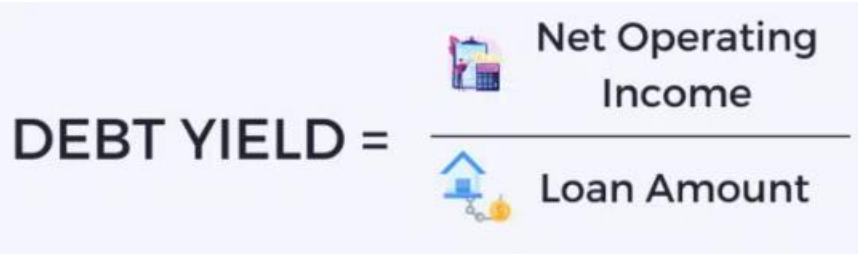
Which method is best? *Direct Capitalization* or *DCF?*

Project Type	***Best Method***
Apartments with stable rents (5 year loan)	**Direct**
Apartments with fluctuating rents dependent on projections	**DCF**
Warehouse with long term tenants at stable market conditions	**Direct**
Shopping center with defined recapture strategy	**DCF**

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Debt Yield Analysis



$$\text{Debt Yield (18.9\%)} = \frac{\$85{,}000 \text{ (NOI)}}{\$450{,}000 \text{ (Loan Amount)}}$$

Key attributes

- Focuses on debt vs. value (how long to get out of a loan)
- Inverse of CAP rate: *greater %* is better

Example:
100 ÷ 18.9 = 5.29 Years

100 ÷ 10 = 10 Years

- Unlike DSC: not suspectable to interest rate swings.

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How to Perform Income Property Repayment Analysis

Income Property NOI Calculator

Revenues	Size (Sq Ft)	Rate	
Grocery	35,000	$ 8.00	$ 280,000.00
Subway	8,000	$ 10.00	$ 80,000.00
Locals	15,000	$ 12.00	$ 180,000.00
Gross Income			**$ 540,000.00**
Less Vacancy (15% of local space)		15.00%	$ 27,000.00
Effective Gross Income			**$ 513,000.00**
Expenses			
Advertising			$ 5,000.00
Cleaning and maintenance			$ 16,200.00
Depreciation*			$ 15,000.00
Legal and other professional			$ 20,000.00
Insurance			$ 3,000.00
Interest*			$ 17,000.00
Management			$ 19,000.00
Repairs			$ 21,000.00
Supplies			$ 11,000.00
RE Taxes			$ 5,400.00
Utilities			$ 10,400.00
Total Expenses			**$ 143,000.00**
NOI (Net Operating Income) *(Effective Gross Income-Total Expenses+Depreciation+Interest)			**$ 402,000.00**

Income Property Loan Analysis Calculator

Step	Inputs	Outputs
1. NOI	$ 402,000	
2. Property Value (NOI/Cap Rate)		
Cap Rate	10.00%	$ 4,020,000
3. Annual DSC by NOI (NOI/DSC)		
DSC Ratio	1.30	$ 309,231
4. Optimum Loan Amount ($DSC/Cap Rate)		$ 3,092,308
5. Debt Yield (NOI/Optimum Loan Amount)		13.00%
Years to Pay-off (1.00/Debt Yield)		7.69

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Calculate a NOI based on the following

- **Adjusted Gross Revenue (factoring in vacancy): $800,000**
- **Operating Expenses**
  - Advertising: $6,500
  - Maintenance: $18,500
  - Depreciation: $22,000
  - Legal & Professional: $26,000
  - Insurance: $12,000
  - Interest: $23,500
  - Management: $25,000
  - Repairs: $28,000
  - Supplies: $21,500
  - RE Taxes: $15,500
  - Utilities: $19,000

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Assuming the NOI, calculate the following

- Property Value (at various Cap rates)
- Annual Debt Service Coverage (DSC) (at various coverage %'s)
- Optimum Loan Principal Amount
- Debt Yield

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Common (but Bad) ideas to make the deal “work” for Income Property

- Amortization schedule > useful (non-renovated) life of property
- Accepting “fake” equity in RE as “real.”
- Presuming individual strength without analysis
- Accepting unrealistic Lease Projections
  - New Property – better than market terms
  - Existing Property – new owner can do better than previous (better than market)

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Other key metrics often used (often from investors' perspectives)

- ## Internal Rate of Return (IRR)

  Used to measure a project's profitability. This metric accounts for initial investment costs, cash flow, and property sale proceeds. The higher the IRR, the more attractive the project.

- ## Cash-on-Cash Return (CCR)

  …or cash yield, is a common metric in the commercial real estate industry. The rate of return measures the annual pre-tax cash flow divided by the total cash invested. This figure measures the investment's performance.

- ## Gross Rent Multiplier (GRM)

  For an easy assessment tool to compare properties, the gross rent multiplier metric can help narrow down the best opportunities. To calculate this, divide the property's price by its potential gross annual income. If a property is listed for $500,000 and carries an annual income of $100,000, then the GRM is 5. GRM works best when ranking similar properties in relatively close proximity. Note that it does not factor operating expenses, market fluctuations, or loan amortization.

- ## Operating Expense Ratio (OER)

  Add the day-to-day operating expenses–insurance, landscaping, maintenance, utilities, taxes, management fees, et al.–but not any mortgage repayments or capital improvements. Then, divide the total operating expenses by your potential rental income. Essentially, the lower the OER, the more profitable the property.

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Stress Testing

- **Current/accurate data dependent**
  - Rent rolls
  - NOI
  - Independent market trends & valuations (REIS / CoStar)
- **Loanable amount**
- **Break-even analysis**
- **Stress scenarios**
  - LTV
  - NOI
  - Cap Rate
  - DSC

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Property for Sale

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Common miscalculations regarding A&D Lending

- RE lending is all the same
  - Risk is acceptable if secured by dirt
- Lack of respect for market change potential
- Every project will eventually sell out
  - Developer just needs time
  - Bank just needs to be patient.
- Foreclosure and resale can’t be all that hard

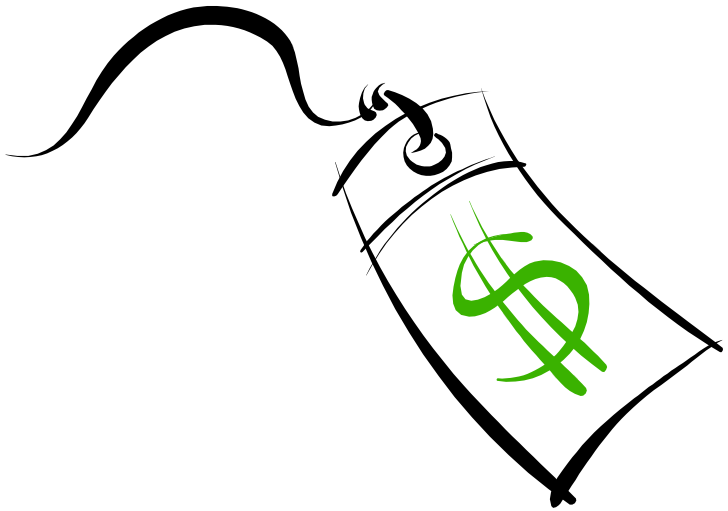
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Pre-Sale or *Spec*?

- A “real” Pre-Sale has:
  - Verifiable contract, and
  - Reasonable deposit, and
  - Permanent financing commitment, or
  - Documentation that buyer would qualify for permanent financing.

- Otherwise, it’s a Spec!



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Loan Amount / Structure

- Fixed loan vs. revolving LOC
- Hard/soft costs
- Contract types
- Loan exposure ratios
  - Loan-to-net sellout
  - Loan-to-cost
  - Repayment Point # of Lots
  - Repayment Point % of Lots
  - Loan-to-value (wholesale / retail)
- Loan covenants

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Loan-to-Net Sellout Ratio

$$\frac{\text{Loan Amount}}{\text{Net Sellout of Project*}} = ?\ \%$$

$$\frac{\$450{,}000}{\$642{,}857} = 70\%$$

*After payment of sales costs/commissions

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Loan-to-Cost Ratio

$$\frac{\text{Loan Amount}}{\text{Cost of Project}} = ?\ \%$$

$$\frac{\$450{,}000}{\$500{,}000} = 90^{*}\%$$

*Generally front-end cash equity

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Repayment Point (# Lots)

$$\frac{\text{Loan Amount}}{\text{Net Sales Proceeds (per lot)*}} = ?$$

$$\frac{\$450{,}000}{\$\ 16{,}071} = 28$$

*After payment of sales costs/commissions

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Repayment Point (% of total lots)

$$\frac{\text{Repayment Point (Lots)}}{\text{Total Lots in Project}} = ?\ \%$$

$$\frac{28}{40} = 70\%$$

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Administering the Loan

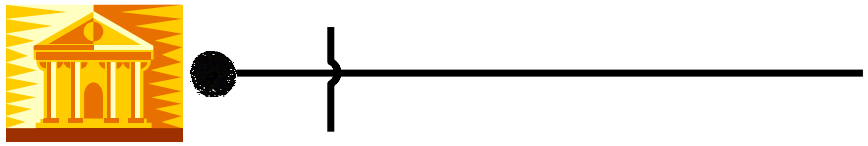
- Conducting inspections
- Monitoring loan draws
- Monitoring inventory

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All construction & development lending is about *imputed value* & *timing*

Construction/Development Timeline

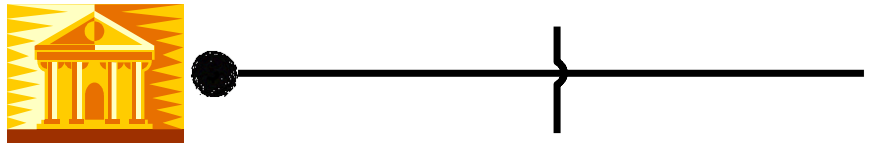




Project Improvements



Construction/Development Timeline





Project Improvements



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Discounted Cash Flow Analysis *(Cash Budget)*

	Jan	*Feb*
Lot Sales	$56,800	$40,750
Other	600	0
Total Income	*57,400*	*40,750*
Taxes	3,890	245
Closing Costs	1,704	1,223
Overhead	3,697	3,068
Marketing	6,970	8,590
Site Work	16,876	3,785
Other Projects	12,750	0
Interest	3,456	2,897
Total Expenses	*49,343*	*9,808*
Net Cash Flow	*$8,057*	*$20,942*

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Other Issues

- Amenities
- Phasing
- Change Orders
- Unsecured Loans
- Interest Reserves

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Mitigations of Risk

Risk Factors	***Mitigating Factors***
Market acceptability	Leases (or Pre-Leases), Liquid guarantor
Thin cash flow coverage	OK if aggressive amortization, Liquid guarantor
Lack of cash equity	Land equity (no debt)
Illiquid guarantor	Solid overall guarantor NW, preferably improved RE
Unproven project	Low LTV, liquid guarantor

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What is “Global” Cash Flow?

- A comparison for a specific group such as:
  - Related businesses
  - Individuals in partnership
  - Multiple investments owned by one individual
- A comparison of collective cash available to pay debt service v. collective debt service of the group.

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Why do a Global Cash Flow?

You Want to Know:

Will operations and investments “outside” of the borrower provide excess cash to help repay your loan?

Or

Will these outside “activities” cash away from your borrower, thus straining repayment ability?

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Benefits of Quality Underwriting

Understanding your borrower financially is more than an investment in quality control– it's your Bank's ticket to profitable growth.

Thorough underwriting shouldn't be confused with an unwillingness to lend.

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10 Recommended Steps to Take on CRE

- Be aware and document market trends
- Revisit CRE underwriting & servicing policies
- Cherry-pick loans shut off from larger banks (moving up in quality)
- Consider more work-out expertise
- Stress test throughout the post booking period
- Utilize loan data tools to anticipate and jump on emerging CRE hotspots
- Anticipate and prepare for maturities / re-pricings at least one year ahead
- Expand MIS and communications with management & boards with more:
  - concentration analyses
  - CRE subset portfolio growth, performance trends & vintage analyses
  - underwriting & post booking servicing exceptions focus
- Bulk up loan review CRE samples *(early detection : reduced losses)*
- Be prepared to *write your own credit script,* and above all, ***minimize credit surprises!***

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Q & A

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