



Many Commercial Financing Options Exist

By Vito J. Taphorn

For owners, developers and investors of commercial real estate, there are abundant options within the financial markets that should be explored when obtaining debt.

Prior to exploring financing options the owner/borrower must first examine a few aspects of the investment they are looking to finance. The Borrower should analyze the real estate and make assumptions on the following items:

- The holding period for the subject real estate.
- The proforma operating income.
- The proposed value for the property.
- The minimum rate of return.
- Borrower's tolerance for interest rate risk.
- Construction or structural renovations needed for the property.

The underwriting of a construction loan by a lender requires the evaluation of the four primary factors that make up the property. The factors include property value, borrower experience, financial risk and construction risk. Evaluating these factors allows a lender to propose the proper debt structure best suited for the project and the short and long term goals of the borrower.

Most banks and financing institutions offer the following products and services refined to the specific project:

- Construction Loan: Short term loan used to pay for the construction of commercial property. Loan funds are disbursed at periodic times (usually monthly) through draws.
- Acquisition/Bridge Loan: Short term or interim loan used by borrowers when acquiring a property that needs to be rehabilitated or repositioned.
- Mini-perm: A mini-perm loan is an intermediate term loan that usually extends up to seven years.

After the property is constructed or rehabbed/repositioned the borrower may seek a permanent loan, which is longer term financing typically used to take out the above referenced loan types. One form of permanent financing is a conduit, which makes loans under standard terms, underwriting and documentation. Pools of these loans then are segmented and sold to investors in the CMBS (Commercial Mortgage Backed Security) market. Most conduit loans are also non-recourse, or not personally guaranteed by individuals. The other major source of permanent debt is insurance companies.



Once the type of loan is determined the borrower and the lender must determine the proper interest rate for the facility. Adjustable rate mortgages are loans with an interest rate that changes periodically according to an index that is selected prior to the mortgage being issued. The most common indexes used are based off of a bank's prime rate or the current LIBOR (London Interbank Offered Rate) rate.

Fixed rate mortgages are loans with interest rates that remain constant for the life of the loan. These loans are priced off of indexes usually associated with the term of the loan, i.e., a 10-year treasury note may be used as a base index for a 10 year fixed rate loan. Most permanent loans are fixed-rate mortgages.

Borrowers who are looking to actively manage their interest rate exposure could look toward financial derivatives to help them reduce/hedge interest rate risk. Interest rate swaps are the most common product utilized and are used to fix some or all of a loan's interest rate. Benefits of a swap are increased flexibility, a lower effective rate, and the possibility of a gain on the early termination of a swap. If interest rates are higher than at the time the swap was entered into, the borrower may actually receive a gain upon termination.

Another derivative product is an interest rate cap, which allows you to effectively hedge your interest rate risk by allowing you to put a ceiling on an adjustable interest rate.

Commercial properties are complex investments, which if financed properly, can provide financial gains for its owners. Obtaining the proper financing for a commercial property requires a proper assessment of the Borrower's short and long term goals for the subject property.

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