Commercial Real Estate

there's a muddy area when it comes to owner-occupied commercial real estate loans. c&i and cre lenders both encounter problems, because owner-occupied is a different animal. problems associated with standard c&i practices are linked to key service providers; title insurance; equity; inspections; draw process; the construction contract; standby letters of credit; and ground leases. problems that occur when issuing standard CRE practices are linked to a non-arm's-length lease; customer serving as general contractor; customer lack of experience or sponsorship; property location choice; tenant finish; completion cycles; and shell entities and common ownership. here's the dirt on finding that middle ground for your monkey in the middle.

by richard hamm

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Owner-occupied loans involve commercial real estate in which the owner occupies 50% or more of the leasable space or provides 50% or more of the rental income. In many cases, such as manufacturing plants and industrial warehouses, the owner occupies 100% of the space. These owner-occupied (OO) loans fall into an interesting middle ground in commercial lending. The analysis leans heavily toward conventional commercial and industrial (C&I) loans, while documentation and administration lean heavily toward non-owner-occupied (NOO) or income-producing property loans. As such, there is no clear advantage to having C&I lenders or commercial real estate (CRE) lenders handle these loans. In fact, OO-CRE loans present challenges when originated and administered by C&I lenders who have limited commercial real estate experience. Also, if administered by lenders with extensive commercial real estate backgrounds, these loans have aspects that may not fit within the expected real-estate-related procedures for NOO properties.

Table 1 illustrates the analytical and documentation/administration “middle ground” of owner-occupied commercial real estate loans. So, what are the challenges of OO real estate loans and how can you avoid making common mistakes?

Problems in Applying Common C&I Lending Practices and Procedures

Lack of familiarity with key service providers. C&I lenders and their customers sometimes do not know, nor do they regularly deal with, key service providers such as surveyors, environmental engineers, appraisers, title companies, architects, contractors, and inspectors. This can cause unnecessary delays in completion (if construction) or in closing (if a purchase). It also can lead to selecting less-than-qualified providers based on the cheapest or first quote rendered over the phone or by not asking for and checking references. As a countermeasure, the lender or customer should get a real estate professional involved, even if it requires paying a consulting fee. On the bank side, the C&I lender needs to involve appropriate persons with CRE experience.

Treating title insurance as merely a checklist item.
Without thoroughly reviewing a title insurance policy, the lender cannot ensure that exceptions are understood and cleared. Two such exceptions—easements/encroachments and survey—are usually disclosed on the initial title binder or abstract or can be found by closely comparing the legal description to the other documents, such as the appraisal and the survey.

- Easements and encroachments can affect the value of the property and should be fully addressed in the property valuation or appraisal.
- Without a proper survey, the typical survey exception contained in the preliminary title binder drastically limits the effective coverage. Ironically, surveys tend to be one of the least expensive closing items, and in some cases an existing survey can be used if there have not been any changes to the “footprint” of the buildings or no new easements recorded.

Another common mistake is allowing construction to com-

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mence prior to closing or allowing improvements to start prior to purchase. Doing so can lead to potential lien issues for services, labor, or materials—rules on these lien rights vary from state to state. Preserving mortgage liens in purchase and construction situations is a great topic for a local CRE attorney to address during a visit with your lending staff. Over lunch or a half-day session, he or she can expand on the ins and outs of title insurance, addressing specific laws in your state.

Seven problem areas related to commercial construction situations.

1. **Lender does not require borrower to inject equity prior to loan draws.** Most loan policies assume that borrower equity is injected before any loan draws or advances are made. This equity usually is in the form of cash. Not injecting equity early on risks the ability to get equity later. This problem can be compounded if the lender did not identify the exact source of equity during the underwriting process. Those involved in the loan approval process need to ask about the source and timing of the borrower’s equity contribution—don’t assume the lender fully understands the policy issue.

2. **Lender fails to make irregular and unannounced inspections of project or site.** For all construction loans, it is critical for the lender to actively visit and inspect the site, even in the case of large loans where the bank’s loan policy requires use of a qualified third-party inspector to approve loan draws. While the lender may not have the experience of the inspector, the lender cannot totally delegate this important duty. Inspections should be made even in months when a draw is not made (generally a minimum of 30 days from last draw). It is important to know that work is continuing on the project, even if a loan draw request has not been made.

3. **Lender does not use standard draw process.** Many C&I lenders have not prepared for OO-CRE construction loans by creating a true system for filing receipts and draw requests, along with the related inspection reports. Further, they do not compute and compare the percentage of loan funds drawn to date with the estimated percentage or level of completion rendered by the inspector. Without these two numbers, the lender does not know if the loan is “overdrawn” (where the percentage of loan funds advanced exceeds the estimated percentage of completion). Most loan policies have limits for the level of over-advance allowed before additional approval is required (by a manager or credit officer). Two additional potential problems in the draw process are: 1) lender does not monitor or categorize disbursements by budget line item, then enforce limits; and 2) lender allows depletion of any budgeted contingency early in the project or does not correct-ly monitor usage. To prevent these mistakes, a C&I lender should enlist the help of and use the systems and procedures of experienced CRE lenders. If time and location make this difficult, he or she can at least create a system similar to residential home building. In any event, tracking and monitoring of draws is very important—in some title policies, systematic oversight is required to maintain coverage.
Changes can increase risk, and the bank must be aware of and given the chance to reject or modify requests that are not reasonable.

4. Customer and lender do not fully understand the construction contract. Again, this is not part of the lender’s or the customer’s normal area of expertise. First, the customer should get an experienced CRE attorney to review the contract. An architect or another contractor should review the feasibility of completion under recommended budget. Second, the lender should require and analyze a full sources and uses schedule for the project, including an adequate contingency line item in the budget.

   The lender should determine the source of interest payments—from project budget or operating cash flows—as well as the ability to pay more should delays occur. Ideally, the contract will have a fixed price with a clear mechanism for changes and/or substitutions and clear deadlines for completion. It should provide for bonding of the contractor.

   There should be a minimum 10% retainage on payments for all work performed, materials, general conditions, and fees. Final payment should not be made until:
   - Certificate of Occupancy (CO) is issued.
   - Contractor submits Affidavit of Final Payment.
   - All punch list items have been completed to the satisfaction of the borrower/owner and architect.

   Perhaps the most common mistake made by inexperienced customers is to request numerous changes during the construction project. While the customer may have been very diligent during the initial competitive bidding of the contract, change orders during the construction process open the door for price increases and delays, even “profit recovery” by the contractor in areas where original pricing may have been aggressively quoted in order to win the job.

5. Lender does not require a construction loan agreement. This loan agreement will be similar to C&I loan agreements, with representation and warranties, affirmative and negative covenants, and events of default and remedies. Specific to construction situations, the agreement should include:
   - Assignment of the construction contract and documents. The bank legally can step into the customer’s shoes and complete the project, if needed. It also creates a legal relationship between contractor and bank.
   - A definitive completion date instead of “reasonable dispatch” toward completion.

   This “date certain” should trigger an event of default if construction is not completed. The bank faces additional risk when a project is not completed on a timely basis, and it should be allowed to take steps to mitigate this risk.

   - Lender approval of any changes to the plans, specifications, and construction budget, at least at some minimum dollar level appropriate for the overall size of the project. Changes can increase risk, and the bank must be aware of and given the chance to reject or modify requests that are not reasonable.

   The loan agreement and exhibits will identify the method and forms to be used for making draws, as well as establish the borrower’s duty to use loan proceeds solely as set forth in the project budget and plans.

6. Lender and customer are not prepared to issue standby letters of credit (SLOCs) for completion.

   Governmental entities often require some form of assurance of completion of sidewalks, adequate parking, and so on, or for establishing or increasing an account with utilities providers. In lieu of cash deposits, these entities will often accept being named the beneficiary of a SLOC. While the dollar amounts involved are often small, the requests tend to be very time sensitive, so the lender accommodates the credit need on an unsecured basis. A better practice is to establish an
amount, much like a contingency, to be built into the sources and uses (budget) and that addresses pricing, notice from borrower and secured status within the loan agreement, and mortgage or deed of trust (collateral) documents.

7. Dealing with ground leases. Ground leases tend to be more common in NOO-CRE situations, where land costs are high and make the outright purchase of land un economical. Nevertheless, ground leases can arise in OO-CRE situations for two reasons. One is a lack of understanding by the C&I customer of the weaknesses and ramifications of entering into a ground lease. Another is the legal structure sometimes required in industrial park settings or others where a tax break is granted for creating or maintaining jobs. This tax break is often tied to some governmental entity actually owning the land (and, in some cases, the improvements) and leasing it to the operating business.

Lenders should obtain and review a copy of the ground lease. Further review by an attorney is also recommended. From a credit risk perspective, the lender needs to know that financial terms of the lease and the lease maturity should exceed the full amortization period (not just the maturity or bullet/balloon date) of the proposed loan.

Within the loan documentation, there should be a “tri-party” or “inter-creditor” agreement between the bank, landlord, and lessee (borrower) that provides notice to the bank of any default under the lease terms and a chance for the bank to cure any default.

Problems in Applying Common CRE Lending Practices and Procedures

Non-arm’s-length lease. Real estate lenders typically focus on the lease—its terms and conditions—as an important element of underwriting. However, in OO-CRE situations where a “shell” company holds the real estate (as shown in Figure 1), the lease is often an afterthought or is loosely thrown together prior to closing.

The first potential mistake in this situation is accepting a lease where the monthly rent does not sufficiently cover the debt service, has no provisions for rent increases based on inflation (escalation clause), plus no room to cover a “stress test” loan payment (at a higher interest rate upon renewal three or five years down the road). If \( \frac{Rent}{Loan\ Payment} \geq 1.25x \), then a potential “pass” asset quality rating can occur. If \( \frac{Rent}{Loan\ Payment} < 1.25x \), then a potential adverse risk grade can emerge due to improper cash flow coverage or even guarantor dependency.

A second mistake is not fully analyzing the ability of the tenant (operating business) to make the rent payment, using conventional C&I analysis. Leases in OO-CRE...
situations also differ from “typical” NOO leases in areas such as:

- No “widely dispersed” group of tenants, as encountered in apartments, self-storage, and lodging.
- No “credit tenant” as often encountered in large office buildings and retail centers.
- In effect, “double coverage,” where the rent payment exceeds the loan payment, and either
  - \[ \frac{EBITDA + (CM+I) + interest exp. + rent}{2} \times 1.25 \] (usually called a fixed-charge coverage ratio); or
  - An acceptable global cash flow coverage.
- More extensive and continued monitoring of the financial condition of the tenant/owner/operating business with a thorough, C&I approach to financial statement analysis.

A good risk management practice is to require a comprehensive loan agreement with covenants that ensure the following:

- Maintained integrity of lease structure (rent payment exceeds debt service, renewals made promptly, etc.).
- A default triggered by one of the following events:
  - The underlying business ownership changes.
  - The rent payment coverage of debt service deteriorates.
  - The borrower defaults on any other loan agreement (“cross default”).
  - Establishing a conventional assignment of rents and leases.

**Customer wants to be its own general contractor.** Most CRE professionals do not attempt to undertake the role of general contractor. However, many business owners in an OO situation believe they can save money in construction costs by doing so. These business owners are accustomed to wearing many hats in their own businesses and simply transfer this approach to their real estate efforts.

The biggest drawback is the lack of relevant experience, despite the borrower’s general business acumen. Most bank loan policies wisely do not allow the customer to serve as general contractor, but if it is allowed, the bank should mitigate this risk by “tightening” other aspects of loan structure, such as a lower loan-to-value, higher DSC, and/or firm completion milestones in the construction loan agreement. If these aspects cannot be adjusted, then additional collateral and/or global cash flow should be so strong that real estate collateral is no longer material to loan structure and the primary source of repayment.

**Customer lacks tangible real estate developer-investor (REDI) experience or sponsorship.** Many lenders underestimate how disruptions in a real estate project can divert management attention and crucial cash flow from the normal operations of the tenant/operating business in OO-CRE situations. During construction, it is important to promptly identify and address any delays or problems, particularly as noted in the inspection process.

Further, once the property is completed, the reality is that the customer/business is now also in the real estate business. Once the customer owns the property, it must determine whether this fits the overall strategic plan and whether management can handle it. In this regard, some operating businesses are better off just leasing property from a third party.

**Property location choice is not consistent with normal real estate thinking (“location, location, location”).** Manufacturing facilities need to be near the labor pool, raw materials, and shipping
outlets (or, to minimize property taxes, near more rural locations. Warehouses are often located near transportation hubs or near manufacturers. In both cases, visibility to customers is usually not a key factor. Bankers often do not understand the unique factors influencing the location decision and, ultimately, the business’s “marketability” to other businesses based on these factors. This can also be a factor in the appraised value and can spill over into the whole flow and tone of the construction administration process that is geared toward more typical and more comfortable income-producing property situations.

Unique and unusual tenant finish. OO-CRE properties have a variety of designs and unusual interiors. For example, a medical office requires plumbing in almost every room. A religious building can include unique fixtures such as naves, apses, or confessionals. A warehouse can require high ceilings, loading platforms, and room in the parking area for tractor-trailer turnarounds. In contrast, income-producing properties have more “standard” features and homogenous units as in apartments, motels, and self-storage.

Lenders can make the mistake of not fully discounting the facility’s resale value based on single-purpose aspects of design and materials and, therefore, not requiring an appraisal that distinguishes between “value in use” versus “value in exchange.”

Related construction issues include the propensity of business owners to make substantial changes during construction or making modifications (from working capital funds) after occupying the building. As mentioned earlier, whereas the contractor may have made an aggressive (low profit, low price) bid to win the contract, it can catch up by extracting full profits on changes orders. Also, both customer and banker may underestimate the cost of furniture and fixtures to fill the new space.

Projects often do not follow normal completion cycles. The process may be postponed or delayed during peak seasons (if any) of the underlying operating business. Likewise, daily work hours may be modified to accommodate the underlying operating business. Real estate lenders may not fully understand the unique aspects of the construction time line, which can be substantially different from that for income-producing properties, for which there is a compelling desire to finish quickly and to begin collecting rents. Further, these likely delays or extended construction time frames increase the interest expense, whether paid out of pocket or as part of the overall construction budget.

Prevalence of shell entities and common ownership (see Figure 1). The same ownership group controls both landlord and tenant, so the lease can be changed whenever desired or rental payments can be late and no one cares. Further, there may be: 1) a lack of clear delineation of which entity pays for tenant finish and major maintenance items or 2) deviations from that delineation even if these items are spelled out in the lease. Lenders make the mistake of not thor-oughly combining (using global cash flow or another method) and analyzing the overall financial picture such that manipulation of entity roles does not add risk to the loan. A good procedure is to require interim (quarterly, at least) financial statements of all entities involved, looking for rental income (expense), where necessary, and expenditures for leasehold improvements. This is not your conventional “Are they making a profit?” C&I analysis.

Summary
The unique characteristics of OO-CRE loans create challenges for both C&I and CRE lenders. As this article demonstrates, a number of mistakes can be made that inadvertently increase the bank’s risk. The risk can be mitigated by understanding potential problem areas and by having C&I lenders assist CRE lenders, or vice versa, when underwriting and administering OO-CRE loans.

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