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Financial intermediary: The value of a straight shooter

In addition to dealing from dashed expectations when the loan amount falls short or the interest rate is higher than anticipated, an owner could be forced to call off an acquisition due to a shortfall in loan proceeds, live with lower yield expectations, or go hat-in-hand to equity partners who might demand a preferential return for an increased contribution.

The value of an informed, candid financial intermediary is often minimized or taken for granted. There are some intermediaries who succumb to the pressure of the job and will tell an investor exactly what the investor wants to hear in order to snare a deal, regardless of the cost to the client; it happens on both the residential and commercial sides of the business; investors must be wary.

On the residential side, most homeowners who interview various real estate agents will run into some who, in an unabashed attempt to obtain the listing, will insist that a house is worth as much or more than the owners believe. After the house is listed it sits on the market because it was overpriced, the initial splash that the house might have made is lost and once-excited buyers have moved on to other options. The homeowners will likely change brokers and lower the price in order to get their house to move — a price that might be lower than what could have been achieved if the house were priced properly at the outset.

Similar challenges exist when an investor speaks with a mortgage banker to get a ballpark idea of available loan proceeds. Some mortgage bankers will estimate on the high side for proceeds and the low side for interest rates in order to grab an exclusive from the owner. In today's choppy markets this philosophy can easily result in the investor feeling re-traded when the actual loan amount

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is lower than expected and the interest rate is higher than anticipated.

The key to establishing clear, meaningful and achievable expectations is a well-informed mortgage banker who can poll credible lenders as soon as the basic deal parameters are known. Since the appetite for various types of loans differs by lender and the desire for certain types of loans by each lender shifts depending on the lenders, specific needs, a quote received 30 days ago for a similar property can be meaningless today. This is especially true this environment where spreads have widened, the 10-year Treasury yield is erratic, lenders price over the swap spread, and more stringent underwriting standards have come into play.

In addition to dealing from dashed expectations when the loan amount falls short or the interest rate is higher than anticipated, an owner could be forced to call off an acquisition due to a shortfall in loan proceeds, live with lower yield expectations, or go hat-in-hand to equity partners who might demand a preferential return for an increased contribution.

Some of the typical pit-falls in the process include:

- Underwriting to projected rents rather than actual rents
- Not knowing whether existing rents are above market rents and have to be adjusted downward
- Employing a vacancy factor that lenders find unrealistic for the property type and location
- Not determining ahead of time what the roll-over schedule is for project leases, which not only impacts reserves and proceeds but may prohibit financing altogether
- Employing inappropriate management fees or using no management fee because a property is or will be managed by the owner
- Projecting operating expenses that bear limited resemblance to operating expenses for similar properties in the market
- Using unrealistic spreads over the 10-year Treasury yield to determine the interest rate on a permanent loan
- Being unaware that some permanent lenders will loan on a 30-year amortization schedule but will size it on a 25-year schedule, or will size the loan at a higher-than-market constant using a 30-year schedule.

Here is an example. In the analysis of this hypothetical 45,000 s/f office building, the rent for a the smallest tenant is written down to market, the vacancy factor is increased from 5.0% to 7.5%, the spread on the permanent loan is adjusted upward by 15 basis points and reserves for leasing commissions and tenant improvements are increased by 50 cents psf to account for short-term rollover risk. Assuming the investor plans to purchase the office building for $11 million (the value using the original proforma and a 7.25% cap rate), the investor expected to borrow $8.5 million and invest $2.5 million. However, when the underwriting is adjusted, the loan amount dropped to $7.65 million. In order to purchase the asset, the investor must find another $850,000 in cash, which increases the equity contribution by 34%. Not only must the investor scramble to locate the additional equity to affect the purchase, the investor's internal rate of return will drop significantly, making the investment much less attractive. Using nationally recognized software, pre- and after-tax returns were calculated to be 12.4% and 10.0% using the original proforma, and 7.9% and 6.2% using the adjusted underwriting.

As shown here, financing drives the transaction. Had the investor obtained accurate information from a financial intermediary at the outset he might have decided against the acquisition or negotiated a meaningful reduction in the purchase price. As it stands, the implied cap rate on the transaction dropped from 7.25% to 6.86%.

The turmoil in the capital markets over the past couple of months underscores that the financial landscape can change daily and without warning. Despite this uncertainty, investors deserve the best information available about the market on any given day. That information is available. Investors need to find the straight shooters who will add material value to their process.

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