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FINANCING UPDATE

Reduced Interest Rates from Portfolio Lenders

A combination of factors, including the recent bond rally and the emergence of portfolio lenders, has resulted in 5-year fixed rates of 6% for average quality multi-family properties. Commercial property financing is available at slightly higher interest rates (6.25% to 6.5%). Portfolio lenders have strengthened their strategic position in the current market, while many conduit/CMBS lenders have elected to cease issuing loan quotes or Letters of Interest. Those conduit/CMBS lenders that are issuing loan quotes have increased the spreads to compensate for challenging capital market conditions. A portfolio lender funds loans with its own capital and has the ability to hold loans on its balance sheet.

Many commercial and multi-family property owners are choosing to pay-off their existing mortgages by refinancing with portfolio lenders to:

- 1- Lock-in historically low interest rates for 5-7 years
- 2- Obtain flexible prepayment penalty – i.e. declining 5-4-3-2-1 for 5-year fixed rate
- 3- Improve the property cash-flow through a combination of reduced interest rates and gradually-increasing rental rates

Understanding Appraised Value in Relation to Sales Price and Loan Amount

Commercial/Multi-Family real estate purchase contracts have customarily excluded any contingency provisions related to the appraised property value as it relates to the sales price. This practice differs from A.A.R, residential purchase contract language, which includes an appraised value contingency provision. According to the residential purchase contract, buyers have the right to cancel the contract in the event that the appraised value is less than the purchase contract. Commercial/Multi-Family real estate buyers waive all contingencies prior to the end of the financing contingency period, based on their receipt of a financing commitment from a reliable lender. The property appraisal

is intended to meet the underwriting requirements of the lender, and is not intended for the use of the buyer or seller.

In the event that buyers and sellers of commercial/multi-family real estate are considering the use of the property appraisal in the negotiation of the sales price, there are several unique considerations that should be addressed:

- 1- Appraisal Assignment Requirements – The appraised value is based on the appraiser’s analysis according to the lender’s assignment requirements. For example, the assignment requirements may specify the use of market vs. actual rents. Since buyers and sellers are not a party to the appraisal, they have no control over the specific scope of work.
- 2- Copy of Appraisal – The appraisal is the property of the lender. Some lenders may not authorize the release of the appraisal to the buyer or seller.
- 3- Appraised Value and Net Operating Income (NOI) – The lender determines the loan amount based on the property’s NOI (i.e. minimum 1.15 debt coverage ratio) and appraised value (i.e. loan not to exceed 75% LTV).

It is important to note that the NOI is one of three factors used by the appraiser to determine the appraised value. Appraisers apply an appropriate Capitalization Rate to determine the value based on the income approach. For example \$100,000 NOI divided by .055 cap rate equals \$1,800,000 value. The other two valuation methods are the cost approach and sales comparison approach. The appraiser uses his professional judgment to use one or a combination of the three valuation approaches to arrive at the final Reconciled Appraised Value.

Receiving an appraised value equal to the sales price does not assure the buyer of a 70-75% loan. For example, multi-family appraisals frequently agree with the sales price when appraisers use current market cap rates. NOI has not kept pace with the increases in the price/unit paid for apartments over the past several years. This has resulted in historically low cap rates.

Since the primary factor in determining the loan amount is the Debt Coverage Ratio (i.e. NOI divided by 1.15), the maximum LTV for many properties is 60-65% of the purchase price. Based on \$100,000 NOI, the maximum loan amount for a 6% interest rate is \$1,200,000 (67% of \$1,800,000 – see above).

In most cases, the ability of the buyer to obtain a minimum loan amount is more critical than the confirmation of the property’s appraised value. Many buyers knowingly pay more than “as-is” appraised value based on their assessment of the potential for increased property value. Increased value may occur from future rental increases, reduced operating expenses, property appreciation, or property repositioning.

According to **Vince Davis, of Davis Valuation Group**, “Appraisers are required to comply with USPAP standards when preparing appraisals for clients. When preparing an “as-is” appraisal report, these standards include the use of actual rental rates and operating expenses. This valuation method does not account for other factors that may increase the property value after close of escrow.”

Conclusion

An appraiser’s conclusion of property value may not be a reliable basis for a commercial/multi-family contract negotiation. Experienced real estate brokers and their clients are in the best position to establish a property’s sales price based on a consideration of:

- Current market conditions
- Financing Terms – interest rate, portfolio vs. conduit, loan-to-value ratio, etc.
- Experience and financial ability of the buyer to complete the transaction successfully

Resources

Vince Davis, Davis Valuation Group – Contributed technical information and editorial review for this article

430 E Southern Ave, Tempe, AZ 85282 – 480 968-7449 -

www.davisvaluation.com

Commercial Real Estate Institute – Continuing Education and Professional Designations for Commercial Real Estate Agents and Brokers

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