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How to live with real estate risk

Second in a Series

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Last month, I listed the four items every property owner should consider when trying to limit the financial and personal exposure that comes with real property ownership. In this article, we will examine the benefits of financing leverage.

• **RECOURSE VS. NON-RECOURSE:** Recourse vs. Non-Recourse: It is recommended, whenever possible, to obtain non-recourse financing wherein the lender only has recourse to foreclose on the property in the event of a default. Without such provision, risk, in most cases, is not adequately mitigated. Non-recourse financing is not difficult to obtain, even in owner-occupied property as long as there are multiple tenants and the quality and the location of the property does not suffer from adverse influences.

•**AVAILABLE RATES AND TERMS:** Commercial lenders have flooded the market with financing products. Rates are generally tied to length of loan, loan-to-value ratios, as well as the loan's amortization rate. As of the 1st Quarter, 2003, the 5-year rate is 5.9%, the 7-year rate is 6.5%, and the 10-year rate is 6.9%. To calculate potential proceeds and costs the following example illustrates the calculations:

Net Operating Income	$100,000
Loan-to-Value Ratio	1.2 to 1
Cash Flow Available for Debt	$80,000
Interest Rate	6.5%
Constant	7.58%
Loan Available	$1,055,408
Due in 7 Years	$954,260

• **CLOSING COSTS:** A significant consideration in any financing decision are the add-on costs in procuring the loan. Most commercial mortgages have an origination fee of from .5% - 1.0%. Additionally, they require either environmental insurance or due diligence, which can run from $1,500 per property. Legal fees charged by the lenders range from $2,500 - $5,000 depending upon the face amount of the mortgage. Additionally, the government takes its bite through a mortgage recording tax which, for loans over $500,000, is approximately 2.75%. Looking at the example provided, such fees could reduce the refinancing proceeds by up to $50,000.

• **HARD MONEY:** Unusual properties, poor credit, or the immediacy of the refinancing requirement sometimes requires recourse to non-traditional lenders. While it should be noted that generally recourse and non-recourse loans can benefit from the same low interest rates, in duress situations, non-recourse financing can only be obtained by approaching second tier lenders. Such loans are generally for terms of up to 3 years, have an interest only payment feature with no amortization, have origination points from 3% - 6%, and interest rates double those being offered by traditional lenders. Not surprisingly, there is significant demand for this type of loan by professionals who deal in real property transactions.

In summary, interest rates are at historical lows and lenders are flooding the market with available cash. This supply picture, coupled with the evident risk of incalculable external events, has caused me to advise my clients who have asked me "to finance or not to finance?" with a single answer... Yes!

The next article will provide specifics on important technology relating to property security.

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