

COMMERCIAL BUILDING AND FARM LOANS

CHAPTER

12

KEY TERMS AND PHRASES

Agricorporate farm loans
Anchor tenant
Apartment buildings
Community center
Endorsement
Fair Housing Amendments Act of 1988
Family-resident farm loans
Farm and ranch loans
Future purchase contract
Leasehold
Mini warehouses

Neighborhood center
Net lease
Office buildings
Office/warehouses
Percentage lease
Regional center
Religious facility financing
Retail store buildings
Shopping centers
Special-purpose buildings
Term lease
Warehouse buildings

LEARNING OBJECTIVES

At the conclusion of this chapter, students will be able to:

- Understand key aspects of commercial real estate finance analysis
- Describe the application process and documentation requirements for commercial real estate loans
- Understand how the property evaluation process relies on more than the appraised value of the property and how the type of commercial loan will affect the approach to valuation and maximum loan considerations
- Explain the draw or disbursement process for commercial construction real estate loans
- Describe the approach used for considering commercial construction loans for residential properties versus other types of commercial real estate loan



INTRODUCTION

Commercial loans deal with a wide variety of properties and businesses. In this chapter, we will consider the major categories of buildings along with some information on the special conditions that lenders must examine to properly underwrite each loan. With certain categories of commercial buildings, different forms of leases are generally used. We will look at these leases along with the buildings that use them. For instance, a term lease is normally used for apartment rentals, net leases are often used in free-standing store buildings and warehouses, and percentage leases dominate shopping centers. Some leases will be defined as creating a **leasehold** interest and this can be for a residential or commercial property. A leasehold interest is a form of land tenure or property tenure where the lessee buys the right to use land or a building for a given length of time. In residential leasehold situations, the lender will require that the lease payment be escrowed like taxes and insurance payments are, and that the lease runs at least until the end of the loan term.

The chapter closes with some information on farm and ranch loans, which are not classed as commercial loans. While they are a most important category of loans and follow different guidelines, this text only gives some generalized information and does not address this kind of loan in any depth.

The study of commercial real estate loans is important as it is a very large, competitive market with highly fragmented ownership and carries many of the same risks as residential real estate in terms of overcentralization in a geographic area (e.g., the Texas oil belt recession of the mid to late 1980s, when the collapse of oil prices affected both the commercial and residential markets) and concentration of risk (e.g., an overexposure to loans on financed properties with Blockbuster or Circuit City as the main tenants or owners). More recent trends reveal that some retailers typically found in malls have failed, such as Dots LLC, Ashley Stewart Holdings, Inc. and Coldwater Creek Inc., all of which declared bankruptcy in 2014. These three firms account for over 1,000 stores. These key issues underpin commercial real estate financial analysis.

In some states, contracts covering commercial real estate space now show increased use of covenants intended to protect health or human safety against the presence of hazardous materials. Such claims may be recorded against a property and remediation expenses can be enforceable even if they do not benefit the land of the party seeking to enforce

the covenant. Environmental issues are a key focus of due diligence in non-residential real property purchase and sale transactions, particularly in areas of current or historical manufacturing, dry cleaning, gasoline stations, auto body and repair shops, and landfill uses. Such uses commonly result in the discharge, release, or disposal of “pollutants” or “contaminants” that cause soil, groundwater, surface water, and indoor air contamination, which can create significant economic, environmental, and public health risks, have increasing impact on the viability and terms of a deal.¹ More detail on these emerging issues will be covered in Chapter 15.

The following commentary points out major differences in the various categories of commercial loans for buildings.

SPECIAL-PURPOSE BUILDINGS

In a sense, all buildings are “special purpose,” as their design generally restricts use to a specific kind of occupancy. However, in the jargon of real estate, *special purpose* has a more precise meaning. **Special-purpose buildings** offer a specific kind of service and are more difficult to convert to any other usage. Examples of special-purpose buildings include fast-food restaurants, bowling lanes, service stations, recreational structures, theaters, and automobile dealerships. Because of the close relationship between the building and the specialized services offered, such buildings are often owned by the business operator. But many are built by investors for lease to professional operators.

Another feature of a special-purpose building is a much greater dependence on the ability of the operator/manager to achieve profitable operation. While management is important in other kinds of income property, such as apartments and office buildings, it is less critical than with special-purpose property. For instance, an office building, once leased up, will continue to show a cash flow even with changes in the management. But an automobile dealership or a fast-food franchise is heavily dependent on the particular skills of management for its profitability. Therefore, lenders may limit the amount of loans in their portfolio for special-purpose buildings. They may also restrict loans for these types of buildings depending on their risk tolerance. In addition, there are also

¹Gotshall-Maxon, Lee, and Nichols, Sandi. “Key Issues in: Real Property Purchase and Sale Agreements.” Presented at *Getting Ahead of the Deals Coming Your Way in 2012* Conference in San Francisco on January 24, 2012.

restrictions for public REITs under Regulation A and Rule 504 and Regulation S-B of the Securities Act—rules that have to do with disclosures and restrictions on holdings under certain REIT classifications related to special-purpose buildings.

Because of this emphasis on management, lenders must look beyond the building itself and examine the capabilities of those who will be managing the property. This is never an easy determination, and it is particularly difficult if the loan applicant is a newcomer to the business. Lenders may use several procedures to make such a determination, as we will see in the following section.

Earnings Record of Applicant

If the company requesting the loan has a record of steady earnings and is creditworthy, there is little problem with approval. Examples of this type of applicant include oil companies building service stations and fast-food franchisers expanding their operations, among others.

Endorsement

A method of credit enhancement sometimes used to expand automobile dealerships or recreational facilities is a manufacturer's **endorsement** of the obligation. This means that the manufacturer agrees to accept a contingent responsibility for repayment of the mortgage obligation on the special-purpose building. For the manufacturer, the purpose of undertaking such a risk would be to increase its sales outlets.

Future Purchase Contract

Yet another method of credit enhancement that has a broader application than just special-purpose buildings is a **future purchase contract**. Consider a situation where a large grocery chain desires assurance of a special product made or produced by a small local supplier. By offering the supplier a large continuing contract for its product, the supplier would have a proven source of cash flow to induce a lender's favorable decision on a loan. As additional security, the lender might ask that the purchase money for the product be paid through the lender's offices as delivery is made to the grocery chain. While such a contract, assigned to the lender or not, falls short of an endorsement of the obligation, it does

give a lender some assurance as to how the loan will be repaid. And that is the key question in the minds of all lenders.

APARTMENT BUILDINGS

An **apartment building**, or *multifamily housing* as the federal government classifies it, represents an investment in residential property. In the past, residential property, particularly low-income housing, has enjoyed certain tax advantages, and it is subject to some restraints that serve to protect the rights of tenants. While tax advantages for a while tended to distort investment decisions, the principal determinant for sound apartment investment still remains the occupancy of such projects in each market area.

Underlying the achievement and maintenance of good occupancy are several qualifying factors. Experienced apartment operators judge three factors to be of almost equal importance in a successful operation: (1) location, (2) physical facilities, and (3) management. Obviously, a careful underwriting analysis must consider all three factors in determining the risk involved.

Location

Location is usually the first limiting requirement of an apartment seeker. A major consideration of location is easy access to jobs. Access to freeways improves accessibility for apartment dwellers, and many apartment seekers regard proximity to schools and churches as important. The availability of recreational facilities such as parks, golf courses, restaurants, and other entertainment is also an important consideration. Apartment dwellers as a group are not as burdened with exterior housework and yard maintenance as are single-family home residents.

Since location is a major determinant of the available market, it is necessary to evaluate the market in that area. For instance, does the proposed rental structure fit the requirements? Will it be competitive? Do the size and type of units meet these demands?

Physical Facilities

The physical plant must meet the market requirements, not only in size of units but also in architectural style and amenities available. Amenities

include such factors as playground areas, tennis courts, swimming pools, club rooms, and entertainment facilities. If the market is primarily families, the two- or three-bedroom units would be the most popular choice; if intended for young singles, the one-bedroom and studio designs are often in greatest demand. The elderly, on the other hand, might prefer one or two bedrooms with a minimum of stairs to climb. Sometimes an assortment of units is used with the hope of covering all phases of the market. In smaller communities, this assortment may best fit local needs. However, in metropolitan areas, this "shotgun" approach is a poor substitute for careful analysis of the market, as it may result in one type or style of unit easily rented and maintaining good occupancy while others go begging for tenants. Before building begins on an apartment complex, knowledgeable operators (developers) study the market for particular requirements and then use their merchandising power to attract suitable occupants.

Management

Management is the third major factor in successful apartment operation. Its importance is well known to experienced owners but too often underestimated by newcomers to the field. Along with location and the physical plant, management, too, can be a "make-or-break" factor.

Larger cities throughout the country have companies that specialize in apartment management, offering a complete management service for a fee of three to five percent of the gross revenues. Good management involves maintaining routine cleanliness of the public areas, prompt repairs of equipment or damaged sections of the building, and fair enforcement of rules for the mutual well-being of the tenants; all are necessary to achieve and maintain a high occupancy rate. Experienced operators learn how to cope with the special requirements of rental properties, such as initial screening of tenants, the most effective methods of collecting rents and keeping them current, the special problems created by domestic pets, handling skip-outs, and dealing with tenants who create disturbances for other occupants. Consequently, an underwriter will look much more favorably, risk-wise, on a property under the management of competent individuals or companies.

As apartment-style living proliferates in cities, underwriters recognize that the better-planned, better-maintained facilities are those that will sustain occupancy in soft or competitive markets. And a continuous high occupancy rate is the key to survival in this business.

Analysis of Income and Expenses

For proposed apartment construction, a projected statement can be prepared to show anticipated gross revenues from each unit and all miscellaneous revenues (for example, from laundry rooms), less a vacancy factor and credit losses. This will produce an effective income from which deductions can be made for all expenses. Fixed operating expenses include such items as taxes and insurance and do not fluctuate with occupancy rates. Other operating expenses do fluctuate with occupancy rates, such as utilities, maintenance, supplies, and labor. A special expense that is frequently overlooked or underestimated is replacement cost. Items such as drapes and carpeting and equipment such as ranges or dishwashers, all in continuous use, have a tendency to wear out. Allowances must be set aside for their replacement. The cash remaining after these deductions then becomes available for debt service. Any remaining cash, after all expenses and debt service have been covered, serves as a cushion against a loss or a slow period.

Many of these costs estimated ahead of construction are subject to interpretation. For example, what occupancy rate may be reliably projected? The FHA uses a percentage figure of 93, with exceptions for 221(d) programs and 223(f) programs where lease-up requirements are less constricted. Conventional lenders generally tend to select an occupancy rate substantiated by actual rates prevailing in a particular area. Most lenders require proof of an occupancy rate near 90% before they will entertain an apartment loan application. Rental rates also must be in line with the going market. Expenses can be projected with reasonable accuracy. In general, total expenses range from 36% to 45% of the gross operating income, depending on the size of the operations and the efficiency of management.

The dramatic drop in commercial real estate values during the recent financial crisis has caused many projects to be put on hold. It has also caused many banks to have to put up additional capital for performing real estate loans as a result of downgrades in loans stemming from the recent and ongoing bank safety and soundness examinations. These examinations are quite vigorous; between 2010 and 2014, about \$1.4 trillion in commercial real estate loans will reach the end of their terms, and some have estimated that half are currently “underwater.”² As discussed in

²Kaufman, Ted. *The Final Report of the Congressional Oversight Panel*. Submitted under Section 125 (b)(1) of Title 1 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343. Accessed Jan. 31, 2015 at <http://cybercemetery.unt.edu/archive/cop/20110402010341/cop.senate.gov/documents/cop-061010-report.pdf>

Chapter 11, there was a renewal in the development of multifamily housing units as early as 2011, but by 2014, the interest moved more toward starts of development of industrial properties. The office building segment shows primary activity in redevelopment of holdings to address shifting tenant demands as well as to attract new tenants.

Debt service is the monthly or annual cost of the principal and interest payment, and should be tailored to ensure timely retirement of the full loan. By careful analysis of the cash available for debt service, an underwriter can determine the most effective loan for the proposed apartment. Adjustable and negotiable factors are the term, which ranges from 15 years upward to 30 years, and the loan-to-value ratio, which determines the equity cash required. The interest rate may be adjustable or fixed, is usually pegged to market rates, and is less subject to negotiation.

Recent data from Fannie Mae and Freddie Mac have shown that delinquency rates for single-family homes have been unprecedented; multifamily loans and leases have delinquency rates far lower than during the last major downturn at the end of 2010. Fannie Mae and Freddie Mac's new multifamily MBS was down over 60% between 2007 and 2010, while FHA multifamily originations had grown more than seven fold by October 2011 than in the previous three years.³ As of the beginning of 2015, delinquency rates continued to abate to pre-recession levels. As of the beginning of 2015, due to the generation "Y" preference of housing in a more urban setting,⁴ the multifamily commercial market should continue to see positive growth—at least in the near term. This will ultimately affect residential housing demand, because generation "Y" is putting off new household foundations to later decades. Moreover, they prefer urban living to suburban living.

Term Leases

Apartments are usually leased under the conditions of a **term lease**—that is, a short-term lease that may or may not be in writing. While state laws control how leases may be handled, a general rule is that a lease for less than one year need not be in writing. The short-term nature of the lease

³Prior, Jon (2011). "FHA multifamily origination breaks record." HousingWire Magazine. Retrieved from <http://www.housingwire.com/articles/13997-fha-multifamily-origination-breaks-record>.

⁴Warren, Andrew, et al. "Emerging Trends in Real Estate 2014." Price Waterhouse/Coopers and Urban Land Institute, Report 2014, page 7.

allows the landlord to make periodic increases (or decreases) in the rent, as the market may require. Occupancy is more volatile in an apartment property than in an office building or retail store, and this can create a lack of stability in its continuing income.

Fair Housing Requirements

The **Fair Housing Amendments Act of 1988** extended the prohibitions against discrimination in the 1968 Fair Housing Act to all residential real estate transactions and represents the only amendment to the act to date. Prior law considers unlawful any discrimination in housing because of race, color, religion, gender, or national origin. The new amendment added two new categories for protection against discrimination: disability and familial status. The additional restrictions are of particular importance in the rental of multifamily dwellings.

The new category of "disability" protection requires proper accommodation in the design and construction of multifamily dwellings. The building and its facilities must provide accessibility and usability for physically disabled people. This includes such items as doors and hallways wide enough to handle wheelchairs, light switches and elevator buttons at a level accessible to those in wheelchairs, and alarm signals in both light and sound to protect those with hearing and visual impairment. People with AIDS are now included in this protected category as well.

Protection for familial status prohibits discrimination on the basis of family composition. Housing must be open to people with children 18 years and under. Parents with children or guardians with children cannot be denied housing. "Adults-only" apartments are no longer permissible. There are exceptions for housing occupied by elderly persons only.

Tax Deductions

As residential rental property, apartments have always offered some special tax advantages for investors. The purpose, of course, is to encourage suitable housing in this country. Under current law (the 1993 Tax Act), as renewed under President George W. Bush, residential property has retained its 27-1/2-year recovery period, while nonresidential property maintains its 39-year recovery period. Another tax advantage is that

since the building—not the land—is depreciable, an apartment offers a favorable combination of values. The building portion of the investment is relatively high compared with the non-depreciable land. Also, items classed as personal property, such as any drapes, appliances, and carpeting necessary for apartment operation, are eligible for even greater depreciation deduction rates than the building, and the calculation can be made using accelerated rates.

Revisions to the 1986 Tax Act changed the tax nature of certain kinds of property formerly considered real estate to the class of “other tangible property,” and thus eligible for greater depreciation deductions. Such land improvements as roads, fences, and landscaping are now placed in the 15-year class and eligible for either straight-line or accelerated depreciation deductions. Qualified real property does not share in the expensing benefits allowed under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act of 2010). Under the 2010 Small Business Jobs Act, a taxpayer can elect up to \$250,000 of the \$500,000 Code Sec. 179 deduction limit (subject to the investment limit) for qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) for tax years beginning in 2010 and 2011. The Tax Relief Act of 2010 does not extend this treatment. Another possible tax break is that sewer pipe is listed in the 20-year class.

While tax deductions have grown fewer since the early 1980s, there remain important benefits for real estate investors. Depreciation deductions are based on the total value of a building, not just the equity interest in it. Since this kind of deduction represents a noncash item, it protects cash flows, allowing more money for debt service if necessary. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced capital gains tax rates from 10% to 5%, and from 20% to 15% for asset sales after May 5, 2003, for assets held a year or longer. Gains from property purchased after 2000 and held more than five years are taxed at an 8% capital gains rate. The Tax Relief Act of 2010 extended the Bush Era individual and capital gains/dividend tax cuts for all taxpayers for two years and also extended the 100% exclusion of gain realized from qualified small business stock held for more than five years—a provision that is particularly important for small commercial and farm real estate investor consortiums. Nevertheless, lenders are generally skeptical of any cash flow that depends on the unstable nature of tax law.

RETAIL STORE BUILDINGS

The free-standing **retail store building**, or strip of stores, is an interesting investment for individuals as well as large companies. The more conservative way to handle such an investment is to first obtain a lease for the premises, then build to suit the tenant. In good economic environments, many such buildings are constructed on a strictly speculative basis, with owners and developers expecting to attract tenants later. However, during times of economic stress, in order to be eligible for financing, properties will have to include either an anchored or unanchored retail store building, as well as net-leased, single-tenant properties with certain occupancy and sales requirements. At all times, the best commercial mortgage rates and terms are possible when a subject property meets some of following basic conditions:

- High visibility
- A profitable operating history
- Direct access to major roadways

Analysis of Income and Expenses

A retail store building rented to a business tenant for a fairly long term—say, 10 or 15 years—offers a stability of income not found in apartment-type properties. A well-drawn lease agreement should allow periodic rental increases, either as a fixed amount every few years or as an escalation clause. The escalation clause ties an increase in rentals to increases in the landlord's operating expenses.

With this type of property, the payment of expenses is usually negotiable between the landlord and tenant and is spelled out in the lease agreement. A common division of responsibility for maintenance is that the tenant pays the costs of maintaining the interior of the building while the landlord is responsible for the exterior. And the landlord is responsible for handling building insurance coverage and payment of taxes.

Net Lease

Free-standing store buildings are often leased to major grocery chains and other retailers on a **net lease** basis. This means the tenant is responsible for maintaining the building, providing the insurance coverage, and

paying property taxes. With the responsibility for paying maintenance, insurance, and taxes passed on to the tenant, this kind of lease is often identified as *triple net*. It is the kind of investment that is attractive to a person who wants to avoid management of the property; the rental rate is based on a fair return on the investment without the addition of a management cost. Financing for this kind of investment may be enhanced by the assignment of all or part of the rentals. A major tenant is an attractive source of loan repayment for lenders.

SHOPPING CENTERS

The development and leasing of **shopping centers** is a specialized business. Some developers not only build major centers but are retained to manage them. Many large retailers have entered the development business themselves to expand their own market reach. It is likely that shopping center owners work to prelease their centers' space more than the owners of most other types of property investment. To attract tenants to a new project, the developer can undertake a careful market analysis of the area to be served. Such a market study includes potential sales volumes for the various commodities that will be offered at the center. With this information in hand, the developer can better prove to a merchant the value of opening an outlet in the subject area. The market study would also be of benefit to prospective mall owners seeking a mortgage loan.

Anchor Tenant

Crucial to the successful operation of a shopping center is having a major tenant, or **anchor tenant**. The big merchant can attract shoppers that benefit the smaller merchants. Major retailers have learned that smaller stores can also attract customers on their own, thus benefiting all, as this arrangement offers greater convenience for the shopper.

The value of an anchor tenant is such that many major retailers have spearheaded their own projects. Some rely on experienced shopping-center developers to implement their plans and manage the center upon completion. Others, such as Sears, Roebuck & Company, have entered the development business themselves. Sears has built a number of major centers through its Homart Development Company subsidiary.

Shifts in consumer attitudes, along with consumer interests in better values, have caused mall owners and mall developers to embrace more

discount stores as anchor tenants. For example, the Palisades Center, a 1.8 million sq. ft. regional mall located 20 miles north of New York City, has four levels that boast BJ's Wholesale Club, Home Depot, and Target built on top of one another.⁵ The structuring has worked well because the section of the parking area was built on a slope, and each store has direct access to the lot, along with over 150 other retail stores and eateries.

Classification of Centers

Shopping centers defy easy classification, as most major developers try hard to be different. Something unique has more appeal, and the intent is to attract the general public. Centers fall into roughly three classes, based mostly on size and merchandise offered: neighborhood, community, and regional.

Neighborhood Center: Smaller **neighborhood centers** often consist of a large corner area with a strip of two or more stores. Merchandise offered is mostly daily essentials such as food, drugs, hardware, and other everyday services.

Community Center: A **community center** offers all the services found in the neighborhood center plus an anchor tenant, such as a general merchandise store, an apparel store, a furniture outlet, a professional service, or some recreational facility.

Regional Center: The largest category, a **regional center**, offers a full range of merchandise and services. It contains at least two anchor tenants as well as scores of lesser shops, and a variety of restaurants, theaters, and other recreational facilities. Often, there is a large mall that offers various kinds of entertainment to attract the general public. Hotels, office buildings, and apartment complexes are often found around these areas. Regional centers have become an attraction for business meetings of all kinds since they offer easy access to "off-duty" activities for those attending (or not attending) the meetings.

Income and Expenses

The income from a shopping center depends to a considerable degree on the success of its tenants. High-volume sales attract and retain tenants.

⁵Luxenberg, Stan. "Redefining the Mall Anchor Tenant." *National Real Estate Investor*. Accessed Jan. 31, 2015 at <http://nreionline.com/mag/redefining-mall-anchor-tenant>

Management expertise can add to the success with advertising, crowd-attracting displays, and entertainment. The reason for the tie between center profitability and tenant success is that most leases are based on a percentage of the tenants' sales. To enhance promotion of the center, management usually organizes and spearheads a tenant/management association that meets regularly to plan and arrange financing for various sales events. Larger shopping malls are capable of offering rather lavish seasonal entertainment spectacles that boost sales. Some malls actively encourage senior citizen walking clubs that use the climate-controlled areas for exercise and perhaps spend a few dollars with the merchants as well.

Operating Expenses

The costs of operating and maintaining a shopping center are divided between landlord and tenant. There is no standard procedure, as negotiation plays an important role in attracting larger tenants. Typically, however, one finds that the higher the costs borne by the tenant, the lower the rental. Usually, all exterior maintenance of the building, grounds, and common interior areas are the responsibility of the landlord, while the tenant pays for interior maintenance of its space. Janitorial service normally follows the same pattern: the landlord pays for cleaning public areas while the tenant services its own space.

Utility service is usually separately metered to tenants. However, a recent trend in larger centers is to install their own electric generating plants, even selling surplus power back to the local utility company under a co-generation agreement. Some commercial operators have turned to new technology. For example, Bloom's Energy Server® provides a solid oxide fuel cell in a new class of distributed power generator, producing clean, reliable, affordable electricity at the customer site. This allows larger energy consumers to produce electricity using natural gas at 2-½ times less energy per kilowatt produced by the most energy efficient natural gas electrical plant.

Heating and air conditioning may be either centrally furnished or supplied by each tenant with its own equipment. Shopping center management prefers that tenants furnish such equipment and take responsibility for its operation for several reasons. One is that maintenance and operating costs are not easily predictable, and providing the proper temperature often causes problems. Another reason is the potential for liability if sales

are lost through failure of the equipment to maintain comfortable temperatures.

A growing practice is to separate the base rent from many of the operating costs. This is accomplished by billing such operating expenses as a separate "service fee" to the tenant. It allows a more stable rental structure yet provides the landlord with some protection against the uncertainty of future operating costs. An alternative method of allowing for fluctuating costs is to include an escalation clause in the lease agreement that allows for an annual rental adjustment based on changes in operating costs.

There is an emphasis on increased sustainability with regard to energy efficiency and environmentally sustainable design. Some state and local governments have implemented standards that govern future development or redevelopment of commercial property to meet energy efficiency or environmentally sustainable design, or both. One well-known voluntary standard is the Leadership in Energy and Environmental Design (LEED), an internationally recognized green building certification system. The LEED green building certification system is the leading third-party verification of construction designed and built using strategies aimed at increasing performance, reducing waste, and improving quality of life. This is covered in greater detail in Chapter 15.

Percentage Leases

Usually, shopping centers lease space at percentage rates based on the nature of the tenant's business, rather than as a flat percentage for the entire center. The rates vary from a low of 1% to 1.5% of gross monthly sales for large volume stores such as supermarkets and discount stores, to a high of 10% to 20% for smaller shops and boutiques.

Percentage leases usually require a base, or minimum, rental payment each month. Otherwise, it would be possible for a merchant to achieve a profitable operation on high-margin merchandise that could produce too low a gross volume for the landlord to pay its own expenses. The minimum may be stated as "amounting to 6% of gross sales each month but not less than \$1,500." Or the base rental could be separated from the percentage with language such as "rental shall be \$1,500 each month *plus* 3 percent of gross sales." The minimum rental payment may be subject to an escalation clause based on a landlord's cost experience.

Verification of the tenant's monthly sales volume is usually a requirement in the lease terms. It can be achieved through submission of a copy

of the tenant's state sales tax report to the landlord each month. Or the landlord may require a periodic audit of the tenant's sales records.

Where Are We Now?

Typical Percentage Rent Rates

The following table represents typical percentage rates for various types of tenants:

Type of tenant	Typical % rate
Grocery store (national credit)	1%
Drug store (national credit)	1%
Variety store (regional credit)	1.2%
Video store (regional credit)	2%
Shoe store (local credit)	4%
Electronics store (local credit)	4%
Liquor store (local credit)	5%
Cleaners (local credit)	5%
Restaurant (local credit)	6%

Financing of Shopping Centers

Three categories of retail store facilities must be considered separately for loan purposes. The differences are based on whether or not a merchant wants to own or lease its premises. It is a top policy decision, and major retailers differ in their answers. Some prefer to lease their store space and use that capital for other business purposes, a practice that is fairly common for grocery chains. Others see an advantage in anticipating a market growth area and building their own facilities to maintain a better control of operating costs. Following is a discussion of the three categories: (1) owner-occupied buildings, (2) preleased space, and (3) speculative projects.

Owner-Occupied Buildings

An owner/occupant merchant seeking financing to buy or build a new facility has several options. The company may use its own cash flow as a

source of funds or, if the company is large enough and well recognized, it may obtain funding through the sale of mortgage bonds in the financial markets. If the decision is to seek financing from a mortgage lender, the financial record of the company itself becomes as important as the value of the property pledged as security. While the property serves as collateral, the success of the company's operations is a key factor in loan approval.

In the current environment, many owners are attempting to obtain loan modifications to take advantage of historic low rates or to make necessary improvements to retain or attract new tenant stores. Lenders need to understand that a somewhat troubled existing borrower requesting a loan modification is usually told that he or she must keep payments current for the period leading up to the modified mortgage being finalized and closed. Sometimes to keep debt service current, a mortgagor may have ceased paying his or her vendors and suppliers, and by the time the lender finds out about the liens these vendors and suppliers have placed on the property, the modification has become much more difficult to execute.

Preleased Space

The method used by most shopping center developers is to prelease as much space as possible, and certainly this would include the major tenants. With leases in hand, the developer can show a lender exactly what kind of stores will be operating in the center and, more importantly, that there will be a commitment of rental income. It is not unusual for a lender to base the loan amount on the value of the leases rather than on the value of the buildings as collateral. Thus, the better the quality of leases, the greater the loan commitment, which reduces the equity cash required up front. Few centers are able to fully prelease their space, so usually some additional, speculative space is included. This space is easier to lease if the smaller merchants know who the other tenants will be and what kind of competition they will encounter.

Speculative Projects

Only financially strong builders/developers are able to construct speculative store space, either as free-standing buildings or neighborhood centers. The larger shopping centers cannot be financed without obtaining leases with substantial tenants. The risk of leasing speculative space is considerable, and the quality of the tenant is unknown to the lender.

Nevertheless, a number of developers are quite capable of erecting smaller projects and have proven successful. One key is to keep up-to-date on the growth in market areas and select appropriate building sites. Another key is to maintain a sound list of prospective clients—that is, merchants who have proven records of success and are aggressively expanding their operations. A track record of successful development is essential for any loan approval in this field.

OFFICE BUILDINGS

The owners of all types of **office buildings**, ranging from the largest to the smallest, acquire or construct them for one of two purposes: (1) their own occupancy, or (2) for lease to others.

Business Owner-Occupied Buildings

Many owner-occupied office buildings are bought or built by companies or persons with a financial history that makes the decision on underwriting such a property somewhat easier for the lender. This is because the credit reputation of the owner is the major qualifying factor under consideration, whereas the real estate to be pledged is of secondary importance. Ultimately, the source of loan repayment is closely tied to the owner/occupant's record of profitability and the manner in which previous financial obligations have been met.

In financing large owner-occupied buildings, an alternative choice to straight mortgage financing is the sale of first-mortgage bonds (where a pledge of the property collateralizes the bond issue) through an investment banker or a mortgage banker. Acquisition of large office buildings by investing institutions such as banks or insurance companies is a common practice. To accomplish this, owners may simply finance the property from their own investment funds. On occasion, a firm needs to free up capital in an existing building that they occupy and will enter into a sale-lease-back. The sale-lease-back and the discounted sale/leaseback will be more fully discussed in Chapter 13.

Various local, state, and federal governments and their agencies build office buildings for their own use with legislative appropriations or through the sale of various types of bonds. Some government buildings, such as post offices, are built by private investors under long-term lease contracts and are financed through private sources.

Office Buildings for Lease to Others

The underwriting of buildings intended for lease to others calls for some specialized techniques of real estate mortgage financing and requires extensive analysis of the property involved. In this category, there are four main groups: (1) a builder-investor with preleased office space to build, (2) a speculative builder-investor hoping to attract tenants before the building is completed or soon thereafter, (3) an owner-occupied building with extra space for lease, and (4) a "stabilized income property" that is being acquired.

Preleased Office Space

A substantially preleased building is the more conservative method of making an office building investment. For financing, it provides the underwriter with a lease to analyze a tenant to examine for creditworthiness, and a building and location to study. If the building is specialized to meet a tenant's unusual requirements (such as heavy electrical gear, raised or lowered floors, or special wall patterns), the term of the lease should be sufficient to recover the extra investment. Most underwriters will limit loans to a percentage of the total lease payments, as this is the main source for loan recovery, or to at least secure sufficient preleased space to cover debt payments and forecast operating expenses.

Similar to a shopping center, a preleased office building faces an inflexible situation in regard to an overrun on construction costs. The building must be designed and constructed in a manner that meets projected costs, and the contractor must have the ability to complete the project within the contract terms. Bonding of the contractor is a normal requirement. Preleased office buildings for single tenants are usually "bare-wall" leases—that is, the tenant pays for finishing the interior (not added to the rental payment) and provides future maintenance.

Speculative Office Buildings

The speculative builder presents a greater risk to an underwriter, and this limits loans to only the more experienced and creditworthy builders. In addition to the usual analysis of the building and its location, consideration must be given to the market and the regional economic pattern. What are the chances of the speculative building becoming fully leased? However, the underwriter, by choice, is not in the business of chance, so a protective

restriction is sometimes applied that would require the building to have a 75%, 80%, or perhaps 85% occupancy with bona fide tenants before the permanent loan will be released. A minimum rental provision clause used to protect the lender's repayments is often included in a speculative building loan. Of course, restrictions based on lease-up throw a real burden on construction financing and usually mean that the builder of a speculative building must have the credit strength or cash reserves to build and lease the building without an assured permanent loan commitment.

It is not unusual for a knowledgeable builder-contractor entity to build and lease a moderate-sized office building with its own funds, then mortgage out for more than the costs. In such a case, the loan security rests as much on an assignment of the lease income as on the mortgage pledge. One method of measuring loan size based on lease assignments is to calculate the current worth of future lease payments and loan 80% of that value.

Owner-Occupied Building with Space to Lease

A building constructed or acquired for owner-occupancy is often larger than needed at the time. The expectation, of course, is of future expansion. This would mean offering leases to others of shorter duration, like two- to five-year leases, or even including cancellation clauses in anticipation of future needs. Such limitations on occupancy could mean lower rental rates.

In periods of downsizing, owners may reduce their own use of office space. In an effort to attract new tenants, favorable rental rates may be offered in an effort to further reduce overhead expenses.

Regardless of how multi-tenant occupancy is created, owners tend to use contract management companies to handle operations rather than self-managing the property. Management is a specialized business, and building owners generally recognize the advantages of having experienced personnel handling lease-up and operation of a property.

Where Are We Now?

Rent Calculations for Office Buildings

Consider an 11-story multi-tenant office building. The size of floors 2 through 11 are 21,000 square feet. Of that space, 1,000 square feet are part of the "core" (elevator, stairwell), 3,000 square feet compose the "common area," and the remaining 17,000 square feet make up the leaseable space.

The quoted rental rate for the lease space is \$30 per net rentable area (NRA). If a prospective tenant wants to rent 4,000 sq. ft. for a new office, the 4,000 sq. ft. is considered net useable area (NUA). To calculate the contract rent, multiply $\$30 \times 4,000 \times 1.15$. The 1.15 is called the add-on factor (AOF). The actual rent, therefore, is $30 \times 4,000 \times 1.15 = \$138,000$.

Another way to express the rent rate calculations would be:

$$\begin{aligned} \text{NRA} &= \text{NUA} \times \text{AOF, or} \\ \text{Contract rent} &= \text{NRA} \times \text{NUA} \times \text{AOF} \end{aligned}$$

The landlord pays for the core and the tenants pay for their demised premises plus their pro-rata shares of the common area.

On the first floor, because of the enlarged entrance area, the add-on factor is likely more, such as 1.20.

Stabilized Income Property

Stabilized income property is a property type in which the building has a longer operating history; it usually has an 85% or higher occupancy and is for sale by its current owner for varying reasons. One of the typical issues facing a lender on these types of loans is that the current owner may be selling due to a lack of funding for reseating tenants when existing leases expire, or the building may need renovation and the owner is a passive investor, such as a pension fund or certain types of real estate investment trusts, without the management expertise or authority to complete such a transition. Therefore, many borrowers interested in stabilized income property may want additional financing, not just for the purchase of the office building, but for rehabilitation costs as well. For this reason, this type of loan sometimes has similar characteristics to the speculative office mortgage in terms of final LTV and expected occupancy after all rehabilitation construction and reseating of tenants is complete.

WAREHOUSE BUILDINGS

The **warehouse building** is another type of income property that is preferred by many investors because of its relatively low maintenance and management requirements. The demand for warehouse space has grown substantially in the past decade for several reasons. Many types

of companies use general warehouse space to store merchandise in peak seasons, to keep a product closer to its ultimate market, or to house an unusually large stock of a particular raw material.

Somewhat like office buildings, this type of facility can be built for use by an owner, such as a grocery chain operator; it can be built for use in part by an owner, such as a light manufacturer, with portions available for lease to others; or it can be built for speculative leasing as commercial warehouse space. It is the speculative warehouse that requires the most careful loan evaluation of the property. Owner-occupied or partially occupied buildings provide an established business with a source of income to substantiate and undergird the loan analysis. Warehouses are built fully preleased and partially preleased in much the same way as office buildings and shopping centers, so the analysis of the different types is similar.

General Warehouse

There are several basic requirements for general warehouse space that make it more easily rentable during the life of a loan. Like all other income properties, location is of paramount importance. Location should include accessibility by roads running in several directions that are able to accommodate large trucks or tractor trailers. The land need not be in high-density traffic zones as required by shopping centers and some office buildings, but neither should it be locked into small street patterns that limit the size of the truck that can transit through. Warehouses should also be accessible to rail spurs, if possible. Availability of a rail siding is not essential to every user, but lack of this facility may limit future marketability.

Because general warehouses may be built in older or less-developed areas of a community, it is important to check out the availability of adequate water lines and water pressure to support proper fire extinguisher installations. Without adequate fire protection, insurance rates skyrocket and greatly increase storage costs for the prospective tenant.

In the construction design of the building itself, provision should be made for loading docks capable of handling truck and freight-car loadings at the proper heights. The ceilings must be high (generally over 15 feet) for more efficient stack storage of merchandise. The costs of construction of a warehouse building are similar to those for a shopping center building insofar as both are fairly high-ceiling buildings with little or no interior finishing provided by the builder. Warehouses require heavier floors to support more weight but use much less parking space than a shopping

center building. Furthermore, the cost of land suitable for a warehouse is much lower than that required for freeway-accessible shopping sites.

Net Lease

Warehouse leases often provide for a triple net return to the owner, which means the tenant pays all maintenance and operating costs, plus all insurance and taxes on the building. In such a lease, management expenses are held to a bare minimum. The cash available for debt service is therefore very easy to calculate. For general warehouses with multi-tenant occupancy, the owner may provide some services and most likely will be responsible for taxes and insurance costs.

Office/Warehouses

A variation of the general warehouse is the type of building that combines an office facility in front and larger warehouse-type space in the rear. These **office/warehouses** have many uses—for example, as sales and storage offices for such items as parts or distribution of equipment, small manufacturing operations, and repair facilities. Office/warehouses should be more accessible to general traffic than general warehouses and are more likely to be attractively landscaped, with parking available for the tenants' customers. Construction costs are about the same as for a general warehouse except for finish work in the office area.

Mini Warehouses

A growth segment of the warehouse market has developed in the building of one-story structures partitioned into small rental spaces. The market for these **mini warehouses** comes from the more affluent and mobile citizens who accumulate material goods but are unable to accommodate them in small apartments and houses. The structures usually contain from 100 to 300 rental spaces, each ranging in size from 5' × 5' to 20' × 20'. The management requirement, depending somewhat on size, ranges from almost nil to full-time administrative personnel and security guards. Returns on investment have been good. Owners have reported that a completed warehouse averages about one-half the cost per square foot as that for an apartment building, and the rental rates per square foot are about the same.

FARM AND RANCH LOANS

Farm and ranch loans are distinctive and should not be classified as commercial loans. They require a very specialized knowledge of both the borrower and the property pledged to make a sound underwriting judgment. Almost all of these loans are analyzed in the local area. There are few, if any, national guidelines, as each local area presents its own distinctive soil, weather, crops, and markets. Because of the great importance of agriculture to the national economy, federal and many state governments have undertaken a number of helpful loan programs to support some stability within the industry. Government land and crop loans are the single most important source of farm loans, accounting for about half of all farm mortgage debt outstanding. The other half of the market is covered by commercial banks in rural communities and life insurance companies dealing through mortgage companies. The creation of Farmer Mac by Congress in 1989 and its expansion of powers in 1996 enhanced the willingness of regulated lenders to undertake farm loans. Farmer Mac is now authorized to buy agricultural loans and create its own mortgage pools very much like Fannie Mae and Freddie Mac.

The term of a farm loan varies as to need and may run from 10 to 40 years, with 33 years being a popular term partly because the Federal Land Bank formerly used 33 years. More leniency is given in the repayment of farm loans than other real estate loans. A farmer's income is subject to greater variation, and a rigid payment schedule can be self-defeating. But any long-term farm loan should have full amortization as a goal.

Some of the major government agencies handling direct farm loans were discussed in Chapter 3 as a part of the primary-mortgage market. This section addresses some of the questions that would be involved in conventional underwriting of farm and ranch loans. Two general categories of farm loans are (1) family-resident loans and (2) agri-corporate loans.

Family-Resident Farm Loans

The **family-resident farm loan** has not changed a great deal in the past 30 years. It is still based on the three legs of any good mortgage loan: (1) a creditworthy borrower, (2) a property of sufficient value to provide good collateral, and (3) the ability of the property and the borrower to produce

an income, assuring repayment of the loan. Judgments on farm land value require good knowledge and experience in the local area. A single-crop farm is the most vulnerable to failure and subsequent loan default. A diversified crop operation, plus some livestock, provides the best security. So the ability of the farm to produce a continued income, regardless of an occasional crop failure or a fluctuating market, is a prime consideration in making a sound farm loan.

The land value itself may be distorted by outside pressures such as a city developing nearby, a large neighboring farm desiring to expand, or possibly a new freeway providing much frontage acreage. But the farm underwriter should confine the analysis to the producing factors—soil conditions, weather, available irrigation, type of crops, nearness to markets, and condition of the markets—that will produce the income from which the loan can be recovered. To give any substantial weight to possibly increasing land values takes the loan into the speculative category of land development.

Agricorporate Farm Loans

Agricorporate farm loans show some similarity to special-purpose property loans. Large commercial farm companies control much of the nation's agriculture today and usually provide good business records to assist an underwriter in making an evaluation. Studies of land productivity with various crops and fertilizers, the most effective methods of breeding and feeding livestock, and management techniques in cost control have developed economies of operation. Equipment can be more fully utilized and better maintained than on smaller holdings. Along with the advantages, there is a word of caution: the dependency on hired labor and fixed management costs make commercial farms less flexible and more difficult to retrench in periods of declining prices.

Ranch Loans

A ranch loan presents only slight variations to a farm loan in that it produces livestock as a principal source of revenue. Because ranches are predominantly in the drought-prone southwestern regions, an underwriter must take care to analyze the water situation. Often, water rights can be of greater value than the land, since without water the land may be worthless. A common practice in ranching is to lease public lands

for grazing. The acreage so leased becomes of value to the ranch only in terms of the productivity it can add to the ranch, and this can be limited by the term of the lease. But leased land or grazing rights do add value and should be included in the appraisal for loan purposes. Sometimes, ranches produce additional revenues from the sale of timber rights, from mineral leasing, and even from hunting leases and dude ranching. All income has its value, but must be considered according to its tenure and stability.

Religious Facility Financing

Church or other financing of buildings for the use of religious organizations requires the authorized officials of the organization to meet some unique prequalification requirements. For the typical church facility, for new construction or refinancing a lender will typically want, at a minimum, the following:

- Minimum of three years of financial statements (five years is preferable) and a year-to-date financial statement for the current year including both balance sheets and income statements
- Minimum of three years' worth of average adult worship attendance
- Annual contributions from each of the largest 15 donors for the previous year (the names of the donors are not usually required)
- Cash on hand in building fund
- Value of land or building already owned
- Current liabilities of organization
- Method of fundraising to finalize repayment and current status

A lender will also want to ask about the level of borrowing that will be needed, so a preliminary budget should be prepared and the authorized officials of the organization making the loan request should be able to answer the following question: Should your fundraising campaign not come to fruition, could the organization pay for a self-amortizing mortgage out of its existing budget?

There are three dominant types of funding for religious-use facilities. These are conventional loans from a bank or other financial institution, a bond offering, or a capital stewardship campaign. Conventional loans will run the gambit of types as the loan may be for new construction, remodeling, or acquisition of land or other facilities such as a day care center or

school, and as such will have many differing options, including funding projections, that might vary from those of a traditional new house of worship.

With conventional lending, borrowers might approach a direct lender such as a commercial bank or broker, usually obtaining a construction loan based on the future value of the facilities to be built, using available assets as collateral. Borrowers will generally obtain money from one lender; however, in some small communities, local banks will participate in making the loan, with one as the lead on the construction loan while the other becomes the servicer on the permanent loan at the end of the construction. The transfer is usually handled like the construction-to-permanent single closing procedure discussed for residential construction financing in Chapter 6.

The second source of funding is bonds. A religious organization would deal with a bond company that specializes in putting together and promoting the offering. As discussed earlier, lenders and bond underwriters will limit the amount of money that can be borrowed based on current income, membership trends, and cash flow trends. Many bond underwriters will tell a church it can only borrow three to four times its current earnings. For example, should a religious organization be able to demonstrate an annual income of \$200,000 over the past three years, it might have a bond borrowing power of between \$600,000 and \$800,000, to be offset by expected cash flows from a capital stewardship campaign and/or the existing value of collateral, such as the land. Some more centralized religious organizations have developed their own bond underwriting and issuance capability.

Many religious organizations use capital stewardship campaigns for new facilities, schools, or other facilities. These capital stewardship campaigns will range in terms of need, funding between one and three times the organization's current total income over a three-year campaign period. Many religious organizations have carefully crafted professionally-facilitated campaigns or templates for local use. This is a highly desirable way to fund any building program and aid in obtaining permanent funding from conventional lenders or bond issuers.

Most successful fundraising and financing programs for new construction start with plans developed by a professional architect, ideally based on a budget or bid from the expected contractor. The funds for the architect's fee must be paid for by the religious institution desiring funding, as this demonstrates the level of commitment and competency looked for by funding organizations.