Berkeley Investment Advisors
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Anatomy of a Deal (Part III): Financing

In the first 2 parts of this series we looked at the contract negotiation process and the use of contingencies to manage the risks of the transaction. The most important of the contingencies in any contract is the financing contingency. Getting the right loan will make or break a deal; this is the most likely way a deal will fall apart. In addition to interest, you pay upfront fees, and possibly a prepayment penalty. Besides the cost, the other key thing you're looking for is the amount the bank will lend. Loan qualification requirements vary across banks and sometimes across loan types within the same bank. As a result, the amount offered may differ greatly depending upon both the bank and the specific loan "product". This month I will discuss in detail the various facets of financing the purchase of an investment property. I will concentrate on deals with 5 or more units while mentioning key differences of residential (1-4 units) mortgages.

Most people focus on interest rates in comparing loan offerings so we will start there. At one extreme we have the standard fixed rate 30-year mortgage that has traditionally been used for home purchases. The other extreme is an adjustable rate mortgage (ARM) with monthly or quarterly changes in the interest rate. These loans tie rate adjustments to changes in a short-term reference (also know as "base") interest rate. Typical short-term rates used as a reference include Prime, LIBOR[1], and 11th District Cost of Funds. There are various other, less common, alternatives, such as Treasury rates and individual banks' Cost of Funds indices. Besides pure fixed and pure adjustable rate loans, there are many choices in between: hybrid adjustable rate mortgages allow you to fix your rate for a certain number of years, after which the loan turns into an ARM.

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[1] LIBOR stands for London Inter-Bank Offered Rate.

The Federal Reserve Bank ('the Fed") controls (indirectly) the short - term interest rates used in ARMs. The Fed uses these rates to steer the economy; they can rise dramatically if the economy strengthens and the Fed raises rates to control inflation. Typically borrowers get some protection from increases in rates. Typical provisions limit increases in ARM rates to 2% per year and 6% over the lifetime of the mortgage. These are called "Caps". They still leave the borrower with a lot of risk: payments would increase by 77% if a mortgage rate went from 5% to 11%. Thus, ARM financing is risky! Unless, inflation has had a chance to push up rents sufficiently, rising loan payments can lead to negative cash flow and even outright losses if a sale is forced when rates are high. The risks may be worth it if you plan on holding a property only a short time – otherwise you should be looking to fix your rate for some period to reduce financial risk.

In a normal rate environment, such as we have today, the longer the term of the fixed rate, the higher the rate will be. Long term fixed rates will substantially exceed the short-term rates used for floating rate loans. This difference is the cost of reducing risk. We have a classic trade-off between risk and return. In such an environment it's smart to choose a fixed rate that matches the period for which you expect to keep the loan in place. If you know that you will want to either sell or refinance in 5 years, then it's best to choose a loan with a rate fixed for only 5 years. This way you don't pay an even higher rate for a longer term than you need.

There may also be some relationship between prepayment penalty terms and the period of the fixed rate. Although some ARMs may carry a prepayment penalty (a few percent of the loan balance), most ARMs would not. Fixed rate loans, however, will often have a clause that specifies a penalty calculation based on the remaining fixed rate period and the amount by which rates have dropped since you took out the loan. Such provisions may make it uneconomic to refinance or sell before the end of the fixed rate period. In considering such loans, it is important to consider the likelihood of paying the penalty and the cost of choosing a loan that provides more flexibility. Again, these potential costs provide an incentive to think ahead about how long you are likely to operate the property before you need to re-leverage it by refinancing or selling. Note that this issue normally doesn't arise for 1-4 unit residential mortgages because these loans usually allow the borrower the option to prepay any amount, anytime, without penalty.

Besides interest rates and prepayment penalties, upfront fees are also a significant component of overall financing costs. The importance of these costs is especially important because they directly impact the amount of cash you must invest in the deal on day one. There are many types of fees with all kinds of names. The only important distinction is between those that affect your loan rate, discount points, and those that don't affect the loan rate (all the rest). At the time you choose your loan you will be offered the chance to "buy down" the rate. You can reduce the loan rate by paying discount points – i.e. you pay a percentage of the loan amount to the bank at origination and this reduces the amount available to purchase the property. You can look at this opportunity in terms of how many years it will take for the interest savings to offset your upfront cost. The terms vary – usually the breakeven point is somewhere between 3 and 7 years. Whether you should pay or not is a complex financial analysis. I'll discuss this later.

In the other loan cost category, I lump all the other up front fees: origination fees, underwriting fees, processing fees, document preparation fees, courier fees, appraisal fees, answering the phone fees, and all the other "junk" fees that are shown separately to make them seem less objectionable. It doesn't matter what they call them, or how they justify them, to the borrower they are just fees – a cost of financing. As such, they should be included in your analysis as you shop for the best deal from potential lenders. When the actual deal closes, all these fees will be detailed on the settlement statement. What you need in order to compare loans is the full set of fees the lender will charge - in addition to the interest rate and the discount points. Be wary of any lender who cannot provide and commit to the complete list of charges that will appear on the settlement statement. (Likewise be wary of the broker who presents an investment analysis that ignores loan costs and the risk of an ARM or short-term fixed rate loan).

Your loan broker (if you are using one) should provide the details of all costs for every loan product he suggests. For relatively straightforward deals, it is a good idea to get a couple of quotes direct from lenders before engaging a loan broker. That way you don't pay extra costs for the broker's services unless they add value by finding a better deal. Note, however, brokers sometimes over-promise. There are brokers out there who promise whatever they need to in order to get your business – knowing that they can raise the price and change the terms when its too late for you to pursue alternatives. They inform you that the bank changed the deal on them (and you) and you are stuck with whatever the true costs turn out to be.[2] If it sounds too good to be true, it probably is. Ask questions and check references to smoke out these phonies while there's still time to do something about it.

[2] Real estate brokers may also tempt you by over-promising. Skepticism is healthy for your returns!

Even when you have complete disclosure of costs on competing offers, it still may not be obvious which choice is best. Often the loans offered will differ along multiple dimensions: interest rate, fees, prepayment penalties, loan amount, term of fixed rate, and reserve requirements[3]. With so many variables, how do you reduce this to a single measure for making a decision? The government regulators' answer to this is the Annual Percentage Rate (APR) – a standardized measure of credit cost over the *life* of a loan. Unfortunately, this is not adequate. The key to building wealth for retirement is an unrelenting focus on your return on investment. Therefore, you must use a financial model that takes everything into account to calculate return on investment (equity) over your investment's expected holding period. You can plug in various financing offers to see which will maximize your return on investment (equity). Obviously, this is a very complex analysis. Have no fear: Berkeley Investment Advisors produces these models for every client investment.

Besides loan costs, how a loan is underwritten is very important. Underwriting refers to the process of deciding who gets a loan, how much they get, and how much it will cost. When you are quoted a rate and a loan-to-value ratio (LTV), it is based on you and your property fitting within the underwriting guidelines for that loan "product". When the lender actually *officially* evaluates the facts of the case, they may find that you don't meet the guidelines. In that case they may reject your application, or reduce the loan amount/LTV, and/or increase the cost of the loan.

Underwriting falls into two categories: 1) your credit worthiness, and 2) the property's quality as collateral. In evaluating your credit they look at three things:

- Income relative to debt service,
- Assets relative to liabilities, and
- Your history of debt payments.

The first two usually require extensive documentation. The last of these, measured using a FICO[4] score, is the most important. If your FICO score is high enough, you may be able to go with a low or no documentation loan. In other words they just take your word for it on your income and accept your credit based on your superior credit record.

In evaluating the property, the bank will require an appraisal of its market value. The lender's maximum LTV, applied to the appraised value, sets the maximum possible loan amount. Most banks have a maximum LTV

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[3] I am referring to the bank holding your money to make sure property taxes and insurance get paid.
[4] FICO stands for Fair Isaacs Company

of 75% - though it may occasionally be as high as 80%. Here is where there is a divergence in policy for the 1-4 unit sector. These loans can go all the way to 100% LTV in the case of owner occupied property. Note that the borrower pays for the appraisal (via the bank) before the loan is approved. This cost is not refundable if you switch lenders. Ideally you'd like to have the bank hire an appraiser you know can properly value the property (i.e. at or above purchase price) in the time frame stipulated in your purchase contract.

In the 1-4 unit segment, an appraised value is enough. For 5 or more units, the bank will determine whether the property will generate enough cash flow to make the loan payments (over the life of the loan). The tool for this evaluation is called the debt coverage ratio (DSC). The numerator of this ratio is the current year projected net operating income (NOI) of the property. Depending on the bank, this may, or may not, be adjusted to account for reserves for capital replacements (i.e. roof, appliances, carpets, repaving, etc.). The bank will use current rents and the appraiser will provide estimates of vacancy and expenses (though these may be influenced by actual historical results). The denominator of DSC is the annual loan payments. A minimum ratio of 1.2 is somewhat standard. Thus the bank requires a cash flow cushion of 20% of annual debt service. If the requested loan amount results in a DSC less than 1.2, the bank will reduce the loan amount to the point where DSC is 1.2. This criterion implies that richly priced properties (high Price/NOI or high Price/Rents) will not reach the 75% LTV target – thus increasing the equity requirement and decreasing projected return on investment. Of course, if you've done your homework on the property (or had us do it for you), you will know ahead of time how the property will stack up against the bank's underwriting procedures.

One final point about banks – there are important differences between large and small banks. Large banks are cheaper for deals that fit into their parameters but tend to have stricter standards and are much more inflexible than smaller banks. Therefore, for the problem properties, you will deal with smaller niche players who will charge you more. If you try to do a non-standard deal with Wells Fargo or Washington Mutual you will probably end up with the loan rejected late in escrow - and lose the deal.

Conclusion

Financing is the key to closing a deal and maximizing your return on investment. Choosing the right lender and loan is a complex process; a good advisor is essential. Berkeley Investment Advisors helps its clients evaluate both direct lenders and loan brokers. We use sophisticated financial modeling to help you maximize your return on investment (equity) given your tolerance for financial risk and your investment horizon. Whoever you work with, make sure they proactively help the bank and the appraiser understand the property and how it will perform under your ownership. Most importantly, follow up frequently with the lender and/or loan broker to make sure the underwriting and appraising work is on schedule and that there are no surprises in the loan terms you will actually get at the closing. When you use Berkeley Investment Advisors on your purchase, we manage the process for you to keep your deal on track.

Featured Investment Opportunities

This is a fast oil change facility in Pacifica CA (10 minutes from San Francisco) leased long-term under a triple-net lease. This is a very strong location. I estimate that gross margin is 1.7 times the tenant's fixed charges (rent and property expenses). The nearest competitor is 3 miles away, with little prospect of new competing properties being approved. Thus there is little re-leasing risk and much appreciation potential. This property is available at $1,800,000. The current capitalization rate is 8.28% and rent escalations are 4% every year! A mortgage for 75% of the price at a rate of 7% would result in first year cash on cash return of 10% and projected total after tax returns in excess of 15% over a 10-year holding period. Returns this high are very rare for a property with such low risk and so close to San Francisco. Considering the management free aspect of this lease, this is truly a great opportunity. There is a possibility of partnering with another investor on this deal if you can't afford to purchase it on your own.

For those of you looking for something smaller, I have a 3-bedroom, 2-bath townhouse in Houston for sale at 70,000 – about $5,000 below market. This property can breakeven at a 90% LTV. After adding closing costs and working capital, the required investment is only $9,000. Over a 10-year holding period, I expect annualized return on equity of at least 12% (based on a conservative appreciation forecast of 1.7%).

Contact Information:

RayMeadows@BerkeleyInvestment.com
Tokyo phone: (080) 3122-9601
San Francisco phone (510) 367-3280