



ESSEX FINANCIAL GROUP

Adding value with strategic creativity combined with long-term relationships

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Articles from CREJ | December 7-20, 2011

FITTING INTO THE LENDER'S BOX

Ed Boxer

One of the main attractions to owning stabilized commercial real estate is the ability to finance the acquisition with an appropriate combination of debt and equity.

Low-cost, long-term debt allows the investor to achieve positive leverage that enhances the equity dividend when compared with the un-leveraged capitalization rate. This is especially true in today's low-interest-rate environment. Not only is senior debt for stabilized properties incredibly cheap by historic standards, but also it often can be obtained on a non-recourse basis! No wonder that everyone reading the Colorado Real Estate Journal wants to own high-quality income properties. The savvy investor, however, must understand what property types and markets lenders prefer at the moment. This article will provide an overview of different property types that lenders seek for senior debt. Life insurance companies are the most active nonrecourse lender in today's capital market. My comments will reflect what the life company investment officer prefers. While there are differences from one company to

the next, in general, they are all chasing the same deals and conversely they are all turning down the same ones as well.

APARTMENTS | Almost without exception, lenders are most interested in financing newer multifamily properties, followed by distribution warehouses, grocery- anchored retail and office buildings, in that order. It all boils down to market fundamentals. Nonrecourse lenders rely on cash flow from the property to service debt, and that means such lenders must have confidence in the property to stay well occupied at rental levels that ensure the borrower's ability to make the mortgage payment.

Investors and lenders are flocking to apartments. According to Real Capital Analytics, some \$21.6 billion in multifamily properties traded in the first half of 2011, more than doubling last year's number. As home ownership continues its decline, more people are becoming renters at a faster pace than new apartments are constructed. Vacancy rates across the country, including Denver, have plummeted. Rents are rising and hopefully all of this capital chasing apartments will not create an asset bubble. Cap rates are falling as investors compete for the best

apartments and they will need to see rents continue trending upward to achieve their projected returns. Interest rates are hovering around 4 percent (+/-) depending on the loan to value for a 10-year loan.

INDUSTRIAL | Industrial properties historically are favored by the life companies. Lenders love the large distribution facility that attracts strong corporate tenants. The industrial market fundamentals are more stable than other property types and the real estate is fairly basic when compared with more complex apartments, office buildings and shopping centers. The level of tenant finish is minimal and therefore the cost to re-let vacant space is relatively low. The loan per square foot is much lower for industrial buildings than other asset classes.

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RETAIL | Grocery-anchored shopping centers also are desired by



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investors and lenders. The grocer generally needs to be No. 1 or 2 in market share with better than average sales per sf. The grocer also must provide a substantial portion of the rental income compared with the smaller shop space in the center. Many centers built in the 1980s and 1990s have too much shop space, and that is viewed negatively by lenders. Shadow-anchored centers are not as desirable as a center with the grocer as part of the collateral but many lenders will finance them – albeit with a higher interest rate. The biggest challenge with retail in many markets is proving that the rental income will not decline as leases roll over. Lenders are very leery of retail centers that have a lot of leases expiring in the near term. Denver retail has held up relatively well compared with

other Western cities.

Strip retail that does not have a grocer or other “necessity” stores (e.g., Walgreens) is more difficult to finance. That being said, there are non-recourse lenders out there for this asset class but the loans to values are more conservative than for grocery-anchored properties. I recently provided a client with a very competitive nonrecourse loan from one of our correspondent lenders on a 100 percent-occupied strip retail center.

OFFICE | Lenders are very particular about office buildings in terms of the quality of the improvements, location and the credit strength of the larger tenants. The lender is also very selective depending on the amount of lease rollover in the near term. Core as-

sets in the central business district are the most desired. Many lenders will not entertain suburban office unless it is very low loan to value.

Overall, it is possible to achieve very attractive financing with a historically low long-term fixed rate on a nonrecourse basis. All you have to do is own a property that fits the lender’s box. The box is smaller than it used to be, but it is still there to be filled.