Course Title: Commercial Mortgage Basics

Course Description: The course will inform students of different types of lenders,loans and metrics in submitting and approving a commercial mortgage request,

Learning Objectives (See attachment on Bloom's Taxonomy and Learning Levels)

Learning Level	Learning Objective
I:Knowledge	What is pre-qualification in both residential and commercial lending? What is the capitalization rate? What are lease types and terms (triple net,percentage,escalator clauses)
II:Comprehension	How would one classify a lender or loan type? How would they compare or contrast the cap rate in listing/sales vs the cap rate in obtaining a loan
III:Application	What kinds of questions will the student ask both their clients and a loan officer? Can they explain the "red tape" to buyers or owners? And can they know when to engage a loan officer or broker to directly inform the client.
IV:Analysis	What are the differences among lenders and loan types? Can the student identify why some properties may not qualify for certain financing options?
V:Synthesis	What would the students do if they could to change or improve the commercial financing landscape? What kinds of sources and alternatives do they believe the market warrants?
VI: Evaluation	Role Play: What choice would the students make in a scenario in which the property is a shopping center leased by both national and local tenants? What would they do if the appraised value came in less than the contract sales price? Or the lender underwrites it to certain risk factors?

The following will be the means used in assessing whether the Learning Objectives have been met (Pre and post test, Q&A etc.)
Q&A; scenario(s)

Timed Outline: Describe in detail the components of the course by breaking it down into subject matter areas of no greater than 15 minutes. What will be the method of instruction or teaching technique used for each area (lecture, slides, group activities, videotape etc.)

Length in Time (15 min. increments)	Teaching Technique	Subject Matter Segment and Description
1: Overview:	Lecture;Q&A	Listing/selling; APOD,cap rate and how they factor in quoting or approving a loan; lease types and terms and gauging past and potential performances via leases and accounting statements

2:Lender Types	Lecture;Q&A	Explains types of lenders: banks, investment banks, life insurance companies, SBA and private sources
3: Loan Types	Lecture;Q&A	Explain the basic loan types: purchase, refinance, bridge, mezzanine and seller financing; what a Credit Tenant Lease is
4:Mortgage Metrics	Lecture,Q&A; handouts	Explain several different formulas or benchmarks used by commercial lenders beyond the APOD/cap rate
5: Penalties	Lecture,Q&A; handouts	Explain the different types of pre-payment or early payment penalties that may be associated with loans
6:Documents	Lecture,Q&A; handouts	Sample loan applications, estoppel certificates; explain that lenders may also require environmental assessments
7: Scenario	Handout;around the class Q&A	Role play: Students and instructor will play the roles of various parties to a loan: listing broker, buyer broker, mortgage broker, loan underwriter, appraiser and inspector
8: Wrap up	Q&A's	Ask if anyone has any questions about material; evaluations& certificates
Length in Time (15 min. increments)	Teaching Technique	Subject Matter Segment and Description

COMMERCIAL MORTGAGE BASICS

Objective: By the end of the class, students should have a basic understanding of commercial real estate financing and general metrics used by lenders; different types of lenders and loans. The goal is to understand there is not always a right or wrong answer. Rather, the answer is It Depends and there are many nuances in financing commercial transactions.

I: Overview:

When a commercial property owner lists their property for sale and the buyer submits a purchase offer, the pre-qualification is different than applying for a residential mortgage. In a residential mortgage, the lender or mortgage broker can pre-qualify a borrower through their personal income and credit. With a commercial loan, a loan officer or broker can give a rough estimate based on property type, loan to value ratio and net operating income. Some companies such as Marcus & Millichap Capital Corporation have loan calculators that allow borrowers to get an estimate/quote. Others use their own internal models.

A key form used in listing and selling commercial real estate is the APOD or Annual Property Operating Data form. It states the current income and expenses, from which the broker can come up with a capitalization (cap) rate. The general formula:

Potential Gross Rental Income
Less Vacancy
=Effective Gross Income
Less Operating Expenses & Replacement Reserves
=Net Operating Income

Net Operating Income/Value = Capitalization Rate

However, when seeking financing, the APOD is primarily useful for the moment; snapshot. It gives an idea of the property's income and expenses. But it does not state past performance is nor does it give any hint for future performance.

For example, a shopping center that has as its tenants a grocery store, like Smith's, a hardware store like Ace or a restaurant /fast food eatery and various ancillary shops may have Escalator Clauses; rents go up by a set amount each year. Some leases may be coming up. Will those tenants renew? What kind of industry are many tenants in? An example :La Mirada Square Shopping Center. It was anchored initially by Albertson's, later Raley's, Hastings and Hobby Lobby. Raley's left Albuquerque in 2007.Hastings closed nationwide in 2016 and Hobby Lobby relocated to another shopping center further up Montgomery.

To gauge a property's historical performance , lenders will want 2 years and Year to Date of Profit & Loss reports; generally monthly or Trailing 12 format; possibly tax returns by one or both parties To gauge future income, lenders will also request rent rolls and leases. They may also want tenant financial information, especially if it is a single tenant leased property or if a company has changed hands and is carrying significant debt or is in a declining or consolidating area such as book/music/movie sales and sporting goods. See rent roll sample attached

A buyer’s broker and/or mortgage broker often needs the cooperation of a listing broker and seller. In order to obtain certain information, the seller may want the buyer to sign a Non-Disclosure or Confidentiality Agreement; stating the buyer only intends to review the information to evaluate the investment potential or for loan approval purposes. Sample attached

Questions & Answers; 5 min break

II: **Types of Lenders:**

A: Commercial Banks: Wells Fargo, Bank of Albuquerque. These are Depository institutions, regulated and insured by the Federal government.Because of such,they are very strict in their lending parameters. They generally like multi-family properties, institutional use office properties, higher end shopping centers that are anchored by a major name grocery store and a Walgreen's inline or pad site. They tend to shy away from certain owner-occupied properties such as car washes and laundromats; vacant land and speculative rehabilitation deals.

B: Commercial Mortgage Backed Securities/Conduit Lenders: Generally refers to the mortgage divisions of investment banks like JP Morgan and Goldman Sachs but can also be bank divisions i.e. Wells Fargo Small Balance CMBS or private, small balance lenders. They issue the loan and then sell it off as investments or securities in the secondary market or to an investment bank who will then sell the securities.

While CMBS lenders have more latitude in underwriting than commercial banks, they are often only slightly less stringent. The reason is their investor pools or clients often require certain returns on investment. Pension funds, hedge funds and other

institutional and individual investors have certain metrics or expectations. CMBS lenders will often be more aggressive in rates,terms and LTV ratios though. Rates are usually tied to the 10 year Treasury or 10 year Swap.

C: Credit Unions: Credit Unions have recently become more active in commercial mortgages. While they have many similarities with banks, they often have longer amortization schedules (25 years vs 20 years) and if they are Federally chartered, they do not assess pre-payment penalties for paying off the loan early.

D: SBA: These are loans that are issued by private lenders but insured by the U.S. Small Business Administration. There are two types:

SBA 504: The loan is for buying fixed assets, like real estate and/or equipment. If the purchase is for an existing property, the borrower must use and occupy 51%. If it is new construction, borrower must use 60% initially and subsequently occupy 80%.

The funding is divided into three parts.

1: The borrower invests 10% down: 2: A private lender will lend 50%.: 3: A Certified Development Company, which is generally a non-profit that exists under the 504 code will invest the remaining 40%.

Max Loan Amount: $5 million; $5.5 million for manufacturing and certain energy related policy goals.

The rates are based on the 5-10 year Treasuries

SBA 7A Loan: Can be used for working capital or real estate purchase, construction or renovation.

Loan issued by a private lender, insured by SBA. Maximum loan amount is $5 million. Unlike the 504,the LTV is negotiable between the borrower and lender and there is no third party. However, the rates may be higher, as they are generally tied to the WSJ Prime Rate,which is currently 4.25%. They may also use the One Month LIBOR rate or SBA Peg Rate.

E: Life Insurance Companies: Companies like New York Life or American National invest their funds from premiums into commercial loans. Because many life companies are established as mutual companies, owned by its members, they tend to run very conservative: 65%-70% LTV; good cash flowing real estate, generally Class A executive office high rises, large shopping centers and upscale rent multi-family properties.

F: Quasi hard money lenders: Lenders such as Silver Hill and Velocity lend on properties such as automotive services, day care centers and laundromats or borrowers who may not wish to state or verify their income or assets. LTVs can be relatively low (65%) or high (90%). They charge from 6% to 10% . The reason they charge higher is because of the higher risks involved. Auto repair stations and laundromats have high environmental risks because of the various chemicals and waste disposal issues. Borrowers who don't wish to present financial documents are also risky.

G: Hard Money Lenders: Private investors who lend on real estate but at very high interest rates and 2-3 points up front or an ownership stake. Borrowers who want hard money are often seeking to buy a parcel of vacant land or reposition/restructure the ownership of a piece of land or want to finance the purchase of a note or dilapidated property they intend to refurbish but don't want to go through the process of a conventional loan.

H: Real Estate Investment Trusts (REIT): These are set up like mutual funds. Investors put money into fund. 75% of REIT's income must be from real estate and 95% must be distributed to shareholders. A Mortgage REIT issues loans and buys CMBS investments (see above).

I: Owner Financing: An owner may elect to accept a down payment from a buyer and take back a Real Estate Contract For Deed or Seller Carryback Mortgage or Deed of Trust.

Questions & Answers; 5 min break

III: Types of Loans

A: First purchase: This is the standard, bread and butter loan of any type of lender; initial purchase of commercial real estate

B: Refinance: Borrowers may wish to refinance to take advantage of lower rates, to use the funds for improvements or cash out against their equity

C: Mezzanine Financing: A loan that sits between a first mortgage and any equity investments. A mezzanine loan is often subordinate to the first position loan, many times requiring an intercreditor agreement. A mezzanine loan may allow for the lender to become an owner if the borrower defaults and the mezzanine lender will assume all obligations to the senior lien holder.

D: Bridge Financing: Short term financing that is similar to a hard money loan but offered by institutional lenders. They can be used for taking a property out of foreclosure, funding for improvements and lease up; usually 3 month LIBOR+650 basis points or a Swap+450 basis points, depending on evaluation.

E: Seller Financing: This breaks into three options:

i: Real Estate Contract For Deed: Owner accepts a down payment, retains legal title to the property and buyer has equitable title and possession. Generally, the seller signs a general warranty deed and the buyer signs a special warranty deed. These, along with the contract are held in escrow. If the buyer refinances or pays off the contract, they get the general warranty deed and full legal title. If they default, the seller simply forfeits the contract and receives the special warranty deed from escrow, which re-conveys possession. A key issue with the REC is some states do not have any statutes governing it; common law.

ii: Seller Carryback Mortgage: Similar but the seller may not necessarily retain the legal title, depending on state law. If the state is a lien theory state, the borrower has legal title and the lender has a lien. If it is a title theory state, the lender holds legal title until the loan is repaid in full. In advent of default, seller can seek recourse through foreclosure per state mortgage laws.

iii: Seller carryback deed of trust. This is an option between the REC and the mortgage. Unlike an REC, deeds of trust are often governed by statute. Unlike a mortgage, the owner may entrust a third party trustee to execute a non-judicial power of sale foreclosure after default and failure to cure. In NM, the trustee sale cannot be held until 90 days after the notice was recorded.

F: Credit Tenant Lease Financing: If a property is leased by a national company such as Target or General Motors, it may qualify for certain financing considerations-lower rates, shorter pre-payment penalty period, etc. However, franchises like McDonald's or Ace Hardware may not necessarily qualify as credit tenants unless the corporation/franchisor guarantees the lease. Same with subsidiary corporations. If ABC wanted to lease out property for a studio, it would generally not be considered a credit tenant unless the parent company, Disney, guaranteed the lease. Generally refers to free standing buildings. In a multi-tenant property in which one tenant is a national credit tenant but others are local or franchised, those may offset the credit tenant lease.

Questions &Answers; 5 min break

IV: Key Commercial Mortgage Metrics

In commercial real estate brokerage, a key benchmark is the capitalization or cap rate, which gives an owner or buyer a basic rate of return after expenses but before mortgage payments and taxes. However, in evaluating a potential loan, underwriters will use several more benchmarks in addition to the stated cap rate.

1: Band of Investment Rate of return: LTV x Loan Constant x Down Payment/Equity+Cash On Cash Rate of Return. This reflects the borrower's rate of return when factoring both debt and equity.

Ex: 75% x 8% x 25% + 5%=6.5%

Loan Constant: First year annual debt service/Loan Amount; measures debt service amount per borrowed dollar.

Cash on Cash: Rate of return after mortgage payments but before any taxes. It is:

$$\frac{\text{Pre-Tax Cash Flow}}{\text{Cash Invested (down payment + 5\% ; closing costs}}$$

Example: Pre-Tax Cash Flow: $15,000. Sales price: $1 million. Cash Invested: 30% (25% down, 5% closing costs). $15,000/$300,000=5%

2: Debt Service Coverage Ratio: Net Operating Income/Annual Mortgage Payments. This gauges if the income is sufficient enough to cover the loan

Example: NOI is $100,000. The annual mortgage payment is 80,000

$$\frac{\$100,000}{\$80,000} = 1.25$$

This means the NOI is 1.25 times the annual mortgage payment. Lenders generally require 1.25 Debt Service Coverage Ratio.

3: Maximum Loan Estimate: Some lenders use this to determine the maximum dollar amount they would lend on a given property. It is measured as: NOI/Debt Coverage Ratio/Loan Constant

Example: NOI=$100,000 Debt Coverage Ratio: 1.25 Loan Constant: 6%: 100,000/1.25/6%=$1,333,333.33

4: Debt Yield Ratio: Rate of return a lender would receive if they foreclosed/took ownership: NOI/Loan Amount x 100%

Example: An office building has an NOI of $100,000. The buyer secures a loan for $1 million. The lender's Debt Yield Ratio is

$$\frac{\$100,000}{\$1 \text{ million}} \text{ x}100\% = 10\%$$

These are some of the benchmarks lenders will apply when reviewing loan applications. They go beyond the stated cap rate to determine if the property is receiving enough income to meet the debt and their investor requirements.

If the property is owner occupied and not necessarily an investment property, the lender may review comparable lease rates to estimate the income it would receive if it was an investment property and the borrower's financials: equity, credit, cash on hand and reserves.

Non-Recourse vs Recourse Loans: A non-recourse loan means the lender can only foreclose the property on default. The lender cannot sue the borrower or its principals for any deficiency judgment.

A recourse loan allows the lender to sue the borrower and/or its principals for any deficiency judgment. A Limited Recourse loan allows the lender to sue for or claim up to a certain amount above the foreclosure sale proceeds.

Q&A;5 min break

V: Rates:

Loans are tied to various index rates: the Prime Rate, the 10 Year Treasury Rate and the London InterBank Offering Rate (LIBOR) are examples. The effective rate is the index plus a percentage above the index rate called a Spread or Margin.

The Spread or Margin is the return investors and/or depositors want in exchange for assuming higher risk in allowing their money to be placed into mortgages rather than Treasuries or other, less risky investments. Spreads are measured in Basis Points. One Basis Point = 1/100 of 1 Percent.

Example: The Loan will be issued at the 10 Year Treasury + 250 Basis Points or 2.5%.

VI: Prepayment Penalties

Lenders and investors expect a certain return from the interest on a loan. If the borrower pays off early, they lose that income.

They build in prepayment penalties to discourage refinancing or selling within a certain period. There are three different types of penalties.

1: Declining balance: The lender will charge a percentage of the loan as a prepayment penalty but it declines by 1-2 percent each year of the penalty period

2: Yield Maintenance. A fee paid by borrower; the difference in the present value of what a lender will get with and without the fee. One common formula is:

(C -R) x F x B, where C is the loan interest rate, R is the current Treasury note yield, F is the present value factor and B is the unpaid loan balance as of the prepayment date.

Find the Present Value Factor By:

(1 - ((1 + R)^-N/12)))/R,

For example, suppose you pay off the remaining $61,613 of a 5.6 %loan 32 months early, when the yield on a Treasury note with 32 months to maturity is 2.08 percent. The value of F is 2.57 and the yield maintenance amount is (5.6 percent - 2.08 percent) x 2.57 x $61,613, or $5,574.

3: Defeasance: If a borrower prepays ,the lender may require them to buy a bulk of securities such as bonds allowing the lender or CMBS investors to continue to receive a Return On Investment

Questions & Answers; 5 min break

VII: Loan Applications/Submissions

A lender may use its own application, the Fannie Mae 1003 or Freddie Mac Form 65. Attached are the first pages of each

A lender may require certain supporting documents:

1: Business and Personal Tax Returns: 2-3 years: 2: Profit & Loss Statements: 2 years, Year To Date: 3: Personal Financial Statements: 4: Rent Rolls: 5: Leases: 6: Estoppel Certificates; signed by tenants stating they have paid the last month's rent and they are not suing the seller nor is there risk of a lawsuit by the seller for back rent.: 7: Environmental Reports: Lenders are concerned with environmental liability from chemicals, toxic waste and hazards. They may and often do require a Phase I Environmental Assessment.

SCENARIO/ROLL PLAY

Students will do a role play of the commercial loan process, based on facts below and sample forms given.

Property: Preston Logan Shopping Center: 1989 Preston Logan Boulevard: Albuquerque, NM 87110: Size: 71,000 Square Feet

Asking Price: $7.3 million

Vacancy: 8.5%

Income: $975,000

Operating Expenses: $245,000

Net Operating Income: $730,000

Cap Rate: 10%

Tenants

Mister Supermarket: National grocery store chain; corporate lease. Will renew at start of new year

Oates Hardware, Home & Garden: Locally owned affiliate of national brand. Corporate lease guarantee expires at end of year. Has stated they will renew in 2019

5150 Music & More: Sells CDs, Records, DVDs. Instruments and music books; also offers music lessons. Local, single location. Has two years remaining on lease

Rocky Mountain Fitness: Local fitness/gym; three locations in the area. Has been in business for eight years. Has two years remaining on lease

Kate’s Burgers: Locally owned, single location. Has four years remaining on lease

One student will be a real estate broker representing a buyer of the Preston Logan Shopping Center; Arthur Murphy. It will be the broker’s first solo commercial deal. They have a copy of the listing and Mini-Pod, with the cap rate.

One student will be a buyer client who wants to buy the Preston Logan Shopping Center; Wells Real Estate Investment & Development, LLC, represented by Robert Wells, its Managing Member; will put down 25 percent but wants a 12% cap rate; submits offer for $6,083,333.

One student will be the listing broker, representing the seller; Pam Gordon. She is a veteran commercial broker. The property owner is Preston Logan Retail Excellence, Inc, represented by William Preston, its CEO. Preston Logan accepts offer. Closing to occur in 60 days from date of acceptance.

One student will be Aubrey West a mortgage broker/loan officer for West Funding Group; reviews application. After running several estimates, she decides to submit it to JT Simpson Investment Bank Commercial Mortgage

Instructor will play Sam McKee, analyst and underwriter at JT Simpson Investment Bank Commercial Mortgage. He will issue a letter of intent.

One student will be appraiser James Chamberlain; will be assigned by JT Simpson to appraise property if borrower signs Letter of Intent:

Loan: Lesser of 75% of sales price, $4,562,500 or appraised value

Rate: 10 Year Treasury + 200-250 basis points 2% to 2.5%)

One student will be Mike Winters, who is the area inspector/construction expert who will inspect the property for structural issues.

Review Rent Roll for Tenant Information as well as the Pro-Forma above.

Based on the above information, how would the buyer broker go about seeking the financing needed to complete the purchase. What would they do if appraisal came in at less than the contract sales price? Why would an appraisal possibly come in lower than the sales price? If the appraisal matches the sales price, why would that be the case?

What if Mike Winters found issues with the structure. JT Simpson can extend its Letter of Intent by another month and keep the stated rate. But if any extension goes beyond that, it would have to issue a new Letter of Intent. Lender can also apply higher margin or spread, depending on certain risk factors.

The exercise above is not about a right or wrong answer. Rather, it is to teach students about possible ambiguity in financing a transaction and when dealing with the capital markets side, it is a bit more of a grey area in which the answer is often It Depends and that answer may change, based on certain factors.

Questions & Answers ; conclusion