Ten Ways to Structure Deals So They Don't Blow Up

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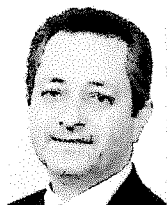
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The major reasons why deals blow up even after being fully underwritten is inextricably tied to how well the originator and the underwriter understand the requirements of rating agencies and B-piece buyers. Unlike portfolio lenders who buy and hold real estate debt for their own account, a commercial mortgage-backed securities (CMBS) loan underwriter is more concerned about what bond investors on Wall Street want, how they perceive the credit risk in the deal and the marketability of the loan. In a securitized transaction, the key to structuring and making deals is understanding both the property and the credit risk requirements of the rating agencies and B-piece buyers, and the "hot buttons" of your own internal Loan Committee.

The purpose of this article is to save originators and underwriters some time by identifying potential issues early so that good deals are sorted from the bad. We recognize that almost every deal underwritten today has some "hair" on it and has risks that need to be mitigated. We believe a majority of the deals in your pipeline can be securitized if they are carefully underwritten and if your borrower is creditworthy and flexible

Here is a summary of the top ten pitfalls to avoid when structuring deals:

1. **Month-to-Month Tenants** affects the duration and durability of the income stream and inflates the property's net operating income (NOI). Since this income can disappear at any time, it shouldn't be given any credit when underwritten. For example, in a recently submitted $8.5 million dollar Washington, D.C. strip shopping center transaction, the month-to-month tenants were included in the appraised value as if they were "regular" tenants. Therefore, at first blush it appeared as if the center was 92% occupied and all of the tenants were paying base rent and expense reimbursements. In reality, the property was only 72% leased and the borrower had been trying to get the tenants to renew. The borrower even indicated that the leases would be signed within a week or two. Unfortunately, it didn't happen. In the end it turned out that several of the tenants had been month-to-month tenants for 1-2 years but yet were still paying their rent on time each month. This deal never made it to Loan Committee. It should be noted (and some consideration should be given to the fact) that the month-to-month tenants had been paying rent on a month-to-month basis for several years and had below-market rents, which indicates a willingness and ability to stay and continue to pay rent. The loan could be underwritten with guarantees and a strong debt service coverage ratio (DSCR), but would be better placed with a portfolio lender and not in a securitized pool for Wall Street.

2. **Double Counting Revenues** creates an inaccurate picture of the gross effective rent, and increases NOI and DSCR. Therefore, the underwritten amount should be checked by reviewing the leases and examining the prior three years of actual reimbursements to uncover any potential double counting. For example, in a Dallas office building submission, expense reimbursements were being double counted. The borrower "accidentally" added together the base rents and expense reimbursements, and then inadvertently the mortgage broker analyst added back the reimbursements again, making the gross potential rent approximately 20% higher than it should have been. The deal still worked, but much more time was spent recalculating all of the reimbursements for each tenant. The lesson learned here is to call the borrowers accountant early in the process to clarify any numbers that appear to be unreasonable.

3. **"As Is" and "As Stabilized" Values** contained within the appraisal report are an often overlooked part of an underwriting analysis that need to be understood. Most appraisal engagements require these two values to be explained and described in the letter of transmittal. However, in about 30% of the appraisal reports submitted, the "as is" and the "as stabilized" values are not broken out separately or completed properly in the report. The "as is" value is based on the actual current occupancy and income, and the "as stabilized" value is when the property reaches its long-term occupancy. These values should be different if the property is not currently stabilized. The report should contain a detailed explanation as to how these two different numbers were reconciled into a final conclusion of value. An incorrect value causes an obvious problem in calculating the loan