

# Fundamentals of Multi-Family Financing - 2023

By Michael Becker & Paul Peebles

## Apartments are a Resilient and Proven Asset Class

Coming out of the 2008 Great Recession, multi-family properties (i.e., apartments) became one of the most popular asset classes. As a result, multi-family recovered faster and has performed better than most other real estate investment niches over the last several years.

However, long before the Great Recession, multi-family properties had been a staple for both individual investors and institutions like REITs and insurance companies.

For individual investors, owning income producing residential real estate is a proven way to create financial freedom. It's a timeless asset which serves an essential human need, so it's in demand in both good times and bad.

The natural progression for most real estate investors is to start with single family houses and then grow up into larger multi-family properties. This progression allows the investor to leverage other people's money, credit, experience, and efforts to acquire bigger properties and enjoy larger, more stable streams of income.

There are several reasons why multi-family is considered by many to be "best in class" within the investment real estate world...both for investors in the property AND investors in the paper (the mortgages that fund the property).

### Housing is an Enduring Universal Need

Not everyone works in an office, belongs to a health club, eats in a restaurant, stays in a hotel, operates a factory, or stores their personal treasures in a storage bay.

But EVERYONE needs a place to sleep at night. And because most people prefer walls and a roof, housing will always be a basic need for everyone.

With tighter home mortgage lending standards, there are fewer people able to qualify to purchase a home of their own. And with a weak jobs market and slow (if any) real wage growth, saving up for a down payment is a slow, if not impossible task. The result is more people are renting.

Another factor growing the renter population is the size and lifestyle of the generation known as the Millennials. There are nearly 80 million of these children of the baby boomers, and they are starting life with student debt, little savings and little desire to buy a home. They saw many of their parents lose equity, and in some cases, lose homes during the crash. They're in no hurry to buy and are happy to rent.

As for those former homeowners who lost their homes during the Great Recession, they too have joined the renter population. In fact, home ownership in the United States is now at its lowest rate since 1995.

Even empty nester baby boomers' factor into the mix. For those who don't have adult children or elderly parents moving in with them, downsizing from a home into an easier to care-for apartment is a way to free up equity for investment and simplify their lives. Are you familiar with the term, "lock and leave?" That's what retiring adults are seeking today.

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They lock the door and leave to visit the grandchildren hundreds of miles away. They no longer worry about yard and house maintenance, no leaky roof or leaky sink.

Add to this to a population which is growing through immigration...often on the lower end of the pay scale...and it's clear there are more and more people are needing affordable housing. Apartments meet this need. Freddie Mac has estimated that the nation is short 3.8 million housing units to keep up with the household formation. Apartment and Home Builders can't keep up with demand. What's causing the shortage itself is complex. The home-building industry lost about 1.5 million workers in the Great Recession of 2007-9 and has been in a labor shortage since. Land has grown more expensive. Lending tightened for builders, just as it did for home buyers after the bubble. The cost of lumber and other materials has risen. And the sheer difficulty of building a home in many communities makes it all worse. Local residents often oppose new housing. Local governments require development fees, studies and public meetings that drag out construction and drive up its cost. Through zoning rules, governments also force developers to build on larger lots than some buyers might want and create more parking than buyers might use. And these rules frequently make it impossible to build townhouses, duplexes, and apartment buildings.

## **Renter Satisfaction and Perceptions of Affordability**

Research by Freddie Mac Multifamily finds a large and growing segment of renters continue to believe renting is a more affordable option than owning, even as many of those same renters are feeling the squeeze of rising housing costs. The "Profile of Today's Renter" in June 2019, revealed that all generations of renters continue to perceive renting as the more affordable housing choice and remain satisfied with their current situation.

82 percent of renters believe renting is more affordable than owning – up a stunning 15 points from February 2018. The upfront costs of purchasing a home, including down payments and closing costs, are commonly rated by all renters as a primary obstacle to homeownership. Specifically, nearly nine in ten (88%) low-income renters said that having the money for a down payment and closing costs would be an obstacle to homeownership if they were considering buying a home. Middle-income renters (72%) also indicate the same challenge. Of these groups, 62% of low-income and 39% of middle-income renters consider having these funds a “major obstacle” to homeownership. The impact of these costs is also stark across generations of current renters; 80% of millennials, 81% of Gen Xers and 71% of baby boomers perceive not having enough money for a down payment or for closing costs as an obstacle to homeownership.

In addition, the expectation that mortgage payments would be higher than rent payments is also rated as a major obstacle to owning by 40% of renters. However, female renters are significantly more likely than their male counterparts (48% vs. 28%) to say high mortgage payments would be a major obstacle for them. In one of its most dramatic findings, the survey shows that majorities of both renters and homeowners have made changes over the last two years to afford their current monthly rent or mortgage. More than half of Americans (51%) say they have made spending or housing changes to afford their monthly housing payments, including 62% of renters and 47% of homeowners. Homeowners are not immune from these affordability concerns —of those who had to make changes to afford housing, 52% of owners spent less on non-essential items over the past two years to cut costs, while 33% spent less on

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food, utilities and other essentials. Moreover, 35% of owners- who reported trouble affording housing in the last two years- reported having to move to find a more affordable place to live, an increase of nine points since August 2018.

Finally, the survey looked at how the common costs of everyday life impact renters and owners. It finds that a majority, 51%, of younger millennials (aged 23-29) who rent had to make a different housing choice because of student loans, compared with 38% of younger millennials who own a home. In addition, the survey found 41% of older millennials (aged 30-38) who rent and 36% who own experienced the same phenomenon. In addition, over half of workers employed in the essential workforce, serving in crucial positions like healthcare, education, and law enforcement, have made housing decisions with their student loan repayment obligations in mind. This includes 51% of owners and 53% of renters working essential jobs.

Affordability issues will continue to have a profound impact on homeowners and renters.

## **Apartments are Diversified Cash Flow Machines**

A common goal for many investors is to create enough cash flow to meet or exceed personal monthly expenses. *Rich Dad Poor Dad* author Robert Kiyosaki calls this “getting out of the rat race.”

Once you get there- you’ve achieved financial freedom. Owning an asset, like an apartment complex which produces monthly cash flow, is a great way to help you achieve that goal. Owning an apartment is like owning a business. You will be rewarded by managing your asset more efficiently than your competitor.

Like you, your lender is depending upon the property cash flow because they know the average borrower can’t support the property without rental income in excess of expenses. That’s why the lender is very interested in the quality and experience of the property management person or company.

## **Cash Flow Creates Equity**

This is one of the most important distinctions between houses and apartments. It’s also one of the most important concepts to understand as an apartment investor. Single family valuation is based on competing properties of similar size, age, and quality construction that have been sold recently in the same submarket.

While a house may be bid up by a homeowner to a price far in excess of what the rents will support, that can almost never happen with an apartment.

In other words, value is a product of income. The more income, the more value. So even though investors may bid more for the same income (causing the ROI or cap rate to fall, just like bonds), there’s far less pure speculation in apartments. Apartment investors and lenders are VERY fixated on positive cash flow.

Apartment operators can typically raise their rents once per year as leases expire, subject to local market conditions.

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As rents increase, the value of the property increases with it. As mentioned, apartments are valued off of a multiple of net operating income.

Net Operating Income (NOI) is Gross Rents Received less Expenses. The NOI is what is used to make your mortgage payments.

As in any business, lowering expenses and increasing income will increase your net operating income.

Something as simple as moving the trash bill from the landlord to the tenant can increase the value of your investment by several thousands of dollars. This is because a small increase in income per unit can be a substantial amount for an entire complex.

Even more exciting is that an increase of income can lead to a substantial increase in equity (value).

For example, if you own a 50-unit apartment building and you increase the income (without incurring any additional expense) by \$20 per unit, you have created an extra \$1000 per month. At a 10% cap rate, you have created an additional \$120,000 in value. A small movement to income can have a large impact to value.

Even better, the extra \$1000 per month can be used to help extract the new equity to repay investors, yourself or to use as a down payment on another property.

## Apartments Can Help You Hedge Against Market Fluctuations

The other side of rising rents is a soft market, so you never want to cut your cash flow too thin. Fortunately, your lenders will require a cushion. In many ways, your lender is like your partner.

In a soft market, you can lower your rents slightly to keep your building full. While lower rents are unpleasant, vacancies are terrible and expensive. It could cost you more to re-lease a vacant unit. Consistent cash flow is needed in apartment management. If you have a diverse mix of units, you may find your smaller, more affordable units become more popular and you can keep a good tenant simply by downsizing them.

When the market recovers, you'll be able to ratchet your rents back up again. Unlike commercial leases, which may be 5 or 10 years long, residential leases are typically 6 months to a year. This means you can respond more quickly to changes in the market; both up and down.

## Apartments are Tax Efficient

Depreciation expense is one of the few gifts the government gives us. It's essentially a non-cash expense apartment owners use to shelter their income and reduce their tax bill.

Apartments are considered residential and enjoy a slightly faster depreciation schedule than commercial properties. This means more deduction per year to offset the income tax on your positive cash flow.

Another tax advantage of apartments is scale. With large apartments it can make sense to invest the time and money for a cost-segregation report. The IRS allows you to depreciate

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residential rental real estate over 27.5 years. A cost segregation report allows owners to itemize components of an apartment building (doors, windows, fixtures, etc) at an accelerated depreciation schedule; thus giving larger depreciation, recognized faster by the IRS.

Make sure your CPA discusses BONUS DEPRECIATION and the personal benefits you may receive in real estate ownership. Bonus depreciation is a tax incentive that allows a business to immediately deduct a large percentage of the purchase price of eligible real estate assets.

The bottom line is apartment investing may provide less tax and more after-tax income.

## **Apartments Hedge Against Inflation**

Apartments are real estate and can be classified as a “real asset”. This means that if the dollar continues its 100-year trend of falling in value over time, apartments will retain their value (increase in dollar terms).

Also, rental rates tend to move up with inflation. As previously mentioned, because apartment leases usually carry a term of one year or less as opposed to other commercial real estate asset classes that carry terms of 3-20 years, you have the ability to more quickly adjust and capture rising rents.

Annual rental appreciation has been steadily rising for the last 10 years. It is not uncommon to have annual rental increases of 2-4% throughout the nation. In the last few years rents have risen over 20% per annum. Wow!! Can you remember what you paid to rent your first apartment? Imagine what it is now!

## **Apartments are Operationally Efficient**

All businesses look for economies of scale. When you can set up standards and systems, and spread expenses across a larger revenue base, you can create additional profit margin. Apartments have scalability.

Let's look at some examples:

Apartments allow you to finance more units with one loan. While apartment loan costs are more than a typical house loan, you only need one loan to finance even hundreds of units.

The same can be said for the time it takes to find, negotiate, and close the transaction. Building a portfolio of 20 single-family houses is a lot more work than simply buying a single 20-unit apartment building.

Apartment buyers like scalability. As you get bigger in the number of units you own, management becomes easier. Once you own and are operating the property, you only have one tax bill, one insurance policy, one roof, etc., to deal with.

Of course, later if you decide to sell or refinance, you will only have one transaction to get through. If you're doing a 1031 tax deferred exchange, it's much easier with a multi-family building versus the nearly impossible task of executing multiple concurrent single-family transactions.

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Lastly, when it comes to professional property management, many apartments will be large enough to justify (or in some cases require) a full-time on-site manager and maintenance staff. This means your property and your tenants will be getting more and better attention than is practical with a collection of single-family homes.

Now that we've covered some of the many benefits of owning apartment buildings, let's discuss how apartment financing works.

## How Apartments Get Financed

Real estate investors get excited about potential, but lenders are much more concerned with current reality. When it comes to financing apartments, there are two basic categories of properties: 1) Stabilized or 2) Non-Stabilized

### Stabilized Properties

Stabilized properties are easier to get financed. A stabilized property can typically be described as one with 90%+ of physical occupancy for greater than 90 days. Two different occupancy terms you must consider in underwriting apartment transactions are 1) physical occupancy 2) economic occupancy. Many apartment owners say, "It's easy to lease out units, the difficult part is collecting the rent." Physical occupancy is the number of occupied units divided by the total number of units. Physical occupancy indicates the percentage of tenants that have signed leases and should be paying rent on time. Economic vacancy considers the economic loss from physical vacancy as well as the loss from occupied units that are underperforming. Economic occupancy takes into account the tenants that are NOT paying current or have been offered concessions to rent. Lenders want to see high economic and physical occupancy because it indicates the landlord is capable of collecting rents that are due. Typically, stabilized properties are 90% physically occupied and at 85% economic occupancy for the previous 3 months.

Lenders would like to see the historical two year's cash flow to determine possible future cash flow available to repay their mortgage. Imagine that the lender is looking at the operating statement in a rear-view mirror. They want to analyze what has happened in the past year or two to give them a good idea on how the property will be operated in the future. Higher leverage from the lender can be the reward for a stabilized property.

### Non-Stabilized Properties

As the name would imply, these are properties, sometimes referred to as a "broken property" that does not meet the aforementioned criteria of income stability.

Distressed assets are usually non-stabilized. These properties have functional and physical items that need to be corrected. Many distressed properties suffer from low occupancy, lower net operating income, and physical ailments that need to be corrected. Does the property need to change managers or install a better quality of tenant? Does the property need updating to compete? Buyers of non-stabilized properties are putting "humpty dumpty" back together again with corrective action. Investors sacrifice immediate cash flow today; for a future capital gain and/or larger cash flow tomorrow.

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## Where Does the Money Come From?

When you purchase an apartment complex- choosing the correct lender is critical. In a typical apartment purchase the bank puts in 70-75% of the total cost so in many respects “the bank is your largest partner” in the deal. They will make or break your ability to purchase the property.

There are two primary channels through which apartments are financed: traditional banks and/or a government sponsored **agency lender** (Fannie Mae or Freddie Mac).

## Traditional Bank Lending

Traditional banks are just what they sound like- private institutions that take in deposits (from Grandma) and make loans. They might be large national banks, local community banks or credit unions.

Traditional banks are generally preferred over agency lending in the following circumstances:

- You are new to multifamily investing. Fannie Mae will only loan to individuals that have previous multifamily ownership experience. Fannie Mae will not put you in the apartment business unless you team up with additional partners that have past or current Fannie Mae apartment ownership or management experience. That partner must sign on your loan documents. You are using their experience to mitigate your lack of experience. Freddie Mac will lend to first time investors on selected instances, but the terms and leverage will likely be less aggressive than you may get from your community bank. In both cases the agency lenders, do not want you learning on their dime.
- The property itself has some level of distress typically due to some physical issues that need to be cured and poor historic financial performance of the property. Fannie Mae & Freddie Mac typically only lend on stabilized properties in relatively good physical condition. Fannie Mae & Freddie Mac hangs their hats on stabilized cash flow streams. Also, the Freddie Mac Small Balance will not provide rehab funds to be included into their loan; a community bank or credit union will.

## Loans to Newbies

When you are initially getting into ownership of apartments, lenders will typically take a more conservative stance. They generally want owners to have more skin in the game for their first deal. They'll also want a larger margin for error if something goes wrong.

## Bank is your Partner

In commercial lending, the Bank is your greatest partner. You are putting in 25-30% of the equity needed in the transaction; but the bank is putting in 70-75% in debt. You are the operating partner- with measured upside and operational daily control of the asset and your bank is the silent partner-with hope on getting their principal balance returned with nominal interest. The bank is willing to “put you” into the apartment business as a new borrower. They are willing to take a prudent risk on you and your first transaction. Fannie Mae will not put an



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inexperienced borrower into a transaction. Freddie Mac will- in certain instances- for borrowers with strong personal financial, well-located properties and strong third-party managers.

## **Personal Guarantees (“Recourse” Loans)**

Bank loans to newbies typically require personal guarantees from all guarantors (signers). From the bank’s perspective, the more personal balance sheets backing the deal up, the better. The bank is not only taking a collateral interest in your property, but also in your personal balance sheet in case of a possible future deficiency balance. Think of it as giving the bank control of your wallet. Not only will they have the subject property as collateral, but they will collateralize your wallet. A deficiency balance is created if the bank must foreclose on the property and sells the asset to a third party for an economic loss. That loss must be cured (paid off) with liquidating your personal assets. Sometimes this is the only way that the transaction gets funded. By giving a personal guarantee, lenders are usually more flexible with terms and leverage; than without it.

## **Cash Reserves**

“Post-closing liquidity” (lots of cash in the bank after the deal is done) is critical for loan approval. The lender doesn’t want you to put ALL your money into the deal. They want you to have cash in reserves in case there is an unexpected expense. For newbies, the lender may require reserves between 10-30% of the loan amount to be held. The lender wants to see bank or investment statements that support your personal liquidity. Those reserves cannot be equity in other real estate investments or IRA’s or 401k’s. Lenders want to see cash, stocks, or bonds in your name. If there is an unexpected loss, the lender wants you to be able to pay for that expense, not them.

## **Professional Management**

Lenders will also want a third-party professional property management company hired for larger properties. From the lender’s perspective, handing an inexperienced operator for a large property to manage- is akin to giving a young child the keys to a very expensive car. Why take the immediate risk? Hiring a local professional property management company should help to educate you on what is important in Fair Housing, accounting & bookkeeping, and city inspections. Perhaps in the future, if you want to manage your property, contact your loan servicer on what will be required for you to manage your own asset. Remember, your lender has to agree that you can manage your own property.

## **Due Diligence**

Know what you are buying- when you buy an apartment. Your purchase contract should have a few qualifying timing markers that should aid to protect you. The two most important are: 1) Physical Due Diligence 2) Financing Contingency. Physical Due Diligence is having you and a multifamily inspector review the physical deficiencies of the property. This first step should happen immediately after the contract is executed. Your rehab budget is based on this report. Example items that must be reviewed are condition of sewer lines by a camera scoping the lines for breaks, electrical panels, roof condition, appliance, and fixtures. You will want to engage



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your property management company to review all leases, rent rolls and tenant files for credit and criminal background. This auditing task is very important in clarify your tenant base.

The second step is the Financial Contingency. This is the timeframe that it should take to apply for credit and receive your loan commitment from the lender. Quality third party reports- bank due diligence – are required from the lender and can take several weeks to complete. A new apartment buyer is sometimes surprised at the number and expense of all the reports the lender will require. But in a big property, there are lots of things to look at and what might be an inexpensive problem in a single-family home can be a significant expense in a large building. These reports should include Appraisal, Property Condition Assessment Report, and a Phase I environmental report and the updated flood map report.

Prior to the end of the due diligence period; on either the Physical Due Diligence or Financing Contingency; if you encounter any physical or financials issues on the property that cannot be resolved- you should be able to cancel the contract and have your earnest money returned.

## Create an Entity

Almost all lenders will require you to create a Single Asset Entity to be the borrower. Meaning that your new property will be held in the entity. (No other assets will be held under that entity) Your asset is typically held in a Limited Liability Corporation. Typically, you will not create the new LLC until after your offer for purchase is accepted. You are the sponsor and not the borrower. The LLC is the borrower; the managing member and the other guarantors of the LLC will sign for loan documents on behalf of the borrower.

## Value Added Lending “Humpty Dumpty Loans”

These programs are specifically designed for properties which are either non-stabilized or need minor to moderate renovations or some other value-added strategy. Meaning that you are putting the property back together. Moderate renovations can be funded at acquisition so the property can be positioned to secure permanent financing in the future.

Here are some typical guidelines for this type of financing from a traditional bank:

## **Traditional Bank Lending (Bridge)      Typically RECOURSE REQUIRED**

- Loan Amounts: \$400,000 to \$10,000,000+
- Loan to Value / Loan to Cost: 65% to 75% (loan based on acquisition price + rehab needed)
- Term (maturity): Up to 7 years
- Amortization: 15, 20, or 25 years (largely dependent on the age and condition of property)
- Rates: Fixed & Adjustable
- Interest Only Payments Possible: Up to 1 year during rehab
- Rehab budget: Needed before appraisal
- 24-month monthly pro-forma operating statement: Needed before appraisal

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- Debt Service Coverage (DSC)<sup>1</sup>: Not lower than 1.0X
- Recourse: Yes, personal guarantees are typically required by the bank.
- Origination fee: 1% of loan amount + Appraisal/ Phase 1 environmental study
- Escrows: Not typically required, you will be responsible for paying your own taxes, insurance, and capital projects.

As previously stated, the lender is looking for the guarantors (sponsors) to have strong personal balance statements to provide the lender with additional security. A lender will typically look for Post-Close Liquidity (cash or securities left over after the needed acquisition equity) from all the guarantor(s) of 20-30% of the loan amount or more. The lender wants to know that if something financially happens to the property (insurance claim not paid, lower than expected operating income, etc.) that the guarantors can still be able to operate the property without a capital call from the bank.

Most Banks will require a depository relationship. (Personal and Operating accounts)

Banks require that you provide quarterly reporting on operational performance of your apartment with a current rent roll. They will also require you to update your personal financial statement annually and submit your most current personal tax return. This is a business loan; so, regulators want to monitor how your 'business' is going.

One great benefit in getting a traditional bank loan is that it earns you ownership/ management experience with Fannie Mae and Freddie Mac for future loans.

## Rules of Thumb for Bank Financing

Not all Lenders are the same; some Banks are not real estate lenders

Not all Lenders like Apartment loans

Not all Lenders like older properties that need to rehabbed and repositioned

Not all Lenders like non-recourse loans; most will not even offer non-recourse loans

Not all Lenders will like the part of town that you want to invest in.

Not all lenders will give you maximum leverage to acquire and rehab with your loan.

Not all lenders will amortize apartment loans greater than 15 years.

Your large bank loan officer is not the decision maker; help him/her build a case for their credit committee to approve the loan. Loan officers are salespeople and problem solvers, but they don't have signing (approval) authority.

Help mitigate the lenders risk. Examples: You may need to add another guarantor or have the lender temporarily hold additional collateral in the form of a CD pledge. If you are new to

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<sup>1</sup> DSC is a ratio of Net Operating Income versus Principal & Interest. So if a property brings in \$12,000 per month of NOI and the lender require a minimum 1.0x ratio, the largest the Principal & Interest payment could be would be \$12,000 per month. If the lender required a 1.2x ratio, the PITI payment could only be \$10,000 per month ( $\$12,000 / 1.2 = \$10,000$ )

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apartment ownership, hire a very qualified property management company that manages similar properties in the local area. Lenders trust you, but they really trust a qualified property management company that already manages properties in the same submarket. The lender wants to see two things: 1) strong resume on management experience of similar type and size of properties in the area, and 2) a comprehensive monthly pro forma on how they will operate the property.

So now let's look at what a typical traditional bank loan looks like for a FIRST TIMER.

## EXAMPLE: Typical 1st Transaction (Bank Loan):

- \$900,000 Purchase Price
- \$100,000 Rehab Needed to Secure Higher Future Rents
- \$1,000,000 Total "all in" Costs
- \$750,000 Loan Amount (max LTC 75%)
- \$250,000 Down Payment Needed (25%)
- 60 Months Term
- 25 Year Amortization Max
- \$225,000 Post Closing Liquidity Required is 20-30% of loan amount (Cannot be 401k's or IRA's, if under 59 1/2) Post-Closing liquidity is NOT HELD by the bank. The bank wants to know that you have immediate access to your personal funds for a future rainy day.

## Simple Underwriting: Calculation of NET RENTAL INCOME (NOI)

GROSS RENTAL INCOME - the lesser of (i) actual rents in place, or (ii) market rents for occupied units, plus market rents for vacant units based on a current rent roll (multiplied by 12)

### Plus

To the extent deducted as an expense, rents for other non-revenue units (including model units), owner-occupied units, and employee units

### Equals

GROSS POTENTIAL RENT (GPR)

### Minus

Economic Vacancy (not less than 5%) based on the current rent roll (multiplied by 12), including physical vacancy, concessions, and bad debts.

### Equals

NET RENTAL INCOME (NRI)

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## Plus

COMMERCIAL INCOME (parking revenue, laundry, vending, etc.)

## Equals

EFFECTIVE GROSS INCOME

Calculation of OPERATING EXPENSES

Use Line-by-Line stabilized property expenses. Stabilized properties typically will have these variable expenses- combined utilities (gas, water, electric) trash removal, pest control, continuous maintenance and repair, interior & exterior decorating, cleaning & supplies, third party property management, on-site property management payroll, janitorial & maintenance payroll, general & administrative, professional fees (legal and accounting)

## Minus

Real Estate taxes is based on the actual future tax bills

## Minus

Insurance is based on a new 12 month policy

## Minus

Replacement Reserves equal to \$300/ annual per unit

## Equals

UNDERWRITTEN NET OPERATING INCOME (NOI)

Calculation of DSCR (DEBT SERVICE COVERAGE)

UNDERWRITTEN NET OPERATING INCOME (NOI)

## Divided

Annual debt service for the mortgage loan amount. Debt service must be calculated at current interest rate or acceptable interest rate floor. Must be greater than 1.25X for stabilized properties.

## Things to watch:

Some, independent owner-operators of *small* apartments, fail to include many operating expenses (management fees or maintenance payroll) into their financial statements. These operators 'forget' that even though they are doing the actual work on the property they fail to include those costs... bank underwriters must use that *true* expense. So, if the annual expenses on a small property look too low... the seller is not including several legitimate expenses.

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## **Bridge Loans with DEBT FUNDS or NON-BANKS:**

This type of apartment financing, with a non-bank bridge lender, is new for value-added properties. Funds are NOT provided by FDIC insured banks but are debt funds or a privately held investment pool of money. They are usually non-recourse. These lenders are going to approve the loan based on your history of successfully acquiring, rehabbing, and stabilizing similar size apartment properties. The lender is focused on debt yield and not a debt coverage ratio to approve the loan. A debt yield can be determined by taking a property's current net operating income and dividing it by the total loan amount. These lenders use debt yield to understand how long it would take for them to recoup their investment if they had to take possession of the property. Bridge lenders want to hear your story on how you are going to improve the subject property and the time that it will take to eventually get to a stabilized and consistent income.

The lenders only collateral is the apartment building and the rental cash flow; so DEBT FUNDS will be more critical on making sure they agree with your PROFORMA business plan.

## **NON-RECOURSE VALUE ADD- BRIDGE LOANS**

Loan Amount:	\$4,000,000- \$60,000,000
Loan Term:	3 years initial term with two, one year extension options
Loan to Cost:	up to 85% of purchase price plus up to 100% of capital expenditures
Interest Rate:	30 days SOFR + market rate spread
Fees:	1.5-2% origination + possible .5%-1% exit
Amortization:	Interest Only Payments during initial term
Recourse:	Non-Recourse with ongoing liquidity loan covenants
Debt Yield:	Minimum 6% going into transaction with 8.5% exit

Bridge loans can be a good alternative to bank financing but remember...they are designed for you to acquire, rehab, and stabilize your asset AS FAST AS YOU CAN...because they have a very short-term maturity. Get in, fix the problem, and get out quickly with a refi or a sale.

These type of BRIDGE LOANS carry the most amount of risk because they can be non-flexible after the loan is closed based only on the language in the loan documents.

In the last few months, NON-RECOURSE Fixed Rate bridge loans have started to appear. Previously almost all Bridge Loans through the Debt Funds were adjustable rates that required the purchase of an INTEREST RATE CAP for the initial term of the loan. An interest rate cap is insurance for the borrower and the lender that protects both with large adjustable interest rate movements upward.

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## Permanent Agency Non-Recourse Loans with Fannie Mae or Freddie Mac

As previously mentioned, Fannie Mae or Freddie Mac financing are primarily for stabilized, cash flowing apartments. Both prefer borrowers that have current or historical ownership or management experience with apartments.

Each has specific underwriting guidelines for these two separate loan programs.

Typical Agency Loan Guidelines:

### Fannie Mae:

Loan Amount:	\$1,000,000 - \$25,000,000+
Experience:	Borrower must have <u>PRIOR</u> multifamily experience
Loan Term:	Fixed-rate terms 5, 7, 10, 12, & 15 years. Variable rate options available as well.
LTV/ LTC:	Max 80%. (Lower leverage in some submarkets) Possible to include rehab into loan amount, if qualifies. Lower leverage in designated Fannie Mae Pre-Review Markets within US.
Recourse:	Non-recourse with standard exceptions for fraud and misrepresentation
Collateral:	Multifamily with a minimum 5 units
Occupancy:	Minimum 85%+ physical occupancy & 75%+ economic occupancy for prior 3 months; prefer 90% physical occupancy & 85% economic occupancy
Amortization:	Up to 30 years
Minimum DSC:	1.25x in most parts of the country
Interest only:	Multiple years of interest only possible, but not guaranteed.
Borrower:	Single-asset entity only
Tax & Insurance:	Higher leverage loan requires tax, insurance, and replacement reserves escrows.
Assumable:	Yes, new buyer/sponsor needs to be qualified
Prepayment:	Yield Maintenance or step-down prepayment penalty is available
Supplemental:	"Cash out" or new subordinated debt is available (2 <sup>nd</sup> lien); after 12 months with higher NOI to qualify.
Reserves:	Replacement reserves are underwritten at a minimum \$200 per unit per annum for newer assets but defer to (PCA) Property Condition Assessment Report for ACTUAL annual replacement number to be used.
Interest Rate Lock:	Typically, at loan commitment. (60 days after signed application) In certain transactions, you can "Streamline Rate Lock." SRL means that with preliminary due diligence given to the lender, Fannie can allow certain borrowers to rate lock early after signed application.
Rate Lock Deposit:	Minimum good faith deposit of 2% of loan amount required at rate lock.
KP Qualifiers:	Key Principals (as a group) must have 10% of loan amount in post-closing liquidity. Key Principals must have an aggregate personal net worth equal to loan amount. Anyone that owns greater than 25% of entity must be a Key Principal.
Reports Needed:	Fannie Mae will order appraisal, property condition assessment and Phase 1 environmental.

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## Freddie Mac (Small Balance Loan): -Good for Inexperienced Buyers-

Loan Amount:	\$1,000,000 - \$6,000,000 (Up to \$7.5 Million in larger markets)
Loan Term:	Fixed-rate terms of 5, 7, or 10 years. Hybrid ARM loan terms of 20 years, with initial 5,7,10 years fixed and modifies to adjustable rate for remaining term.
Recourse:	Non-recourse with standard carve-out provisions required.
Experience:	Freddie Mac will typically require 3 <sup>rd</sup> party property management, IF borrower does not have historical ownership or management experience. IF limited or no MF experience; Freddie Mac may reduce the loan amount...due to inherit risk and/or require an adder of .05x to minimum DSCR.
Minimum DSCR:	1.20x (Top Markets); 1.25x (Typical of a Standard Market) 1.30x (Small Markets); 1.40x (Very Small Market)
Amortization:	Up to 30 years
Interest Only:	Yes, up to a possible 3 years in specific markets.
Collateral:	Multifamily, minimum five residential units.
LTV:	Max 80% LTV in a top/standard market (acquisition and refinance) Max 75% LTV in small/very small market on acquisition Max 70% LTV small/very small market on refinance Cash-out refi's reduce LTV by 5 bps and increase DSCR by 0.10x
Borrower:	US Citizens typically, Possible for Non-US Citizens with additional guidelines. Must be held in a single-asset US entity (sole asset)
Occupancy:	90%+ physical occupancy over the trailing 3-month period. 85%+ economic occupancy (actual collected net rental income amount as % of gross potential income) - ideally, but no hard and fast rule for economic occupancy Subject property has not experienced volatile historical occupancy swings; and No history of serious crime at the subject property.
Tax & Insurance:	Real Estate tax escrow deferred for deals with 65% LTV or less. Insurance escrow deferred. Replacement reserve escrow deferred for <50 units.
Assumable:	Subject to approval and 1% fee
Cash Out-Refinances:	Max 80% Loan-To-Cost with less than 1 year of ownership Max 90% Loan-To-Cost with less than 2yrs of ownership Possible 100%+ Loan-To-Cost after 2 years and before 3yrs of ownership with a property value creation story. Cost basis includes most improvements to the property. Ideally, Freddie would like to see the owners have increased value in the property by way of increased EGI- not NOI. Improvements made that increase EGI when compared to EGI at acquisition will traditionally allow Freddie Mac to go above the afore-mentioned LTC criteria.
Prepayment:	Declining schedules (step-down) and yield maintenance (YM) available for all loan types. YM loans typically will have lower interest rates. Examples of step-down prepayment penalty: 10yr Strong Prepay - 5544332211 (5%, 5%, 4%, 4%, 3%, etc.) 10Yr Weak Prepay - 3332221111 7yr Strong Prepay - 5544321 7yr Weak Prepay - 33221111



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	5yr Strong - 54321
	5yr Weak - 32111
	5yr Weak Plus - 31000
Rehab:	Cannot include rehab improvement expenses into loan
Supplemental:	"Cash out "or new subordinated debt is NOT available
Interest Rate Lock:	Interest rate is held from loan application to submission of loan package to Freddie Mac (35 business days)
KP Qualifiers:	Key Principals (as a group) must have 9 months of P & I payments in post-closing liquidity. Key Principals must have an aggregate personal net worth equal to loan amount. Anyone that owns more than 25% or greater ownership is called a Principal. The Principal must be underwritten also but does not necessary to function as a guarantor assuming that other guarantors meet the liquidity and net worth requirements.

## Clarification Points:

- Fannie Mae doesn't want the property to have been recently leased up simply to qualify for the loan. They want a history to show the occupancy level is real and sustainable. No bank depository account required. Freddie Mac would like to see a positive trend in collections over the last 6 months.
- Annual financial reporting to Fannie and Freddie is required. The Agencies want to know how the property is operating. You will need to send year-end financials and rent rolls to your loan servicer. You will also need to update your personal financial statement. Keep your property in great physical condition. Remember, the Agency is your largest financial partner and will make an annual onsite physical inspection of the asset and 'risk-rate' the condition of the asset. The lower the rating; the more difficult it will be to borrow from the Agency lender in the future.
- Non-Recourse - All Key Principals ("KP's") must sign a "Bad Boy carve-out". Fannie Mae and Freddie Mac require the experienced individuals in the group sign and certify they will run the property ethically and not commit fraud. As long as there is no fraud, if the loan goes bad, they can't come after the individuals. If the borrower commits fraud for items like falsifying financial statements, insurance fraud, etc. ("bad boy" behavior), they CAN come after individuals PERSONALLY for money lost in a default situation.
- Pre-Payment- Yield Maintenance (this is a fee equal to the amount of interest the lender would have earned if you didn't pre-pay the loan, so it "maintain the yield" to the lender on their invested funds) Freddie Mac Small Balance and Fannie Mae both have a step-down prepayment penalty based on % of unpaid loan balance.
- Applying for the correct type of loan upfront is critical. Example: If you know that you will hold the property for 2-3 years only; applying for a 10 or 12-year Fannie Mae loan would be ill-advised. Fannie Mae has a significant prepayment penalty on this type of a permanent loan if it is paid off early and is not assumed. Perhaps a Fannie Mae 7/6 ARM would be a better choice. The 7/6 ARM is an adjustable rate with greater prepayment flexibility and significant cost savings. Apply for the right type of loan based on your exit strategy.
- Fannie Mae credit score must be >650 (no BK's or foreclosures)
- Freddie Mac requires a >680 (no BK's or foreclosures)

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- Waiver needed IF violent, drug related or persistent pattern of lesser crimes at the subject property in the past 5 years. (On property or within neighborhood)
- Waiver needed IF sponsor resides more than 100 miles from subject property.
- Fannie & Freddie will underwrite property taxes based on new buyers stepped up taxable value, not sellers current taxed value or amount.
- Fannie & Freddie will use the higher of submarket vacancy, 5% of the in-place/T3
- Lenders will handicap a portion of operational income if it is viewed as non-reoccurring, ie. Late fees, application fees, etc. Freddie will use T12
- Typically, 3<sup>rd</sup> party reports are required for appraisal, environmental & property condition engineers report
- Typical loan origination is 0-1%
- Typically, it will take between 45-60 days to close transaction.
- Large Fannie Mae Application Fee (legal & third parties included) is \$20,000
- Large Freddie Mac Application Fee (legal & third parties included) is \$15,000

## Important to Understand

Even though Fannie and Freddie MAY state that they can approve and fund a loan up to an 80% LTV; (80% of the purchase price) they MAY NOT be able to get to that high leverage point because of the property being NOI CONSTRAINT. Net Operating Income Constraint means that there is not enough income to support the desired loan amount. Fannie and Freddie MUST have at least a 1.25X debt service coverage ratio (DSCR), meaning that the borrower must have enough NET OPERATING INCOME to pay the debt service and have a small profit left over. If they have anything less than 1.25X, then the loan amount will be reduced to support at least a minimum DSCR of 1.25X.

## Rules of Thumb for Agency lending

Key Principal (“KP”) Requirements:

- Prefers KP’s to live in same area as the property
- Prefer prior multi-family ownership
- Prefer 3rd party professional management unless borrower has extensive self-management experience
- Show pride of ownership in current properties - Take good care of your asset.
- Total KP’s net worth to equal loan amount (aggregated from borrowers)
- KP’s to have at least 10% of loan amount in post-close liquidity - no hard/fast rule for Freddie
- Fannie Mae & Freddie Mac will not use IRA’s or 401k’s for liquid assets unless the Key Principal is over 59 1/2

## Get Your Fannie Mae “Gold Card”

Your “Gold Card” is your ticket to Fannie Mae financing. Fannie Mae financing is the preferred method for investors wanting to syndicate apartment transactions. There are four primary ways to get the multi-family experience required to get your “Gold Card”:

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1. Do your first multi-family transaction with a traditional bank loan and have at least 24 months of ownership.
2. Be a key principal (loan guarantor) in another Fannie Mae borrower's transaction - you essentially earn your experience through someone else.
3. If you are the managing member or general partner, have another experienced & qualified KP sign with you.
4. Perhaps start with a Freddie Mac SBL loan and get into the agency family first with a smaller transaction.

## After you close the loan:

Agency lenders are very serious on how you maintain your asset AFTER you close. Remember they are the largest partner in the transaction. It is very important to stay involved in your investment. A hired third-party property management company will not maintain your asset IF you will not oversee them. Make numerous visits to your property. Find out what needs to be updated, repaired, or corrected. Make those repairs immediately. Agency lenders WILL make unexpected visits to your apartment property and review the condition of the asset. If they find deferred maintenance or health and safety concerns...they will put you on "A" check or ACHECK. Unfortunately, being on ACHECK could impede your future ability to borrow with Fannie Mae. Remember, Agency lenders, want you to make a profit, but they do not want to jeopardize the health and safety of your tenants.

Be an active owner by finding solutions to make your asset better for you and the community.

## Getting Started

If your head is spinning a little, don't worry. You don't need to memorize all of this. In fact, it can change. These are simply guidelines, so you have a basic understanding of the options available and what you need to do to qualify.

The key is to work with an experienced commercial loan broker who can look at your specific deal and walk you through the process.

Now let's discuss what the things you will need to pull together when you are ready to do your first or next apartment loan.

## Pre-Approval/ Pre-Qualification

Apartment lending qualification is very different from single family home loan qualification. In home lending, a lender can issue you a pre-approval based on your personal income, credit report, amount of liquidity, etc. This written approval is based on the borrower's strength to qualify....and not as much on the property and location of the home.

With apartment lending- the quality, condition and location of the asset are the most important factors in underwriting. A *pre-approval is not going to be available* because 2/3rds of an apartment lending decision is based on subject property. The lender needs to have a complete

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picture on a number of critical underwriting variables. Examples: Where is property located and age? What are historical cash flows for the last 2 years and year to date? How much deferred maintenance does the property currently have and what is rehab budget necessary to cure? Who is going to manage the property? What does your monthly proforma show; what is your future expected operating expenses and total income?

1/3 of an apartment lending decision is based on you. What is your liquidity? What is your net worth? What is your past apartment experience and level of ownership or management? Do you receive consistent personal income outside this transaction? Are you going to have additional guarantors, with a sufficient balance sheet that will stand with you?

Bottom line, the lender can give you an indication on how much you can qualify for, but because the age, condition and location of the asset is so important in an underwriting approval, a written pre-approval **before** the asset is selected is not worth very much. Speak with your commercial mortgage broker on how to structure the transaction for approval. They will give you a verbal insight on how much you can qualify for based on the total picture.

## Checklist of Items You'll Need to Provide Your Commercial Loan Broker:

- ✓ Updated signed personal financial statement
- ✓ Liquidity verification (bank and/or brokerage statements)
- ✓ Last 2 years of personal/corporate tax returns
- ✓ Real estate resume- detail your real estate experience. "I bought a home, fixed it up, and sold it." Tell the story of your successes in real estate. It's like you're applying for the job of running the property.
- ✓ Schedule of Real Estate owned (what do you currently own; loan balance, value, contingent liability or non-recourse; annual NOI, annual debt service, etc.)
- ✓ Broker's Offering Memorandum on the property you are looking to purchase
- ✓ Property's historical monthly operating statements (last two years and YTD)
- ✓ Current rent roll
- ✓ Five digital pictures of the interior/ exterior of the property
- ✓ Your analysis of transaction; share your monthly PROFORMA for the next 12 months. How are you going to operate property?

## The Value of an Experienced Commercial Loan Broker

Whether you are an experienced multi-family operator or new to the business, financing a multi-family property is not simple. Having an experienced commercial mortgage broker on your team can be the difference between getting funded or being rejected. An experienced commercial mortgage broker will be your most valuable partner, because you will have

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thousands of dollars and your reputation at risk if you are not able to execute on financing and close.

A good commercial mortgage broker will review your personal financial package, the apartment complex in question and your business plan, and will help you efficiently find the best financing available for your situation.

Your commercial loan broker also keeps everything moving. When you get into a contract to purchase you are obligating yourself to hit key deadlines for inspections, appraisals and other milestones. Missing any of those deadlines can jeopardize your transaction. A great broker will work with you and your agent to stay on top of all the moving parts.

Of course, an experienced loan broker has seen a lot of deals, stays on top of the latest loan programs and guidelines and can alert you early if there's something problematic in your deal. It's hard enough to find extra cash, another guarantor or a fast turn-around on an important bid or inspection...but if no one sees the problem until late in the process, it's even more stressful. Your commercial loan broker's experience can make a world of difference.

## Helping Your Commercial Mortgage Broker Help You

Here are a few simple tips that will improve your chances for approval:

- **Work with industry experts.** A good broker will want to help you no matter what kind of deal you're undertaking. But a residential broker (someone who arranges funding for 1-4 unit residential properties) is much different than a commercial mortgage broker. When you are seeking funding for apartments, you will need the expertise of someone who specializes in apartment financing.
- **Engage your commercial mortgage broker EARLY in the process.** It's recommended to engage your commercial mortgage broker when you are submitting your letter of intent (LOI), and to discuss the basics of the deal and your proposed timeline to make sure it's realistic from a financing perspective. Make sure that the commercial mortgage broker sends you his "sizing spreadsheet" of the transaction. You will want to make sure that your commercial mortgage broker has run the debt coverage analysis based on past and pro-forma operating statements of the asset. "Measure twice and cut once." Make sure he or she agrees with your analysis. You don't want to get too deep into a contract that isn't realistic from a financing perspective.
- **Be organized and prepared.** Before you start seriously start looking to acquire a property, gather up your financial package including your real estate resume, signed Personal Financial Statement, Liquidity Verification and Tax Returns.
- **Prep your story and team.** Once you have agreed to purchase a property you should be able to tell the story to the lender on why you like the property and believe it's a good investment, how you plan on operating the property, and be prepared to show them your financial pro-forma. The lender wants to see your strategy and specific tactics on how you are going to make this investment successful. Share with your lender the successes of your

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past investments. If you have been successful in rehabbing and stabilizing properties in that submarket, make sure you bring that to the lender's attention.

- **Be responsive.** It is very important to be responsive to your Lender's requests, and to provide them with accurate and **ALL** of the information and documentation they ask for. The best lenders are busy. If you are not responsive or only provide part of the info requested without providing an explanation, they will move onto the next loan file and put yours at the bottom of the stack. Those delays can cost you your deal. Be responsive!

If you do these simple things, you will GREATLY increase your chances of getting loan approval.

If you have any questions or feedback, please feel free to contact us.

Good luck!

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**Michael Becker** serves as a Co-Founder & Principal at SPI Advisory, LLC and heads SPI's Dallas, Texas office where he oversees all aspects of property operations, including asset management, property management oversight, accounting and taxation, capital improvement and renovation projects, and investor relations. Michael is a lifelong resident of North Texas and a graduate of The University of North Texas with a BBA in Finance. Michael is a 15-year veteran Commercial Real Estate Banker and has originated and managed numerous portfolios of permanent and bridge loans in all major asset classes. Over the last 5 years of his banking tenure, Michael focused exclusively on multifamily properties, where he was the number one loan producer for his division at a Top 3 National lender for his last 3 consecutive years.

**Paul Peebles** has been arranging real estate financing for borrowers and institutional clients since 1987. Mr. Peebles, our National Underwriter at Old Capital, underwrites and structures all transactions handled by Old Capital through an array of sources including conduits, banks, life companies, Fannie Mae, Freddie Mac, HUD and private money lenders. His knowledge of the capital markets and his long term and deep relationships with the decision makers at the various capital sources is a competitive advantage for the client. Old Capital closed over a \$1 billion in real estate transactions in 2018. Mr. Peebles is a "deal maker." Prior to Old Capital, Mr. Peebles was affiliated with Merrill Lynch Capital Markets, World Savings Bank and ITT Commercial Real Estate. He is a graduate of University of Iowa. He is originally from Western Springs, Illinois. He is married and has one daughter at the University of North Texas.

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