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THE SOURCE

BUSINESS EDITION

Evaluating Office Buildings…Over the Phone

By John Odegard, CEO, Seattle Funding Group

"I have the opportunity to buy a 30,000 sq.ft., grade A- office building built in 1998, at a great price. It is currently 60% vacant because the major tenant just moved out, but the building is well located and should lease up again over the next 12 to 18 months. I'm paying $6 million and I need first position acquisition loan of $4 million. I have to close by month end (three weeks) because I have a $200,000 earnest money at stake. I'll pay a slight premium for a quick and certain closing but I don't want a prepay penalty, because I plan to refinance to long-term traditional rates after lease up. Can you get this done? On time? For real?"

IN THIS ISSUE

How do you arrive at value on a deal like this? Income won't get you there, its 60% vacant. Is it really worth $6 million? Will the buyer really be able to refinance in 12 months with a traditional lender? What question should you ask? Let's analyze this… over the phone.

First question: What kind of borrower do we have? $4 million might work with a strong credible borrower, but a weak, poor credit borrower will struggle to get the job done and their exit options will be tough. You'll need additional equity protection with a weak borrower, perhaps an additional 15%, bringing the loan amount down to $3.2 million if all else passes the grade. Now let's move on to what matters most, the property's value.

Office buildings derive most of their value from the terms of the leases they have in place, the strength of the tenants paying on those leases and the building's potential to attract future tenants. From there it is a simple income and expense formula to arrive at the net income or "net operating income" (NOI). Once we get the NOI, we simply divide that number into the capitalization rate investors expect for the asset class and area (CAP Rate) and we get our rough value conclusion. Let's lay out the formula for this building. First, let's assume the building is "stabilized," leased up to the prevalent market vacancy rates. We will deduct for the current real vacancy rate after arriving at its stabilized value.

Gross potential income: $810,000 (30,000sqft x $27 per foot, annual, full service lease rate)

Vacancy rate: $81,000 (10%) All areas and building grades are different. Vacancy rate typically ranges from 5% to 15% depending on area. If not sure, use the higher rate, then call a local commercial realtor in the area who specializes in that product type. They will tell you what the vacancy rate in the area is. Plug that number in. Remember, this is a guide. A refined analysis will be done later. You are just making a rough cut to screen the ridiculous.

Expenses: $210,000 ($7 per foot) This expense will range from about five dollars per square foot to 12 dollars per square foot, depending on the expense of operation. Buildings with substantial common areas, landscape, services, association dues, etc will be on the higher side. Downtown towers will cost more to operate. You can always call a local commercial realtor specializing in that product type. They will have a good idea. Plug in that number and err on the side of higher cost. With experience, you will be able to quickly make the decision yourself with a cursory phone review. Note: Leases where the landlord pays all operating expenses, including janitorial, are called "full service leases." Some office leases are written as "triple net leases" where the tenants pay for all expenses. With triple net leases there will be no expenses to deduct. Although its wise to deduct 2% to 5% for reserves prior to capitalizing the NOI. Again, all leases will be looked at later to ensure proper income and expense allocations. But for now just ask the borrower if his leases are "triple net" or "full service."

Proposed Subject Property

Net operating Income (NOI): $519,000 (gross potential income minus vacancy rate and expenses)

Capitalization rate: 7% (Ranges between about 5% and 10%) Depressed areas, buildings or buildings with low grade tenants will require a higher cap rate to compensate for the higher perceived additional risk. A 7% cap rate today represents a reasonably high demand asset in a healthy market area with a reasonably promising future. Lower cap rates reflect superior locations and/or AAA national tenants with long to midterm leases.

Value: $7,400,000 (If only 10% vacant at $27.00 per foot gross rents)

Once you have established the buildings value at stabilization, you must deduct for the current reality if the vacancy is greater than market. In our example, the asset is 40% vacant (12,000sqft). This deduction is an art, not a science. It comes with experience. But for a quick phone analysis, let's deduct the cost of the lease up, including lease up commissions of 5% of total lease income over five years ($81,000), and tenant improvements of 40 dollars per foot ($480,000). Like everything else, tenant improvement costs (TI costs) vary with market conditions. We'll pick $40.00 to represent a balanced market where landlord pays for typical interior improvements. Let's total our measurable deductions.

Lease up costs: $561,000 Depending on market conditions (risk) entrepreneurs will want at least two and a half times that number ($1,400,000) to cover the risk and time it will take to accomplish the lease up. We'll use $1,400,000 as a deduction for the vacancy issues in our example. Again this is a rough cut designed to bracket possibilities.

Deduction for real vacancy of asset: $1,400,000

As-is asset value: $6,000,000 Coincidently this is the price our proposed borrower is paying for the asset in its current condition. Sounds like their purchase price makes sense from a cursory perspective. Their $4,000,000 loan request is a 66% loan to value ($4,000,000 divided by $6,000,000).

Loan structure: $4,000,000 loan with a $561,000 lender hold back to pay for lease up costs. This loan has a rough cut approval based on the proposed loan structure. The borrower stands to profit nicely on this transaction, which is healthy. This loan request deserves a quick letter of intent (LOI) from Seattle Funding Group describing loan terms and cost.

With experience, you can quickly screen a deal like this in about 10 minutes over the phone. Then it is time to agree on loan terms, send out a letter of intent, finish due diligence and close. In total, about a two to three weeks process. SFG

OFFICE BUILDING VALUATION CALCULATION

Subject Property (if stabilized to 90% occupancy)

Gross Potential Income	$810,000	*(30,000 sq.ft. x $27 per foot annual, full service lease rate)*
Less:		
Vacancy Rate	($81,000)	*(10%)*
Expenses	($210,000)	*($7.00 per foot)*
Net Operating Income (NOI)	$519,000	
Capitalization Rate (Cap Rate)	7%	
VALUE	**$7,414,286**	*(Cap rate / NOI)*
ASSET VALUE	**$6,011,786**	*(Value less deduction for real vacancy of asset)*

Lease Up Costs

Tenant Improvements (TI)	$480,000	*(30,000 x 40% = 12,000 sq.ft. x $40)*
Lease Up Commission	$81,000	*(5% of total lease over 5 years)*
LEASE UP COST	**$561,000**	
Deduction for real vacancy of asset	$1,402,500	*(At least 2.5 times Lease Up Cost)*

Private Money Construction Financing:
Ten Fundamental Steps

By Charles Salas, Senior Underwriter, Seattle Funding Group of CA

If your client has a terrific construction project, there is financing available, even when the banks say "NO." Private money financing can be an affordable, highly responsive and refreshing alternative to the protracted money hunt among conventional lenders. Here are a few quick thoughts to consider should you decide to pursue the private money alternative…

1 GO TO THE BANK Try to get the money, OR at very least, satisfy yourself that conventional financing is not available for your client's project. Exhaust the conventional avenues before you step into the private money arena, as this is the most effective use of everyone's time. Prepare your client to pay a little more in financing costs, and know that rates and fees can vary widely between private money lending firms. Also, remain mindful that while private money will be more expensive than conventional sources, we can also be far more responsive and nimble. SFG's responsiveness has resulted in the advancement of opportunities and increased profits for many of our clients.

> If your client's project meets its market…most private money lenders are looking for ways to work with you and your client.

2 EXPERIENCE AND TRACK RECORD COUNT Though not necessarily at todays banks. While SFG and most other private money construction lenders are credit conscious, we recognize that builders have been through a war. If your client's project truly meets its market, the numbers work and their track record underscores their experience, SFG is looking for ways to work with your client.

3 SMALL, WELL CONCEIVED PROJECTS WORK BEST Whether they are an in-fill development or a single spec house. Design and build to the quantifiable demand and opportunity within the sub-market. New home marketing companies and real estate firms with deep experience in new home sales are critical to further defining submarket opportunities and buyer expectations; they can often help your client sell faster and for more money. Most importantly, they can keep your client from making a design, finish or pricing mistake that can be costly in terms of time and profits.

4 CONSTRUCTION COMPLETION, BROKEN PROJECTS AND ASSET REPOSITIONING, TOO Most banks aren't too keen on financing broken projects or construction completion. These projects can pose significant title challenges, as well. SFG is a great fit for these, as well as for asset repositioning, and these loans often lead to future business. SFG strives to develop long-term relationships with you and your builder clients so that we can responsively finance purchase, construction and future development opportunities. As an example: Ken F. sent us a construction completion loan in Woodland Hills, CA, over two years ago. We're preparing to close the third loan for the final phase of that project and Ken will shortly receive his third referral fee.

5 LOCATION, LOCATION, LOCATION The old adage applies now more than ever, and the lenders that are still ready, willing and able don't want to play on the fringes. SFG is very active with construction lending in the California's coastal band and in the Greater Seattle Area, but there are opportunities in other submarkets, as well – find them and focus. Don't let your client's capital get tied up in a sluggish submarket.

6 LET THE NUMBERS DICTATE YOUR DIRECTION They will most certainly dictate ours. Make certain

your client's budget and proforma are realistic before SFG goes through them with a fine toothcomb. Make sure your client has performed their homework, especially as to the market's expectations, product design, construction budget and price points.

7 FOCUS ON THE LTC, NOT THE LTV Most construction lenders are working with loan-to-cost, not loan-to-value. Prepare your client with a likely requirement for 30 to 40% in cash equity. In many cases, this translates to the lot(s) or land being free and clear…or perhaps they need an equity partner.

8 THINK VELOCITY & EXECUTION; GET IN, GET IT DONE, GET 'EM SOLD, GET OUT Private money comes with a higher interest cost than conventional financing. Your client should be prepared to execute and move quickly through the construction, marketing and sales process. Time is money – work it to their advantage and keep more of that money in your client's pocket. Greg L. and his partners did this to perfection on a five house detached project in San Marcos, CA. The result being all five houses built in less than five months, contracted above proforma and before construction was completed – no mean feat in the summer of 2012.

Call SFG to discuss these and other issues. SFG's experienced underwriters can usually cut to the chase and save both you and your client a great deal of time and energy. After all, we do it every day.

9 COMMUNICATE Expect the inevitable challenges and changes that accompany any construction project. Encourage your client to work closely with SFG throughout the construction and sales process. Through open communication, we can generally work through issues toward the completion of the project and the development of an enduring lending relationship. At the end of the day, we all want the same thing – to profit from another success, to develop relationships and to…

10 REPEAT THE PROCESS The economy has a long ways to go before markets truly stabilize on a regional or national basis, but there are submarkets, products and price points that are working today. When you've established a builder/client relationship, your builder/client has successfully built and sold the project and the lender has performed as agreed in support of that successful venture, the heavy lifting is done. It's time to repeat the process.

Some of this analysis and preparation may sound too much like real work, particularly for those uninitiated to the construction loan process. Always feel free to call SFG to discuss these and other issues. SFG's experienced underwriters can usually cut to the chase to save you and your client a great deal of time and energy. After all, we do it every day.

We look forward to hearing from you, and we wish you every continued success. SFG

THANK YOU

We would like to thank some of our key third party associates who have contributed to the success we have had, especially the last few years. Whether it be selling an REO asset out of our portfolio or helping us evaluate the collateral for new loan activity, these are some of the best in the business. Thank you for your contribution to our success.

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Because our thank you list is extensive, more names will be printed in next quarter's issue.

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