Underwriting Private Loans

Conventional lenders typically evaluate loan opportunities by analyzing what is known as the "Five C's" – character, capacity, collateral, capital, and conditions.

- *Character* is assessing a borrower's creditworthiness and standing in their community. Do they have referrals who speak highly of them, or are they an unknown?
- *Capacity* is determining if the individual or business generates enough cash flow to pay their monthly obligations, otherwise known as debt service ratio.
- *Collateral* is evaluating what (if any) type of collateral is being pledged as security for the loan and what caliber it is. Is the loan secured by inventory, equipment, or real property? If so, what conditions and value would be used for it?
- *Capital* takes a closer look at the individual loan and how much "skin in the game" the borrower is putting into the equation. Does the borrower need to come in with any cash to close the transaction, or are they purely using other people's money?
- Lastly, *conditions* pertain to what the loan terms are with regard to loan amount, rate, and the borrower's intended use of the funds. Is the lender going to limit the use of funds to a purchase transaction, or does the borrower have the freedom to do as they please?

This underwriting process can take anywhere from 30 to 90 days, or in some cases even longer. On the other hand, private money lenders, can often perform proper due diligence in a fraction of the time, often in as little as 7-14 days. Key considerations when evaluating any loan opportunity includes understanding the risk factors and identifying how best to structure the loan to mitigate those risks. For private lenders, this process can include: calculating the proper loan amount, establishing the right interest rates, and determining the proper amount of reserves to build into a loan.

Assessing Risks in a Tight Window

When faced with any new opportunity, underwriting teams are tasked with the objective of how to make the loan a success. A successful loan is one where the borrower can achieve their business objectives, with the loan being repaid in full and on time. However, there are several potential barriers to success. Underwriters typically place these risk factors into three major categories: credit risk, operational risk, and market risk.

Credit risk is the potential that the individual borrower will not repay the loan on time, in full. The most common way to assess the degree of credit risk is to pull a credit report on the prospective borrower. Credit reports signal what the potential borrower's past creditworthiness was. This is commonly a good indicator of future performance. However, it should be noted that a credit report is not the lone factor in determining

credit risk. Other options include looking at loan payment history, background checks, or conducting interviews with other individuals who have worked with the potential borrower.

Similar to credit risk is another type of risk associated with the individual borrower, *operational risk*. Operational risk is the likelihood that a borrower will not be able to execute their investment plan, such as rehabbing a project on time and within budget or executing a 1031 exchange in the time that is permitted. While a borrower could be highly credible, the execution of a plan is paramount for a private lender to be paid back in full.

Lastly, there is *market risk*, which is the likelihood that the underlying value a pledged property will decline in value. Like any other sector, real estate is subject to the same cyclical effects we see in other industries, with peaks and valleys alike. When assessing the collateral in question, the underwriter must assess the riskiness of that asset. Typically, the more improved a property is, the less risky that property will be. Proximity to major metropolitan areas also tends to hold up values, as there is higher demand relative to more remote locations.

Understanding these three major types of risk should inform the underwriter as to the most appropriate way to structure a potential loan. The underwriter's job is to adequately assess the risk, and then adjust the terms of the loan to try and mitigate these risks where possible. In a perfect world, a good underwriter wants to have no defaults, no foreclosures, and no loss of investor capital.

Establishing Loan Amount

One of the most difficult elements of making a private loan is setting the proper loan amount. The general rule of thumb is that a transaction with higher risk should warrant a lower loan to value (LTV). The LTV is defined as: $LTV = \frac{Loan\ Amount}{Property\ Value}$; or the loan amount relative to the value of the asset being pledged. Reducing the LTV ratio is applicable to all types of risk previously described but is typically associated most closely with market risk, because of its association with the property's value.

For example, a conforming and good quality single-family residence (SFR) in a major metropolitan area like the Bay Area, Los Angeles, San Diego, or Sacramento will continue to see very high demand from both investors (as rentals) and consumers (as a residence). This is due to these metro areas having robust job markets that demand significant amounts of labor, which in turn leads to these individuals needing housing. Consequently, good quality SFRs typically command higher LTVs in these markets relative to rehab projects or simply residences in lesser metropolitan areas, as investors perceive the risk of them losing significant value as an unlikely scenario.

Conversely, vacant land that is potentially viable for future development is a riskier asset class. Ground up development requires significant capital, a skilled manager, and

disciplined execution to produce a profit. There is considerable execution risk in vacant land, in addition to the general market risk. Therefore, the list of potential buyers for vacant land is much smaller than the SFR space. Given this riskier profile, vacant land is typically structured with some of the lowest LTVs in the private lending space.

Lastly, the loan amount must also fulfill the borrower's intended use of funds. For example, if a borrower wants to pay off an existing loan on an investment property, there is the potential that the new loan may not be enough to pay off the existing note. In that case, the borrower would need to pay out of pocket, or "put skin in the game" to close the transaction. Private lenders prefer these scenarios, as they tend to be a strong indication that the borrower will perform, as it creates an incentive for the borrower to recover their own money.

Establishing Interest Rates

Once the loan amount has been determined, the next item to be addressed is determining the appropriate interest rate. Similar to establishing a loan amount, interest rates tend to be highly correlated to the underlying risk of a transaction. This risk is determined by the caliber of the collateral being pledged, LTV ratio, and overall capacity of the individual borrower as both an operator and creditor.

For example, an SFR in a major metropolitan area with a low LTV is likely to command lower interest rates than a partially leased commercial building in a market segment with high vacancy rates. This asset is easier to manage and is in a less risky market with a low LTV. The risk of default in these scenarios is typically minimal.

Another element that is factored into determining interest rates is how competitive the lending market is. Market competition is contingent upon several aspects, namely how many lenders are present in a given market, said lenders' appetite for loans, and how long an individual borrower has to secure a loan. In markets with significant competition and long lead times to close a transaction, there is a high likelihood that lenders will undercut each other on interest rate to "win" a loan. On the other hand, whenever there is a tight timeline to close a transaction and a potential borrower does not have the latitude to browse various lenders, a borrower is often required to go with the lender that is most likely to perform, regardless of the interest rate.

Reserves

Lastly, an underwriter may make use of reserves, or money that is held back from the borrower, but will be paid back at specific junctures or benchmarks in the loan. Similar to the aforementioned "skin in the game," reserves incentivize borrowers to reach specific benchmarks in order to receive the payout on their reserve. There are many types of reserves that underwriters use, including interest reserves, collateral reserves, and construction hold backs. These reserves are only released at predetermined milestones in the loan term.

Reserves have an effect similar to reducing LTV, but without reducing the loan amount. This provides added protections for the lender in the event of default, and ultimately provides needed capital to help keep properties current, such as by paying property taxes, maintaining maps, or covering legal fees.

Conclusion

In the private lending industry, there is no way to mitigate every form of risk. Underwriters are tasked with trying to take every unique situation and manage the apparent risks with the tools that they have. It takes discipline and fortitude to maintain underwriting standards in ever-changing market dynamics. Lenders that ease or loosen their underwriting standards will often find themselves in difficult to manage situations, and potentially lose investor capital.

To learn more about how we underwrite our loans, contact Socotra Capital today!