

A Collateral Move

Consider suggesting cross-collateralization to clients looking to expand their portfolios

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SUCCESSFUL COMMERCIAL MORTGAGE brokers go beyond being just “transactional conduits” between clients and lenders. They become partners and advisers to their clients. They help them build wealth. As a result, their clients come back year after year.

One type of commercial real estate investment that brokers can suggest to their clients to build wealth is a cross-collateralized loan, in which equity in borrowers’ portfolio can support another loan. It helps to know the ins and outs of this product.

What it is

In a cross-collateralized transaction, the equity in multiple properties is pledged to support a loan on one property. It allows investors to leverage the untapped equity in their portfolio to expand that portfolio — even if they don’t have cash on hand.

Lenders typically require specific loan-to-value (LTV) ratios. If your clients want to purchase a \$2 million shopping center, and the lender requires a 70-percent LTV, they’ll usually need to come up with \$600,000 in cash to borrow the \$1.4 million balance. With a cross-collateralized loan, however, they can borrow most of, all of and sometimes more than that \$2 million.

There are two key ingredients for a cross-collateralized loan. First, the borrowers must have available equity in other properties that they can pledge as collateral for the new purchase. Second, they must find a lender that is willing to use equity in other properties instead of cash for closing.

How it works

Let’s look at an example. Scott wants to buy Property A, a \$1 million office building. He has

\$100,000 in cash and needs to borrow \$900,000 to close the deal. Because the lender has a maximum 80-percent LTV, however, Scott is \$100,000 short for the down payment. Does he have to pass on this deal? No.

Scott already owns Property B, a retail building worth \$500,000. He has a \$200,000 first-trust-deed loan against this property, which means he has \$300,000 in equity that is sitting idle. You can arrange a cross-collateralized loan supported by properties A and B.

How do you determine if there is enough market value in these two properties to support the \$900,000 loan? Run the numbers.

In this case, the total market value of the two

properties is \$1.5 million. Most lenders will lend 80 percent of this \$1.5 million value, or \$1.2 million. Because Scott already has a \$200,000 loan against Property B, the total combined debt of \$1.1 million on these two properties would still be below the 80-percent threshold.

What if there wasn’t enough market value to support the loan? If Scott had available equity in additional properties, these properties could be brought into the deal as well.

Scott decides to use Property B as collateral on the loan to purchase Property A, and the deal closes. The new cross-collateralized loan will have a blanket lien of \$900,000. The title policy will show a \$900,000 lien against Property A and the same \$900,000 lien also against Property B.

The bank will have a \$900,000 trust deed

Other uses

There are more applications of cross-collateralization, such as for:

■ **Obtaining cash for tenant improvements:** How would it look if, in the original example, Scott knew he would need another \$100,000 for tenant improvements?

In this case, Scott could put \$100,000 down to borrow \$1 million, with \$100,000 to be held back and made available as needed. In one year,

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Scott spends the \$100,000 on improvements, brings in new tenants and increases the property value to \$1.3 million. He could now go to a conduit lender and refinance his \$1 million loan.

In effect, Scott would have obtained 100-percent financing of his purchase, using his own \$100,000 for tenant improvements.

In fact, because there was enough combined equity in the two cross-collateralized properties to support a bigger loan, Scott could have obtained a \$1.1 million loan with zero down — full “no cash” financing of the project.

■ **Obtaining lines of credit:** Many lenders will also allow cross-collateralization for lines of credit. For example, Emily owns seven free-and-clear properties worth a total of \$18 million, including one property that she holds in a joint venture with Jack. Jack is going through a divorce. As a result, the property that Emily and Jack hold together is for sale, with the expected \$8 million in net proceeds, \$4 million each.

Anticipating the sale of this property, Emily wants to start looking for a new property to purchase. She doesn’t want to be hampered by

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the timing of the close of the first sale. Although she does not have any cash on hand, she also wants to enjoy the negotiating advantages of being able to make an all-cash, no-contingencies offer. What can Emily do?

She can obtain a \$4 million line of credit secured by the six properties that she holds outside of the partnership. In this case, the lender will put the loan together, Emily will pay the appropriate fees, and the new line of credit will wrap up all of Emily's other properties.

Once Emily finds a property she likes, she'll be in a strong position to close the deal. Then, when the sale of the jointly held property closes, Emily will have the cash to pay off his line of credit. If done properly, a cross-collateralized line of credit such as this can be used in many areas, including 1031 exchanges and reverse 1031 exchanges.

Other ways to tap equity

Sometimes, buyers will initially obtain a cross-collateralized portfolio loan, make improvements to the property and then look for refinancing once the property's value rises. This is not a problem.

Although the lien against the property will be greater than usual, the refinancing will be based on the new, increased property value. The borrowers would need to: tell the original lender that it will be getting a payoff demand; obtain the new loan; pay off the original loan; and ensure that the original lender releases all associated liens.

"But wait," you might say. "Couldn't my clients simply refinance or take out a second on the property with extra equity before trying to purchase a new property? Then they'll have the cash on hand for the down payment." Yes, this is another option.

In this case, though, your client will pay fees for obtaining this additional loan, plus the monthly-interest costs on the loan itself. If multiple properties are involved in the future, they will have multiple loans — each with their own fees for the title policy, escrow, loan documentation, etc.

Cross-collateralization doesn't entail any extra transaction fees. It isn't pursued until the money is actually needed. Further, it may even allow your clients to obtain a better interest rate because they will be obtaining one large loan rather than two or more smaller loans.

The pros and cons

There are many issues that must be carefully considered before pursuing a cross-collateralized

loan. On the positive side, with cross-collateralization, buyers have the ability to:

- **Purchase property that they may not have been able to purchase otherwise**, with little or no cash down
- **Use equity that is idle or unused**
- **Potentially obtain financing of 100 percent or more**
- **Avoid expending time and money obtaining free-standing loans against current properties** (to use these funds eventually for the down payment on a new property purchase)

Of course, cross-collateralization is not all a bed of roses. In evaluating if this is the right path for your clients, keep the following in mind:

- **The buyers' equity in multiple properties will be tied up** in the purchase of one property.
- **They will now be at the mercy of the lender** that is holding their collateral. Having a good working relationship with this lender will be imperative.
- **The lender may demand all the net proceeds** if the buyers choose to sell one of the secondary properties that was used as collateral in the loan.
- **Foreclosure is possible.** If the buyers default on the cross-collateralized loan, the lender holding this trust deed will foreclose on *all* of properties used as collateral for this loan (i.e., the primary property and all of the secondary properties). If the cross-collateralized loan is not brought current, all of these properties will be placed for sale as "one unit" at a foreclosure sale.
- **Default also is possible on the cross-collateralized loan** — even if it is current — if the buyer defaults on the first-trust-deed loan on one of the secondary properties used as collateral. To protect its position, the lender holding the cross-collateralized loan may choose to pay off or bring the defaulted first-trust-deed loan current, adding this amount to the outstanding loan balance of the cross-collateralized loan.

Deals of this type can be beneficial, but they can also get complicated, especially when there are multiple properties used as collateral. Be sure that the property being purchased is indeed a good investment.

What do lenders seek?

The first thing that lenders will look for is if the purchase transaction makes sense. In other words, if this was a straightforward 30-percent down, 70-percent-LTV deal, would they be willing to do the loan? If the answer is yes, the lender will then want to see:

- **The income, equity, cash flow, value and other basics** of all the properties involved in the deal
- **Financial statements showing the values of all of the properties and any debts** that are recorded against them. For example, are the existing debts current, being paid as agreed, etc.?
- **If there are trust deeds recorded ahead of this new loan, the lender will need copies of these deeds and notes** to ensure that the new loan is permissible. Some trust deeds do not allow additional trust deeds to be recorded behind them. This information could be spelled out on either the deed or the note.

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You may get a psychological boost when borrowers come to you and say, "I'll pledge whatever I've got to make this happen." This tells you that the borrowers have done their homework on this property and are truly positive about, comfortable with and committed to the deal. You'll work hard to ensure that you see this potential, too.

Cross-collateralization can be a terrific way for commercial real estate investors to use otherwise idle equity to acquire additional properties. Show your clients how they can build wealth and you'll become a valued member of their team — and stand head and shoulders above your competitors. 