Conduits vs. Portfolios

Long-term flexibility might make portfolio loans a better option for some borrowers

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Conduit loans are terrific. They offer the best-possible interest rate locked in for the long term, which can boost your clients' bottom line. So if your clients qualify for a conduit loan, why would they consider anything else? Because conduit loans are inflexible.

Portfolio loans, on the other hand, usually allow your clients to adapt to changes in the economy, to the property or in their own situation. Although portfolio and conduit loans each have pros and cons, in the long run, getting the right loan for your borrowers' needs sometimes goes beyond getting the lowest rate.

Making comparisons

Conduit lenders offer the best interest rates on commercial loans. They book the loan, put it together, package it and sell it to a third party, such as an insurance company. Generally speaking, conduit loans:

- **Provide a guaranteed return of investment** for lenders (backed by interest-yield-maintenance prepayment-penalty clauses);
- **Provide a fixed-rate, long-term loan** for borrowers;
- **Lock up the borrower's equity** by disallowing second or third loans on the same property; and
- **Do not allow changes** to the loan terms.

Portfolio lenders, however, offer conventional loans that they hold and work into their own portfolios. These lenders have a vested interest in the property's success, and they likely want to work with borrowers to maintain or enhance the property's value.

Generally speaking, portfolio loans:

- **Afford flexibility** when a deal or property involves moving parts;
- **Allow borrowers to forge a relationship with the decisionmaker** handling the portfolio; and
- **Usually have a variable rate tied to prime** (some fixed-rate products are also available).

When flexibility trumps low rates

The interest rate is not always the most important factor in the loan decision. Conduit loans are ideal for borrowers purchasing a fully developed property with locked-up leases. Your clients can lock in their rates and terms upfront and then ride out the loan. The lender puts the loan on a shelf, and the borrowers make the payments. Everyone is happy.

But what if the deal or the property has moving parts? What if the property is not fully developed and your client wants to explore those possibilities?

Take Sam, for example. He is in escrow on a medium-sized strip mall on a busy, suburban street. His initial inclination was to get a locked-up loan with the best interest rate. Then he learned that the property had excess parking, and he began to reconsider his loan options.

Sam wants to carve out a piece of the parking lot and put in a coffeehouse. The extra traffic would bring more business to all the tenants, and the addition would increase the property's overall value.

To make this property improvement happen, however, Sam needs a lender that will work with his changing needs. In this situation, the lender must approve the carve-out and lot-line adjustment, partially reconvey the carved-out piece of property and either fund the construction loan or allow Sam to get the loan from a third party.

With a conduit loan, these types of changes would probably cause a prepayment penalty. The costs of these penalties, coupled with the costs of starting over, could easily kill the deal's financial feasibility. Not so with a portfolio loan. Sam realizes that in this circumstance, the rate is

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just one part of the loan-decision picture.

Consider another example. A few years ago, a development company came out of a 1031 exchange and bought an apartment building. Now the market is changing, and the company realizes the building can be converted into condominiums profitably. The question is if the current lender will allow the company to convert the property into condos; allow the condo map to be created and approved; allow improvement construction to the property; and then allow each unit to be released individually as it is sold.

If the loan on the property is a conduit loan, the answer is "probably not." Conduit loans are sold to third parties looking for clean and perfect deals; they are meant for situations in which no changes are needed or planned for the property.

Even some portfolio lenders may balk at such a deal. Only the most-flexible ones would be likely to take it. Having a flexible lender with the experience and expertise to help build value in the property is key.

If you can foresee a time when your borrowers will want to take equity out of their property to fund the purchase of another property or when they'll want to fund future tenant improvements, your best bet is to go with a portfolio lender. Such lenders have the flexibility and stability to work with your clients to make changes to their property and their loan.

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The cost of the wrong loan

It is important to get the right type of loan for your clients' needs upfront because the cost of having the wrong loan can be high. If you choose a portfolio loan when a conduit loan would meet your borrower's needs, the higher interest rate will increase costs and decrease cash flow and profits during the life of the loan. On a large transaction, these costs can add up.

On the other hand, if you have a conduit loan in place when your borrowers want to take out equity or make changes to a property, the conduit lender likely will be unwilling to work with them. Your borrowers therefore will either incur the costs of starting over — including the conduit lender's prepayment penalty and the costs of the new loan (fees for escrow, title, appraisal and documentation, possibly plus points) — or they'll suffer the opportunity cost of the lost deal (tenants lost, value-enhancing property improvements not made, etc.).

Consider the following example. Leticia owns a multitenant industrial building in the city center. After one of her major tenants went out of business, another tenant — a successful manufacturing company — expressed a desire to expand into the now-vacant space. That is, if Leticia paid for the necessary space improvements.

Leticia's lender not only was unwilling to fund the improvement loan but also did not allow her to get the loan elsewhere. Her only option was to pay the stiff interest-yield-maintenance prepayment penalty and start over with another lender.

The costs of doing this, however, killed the deal. The manufacturer had to move out of Leticia's building to a more accommodating property. Thanks to this domino effect, instead of having a happy tenant occupying two spaces, Leticia now owns a half-empty building.

Borrowers' needs and options

So which type of lender and loan is best for your clients? The answer depends on clients' long-term needs. In the short term, the interest rate usually is the most important factor. In the long term, however, the interest rate may be trumped by the need for a flexible lender that will work with clients as the economy and their situations change. If your borrowers see a future upside in their property, find them a lender that also does.

Run the numbers and ask:

- **Is the property fully developed** — does it have upside potential?
- **What is the tenant situation?**
- **Does the lender have the capital** to fund any future tenant improvements?
- **What are the short- and long-term goals** for the property?
- **What are your borrowers' goals** for their overall commercial real estate portfolio?
- **As they build equity,** will they want to take some of it out?
- **How will changes in the economy** affect your clients' goals for the property?

If you determine that a portfolio loan will best suit your clients' needs, bear in mind that not all portfolio lenders are created equal. Look for a lender with:

- **Expertise** in commercial real estate transactions;
- **Flexibility** to help create more value in the property;
- **Accessible decisionmakers** who will work directly with your borrowers;
- **Stability in management** so that your borrowers will be talking to the same people five years after you negotiated the deal;
- **Consistency** in policies and business philosophy so that there are no surprises later; and
- **Strength in capital** so that the lender can meet borrowers' needs.

In addition, be aware that some portfolio lenders continually rebalance their portfolios to ensure that they only keep a certain percentage of their portfolio in any given sector or loan type. What this means for you is that if, for example, your clients want to improve their industrial property in three years, the lender may be unwilling to work with them. At that point, the industrial-property segment of their portfolio may be full.

Having a stable and flexible lender with the financial strength to create portfolio loans can provide great short- and long-term flexibility. If there are any moving parts to the deal — or if any develop down the road — the right portfolio lender will be able to work with your clients. When you run the numbers, interest rate isn't always king.