HARD MONEY LENDING STRATEGIES

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Only one type loan transcends every time period in recorded history, every region of the world, and every economic cycle: The "hard money" loan.

The non-institutional hard money commercial lending market has once again reincarnated itself. In some respects today's private hard money loans remain remarkably similar to your father's hard money loans; yet new millennium hard money lending also requires an increased level of sophisticated scrutiny of some issues.

Today's hard money loan has become for many, the bridge loan or equity substitute of choice among developers in California and other parts of the United States. Though interest rates are at a historic low, hard money lending is on the rise. There may well be a correlation between the development and marketing by institutional lenders of mezzanine and equity products, and the rapidly rising entrepreneurial interest in the simple, privately placed hard money loan.

The following is prototypical of today's hard money real estate-secured loan:

- The lender is an individual, owner/developer/investor in real property, savvy and well-networked.
- The borrower is an experienced developer, will pay almost any price, to quickly close on a property targeted for development or re-development, and is strategy driven.
- Loan amounts commonly range from $500,000 to $5,000,000.
- Interest rates range from 8% to 18%.
- Points range from 5 to 15.
- Philosophy is always "Loan to Own".
- Equity Kickers only if no one else will make the loan.

The resurgence of the hard money loan in commercial real estate lending exists for several reasons. First, institutional mezzanine lenders and equity sources sometimes have requirements that make conduit lending appear to be elementary sand box financing; and while institutional mezzanine loans or equity programs may be well designed for fundings that exceed the appetite of a private individual lender, they are otherwise oftentimes a documental strangulation and economically egregious.
Secondly, private hard money loans are being made by high-net worth individuals who are highly liquid, and realize they can achieve a higher rate of return as investors in loans rather than testing their successful track records as real estate investors against historically low cap rates, overpriced markets, or markets where commercial recoveries are not moving fast enough. Thirdly, a good private hard money loan can be fast and profitable to both the private lender and private borrower.
The speed in which hard money loans are made can be literally within days. Underwriting is often simply limited to how well the experienced investor relying on his/her own history as a developer, understands the marketplace in which the property

is located, and is able to determine exit strategies should it ultimately own the property.

It should be obvious why the hard money loan is profitable to the private lender. But it is also profitable to the borrower for several reasons. Since it may be obtained quickly, a borrower may quickly close on a sale of property. In a fast appreciating market such as the Southern California multifamily market, what a borrower may sacrifice at the closing table is offset by the benefit of immediate appreciation, or a shorter timeline for development or re-development, and then obtaining conventional permanent financing. Borrowers frequently find in proformas that even paying high interest rates and points may well be more cost-effective, than sharing appreciation with equity investors or partners, nor having to be confined by constraints of decision making or fiduciary obligations encountered with partners. Thus, one finds today's hard money funding projects ranging from downtown high rise developments, to subdivisions on expanding edges of suburban markets

Although the "Loan to Own" philosophy frames the parameters of every hard money lender's thinking when considering a particular loan, each loan may present issues which should be considered. Among questions that should be asked are the following:

1. If I foreclose on this property, is this an asset that fits my management skills, expertise and know-how; and if not, can I pay others to meet these needs?
2. If this property is undeveloped, what is the likelihood of entitlements being obtained prior to the maturity date of the loan and if the entitlements are not obtained by the borrower, will I be able to obtain them?
3. Do I have the ability to properly monitor the development activity of borrower?.
4. Am I investing in people, a project or dirt? As all three factors are important, how should they be weighted for the pending loan?
5. Am I obtaining a first or second perfected lien in fee title (or a long term ground lease interest)?
6. Is there a risk/reward benefit here that is heavily weighted towards reward?
7. If my loan is a second, do the loan documents of the senior lien holder permit junior encumbrances?

Successful hard money lenders in today's market not only address the questions above in prudent manner, but also carefully consider due diligence and legal strategies. In some instances, low overhead due diligence may be undertaken at the expense of a senior institutional lender, by obtaining all reports of a senior institutional investor, if the hard money loan is to be a second lien. Additionally, having communications with the institutional lender may open up horizons of insight, not to mention the beginnings of a good intercreditor relationship.

The biggest difference between your father's hard money loan and today's hard money loan is that careful legal documentation is recommended. The one page form note and two-page form deed of trust do not adequately address a myriad of legal issues in today's legal environment. Environmental issues need to be addressed, along with usury issues, and enforceability of guaranties and indemnities. Legal documentation should be at a level consistent with that employed by institutional lenders, only eliminating provisions that may not be relevant or not needed. Additionally, special consideration needs to be given to a well-drafted broker's affidavit, especially in states that an otherwise usurious loan must be brokered by a licensed real estate broker. Title issues need to be closely reviewed. If the private borrower is a corporation, limited liability company, or partnership, the items that would appear on any institutional lender's closing checklist (e.g., certificates of good standing and resolutions), should also be made part of the closing. All issues should be closely reviewed by legal counsel.

Once made, the hard money loan should be carefully monitored. It may not be enough in today's environment to simply collect checks as one might otherwise collect coupons. Instead, private hard money lenders should rely upon provisions in loan documents to review quarterly financials related to the property, and if the loan is a development project, maintain close scrutiny of all aspects of the development process, including receiving monthly reports and other materials which well-drafted loan documents will require a borrower provide to lender.

While the volume of hard money loan dollars may never be reported in glossy national publications or lending industry updated daily internet sites, one must only listen to whispers of profit and success among the many lenders and borrowers who understand this market.

In his next installment, Mr. Gerson will discuss the expanding secondary market for hard money loans. Who are buyers, who are sellers and whether there is a capital market of hard money loan securitizations.