Financing

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Commercial Real Estate Transactions

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INTRODUCTION

Owners of commercial real estate properties fall into a few categories in the context of mortgage financings: **(i)** owners who own their property freehold and want to use property as security to raise capital; **(ii)** owners whose current mortgage loan is maturing and who wish to renew; **(iii)** owners whose current mortgage loan is maturing but who want to refinance for a larger amount; and **(iv)** purchasers of properties who need the mortgage loan proceeds to close their acquisition transaction. As a result, most owners of properties find that mortgage loans are integral to their businesses for the reasons outlined above.

Many owners are motivated to obtain mortgage loans even if the capital is not required to own the property as they are looking to earn a spread on the differential between the cap rate for the property and the interest rate for the mortgage loan. If a property has a cap rate of 7% and mortgage monies can be borrowed at 3-4 % a spread of 3-4% is earned on the lender's capital. Lenders are motivated as they typically are financial institutions looking to invest their capital in a variety of asset classes – only one of which is commercial mortgage loans. The risk being accepted by a lender on a very good property with a strong borrower is low enough to justify lending their capital being lent out at a lower interest rate than they might earn on other asset classes but still better than the interest rate that is earned on an asset class such as Government of Canada bonds.

A Borrower needs to remember that at initial funding of a mortgage loan a mortgage Lender will typically have more of its own capital invested into the property in comparison to the owner as most commercial mortgage loans are in the 60-70% loan to value range. As such a Lender will have a lower risk tolerance in respect of the property than the owner might have. One needs to remember this dynamic when dealing with mortgage Lenders as their mind numbing list of conditions, requirements and expectations can sometimes be overwhelming, but are designed to minimize the Lenders' exposure if the Borrowers default. These requirements have been developed through decades of experience, input from legal advisors and each lenders own risk tolerance profile. As such, mortgage Lenders follow their lending and underwriting criteria and requirements very closely and are rarely willing to materially change same.

Borrowers with a strong financial covenant (ie. a strong balance sheet and excellent reputation in the commercial real estate marketplace) who own very attractive properties (no deferred maintenance, tenants with strong covenants (multi-national vs. local startups) in long term leases) are obviously the Borrowers with the most leverage with mortgage Lenders and will have a greater prospect of

being able to negotiate more favourable terms. The stronger the financial covenant, the more likely that a Borrower can continue to make its payments even in a downturn or a loss of tenants.

Understanding what category your client and its property falls into will help you understand how much leverage you and your client have for negotiating a better deal.

In this paper, I will provide a number of practical suggestions for dealing with mortgage Lenders and will focus on the following topics:

(a) negotiable elements in commitment letters;

(b) why Lenders need commitment fees;

(c) estoppel certificate requirements;

(d) due diligence requests;

(e) mortgages and related security;

(f) third party reports and conditions precedent to funding; and

(g) Borrower's solicitor opinions.

REVIEWING COMMITMENT LETTERS — WHAT IS NEGOTIABLE?

A commitment letter is an offer by a mortgage Lender to extend financing on the terms and conditions outlined in the commitment letter and the specific requirements and conditions that the Borrower must comply with as a condition of getting the mortgage loan. The Borrower accepts the offer by signing the commitment letter and returning it to the Lender together with payment of the commitment fee. Prior to the Borrower signing the commitment letter and paying the commitment fee is when the Borrower has its greatest opportunity to negotiate the terms of the mortgage loan.

Although a commitment letter typically takes a standard form, some terms may be negotiable especially for borrowers with strong financial properties and excellent properties. The Lender's flexibility for negotiation can sometimes depend on how much capital it has to lend into the commercial mortgage market which can vary depending on where the Lender is at in its fiscal cycle. As a Borrower, you will never know if you talk to only one Lender and this is why most Borrowers will routinely negotiate with more than one Lender at a time. If you negotiate with a few Lenders a Borrower is more likely to secure a mortgage loan on more favourable terms.