Commercial Mortgage Insight®

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Conduit Loans Offer Excellent Price Execution With Some Subtle Strings Attached

Borrowers must be aware of the details when opting for the less expensive choice of executing a loan from Wall Street.

BY CARLTON ROARK

The emergence of conduit lending in the mid-1990s and its current popularity have unquestionably been a boon for commercial real estate investors. Where else can one obtain long-term, fixed-rate financing that's often as much as a full point or more below the best rate available from traditional lenders?

To the surprise of many, the old adage that "if it's too good to be true, it's probably not" doesn't actually apply to conduit lending because the low rates being offered by conduits are, in fact, available. However, that may offer little comfort to those who take the bait and later come to realize they are now confronted with another, more ominous old adage: "The devil is in the details."

Those most often confronted with this distressing realization are usually those who suffer from the rate-shopping malady known as "interest-rate myopia" in which the lowest rate of interest is elevated to such a level of paramount importance that it effectively renders irrelevant any serious consideration of other loan terms and conditions.

Regrettably, those who've succumbed to the siren song of conduit lenders soon find themselves acquainted with a loan process characterized by many as grueling, onerous and expensive, but that's not the worst part. Aside from the kind of loan provisions sometimes required by traditional lenders, like impounds, prepayment penalties and annual financial reviews, loan provisions are often required by conduit lenders that are seldom, if ever, imposed by traditional lenders. These include requirements to obtain terrorism insurance, zoning compliance certification and proof of occupancy rights, lockbox/springing lockbox provisions, legal opinions, single-purpose entity formation and, most notably, lockouts and defeasance.

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With regard to the latter, nothing elicits more consternation or regret than when a conduit borrower becomes fully aware of the implications associated with lockout and defeasance provisions. Lockouts are periods of time in which a loan cannot be paid off at all, even with a prepayment penalty.

Even after the lockout period, a conduit loan may only be paid off through a very expensive process known as defeasance. Defeasance allows the prepaying borrower to replace a real estate mortgage with a synthetically created package of non-callable and non-prepayable U.S. government securities as substitute collateral. The total process of defeasing a loan can easily cost as much as 10% to 20% of that loan.

True comparison

Conduit financing does have its advantages for those seeking long-term, fixed-rate financing at the lowest possible rate. However, with conduit loans in particular, the rate of interest is just one component of many, and for borrowers who ignore or downplay the importance of those remaining components, the consequences can be quite costly.

Based on the true comparative costs involved, in the final analysis, choose a conduit loan may ultimately represent a case study in irony for those who choose a loan for its low rate and end up incurring costs far greater than any savings they had hoped to achieve.

The advantage, in this case, goes to the borrower who resists the temptation of low rates in exchange for flexible repayment terms.

Most agree that the historically low interest rates we've enjoyed over the last four years have given investors ample justification for acquiring real estate at cap rates lower than they would have ordinarily accepted - based on the buyers' analysis of cash-on-cash returns, which are heavily influenced by the prevailing interest rates on debt financing.

However, if overpaying for low-cap-rate commercial properties can be jus-

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tified because of low interest rates from traditional lenders, then conduit lending - with its much lower rates of interest - most certainly exacerbates the problem. But it does so in a way that may be far less obvious to many lenders and their borrowers.

Overlooked factor

When an appraiser cites commercial sale comps for a property that will not be financed with a conduit loan but neglects to verify, and thus adjust for, sale comps where conduit financing was involved, the legitimacy of those comps has to be questioned. Why should properties selling at low cap rates because they meet stringent underwriting guidelines and because the owners are willing to accept onerous loan covenants to secure conduit financing be considered as comps for those that do not?

There are higher costs (economic and otherwise) associated with the use of conduit financing. To apply the low cap rates found on newly sold properties financed with a conduit loan to the valuation of those that were not creates a dangerously and artificially inflated value on the latter that just isn't supported, but is oftentimes dismissed as nothing more than a function of excess demand over supply in that market.

Conversely, when commercial real estate values begin to correct themselves - and they eventually do - commercial real estate owners and their lenders in markets where conduit financing played a prominent role may find themselves quite surprised to discover that the end product is not what was anticipated. They may be faced with the implications associated with a Trojan horse that has breached the gates of their investment community. ●

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