



SRM Managing risk.
Improving portfolios.



Assessing Credit Risk in Commercial Real Estate Lending

ICBA CREDIT SERIES WEBINAR

COMMUNITY BANKER
UNIVERSITY[™] 
powered by 

INTRODUCTION

S

- 30 Plus Years in Banking
- Lead Business Advisor at Alerus
- Senior Credit Officer of Two Banks
- Banking Consultant and Trainer on All Credit Matters



BRAD STEVENS

30 Plus Years in
Banking

Lead Producer in
Twin Cities Market

Senior Credit Officer
of Two Banks

Bank Trainer and Consultant



KEY RISK CONCEPTS

- ▶ You Are Not Paid To Make Loans, You Are Paid To Manage Credit Risk!

DEFINING CREDIT RISK

▶ $P \times C = \text{Credit Risk}$



COMMERCIAL REAL ESTATE IN RELATION TO THE BANK CREDIT PORTFOLIO

- ▶ No One Ever Makes A
Loan Decision, All Decisions
Are Portfolio Decisions!

TYPES OF COMMERCIAL REAL ESTATE

- ▶ All Carry Different Risk and Considerations For Analysis
 - ▶ New Construction
 - ▶ Owner Occupied
 - ▶ Investment



WHY IS COMMERCIAL REAL ESTATE SO RISKY?

- ▶ Loan Size
- ▶ Source of Repayment
 - ▶ Lease Structure and Duration
 - ▶ Bankable Tenants?
 - ▶ Terms of Take Out

WHY IS COMMERCIAL REAL ESTATE SO RISKY?

- ▶ Tenant Leasehold Improvements
- ▶ Contamination
- ▶ Code Requirements
- ▶ Documentation Requirements



WHY IS COMMERCIAL REAL ESTATE SO RISKY?

- ▶ Developers/Ownership Structure
- ▶ Government Regulations and Programs
- ▶ Spec Vs Occupied

WHY IS COMMERCIAL REAL ESTATE SO RISKY?

- ▶ Understanding Stabilization
 - ▶ Construction Period Delays
 - ▶ Reaching A Stabilized Occupancy Rate
 - ▶ Period of Time
 - ▶ Pitfalls
 - ▶ Expected Occupancy Levels
 - ▶ Achieving NOI



WHY IS COMMERCIAL REAL ESTATE SO RISKY?

- ▶ Market Changes
- ▶ Location
- ▶ Length and Cost of Work Out

ASSESSING CASH FLOW

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ASSESSING CASH FLOW

- ▶ Global Cash Flow Requirement
 - ▶ Multiple Entities
 - ▶ Assess the Cash Transfers
 - ▶ Non-Cash Add Backs
 - ▶ Dogs Vs Race Horses



ASSESSING CASH FLOW

- ▶ Leases
 - ▶ Maturity Date Concerns
 - ▶ Concessions
 - ▶ Tenant Quality
 - ▶ Seasoning

ASSESSING CASH FLOW

- ▶ Expense Concerns
 - ▶ Leasehold Improvements
 - ▶ Age
 - ▶ Maintenance
 - ▶ Triple Net, Who Covers What
 - ▶ Management Fees



CREDIT RISK IN SPECIFIC TYPES OF REAL ESTATE

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FINANCING OWNER OCCUPIED REAL ESTATE

- ▶ Key Concerns, What to Look For
 - ▶ Primary Repayment Source
 - ▶ Property Use
 - ▶ Sub Tenants?
 - ▶ Growth Options
 - ▶ Should the Borrower Be a Landlord?



FINANCING OWNER OCCUPIED REAL ESTATE

- ▶ Credit Policy Directives
 - ▶ Advance Rates, LTV
 - ▶ Exposure Limits
 - ▶ Front End Guidance

FINANCING OWNER OCCUPIED REAL ESTATE

- ▶ 504 Considerations
 - ▶ Occupancy Requirements
 - ▶ 50/40 Split?
 - ▶ Using the CDC
 - ▶ 10 year/20 year



FINANCING OWNER OCCUPIED REAL ESTATE

- ▶ Underwriting
 - ▶ Cash Flow
 - ▶ Expense Add Backs
 - ▶ New Expense Considerations
 - ▶ Source of Down Payment
 - ▶ Global Coverage vs Project Coverage

FINANCING OWNER OCCUPIED REAL ESTATE

- ▶ Proper Structure
 - ▶ Amortization Vs Maturity
 - ▶ Inversely Related to LTV
 - ▶ Sufficient to Gain Equity Traction
 - ▶ Balloons Vs Pricing Reset



FINANCING OWNER OCCUPIED REAL ESTATE

- ▶ Proper Structure
 - ▶ Covenants
 - ▶ Global Cash Flow Covenant
 - ▶ Reporting
 - ▶ Ownership Changes
 - ▶ Primary Tenant Tie In
 - ▶ Cross Collateralization/Cross Default

FINANCING OWNER OCCUPIED REAL ESTATE

- ▶ Monitoring
 - ▶ Reporting
 - ▶ Site Visits





FINANCING SPECIFIC TYPES OF INVESTMENT REAL ESTATE

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FINANCING INVESTMENT REAL ESTATE

- ▶ Credit Policy Directives
 - ▶ Portfolio Amount Tolerance
 - ▶ Advance Rates
 - ▶ Attribution
 - ▶ Amortization vs Term
 - ▶ The Key Is Cushion!



FINANCING INVESTMENT REAL ESTATE

- ▶ Types
 - ▶ Office
 - ▶ Industrial/Manufacturing
 - ▶ Specialty
 - ▶ Multi Family
 - ▶ New Construction
 - ▶ Residential Development

FINANCING INVESTMENT REAL ESTATE

- ▶ What to Look For- Office Real Estate
 - ▶ Tenant Quality/Rent Roll/Durations
 - ▶ Number of Tenants/Units/Concentration
 - ▶ Location
 - ▶ Parking
 - ▶ Reserves, Cushion
 - ▶ Vacancies
 - ▶ Specialty Nature
 - ▶ PP&E/Build Out Needs



FINANCING INVESTMENT REAL ESTATE

- ▶ What to Look For-Manufacturing
 - ▶ Tenant Quality
 - ▶ Critical vs Non-Critical Tenants/Concentrations
 - ▶ Location
 - ▶ Outside Storage
 - ▶ Parking
 - ▶ Condition/Age
 - ▶ Building Flexibility
 - ▶ Vacancies
 - ▶ Environmental/Tenant Issues

FINANCING INVESTMENT REAL ESTATE

- ▶ What to Look For-Medical/Specialty
 - ▶ Tenant Quality/Focus
 - ▶ Location, Synergies
 - ▶ Building Flexibility
 - ▶ Parking
 - ▶ Changing Technology
 - ▶ Unit Sizes
 - ▶ Environmental
 - ▶ Build Out Needs



FINANCING INVESTMENT REAL ESTATE

- ▶ What to Look For-Multi Family
 - ▶ Location/Type/Crime
 - ▶ Tenants/Rent Roll
 - ▶ Number and Size of Units
 - ▶ Vacancies
 - ▶ Condition/Age
 - ▶ Government Programs, Low Income Housing, TIF
 - ▶ Contingent Liabilities

NEW CONSTRUCTION

▶ Know Your Customer

▶ Developer

- ▶ Get The Global Picture, Global Cash Flow
- ▶ Find the Dogs and the Racehorses
- ▶ Managing Partners vs General Partners
- ▶ Memorize The Owners Names and Affiliation's/ Scour the Sworn Construction Statement
- ▶ Hiding Equity Draws
- ▶ Lease Up, Monitor The Marketing



NEW CONSTRUCTION

- ▶ Draws
 - ▶ Lien Waivers
 - ▶ Review the Sworn Construction Statement.
 - ▶ Inspections
 - ▶ Architect Approval
 - ▶ Title Company Dispersal
 - ▶ Ultimate Responsibility is With The Banker

NEW CONSTRUCTION

- ▶ Lions, Tigers and Bears-OR-Storms, Fire and Vandalism



FINANCING RESIDENTIAL DEVELOPMENT REAL ESTATE

- ▶ Not Recommended at this Time
- ▶ If You Do- Treat it Like a Used Car Lot!!!!

PROBLEM CHILDREN



EARLY WARNING SIGNS

- ▶ Reporting Issues
 - ▶ Tracking Balance Sheet Activity
 - ▶ Rent Rolls
 - ▶ Tax Payments
 - ▶ Distributions/Management Payments



EARLY WARNING SIGNS

- ▶ Site Visits
 - ▶ Counting Vacancies
 - ▶ Condition Issues
 - ▶ Activity
 - ▶ Crime Concerns

RECAP

- ▶ Know Your Borrower
- ▶ Understand the Project
- ▶ Key In On The Primary Risk Areas
- ▶ Recognize This is a Self Liquidating Asset, Is It Working Properly?
- ▶ Inspect What You Expect, Visit The Project Often, Before and After Closing
- ▶ Monitor the Early Warning Indicators



UPCOMING EVENTS OF NOTE

- Commercial Real Estate Lending Seminar, November 9, 2022

NOVEMBER 9, 2022

- ▶ Commercial Real Estate Lending Seminar



THANK YOU

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